D. Morschett / H. Schramm-Klein / J. Zentes

Strategic International Management

Text and Cases

2nd Edition

Dirk Morschett / Hanna Schramm-Klein / Joachim Zentes

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Preface

The first edition of this book has been sold within less than one year so that a second edition became necessary. In this second edition, all chapters have been updated, all case studies revised and recent data were integrated. The concept, as it is described below and in the introductory chapter, remained unchanged.

Over the last few decades, international activities of companies have gained dramatically in importance. Empirical evidence for this statement can be found, for instance, in the rapid growth of world trade and in foreign direct investment flows as well as in the high share of intra-company trade on total world trade, indicating the relevance of cross-border value creation processes. Courses on International Management have, thus, become an integral part of most management studies at universities today and dedicated Masters programmes on International Management have emerged in recent years.

Concept and Overview of this Book

This book intends to give a compact overview of the most relevant concepts and developments in International Management. The various strategy concepts of internationally active companies and their implementation in practice are the core of this book. It is not designed as a traditional textbook or a collection of case studies, but tries to combine both. The book introduces the complex and manifold questions of International Management in the form of 20 lessons that give a thematic overview of key issues and illustrates each topic by providing a comprehensive case study.

The book is divided into six major parts. Part I ("Introduction to Strategic International Management") lays the foundation by explaining basic concepts of International Management. In Part II, the influence of the external environment on Multinational Corporations is described, looking into market barriers and regional integration, the competitive advantage of nations and the influence of country culture. Part III focuses on the coordination of internationally dispersed activities in a Multinational Corporation. An overview of formal and informal instruments is given and some coordination instruments are discussed in more detail. Another core decision with regard to international activities, the foreign operation mode, is dealt with in Part IV. After an overview of the basic types of foreign operation modes, the three

main options – market, cooperation and hierarchies – are explained in individual chapters. Part V is devoted to specific value chain activities, production & sourcing, R&D and marketing. Finally, human resource management and international control are discussed as highly relevant business functions in Part VI of the book.

Teaching and Learning

The book is primarily aimed at students at the beginning of their Masters studies who major in Business Administration, International Management, Strategic Management or related fields. In addition, practitioners who seek compact and practice-oriented information on international strategy concepts can benefit from the book. The case studies accompany each lesson in such a way that they provide additional content and a specific application of the individual lessons on the one hand. They are part of the explanation of the topic, but they also lead to suggested discussion subjects and questions in order to deepen the understanding of the topic.

Instructors are provided with additional resources. A set of PowerPoint slides can be downloaded from the publisher's website (www.gabler.de). Furthermore, for each case study, a draft solution can be obtained.

Acknowledgements

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Fribourg, Siegen and Saarbrücken, July 2010

DIRK MORSCHETT HANNA SCHRAMM-KLEIN JOACHIM ZENTES

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Introduction & Basic Definitions

Globalisation – the growing integration of economies around the world and the increasing international activities of companies – has been one of the most intensively discussed topics over recent decades. Cross-border activities of companies take various forms: *International trade* has been constantly and strongly rising over the last decades. What is even more important as an indicator for its relevance is that worldwide exports are consistently growing more strongly than worldwide gross domestic product (GDP). This indicates that the world GDP is increasingly produced and consumed in cross-border processes. For companies, as well as for countries, international trade can be *exports*, i.e., selling merchandise and services to customers in other countries, or *imports*, i.e., buying merchandise and services from suppliers in other countries. Secondly, companies have increasingly undertaken *foreign direct investment* (FDI) and, e.g., established production plants abroad. Over the past two decades, global FDI flows have increased twice as fast as global GDP.

Foreign Trade

Foreign Direct Investment

In a regional perspective, trade liberalisation has led to major shifts in trade and FDI flows. For example, since China joined the World Trade Organisation in 2001, it has almost quadrupled its exports. Similarly, India and Brazil have become major players in international trade. As a rather recent trend, companies from emerging markets are also active players in international mergers & acquisitions (M&As). More and more often, it is not only Multinational Corporations (MNCs) from developed countries buying companies in developing countries but vice versa, i.e., companies from countries like China, India or Brazil acquire companies in developed countries to enter these markets and to gain access to their know-how and brands. However, even though world trade and FDI have been drastically increasing on a global basis, trade flows within regions still account for a higher share of world trade than flows between regions. Regional integration has moved ahead and the countries of the most integrated trade block, the European Union, realise about two-thirds of their trade-transactions within the region.

Intra-company Trade

Linking FDI and international trade is the fact that about one-third of worldwide trade is undertaken as *intra-company trade*. This is clear evidence of the enormous relevance of cross-border value chains which are internalised in large MNCs. Companies disperse their activities and assets in complex international configurations and production processes are fragmented and located in different regions of the world.

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Definition Multinational Corporations

Eventually, it is the international dispersion of activities that characterises a Multinational Corporation (MNC). We understand the term MNC very broadly as referring to companies with routine cross-border activities. More particularly, following an old definition of the United Nations, we see a MNC as "an enterprise (a) comprising *entities* in two or more countries, regardless of the legal form and fields of activity of those entities, (b) which operates under a system of decision-making permitting coherent policies and a common strategy through one or more decision-making centers, (c) in which the entities are so linked, *by ownership or otherwise*, that one or more of them may be able to exercise a significant influence over the activities of the others, and, in particular, to share knowledge, resources and responsibilities with others" (United Nations 1984, p. 2). Thereby it is not relevant which legal form the entity has but only that "active, coordinated management of operations in different countries, as the key differentiating characteristic of a MNE" (Bartlett/Ghoshal/Beamish 2008, p. 3) is possible. And those entities are not necessarily production plants, they can be mere sales subsidiaries or other activities. While some authors demand certain quantitative thresholds for a "MNC", e.g. a certain number of foreign countries, a certain percentage of employees abroad, share of foreign sales or direct investment, we consider those thresholds to be arbitrary.

Definition Foreign Subsidiaries

As one option – and actually an increasingly popular option – international operations do not necessarily have to be internalised. Instead, contractual cooperations or joint ventures are viable alternatives to wholly-owned foreign subsidiaries. As a consequence, foreign subsidiaries are not necessarily wholly-owned. Instead, we understand a subsidiary to be "any operational unit controlled by the MNC and situated outside the home country" (Birkinshaw/Hood/Jonsson 1998, p. 224).

With this book, our objective is to cover the most important aspects of International Management with a comprehensive, yet brief, and innovative approach. We discuss 20 different topics in Strategic International Management by first giving a thematic overview of the topic which covers the key issues and explains the most important concepts and then illustrating them with the help of extended case studies. For the case studies, internationally known companies were chosen that can be considered best practice cases in the respective strategy fields.

The MNC as Differentiated, Integrated Network

In Part I, the concept of the MNC as a differentiated network is presented. The international dispersion confronts MNC management with the challenge of designing structures, processes and systems that allow flexible responses to the heterogeneous local conditions in the host countries and to simultaneously ensure the necessary coherence to act as one company. The conceptualisation of the *MNC as a differentiated network* (Ghoshal/Nohria 1989) in which different subsidiaries can have individual tasks to fulfil and

be assigned strategically important roles, is increasingly acknowledged to be an adequate design to exploit the capabilities of the different subsidiaries and the advantages of their locations. At the same time, however, the interdependence of worldwide units increases and the structure of an *integrated network* becomes necessary to coordinate the dispersed activities (Chapter 1). A core challenge of such a network is the tension between external forces towards adaptation to the local environment in the different host countries, on the one hand, and the forces towards global integration on the other hand. In the *integration/responsiveness framework*, these pressures are categorised and solutions offered (Chapter 2). Another consequence of a differentiated network is that subsidiaries are heterogeneous and take over specialised roles. To describe and analyse those roles, a number of *role typologies* has been developed in the literature. These are described in Chapter 3. While internationalisation is often considered to be mainly a sales-side phenomenon, many companies internationalise with very different motives, e.g. to gain access to natural resources in a foreign country. The potential *motives for internationalisation* which have major consequences for the internationalisation strategies are dealt with in Chapter 4.

External Environment

A major characteristic – an advantage and a challenge at the same time – of MNCs is that they are active in more than one country. Thus, different subsidiaries are embedded in different external conditions. In Part II, the most important aspects of the external environment are examined. First, it is shown that there are still many tariff and non-tariff barriers between different countries, influencing, for instance, the location choice of companies. But in the last few years, trade and investment barriers have been reduced. This has occurred in *regional integration agreements*, such as within the European Union or by the creation of the NAFTA, but simultaneously on a global basis, mainly driven by GATT and WTO (Chapter 5). Heterogeneity between countries is rooted in many country characteristics. Based on Porter's diamond model, the *competitive advantage of different nations* and specific regional clusters can be examined. These concepts are described in Chapter 6. Finally, one underlying difference between different locations is caused by *cultural differences*. Different host countries and regions may have strongly diverging cultures. The challenges that are caused by this fact as well as approaches to measure and describe culture are presented in Chapter 7.

International Coordination

As pointed out, MNCs are characterised by internationally dispersed activities. To integrate all these activities and organisational units of the MNC under a common strategy, coordination is necessary, which is the focus of Part III of the book. Coordination is a process that tries to achieve alignment between the activities that are dispersed and carried out by different units within the MNC in different countries. The different *coordination mechanisms* as well as different theories to explain the use of specific mechanisms are

explained in Chapter 8. One important coordination mechanism is the formal design of the organisation's tasks, resources and responsibilities. Chapter 9 is devoted to this international *organisation structures* because different structures lead to different employee behaviour, different information flows and different subordination patterns, integrating certain tasks and differentiating others. However the complexity of modern MNC networks and the dynamic challenges are frequently not manageable by formal coordination mechanisms alone. In Chapter 10, the use of the *corporate culture* as coordination mechanism is discussed. This is based on the idea that if managers of different subunits of the MNC around the world internalise the values and objectives of the company, orders and direct supervision may become obsolete and still, the decisions of the dispersed organisational units are aligned with the corporate objectives. As a part of the corporate culture, *values* are important because they provide the employees with a sense of deeper purpose of their activities and daily work. In recent years, more and more companies have adopted the concept of *corporate social responsibility* (CSR) which tries to define the company's place in society and argues that managers are responsible not only to their shareholders but to all stakeholders, including employees (in different parts of the world), the environment, etc. CSR as an emerging concept in International Management is discussed in Chapter 11.

Foreign Operation Modes

Part IV focuses on a major decision in International Management – the *foreign operation mode*, i.e., the institutional arrangement for organising and conducting international business transactions. In Chapter 12, the *basic types of operation modes* are introduced and the most important theories to explain the choice of operation mode are briefly explained. A key strategic decision is the *choice between internalisation vs. externalisation* with regard to all activities of the value chain. In the case of externalisation, the "market" is used as the governance mechanism. Outsourcing is one potential consequence of this strategy. The trend towards outsourcing in the last few decades has resulted in drastically changed value chain architectures. Examples are pyramidal structures, as in the automotive industry, but also the emergence of pure "coordinators". These companies – like *Nike* or *Puma* – are manufacturers without their own production and they focus their business processes on product development, marketing and the control of the supply chain. These new processes are discussed in Chapter 13. Another highly relevant arrangement in which value-added processes are realised in modern MNCs are *cooperative operation modes*. These come in various forms, like licensing or joint ventures (Chapter 14). Eventually, MNCs can use *hierarchy* as an operation mode. In this case, they establish wholly-owned foreign subsidiaries, which can happen either by acquisition or by greenfield investment. Both options are examined in Chapter 15.

Value Chain Activities

While Parts I to IV consider the MNC in general, in Part V, some important value chain activities are looked into specifically. Chapter 16 is devoted to *international production & sourcing*. Very different production processes are possible and, in particular, the geographic configuration of the different stages of such processes has to be determined. Furthermore, the benefits and caveats of own production or external sourcing have to be considered to decide on the optimal level of vertical integration. With regard to a more upstream value-added activity, research and development (R&D), MNCs have to take similar decisions (Chapter 17). In particular, a MNC has to decide on the configuration of its R&D, i.e., the optimal location(s) for this activity. Closely linked to this decision is the question whether to establish an R&D alliance or not. Alliances have some advantages, in particular access to the competences of a partner, but also some disadvantages, e.g. the risk of losing one's competitive advantage to a competitor. In each case, R&D has to be embedded in the structure and processes of the MNC and different organisational models are proposed for this. As a third value chain activity that we consider to be of high relevance, the MNC has to sell its products and services on international markets. The core challenge here is to find the right balance between standardisation of the international marketing mix and adaptation to each country market. This is dealt with in Chapter 18.

Selected Business Functions

Eventually, the core processes and activities of a MNC have to be overlooked by different management processes. Part VI examines two international business functions. First, human resources are among the most critical success factors of International Management. *Human resource management* (HRM) in a MNC faces challenges that are far beyond those of purely domestic operations. Therefore, Chapter 19 is devoted to international HRM. The complexity of international operations can only be managed, however, if the MNC's executives have adequate information to hand. *Control* is a fundamental task of management and its main purpose is to provide information to decision makers at different levels of the company. Control in MNCs faces particularities, both because it is influenced by international heterogeneity and because it usually takes place in a complex multi-level organisation. These challenges and some control instruments that help to overcome these problems are presented in Chapter 20.

This short overview of different fields of Strategic International Management reveals that this issue is highly complex and challenging. In the following 20 Chapters, we cover the most important aspects and give the reader an insight into the main developments and concepts. Based on the case studies, the reader will also gain an understanding of how the concepts are implemented by successful companies around the world.

Part I

Introduction to Strategic International Management

Chapter 1

Multinational Corporations as Networks

The complexity of Multinational Corporations (MNCs) regarding the multiple geographical markets and the dispersed activities within the company often renders centralised management models ineffective and inefficient. The acknowledgement of the increased relevance of foreign subsidiaries and the observation that some subsidiaries take over strategic roles within the MNC led to a conceptualisation of the MNC as a network. In this Chapter, the network perspective of the MNC is explained, nodes and linkages in the network are described and the advantages of this perspective to understand the modern MNC are demonstrated.

From Centralised Hubs to Integrated Networks

From the early 1980s, the limitations of hierarchical models of the company with regard to their capability to manage the complexity of a Multinational Corporation (MNC) became obvious in the course of increasing internationalisation, the emergence of more and more MNCs, and the constantly rising relevance of foreign subsidiaries. Studies by scholars such as Prahalad, Doz, Bartlett and others revealed that top management in the home country had more and more problems in effectively and efficiently processing and understanding the vast amount of information necessary to coordinate the MNC flexibly.

The Integrated Network Model

MNC management is confronted with the challenge of designing systems that allow flexible responses to the strongly heterogeneous context in which the different subsidiaries have to compete, to sense the diverse opportunities and demands that the MNC faces, and to simultaneously ensure the necessary coherence to act as one company, to achieve global scale effects by specialising their subsidiaries' activities and to exploit synergy potentials. In a sophisticated and differentiated configuration of specialised assets and responsibilities, the interdependence of worldwide units increases and the structure of an *integrated network* becomes necessary to coordinate the dispersed activities. In this network model, management regards each of the worldwide units as a source of ideas, skills, capabilities, and knowledge that can be used for the benefit of the total organisation. Efficient local plants may be converted into production sites with worldwide responsibility and innovative organisational units may become the MNC's centres of competence for a particular product or process (Bartlett/Ghoshal/Beamish 2008, pp. 341-342).

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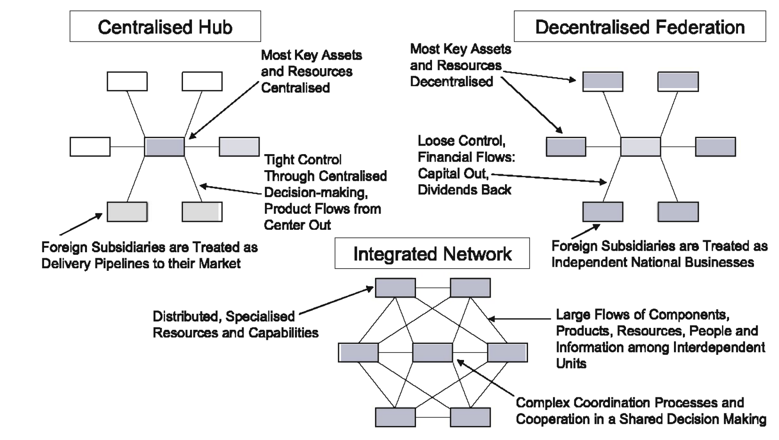
From Dependence or Independence to Interdependence

To understand this modern type of network model better, Figure 1.1 contrasts it with two alternative models, the *centralised hub,* a traditional model where the foreign subsidiaries just implement central decisions and have no autonomy, and the *decentralised federation,* a multinational model with great autonomy of the subsidiaries but only weak linkages within the MNC, which acts mainly as a holding company. While national subsidiaries in decentralised federations enjoy considerable *independence* from the headquarters, those in centralised hubs remain strongly *dependent* on the parent company. Integrated networks are *interdependent* organisations, with dispersed, specialised, but integrated – i.e., coordinated – interrelationships between the units (Bartlett/Ghoshal/Beamish 2008). Such networks result in a so-called *decentralised centralisation,* i.e. the activities are globally integrated and aligned. Subsidiaries are not necessarily coordinated by the headquarters but, in some cases and for some products, by a foreign subsidiary (Birkinshaw/Morrison 1995, p. 734).

Figure 1.1 *Alternative Models of the MNC*



Source: Adapted from Bartlett/Ghoshal/Beamish 2008, pp. 338, 342.

Many Network Models

From the 1980s, more and more scholars started to model the MNC as *a network.* The "transnational organisation" (Bartlett/Ghoshal 1989), the "heterarchy" (Hedlund 1986), and the "differentiated network" (Nohria/Ghoshal 1997) are just a few examples. While there are many differences in detail, all named models agree in the recommendation to organise the MNC as an integrated network of dispersed organisational units.

Nodes and Linkages

Networks consist of *nodes* (in this case mainly foreign subsidiaries) and *linkages* between those nodes (like coordination relationships, product flows, communication, etc.). Some of the nodes, i.e. of the foreign subsidiaries, achieve – due to unique resources, capabilities and competences, for example – a crucial influence on the decisions of the MNC: foreign subsidiaries can take over "strategic roles" (see Chapter 3). Competitive advantages of the MNC are not necessarily developed in the home country anymore and then transferred and exploited in foreign countries but can be established by single foreign subsidiaries or by cooperation in the whole MNC network. *Learning* becomes necessary to create and diffuse knowledge quickly within the MNC (Schmid/Kutschker 2003, pp. 163-164).

Heterogeneity between Foreign Subsidiaries

The network perspective of the MNC acknowledges that foreign subsidiaries are and should be heterogeneous: "to be truly effective, multinational corporations should be differentiated" (Nohria/Ghoshal 1997, p. xv). Looking at the German MNC *Siemens*, which is described in detail in the case study to this Chapter, one can see that the company is active in about 190 countries. Some foreign subsidiaries (e.g. in France or the UK) were established in the mid-1850s, but others are just a few years old. Some foreign subsidiaries focus, for instance, on R&D for energy generation, while others are responsible for the manufacturing of industry automation equipment. Some only occupy a few people, while the subsidiary in the USA has over 72,000 employees. Some work in slow-growing countries like Western Europe, others in fast-growing emerging economies like China. Some have national responsibility, some have worldwide responsibility.

Subsidiary Characteristics

The *Siemens* example demonstrates that subsidiaries can be distinguished by many different criteria. Heterogeneous characteristics of subsidiaries include, inter alia (Morschett 2007):

- value-added activities carried out by the subsidiary, reaching from single activities (e.g. only sales) to full value chains
- dominant motives for the establishment of the country subsidiary, for example, resource-seeking or market-seeking (see Chapter 4)
- available resources and capabilities of the subsidiary
- local conditions of the host country, e.g. political and economic situation
- degree of horizontal and vertical product and communication flows with other subsidiaries and the headquarters
- control and influence of the headquarters

- national, regional or worldwide responsibility of the subsidiary
- age of the foreign subsidiary or time period of belonging to the MNC (in the case of an acquisition)
- size of the subsidiary (sales, employees, financial assets, etc.)
- performance of the subsidiary.

The role typologies of international management (see Chapter 3) try to categorise subsidiary roles following some of these characteristics.

Subsidiaries as Centres of Excellence

Network models also assume that subsidiaries can become "centres of excellence" (or competence centres) for the MNC. A centre of excellence is "an organizational unit that embodies a set of capabilities that has been explicitly recognized by the firm as an important source of value creation, with the intention that these capabilities be leveraged by and/or disseminated to other parts of the firm" (Frost/Birkinshaw/Ensign 2002, p. 997). Studies have shown that most MNCs have foreign subsidiaries in the role of centres of excellence (Schmid/Bäurle/Kutschker 1999, pp. 108-109). Such centres of excellence play a highly strategic role in the MNC network.

High Autonomy and Strong Integration

A high competence is an obvious prerequisite for this role and centres of excellence are characterised by a simultaneous appearance of *high autonomy*, because a relatively high degree of freedom is necessary to deploy its competences effectively, and of *strong integration* in the MNC to ensure that the competence is available for other country subsidiaries as well (Forsgren/Pedersen 1997). Centres of excellence can concern products or processes or functions of the MNC (Frost/Birkinshaw/Ensign 2002, pp. 998-1000). It becomes increasingly obvious, though, that the concept of a centre of excellence is not a dichotomy (to be one or not) but rather a continuum, i.e., each subsidiary experiences a different level of being a centre of excellence within its MNC.

Flows in the MNC Network

The network perspective of the MNC illustrates it as nodes and linkages. Those linkages include potential superordination and subordination in the headquarters-subsidiary relations and coordination relationships that might be more or less centralised. Sometimes coordination might not be given through the corporate headquarters in the home country but rather from a superordinate subsidiary that acts as the regional headquarters.

A Network of Capital, Product and Knowledge Flows

Linkages in the network also encompass a number of different transactions among units located in different countries. Hence, the MNC can also be thought of as a *network of capital, product, and knowledge flows* between organisational units (Gupta/Govindarajan 1991, p. 770). In the network perspective, it becomes evident that, *instead of unidirectional flows* of products, components and know-how from the headquarters to the foreign subsidiaries, there are *bidirectional and reciprocal flows* and interdependencies. Not only are there *vertical linkages* between the headquarters and each subsidiary but increasingly, there are *horizontal relations* between the subsidiaries, concerning product flows but also employees and knowledge exchange.

For example, a French sales subsidiary of the German car manufacturer *BMW* mainly receives product inflows while the German factories exporting to other countries are a source for product outflows. The US factory of *BMW* selling its vehicles to Mexico illustrates horizontal product flows. In cross-border production processes (see Chapter 16, International Production & Sourcing), components are produced in different countries and often transported to a subsidiary that assembles the finished products. Similarly, dispersed R&D activities and innovation processes are only possible through substantial vertical and/or horizontal knowledge flows (see Chapter 17, International Research & Development).

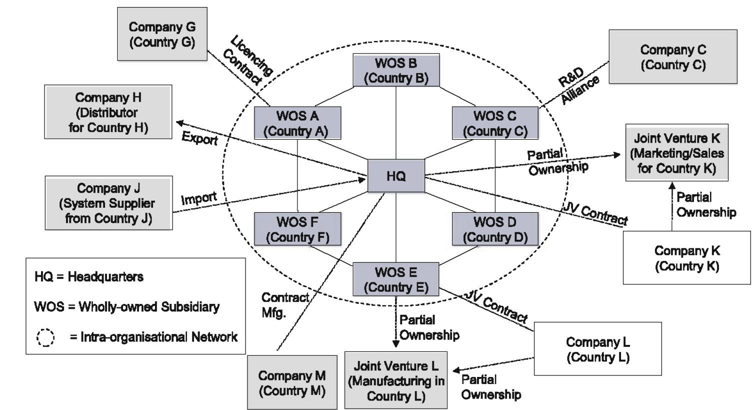
Generally, these flows within the MNC may have different magnitude and different directions, and the transactional perspective increases the number of potentially heterogeneous characteristics of MNC subsidiaries, since substantial differences across subsidiaries within the same MNC will exist. The role typologies (Chapter 3) try to capture systematically some of these differences.

Intra- and Inter-organisational Networks

As has been mentioned in the introductory Section, MNCs comprise entities in two or more countries, regardless of the legal forms and fields of activity of those entities, whereby it is not relevant what legal form the entity has but only that "active, coordinated management of operations in different countries, as the key differentiating characteristic of a MNE" (Bartlett/Ghoshal/Beamish 2008, p. 3) is possible. A MNC must own or control value-adding activities in more than one country (Dunning 1993a). As a *subsidiary* was defined "as any operational unit controlled by the MNC and situated outside the home country" (Birkinshaw/Hood/Jonsson 1998, p. 224), foreign subsidiaries are not necessarily wholly-owned. The enormous relevance of cooperative operation modes (see Part IV of this book), like licensing, joint ventures, franchising, etc., makes the inclusion of these internationalisation modes necessary in the conceptualisation of a MNC.

Figure 1.2

The MNC as an Intra- and Inter-Organisational Network



Source: Adapted from Schmid/Kutschker 2003, p. 165.

As an example of the potential complexity, Figure 1.2 illustrates the MNC network, consisting of wholly-owned subsidiaries but also other foreign activities that are closely linked to the company, by partial ownership, contracts or otherwise.

Increasing Relevance of Inter-organisational Networks

So, it is not only the company itself that is more and more structured as a network. Networks, as *stable relational systems* between different organisational units, have grown tremendously in relevance in the last few decades. Cooperative arrangements between companies are becoming a very common business form: some authors have called that a change from "market capitalism" to "alliance capitalism".

Cooperations as Hybrid Operation Modes

Cooperations, as hybrid arrangements between the transaction forms of "market" and "hierarchy", seem to combine the advantages of both extremes and help to compensate the weaknesses of both (Das/Teng 1999). Bartlett and Ghoshal, who originally developed their network model with the perspective of a purely intra-organisational network, recognised later that this perspective is too narrow and has to be expanded to include the inter-organisational network (Ghoshal/Bartlett 1991). In this perspective, it is acknowledged that the MNC is involved in strategic alliances with other companies.

Blurry Boundaries of the MNC

With this perspective, however, the idea that a MNC has clearly defined boundaries becomes disputable (Nohria/Ghoshal 1997, p. 19). While one could merely see the external network (inter-organisational) as an extension of the internal (intra-organisational) network, a clear separation between both becomes almost impossible (Morschett 2007). For example, while a close and long-time customer would usually still be seen as part of the inter-organisational network, a 95 %-owned foreign company would usually be seen as part of the intra-organisational network. Whether majority-owned subsidiaries, parity joint-ventures or contract manufacturers that manufacture a company's product with a fixed long-term contract are "internal" or "external", cannot be clearly defined, however. One could even argue that MNC networks like this do not even have clearly defined boundaries (Hakansson/Johanson 1988, p. 370). A *"boundaryless corporation"* (Picot/Reichwald/Wigand 2003) might well be the consequence.

However, for practical reasons, it is frequently necessary to define the boundaries, but this is necessarily subjective and it depends on the purpose of the exercise. Some authors suggest that the *perceived identity* of the organisational units might be decisive: "We argue that normative integration is the glue that holds differentiated networks together as entities called firms. [...] it is the distinctive codes of communication shared by the members of the multinational that truly demarcate the boundaries of the organization" (Nohria/Ghoshal 1997, p. 6).

Corporate (Internal) and Local (External) Embeddedness

If, for analytical reasons, one still tries to distinguish between the internal and the external network, a foreign subsidiary is linked to the MNC headquarters and to other subsidiaries, i.e., to the internal or corporate network.

Local Network as Network Resource

Furthermore, the local network of the foreign subsidiary is relevant. Critical resources of the subsidiary are linked to the subsidiary's specific relationships with customers, suppliers and other counterparts (Andersson/Forsgren 1996). This local network is a powerful resource and often plays an equally strong role for the operative activities of the subsidiary and even for the strategic competitiveness of the subsidiary as the relationship to the rest of the MNC. Regarding, for instance, the know-how that is relevant for the subsidiary, it is not only the knowledge transfer from the rest of the MNC, e.g., from the headquarters, but also the question of how new, locally relevant knowledge is created within the subsidiary. Here, the external, local network of the subsidiary is a strategic source for subsidiary-specific advantages. These "network resources" of each subsidiary can enhance the com-

petitiveness of the total MNC, because they influence the competitiveness of each subsidiary in its local market but also – by transfer of knowledge to peer subsidiaries – the capabilities of the company network (Andersson/Forsgren/Holm 2002). As mentioned above, the presence in heterogeneous local contexts can be seen as a basic advantage of MNCs compared with purely national players. Thus, one can also consider *the foreign subsidiary as an important connection*, a "linking pin", between the external, local network in a host country and the internal company network (Andersson/Forsgren/Holm 2002, p. 992).

Subsidiaries as Linking Pins

Embeddedness

To work successfully in a network, each subsidiary is *embedded* in relations with other actors (Andersson/Forsgren 1996). This basically refers to an adaptation of the resources of the subsidiary to its specific network, i.e., other network actors. The adaptation includes specific investment, technical adaptations of production processes, adaptations of the product design, etc. This embeddedness has to occur regarding the local network in the host country ("local embeddedness"), but also regarding the linkage of the subsidiary to the rest of the MNC, i.e., to the intra-organisational network ("corporate embeddedness"). However, this *dual embeddedness* might lead to a conflictual situation. The subsidiary is exposed to *different internal and external stakeholders* who usually try to influence its behaviour in accordance with their own interests. Different contexts can lead to tension which leads to a *dilemma* in the MNC. A strong local embeddedness of the subsidiary can enhance its competitiveness and also the knowledge creation of the MNC in total. And the local embeddedness enhances the absorptive capacity of the subsidiary for new local knowledge. However, this local embeddedness often reduces the embeddedness in the corporation and thus diminishes the potential influence of headquarters (Andersson/Forsgren 1996).

Tension between Local Environment and Corporate Integration

Eventually, this dilemma is a consequence of basic challenges of the MNC, and captured in particular with the discussion of the integration/responsiveness framework (Chapter 2). Higher responsiveness to local conditions and stronger internal integration are potentially two forces in tension that have to be optimally resolved in the MNC.

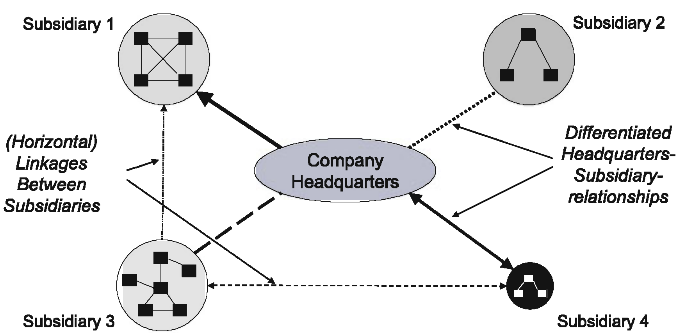
Coordinating the MNC Network

With increasing complexity of the MNC, and the dual tendency to disperse activities to differentiated subsidiaries around the world with simultaneously competitive pressure to coordinate the widespread activities, managers recognised that the organisational structure is insufficient to manage the challenging tasks facing the network. In addition to the formal structure of the company – which is still a powerful instrument – other instruments, including processes, communication channels, decision-making locus and

interpersonal relationships become necessary for coordination. In particular, more subtle and informal coordination mechanisms are seen as relevant for coordinating MNC networks (Martinez/Jarillo 1989, p. 489; Bartlett/Ghoshal/Beamish 2008, pp. 335-336).

The Structure of the MNC as a Differentiated Network

Figure 1.3



Source: Adapted from Nohria/Ghoshal 1997, p. 14.

One main problem with the organisational structure (i.e., a functional or a divisional structure) to coordinate the MNC lies in heterogeneity. All subsidiaries are confronted with the same MNC structure, but in a differentiated network, "variations within such MNCs can be as great as variations across them" (Nohria/Ghoshal 1997, p. 12).

Complex and Differentiated Coordination

Subsidiaries, as has been mentioned, have different tasks, different resources, different competences. They have different internal structures. Thus, as has been shown in the model of the integrated network, horizontal linkages between subsidiaries emerge and are beneficial. Direct horizontal links between subsidiaries, however, make central coordination from the headquarters even more complicated. In all, the headquarters-subsidiary relationships must be heterogeneous as well. Stronger centralisation of decisions for certain subsidiaries and more autonomy for other subsidiaries might be adequate. Formal and standardised procedures might be well suited for production subsidiaries but counter-productive for R&D subsidiaries, and so on. Thus, flexible and more complex coordination mechanisms become necessary. Frequently, delegation of decision power to the dispersed organisational units is suggested, in combination with coordination via a strong corporate culture, i.e., normative integration (Bartlett/Ghoshal 1987; Buckley 1996, p. 32). To stimulate horizontal transactions between subsidiar-

ies, informal communication by means of the creation of a network of personal and informal contacts among managers across different units of the company are seen as crucial. In all, in order to implement complex strategies that result from interrelated, multiple-country, specialised activities around the world, an enormous coordination effort is needed. Thus, all types of coordination instruments, formal and structural, plus informal and more subtle mechanisms, are needed (Martinez/Jarillo 1989, p. 492). The different coordination mechanisms are discussed in more detail in Part III of this book.

However, even in the model of the differentiated network, headquarters still exist and still have a somewhat hierarchical position in the network. While the heterarchical models have become prominent, most empirical studies still indicate a higher power in the headquarters, mostly in the home country. The network model in its extreme, i.e., a network of equally powerful organisational units with extreme decentralisation of strategic decisions to different subsidiaries and no hierarchical power in the centre, is *more an ideal-type* in literature than a common phenomenon (Morschett 2007). "Notwithstanding the fact that MNCs are indeed becoming 'heterarchies' [...] i.e., integrated complex networks with significant devolution of authority and responsibility to the subsidiaries, the parent corporation continues to serve" (Gupta/Govindarajan 2000, p. 483) at least as a *primus inter pares*, and usually as the strongest unit concerning knowledge generation, decision power, etc.

Conclusion and Outlook

Originally, the network perspective was only used for a specific type of MNC model, in which all foreign subsidiaries have rather high autonomy, specialised assets and competences which they leverage for the total MNC (see Figure 1.1).

Every MNC is a Network

It becomes evident, however, that many elements of a network, including relationships with internal and external actors, some degree of horizontal linkages and specialised tasks, some differentiated characteristics of the subsidiaries and transactional exchange between different organisational units in different countries, are not features of a specific MNC type but – more or less – of all MNCs. One can thus conclude that "every MNC is a network" (Gupta/Govindarajan 2000, p. 491), even if some key resources and capabilities might still be optimally concentrated within the home-country operation (Bartlett/Ghoshal/Beamish 2008, p. 205). In any case, the network perspective is very useful to understand the MNC, regardless of the relevance or role of the specific nodes in these networks.

Case Study: Siemens[1]

Profile, History, and Status Quo

Siemens was founded in 1847 by the researcher Werner von Siemens in Berlin (Germany). Starting as a 10-man business, *Siemens* is today a MNC with nearly 400,000 employees. In 2009, it reported worldwide sales of 77 billion EUR . In 2010, the company had two corporate headquarters, in Berlin and Munich, and was present in nearly 190 countries all over the world. *Siemens* is one of the biggest companies in electronics and electrical engineering worldwide.

Business Sectors and Divisions

In 2010, *Siemens*' business operations were divided into three main business sectors with 15 divisions and two cross-sector businesses (see Figure 1.4).

Figure 1.4

Siemens' Business Sectors in 2010 (and Sales in 2009)

Industry (~ 35 bn EUR)
- Industry Automation
- Drive Technologies
- Building Technologies
- Osram
- Industry Solutions
- Mobility

Energy (~ 26 bn EUR)
- Fossil Power Generation
- Renewable Energy
- Oil & Gas
- Energy Services
- Power Transmission
- Power Distribution

Healthcare (~ 12 bn EUR)
- Imaging & IT
- Workflow & Solution
- Diagnostics

Strategic Equity Investments
Bosch und Siemens Hausgeräte
Nokia Siemens Networks
Enterprise Networks

Cross-Sector-Businesses:
Siemens IT Solutions and Services
Siemens Financial Services
(~ 5.5 bn EUR)

Source: Siemens 2010.

The objective of this rather new structure is to exploit better growth and customer potential as well as to increase the company's cost efficiency and profitability.

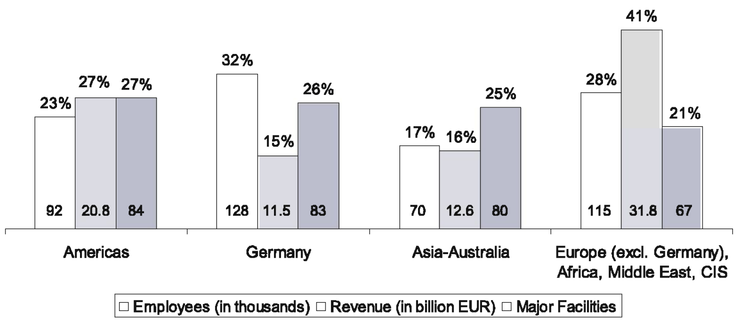
"Company founder Werner von Siemens had an international orientation from the very beginning" (Siemens 2008a, p. 22). Soon after *Siemens*' founda-

1 Sources used for this case study include the corporate web sites (mainly http://www.siemens.com) and various annual and interim reports, investor-relations presentations as well as explicitly cited sources.

tion, in 1850, the company opened its first office outside Germany: a sales office in London (UK). The next foreign subsidiary was established in 1855 in Russia. Over time, *Siemens* expanded its business operations throughout the world.

Regarding its geographical spread, in 2010 the company's international presence was worldwide and within the company divided into four regions: Germany, Europe (excluding Germany)/Africa/Middle East/Commonwealth of Independent States (CIS), Americas, Asia-Australia. Regarding the employee distribution of the group, most employees are located in Germany (32 %). However, whereas Germany shows the highest number of employees within the four geographic regions, it only takes the last place in terms of revenues (15 %). Moreover, most major facilities of *Siemens* are now located in the Americas (see Figure 1.5).

Figure 1.5 *Siemens Global Presence (as of September 2009)*



Source: Siemens 2010, p. 5.

All in all, it can be stated that about half of *Siemens'* employees and facilities are located in Europe (including Germany) where also about half of the group's revenues are generated.

Selected Business Sectors and Business Activities

Siemens' Business Sector "Industry"

Siemens Industry Solution

In 2009, *Siemens'* business sector *Industry* reached sales of about 35 billion EUR and had a workforce of about 207,000 employees in more than 50 countries worldwide. "With the business activities of *Siemens VAI Metal Technologies*, (Linz, Austria), *Siemens Water Technologies* (Warrendale, Pa., USA), and *Industry Technologies* (Erlangen, Germany), the *Siemens Industry Solutions Division* (Erlangen, Germany) is one of the world's leading solution and service providers for industrial and infrastructure facilities" (Siemens 2008f). *Siemens Industry Solutions Division* offers standardised solutions and is coordinated from Erlangen (Germany).

Osram

Osram (Lighting) – to illustrate briefly another industry division of *Siemens* – was registered in 1906 as a brand name. Since 1978 *Siemens* is the only shareholder of the lighting company which has its headquarters in Munich (Germany) and 48 manufacturing facilities in 17 countries. In 2007, *Osram*'s worldwide sales amounted to 4.7 billion EUR of which 41 % were generated in the Americas, 38 % in Europe (including Germany), 17 % in Asia-Pacific and 4 % in other countries/regions. Moreover, in 2007, *Osram* had a workforce of more than 41,000 employees distributed across Europe (35 %), Asia-Pacific (34 %), the Americas (27 %) and other countries/regions (4 %).

Siemens Financial Services

Siemens Financial Services

Siemens Financial Services, one of the cross-sector businesses, provides financial solutions in the business-to-business area across all three *Siemens* business sectors. The financial services sector comprises about 1,800 employees and is worldwide active in more than 30 countries, especially in the regions Europe (including Germany), Americas and Asia-Pacific. The "international network of companies [is] coordinated by *Siemens Financial Services GmbH in Munich*", Germany (Siemens 2008d).

Research & Development

In 2009, *Siemens* invested 3.4 billion EUR in major R&D activities. The company has 30,800 employees in R&D in 150 R&D locations spread over 30 countries worldwide (see Figure 1.6). The most important R&D centres are located in Germany (especially Berlin, Munich, Nuremberg-Erlangen), Austria, the USA (especially Princeton), China (especially Beijing, Shanghai), India (especially Bangalore) and Russia (especially Moscow, Saint Petersburg). Considering R&D employees in the five geographical regions of the

company, Germany employs 36 %, Europe (excluding Germany) 28 %, Americas 23 %, Asia-Pacific 12 % and Africa/Middle East/CIS only 1 % of *Siemens.* In short, the home country, Germany, is the most important location in the world for *Siemens'* R&D activities and nearly two-thirds of the company's R&D employees are working in Europe.

Figure 1.6 *Siemens' Major R&D Locations*

Source: www.siemens.com.

Selected Characteristics of Siemens' Subsidiaries in Selected Countries

Many Large Foreign Subsidiaries with a Long History

Siemens Origin in Berlin

As already mentioned, *Siemens* was founded in 1847 in Berlin. In 2007, *Siemens* had 74 major plants and 35 branch offices located in Germany, generating sales of 12.6 billion EUR and employing 126,000 people, of whom 11,700 were working in R&D.

First Foreign Subsidiaries in the UK and Russia

In 1850, *Siemens* established its first sales office in the UK and in 1858 its first manufacturing plant. The company is established at over 100 locations in the UK. In 2007, *Siemens* achieved sales of nearly 4 billion EUR and had about 20,000 employees in the UK, with about 5,000 employees working in the manufacturing sector.

After delivering pointer telegraphs to Russia in 1851 and setting up a construction office in 1853, *Siemens* established its first manufacturing subsidiary outside Germany in 1855, in Saint Petersburg. In 2007, *Siemens* counted

30 offices and 3,000 employees in Russia, where its sales amounted to 946 million EUR.

USA: Siemens' Largest Market

Siemens' history in the USA reaches back to 1854 when the company was asked to provide the country with a railway telegraph to Philadelphia. In 2007, *Siemens* was present at 795 locations in the USA, in all of the 50 states as well as in Puerto Rico. In 2007, the company reached sales of 14.8 billion EUR. Moreover, in 2007, *Siemens* had about 72,000 employees in the USA. In 2006 and 2007, the USA has been *Siemens'* largest market.

Siemens' Network in China and India

Siemens entered the *Chinese market* in 1872 when providing the country with its first pointer telegraph. In 1904, the company built its first office in Shanghai and quickly expanded its activities to other Chinese cities. As at 2007, the company had set up over 70 operating companies as well as 60 regional offices in *China*. In 2007, *Siemens* achieved sales of 5.2 billion EUR and had 50,000 employees in China. Remarkably, all business sectors the company has around the globe are nowadays active in China, which makes China a very important location for *Siemens*.

Siemens' first business contracts with India reach back to 1867. In 2007, *Siemens* had 17 production plants in India, generated sales of 1,700 million EUR, employed 16,800 people and was embedded in a large regional network of service and sales offices as well as distribution partners.

Relatively Young and Small Foreign Subsidiaries

In contrast to the abovementioned countries in which *Siemens* has been present for more than 100 years, and in which the subsidiaries consequently have very long experience and local knowledge, and often considerable size and own resources, there are also countries where *Siemens* is not been present for long and where it only has small subsidiaries.

Young History in Lower Gulf Region

For example, *Siemens* has a relatively young presence in the Lower Gulf region, comprising the United Arab Emirates, Bahrain, Qatar, Oman and Yemen. *Siemens* set up its first representative office in the Emirates in 1973. Then, in 1999, *Siemens LLC* was founded as a *regional headquarters* which is *responsible* for *Siemens'* activities in the five countries mentioned above.

History in Former Eastern Bloc Countries

A heterogeneous picture is given when considering some of the former Eastern Bloc countries: Whereas *Siemens* has been present in Hungary since 1890 with its first subsidiary, the company started its operations in Poland only in 1991 and in Kazakhstan in 1994. Moreover, in the Ukraine, *Siemens* has been active since the 1850s, but opened its first representative office only in 1992. However, whereas *Siemens* has a long history in Hungary, in 2007, the company counted the same number of employees in Hungary and Poland (each

about 2,000 employees) and generated higher sales in Poland (453 million EUR) than in Hungary (259 million EUR). Moreover, in 2007, *Siemens* had 300 employees in the Ukraine, where it achieved sales of 163 million EUR, and 140 employees, and sales of 68 million EUR in Kazakhstan.

Local, Regional or Global Responsibility of Subsidiaries

Selected Global and Regional Business Centres and Offices

Most of *Siemens'* business activities are coordinated from the company's home country, Germany. The respective CEO and CFO of *Siemens'* business sectors Industry and Energy are located in Erlangen (Germany). However, as a first indicator for decentralised decision making, the coordination of the business sector Healthcare is carried out from Malvern, Pennsylvania (USA). Each CEO of the three business sectors is also a member of the managing board. The 15 business divisions, being rather autonomous, have their own CEO and CFO and are again divided into different national and regional units. The divisions as well as its national and regional units receive mainly strategic directives from the top of their business sector.

Headquarters in Germany

Siemens' office in Berlin, where the company was founded and still has one of its two corporate headquarters, plays an important role for the company's activities located around Berlin, in Germany and all over the world. Berlin is one of the biggest manufacturing locations and many of the Group's activities are concentrated in the German capital. *Siemens* exports 90 % of all products it manufactures in the Berlin area. In 2004, *Siemens* decided to concentrate its formerly dispersed service and sales operations concerning Germany as a whole in Berlin. Moreover, *Siemens* not only coordinates from Berlin the company's activities across Germany, but also coordinates some of its worldwide subsidiaries.

Siemens' office in Munich was established in 1890 as a technical office and was at that time the company's first company-owned sales office outside Berlin. Besides Berlin, Munich is the second location for the company's corporate headquarters. Whereas *Siemens'* office in Berlin is, among other things, the distribution and service centre for the Berlin region and its adjacencies, Munich is the centre for distribution, solutions and services for the regions of Upper and Lower Bavaria. Moreover, the headquarters of *Siemens'* industry division, *Osram*, is located in Munich.

In Nuremberg-Erlangen (Germany) there is another important office which has global responsibility for most of *Siemens'* business divisions, e.g., *Siemens Industrial Solutions and Services, Power Generation, Power Transmission and*

Power Distribution. In total, one-third of *Siemens'* worldwide revenues is coordinated from here.

Division Head Offices Abroad

Although most of the head offices of *Siemens'* business divisions are located in Germany, the company also coordinates some divisions from other locations outside its home country of Germany: For example, *Siemens' Oil and Gas* division has its headquarters in Oslo (Norway) and the healthcare division *Diagnostics* is headquartered in Deerfield, Illinois (USA). Moreover, *Siemens Building Technologies*, established in 1998 in Zurich (Switzerland) by acquisition of the industrial sector of Electrowatt Ltd., employs about 29,000 people in 51 countries. *Siemens Building Technologies* "is part of *Siemens Switzerland Ltd*, Zurich (Switzerland) and consists further of *Siemens Building Technologies GmbH & Co. oHG*, Erlangen (Germany), *Siemens Building Technologies Inc.*, Buffalo Grove, IL (USA), their subsidiaries and affiliates" (Siemens 2008g). Today, the global head office of the *Siemens Building Technologies Group* is located in Zug (Switzerland).

These examples indicate the application of a type of "decentralised centralisation", whereby decisions – in this case for business divisions – are taken in a rather centralised manner but the locus of decision making is not in the home country of the MNC.

Head Offices of Siemens' Joint Ventures

Besides business divisions, *Siemens* is also involved in two strategic equity investments in the form of 50-50 joint ventures – *Bosch und Siemens Hausgeräte* and *Nokia Siemens Networks* – where control is shared with the business partner. While *Bosch und Siemens Hausgeräte*, established in 1967 between *Robert Bosch GmbH* (Stuttgart, Germany) and *Siemens AG* (Munich), is globally controlled from Munich, *Nokia Siemens Networks*, established in 2007 between *Nokia Corp.* (Espoo, Finland) and *Siemens AG* is controlled from Espoo. Similarly, *Fujitsu Siemens Computers*, a joint venture between *Fujitsu Limited* (Tokyo) and *Siemens AG* launched in 1999 was dissolved as of 1 April 2009, and *Siemens'* share was sold to the former partner, *Fujitsu*. A 49% stake in *Enterprise Networks B.V.*, with its headquarters in Amsterdam, is also part of *Siemens'* Strategic Equity Investments. These strategic investments are granted great autonomy in their decisions, being strongly influenced by the business partner.

Regional Business Centres in the UAE

In 2007, *Siemens* established a *Regional Business Centre* for Oil and Gas for the countries of the Gulf Cooperation Council and Iran, which has its regional headquarters in Abu Dhabi in the United Arab Emirates. Furthermore, some divisions of *Siemens*, among them *Osram* and *Siemens Home and Office Communication Devices*, have established regional bases in the United Arab Emirates.

Regional Offices in China

On the subnational level, *Siemens* has 60 *offices* in China which are responsible for coordinating the company's activities in specific regions within China. Furthermore, having regional offices in China allows the company to pursue a *local marketing strategy* and to react to changes in the Chinese market (e.g. changes in consumer needs) without long delays.

Siemens' R&D Activities in China

Importance of Siemens R&D Activities in China

"China already is an important research and development base for *Siemens*, and will be further extended. Emphasis is on locally designing and developing the right products for the Chinese market to meet local customer needs, and also using the advantages China offers to develop technologies in China for global application"(Siemens 2008c). Thus, the Chinese R&D organisation has mainly local tasks, but also some *global responsibility*. Since the end of the 1990s, *Siemens* has established a couple of *R&D centres* in China focusing on different R&D activities in the company's different business areas. Establishing *local R&D centres* in China allows *Siemens* to localise and to customise its products and solutions to the Chinese market. However, products and solutions developed in China are not only intended to be sold in the Chinese market, but may also be exported around the world.

Selected Local R&D Centres in China

Local R&D centres may also provide their capabilities and know-how to other *Siemens* companies around the world specialising in the same business divisions. Moreover, some R&D centres located in China combine their activities with other R&D centres in other countries. For instance, the R&D centre of *Siemens' Osram* division works closely together "with other *Osram* Component Groups in Germany, Italy and the USA" (Siemens 2008c). Some of the company's R&D centres in China, e.g., in the area of medical technology, are the only R&D centres in specific business areas located outside Germany. Furthermore, some bases carrying out R&D also carry out manufacturing activities, such as *Bosch Siemens Household Appliances*, located in Beijing. In addition, the "*Asia Centre of Excellence* in Shanghai, which will focus on R&D, manufacturing, service and marketing for *Siemens* medical products [...] will become the focal point of all *Siemens* medical activities in China" (Siemens 2008c). Besides Shanghai, Beijing and Nanjing are also important R&D locations for the company in China. Furthermore, R&D centres in China also cooperate with other business divisions in other locations in China. Finally, *Siemens* has also entered some R&D joint ventures in China.

Local Embeddedness of Subsidiaries

Cooperation with Regional Suppliers

In many countries, *Siemens* works closely with *regional suppliers*. For instance, in China, where the company has strengthened its local procurement activities since 1999. According to Siemens (2003), the company "works closely with local suppliers to prepare them to meet the company's high standards for quality and reliability, thereby transferring modern management know-how to its partner companies. […] Thanks to its substantial efforts in developing local procurement, *localisation rates* in some of *Siemens*' business areas in China already reach *up to 75 %*."

Cooperation with Research Institutions

Moreover, *Siemens* participates in diverse *projects with different research institutions* in different countries, including Germany, Brazil, Poland and China. For instance, in China, *Siemens* works closely together with local universities and has in total 16 cooperations with high-ranked Chinese universities aiming, among other things, at fostering R&D and sharing knowledge.

In addition to *Siemens'* cooperation with regional suppliers and educational and research institutions, the company also participates in several *cultural and social programmes*.

Summary and Outlook

Starting as a ten-man operation in 1847 in Berlin, *Siemens* grew over time into one of the largest MNCs in its field which is nowadays spread over 190 countries worldwide. *Siemens'* international network of subsidiaries shows strong heterogeneity concerning different characteristics of the foreign units, e.g., with regard to size, age and autonomy as well as geographical responsibility.

Questions

1. Modern models of the MNC characterise it as a "differentiated network". Using the example of *Siemens*, explain this perspective of the MNC.
2. MNCs are characterised – among other things – by complex interdependencies within their internal and external networks. Take the example of *Siemens* R&D activities in China and try to depict the complex internal (and external) interdependencies of *Siemens'* international network. Then, investigate whether *Siemens'* R&D activities around the world are coordinated centrally from one (or a few) locations or whether *Siemens* gives autonomy to its subsidiaries to decide (largely) independently on their R&D activities in their respective countries.

3. *Siemens* is a German MNC. Illustrate and discuss the relevance of *Siemens'* home country for the company's international network today.

Hints

1. See, e.g., www.siemens.com for an overview on *Siemens'* R&D activities in China.
2. For your answer, take into consideration – among other things – the role of specific German locations for the coordination of *Siemens'* international network as well as the importance of Germany in the field of R&D.

Chapter 2

The Integration/Responsiveness-Framework

MNCs are exposed to two sets of strategic forces to which they must respond, but which are at least partly conflicting, namely forces for global integration and forces for local responsiveness. In the Integration/Responsiveness-framework (I/R-framework), a four-fold typology of MNCs has been proposed based on the differing strength of the two forces. This framework is described in detail in this Chapter.

Forces for Global Integration and Forces for Local Responsiveness

One of the most influential typologies of MNCs results from the studies by Doz, Prahalad, Bartlett and Ghoshal in the 1970s and 1980s. The tension between external forces towards adaptation to the local environment in the different host countries ("local responsiveness") and the forces towards a standardised approach, leading to global efficiency by a worldwide integrated behaviour ("global integration") are the basis of this typology (Doz 1980; Prahalad/Doz 1987; Bartlett/Ghoshal/Beamish 2008):

Global Integration

- *Global integration* means interconnecting the international activities of the MNC across all countries, looking for the strengths of the large company, and trying to achieve synergy effects. Thus, the different countries in which a MNC operates can be linked to each other. This could be, e.g., because economies of scale are particularly high in a specific industry, leading to the necessity of internationally standardised products. Alternatively, it could result from comparative cost advantages of a country that offer an incentive to specialise the activities of certain foreign subsidiaries, leading to interdependence between the worldwide activities. Necessity for worldwide learning, in order to exploit knowledge companywide that has been created in a particular country, or the situation in which relevant actors around the MNC (e.g. customers, competitors, suppliers) are the same in different foreign markets, enhance the requirement and the potential to coordinate closely the different international activities. These interdependencies between countries are called "forces for global integration".

Local Responsiveness

- At the same time, a MNC operates under heterogeneous conditions in many different host countries. In each country the local unit is con-

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fronted with different local customers and host governments, different market and distribution structures, different competitors and substitution products. Multinational flexibility, i.e., the ability of a company to exploit the opportunities that arise from this heterogeneity, is necessary. This contingency condition for MNC is called "forces for local responsiveness" and the pressure to adapt varies by industry.

Forces for Global Integration

Global Integration

In a global industry, a firm's competitive position in one country is strongly affected by its position in other countries. The forces for global integration, also called industry globalisation drivers, can be divided into four categories (Yip 1989; Bartlett/Ghoshal/Beamish 2008, pp. 88-91):

- market drivers
- cost drivers
- governmental drivers
- competitive drivers.

Market Drivers

First of all, *homogenous customer needs* in the different markets may create opportunities to sell standardised products. With common customer needs, marketing becomes transferable across countries and the *culture convergence thesis* by Levitt (1983) suggested that different cultures become more similar, and lifestyles and tastes are converging worldwide. However, this thesis is discussed very critically. Meanwhile, more and more often, in particular in B2B markets, companies also meet *global customers*, i.e., companies (or sometimes private consumers) who are their customers in different country markets, e.g. different subsidiaries of the same MNC. Similarly, *global channels* emerge in certain industries, like large international retailers as *Wal-Mart*, *Tesco* or *Media-Markt*, or global e-commerce channels like *Amazon*. All these aspects enhance the need for globalisation in an industry.

Cost Drivers

From a cost perspective, different industries have different incentives to standardise. For example, *economies of scale* at a particular production plant can be increased with standardised products that are exported to different country markets. Economies of scale and scope as well as *experience curves* differ from industry to industry, however. This can be caused by different production technologies. The greater the potential economies of scale and the steeper the experience curve, the more likely an industry is to turn global. Furthermore, industries where *product development* is *expensive* and at the same time *product lifecycles* are *short* or technology is fast-changing usually try to use global scale effects. *Global sourcing efficiencies* might be given in an industry, leading to concentration in supply and manufacturing, and

intercountry differences in labour costs and factor endowments might make concentration of production useful. Over the last few decades, logistics costs have generally been going down, making globalisation easier to realise. How energy prices, climate change but also technological innovations, will influence logistics and, consequently, location strategies remains to be seen.

Governmental Drivers

Many governmental drivers also have an influence on the need for globalisation in an industry. For example, compatible *technical standards* are necessary for product standardisation, *liberal trading regulations* with low tariff and non-tariff barriers to trade and common market regulations are drivers for globalisation, making cross-border trade easier. Inversely, high trade barriers are obviously reducing the forces towards globalisation, protecting local particularities. *Deregulation* of formerly protected industries (like energy, telecommunications, transport) also pushes industries towards globalisation, in combination with the privatisation of formerly state-owned companies.

Competitive Drivers

As the most important competitive driver, the presence of *global competitors* enhances the need for globalisation. Only companies that manage their worldwide operations as interdependent units can implement a coordinated strategy and use a competitive strategy that is sometimes called "*global chess*" (Bartlett/Ghoshal/Beamish 2008, p. 90), that is, responding to threats in one market by reactions in other markets. In addition, large multinational companies offering the same products and brands around the world also promote the convergence of tastes and customer demand. With the presence of many MNCs, international networks appear, e.g. in production, that also enhance the interdependence of countries and markets.

The overall level of globalisation of an industry can be measured, for example, by the ratio of cross-border trade to total worldwide production, by the ratio of cross-border investment to total capital investment, by the percentage of sales of worldwide standardised products or by the proportion of industry revenue generated by large MNCs.

Forces for Local Responsiveness

On the other hand, and depending on the industry, companies are facing another set of influence factors, which make local responsiveness necessary (see, e.g., Hollensen 2007, p. 19).

Differences in Demand

The dominant reason for a need for local responsiveness is a strong difference in *customer demand*. This might be caused by profound cultural differences in tastes, by different environmental conditions (climate, topography, etc.), by different income levels and income distribution, or many other factors. A different *structure of the distributive sector* might make adaptations of the distribution strategy necessary. A different *competitive situation* in dif-

ferent markets might also force a company to change its strategy and adapt it to the local market conditions. Similarly, *protectionism* by governments often leads to the need to produce locally and/or to adapt products to specific markets. While the need for adaptation occurred on the country level in the past, it now occurs more and more often on the level of regional integration areas such as the EU (see Chapter 5).

Differences in Country Conditions

Local responsiveness can also become necessary or beneficial due to different labour conditions, e.g. labour cost or skill level, that require adaptation of production processes to optimise efficiency, or due to the availability or non-availability of good suppliers. A low number of potential suppliers might make a higher level of vertical integration of production steps more or less efficient due to a lack of alternatives. Different work attitudes that may be rooted in different cultures (see Chapter 7) might make different leadership styles more or less effective in different countries.

The I/R-Framework as Matrix

While both forces are interconnected, they are not seen as opposing extremes of a continuum of possible situations but as two separate dimensions.

Figure 2.1 *The Integration/Responsiveness-Framework*

Source: Adapted from Bartlett/Ghoshal 1989, p. 438.

While the full independence of both dimensions is sometimes doubted in the literature (see, e.g., Engelhard/Dähn 2002; Morschett 2007), the assumption has the advantage that one can try to distinguish between both sets of forces

more clearly and that the potential external situations that a MNC faces can be illustrated in a matrix. The typology of Bartlett/Ghoshal (1989) that builds on this two-dimensional framework is the most commonly used. In their model, MNCs are grouped regarding their strategic orientation. The framework has been very influential in IB literature, in particular regarding the transnational MNC. In the following part of the text, the four strategy types are described in more detail (see, among many other authors, Harzing 2000, and Bartlett/Ghoshal/Beamish 2008, for a more comprehensive description).

International Organisations

MNCs with an "international" strategic orientation tend to think of their foreign activities as remote outposts whose main role is to support the parent company by contributing incremental sales. This strategy type can be linked to the international life-cycle model by Vernon (1966), since the focus is on exploiting knowledge, new products or processes of the parent company by transferring them to foreign markets. These are rather seen as a source of short-term and incremental profits. Accordingly, the company does not adapt to the specific host country and the foreign activities are also not systematically integrated in the MNC. This strategy type is ethnocentric since the foreign activities only secure the home-country company. A strong dependence of the foreign subsidiary on the resources of the home country is a consequence.

Global Organisations

Focus on Economies of Scale

Companies with a "global" strategic orientation focus their organisation on achieving economies of scale. They are usually to be found in industries where forces for global integration are strong and forces for local responsiveness rather low. *Price competition* in global industries is high, thus, the dominant strategic need is *global efficiency*. The most relevant resources are concentrated in the headquarters and decisions are *highly centralised*. The MNCs attempt to rationalise their production by producing *standardised products* in concentrated production plants that fulfil a worldwide demand volume. Usually these production plants are located in the home country, and the most relevant task of the foreign subsidiary is to act as a "*pipeline*" for the parent company, selling products in its local market. R&D and innovation is also concentrated in the home country. Information flows and product flows are *unidirectional*, the MNC follows a *centralised hub model* (see Chapter 1).

Multinational Organisations

Focus on National Differences

The multinational organisation, being in the lower right corner of the matrix in Figure 2.1, focuses primarily on *national differences* to achieve its strategic objectives. In many characteristics, it is the *reverse of the global organisation*. Products, processes, strategies, even management systems, might be *flexibly modified* to each country to *adapt to local needs* and sometimes to *local governmental regulations*. This adaptation to the local markets is facilitated by *local production* and *local R&D*. The main task of subsidiaries is to identify and fulfil local needs and the foreign subsidiary is also provided with the necessary local resources to respond to the local needs. The subsidiaries are independent of the headquarters and they are also not linked to peer subsidiaries in other countries. The organisation takes the form of a *decentralised federation*.

Transnational Organisations

While global organisations and multinational organisations emphasise either global efficiency and integration or multinational flexibility and local responsiveness, the transnational organisation tries to respond *simultaneously to both strategic needs*. Thus, in particular in industries where both forces are equally strong, transnational organisations reach for the benefits of combining characteristics of both global and multinational companies.

Responsive AND Integrated

Accordingly, a transnational strategy refers to becoming strongly responsive to local needs while still achieving the benefits of global integration. As has been described in Chapter 1, the underlying model is the *integrated network*, where key activities and resources are neither centralised in the headquarters nor fully decentralised into each country. Instead, resources and activities are *geographically dispersed but specialised*, leading to *scale economies and flexibility*. A certain level of product adaptation to local needs is combined with *cross-border production processes* that still concentrate production, such as for specific common components, in single locations. This leads to *reciprocal and horizontal product flows*. Large flows of products, people, capital, and knowledge between subsidiaries are characteristic of transnational organisations. Innovation occurs in different locations and is subsequently diffused worldwide, foreign subsidiaries can serve in strategic roles, such as for producing specific products, or as centres of excellence.

Ideal Type in Specific Situations

While this strategy type is often seen as an *ideal-type* in literature, it is highly complex, costly and difficult to implement and very ambitious. Empirical studies often show that few MNCs actually represent this type, and while many recent textbooks and management consultants promote the transnational organisation as the "best" MNC type, without differentiation, it

should be analysed carefully. The original authors recommend the complex transnational organisation only for MNCs that are confronted with a complex environment with simultaneously high forces for integration and responsiveness. *"Organizational complexity is costly and difficult to manage, and simplicity, wherever possible, is a virtue"* (Ghoshal/Nohria 1993, p. 24). On the other hand, more and more industries are currently developing into this situation of complexity.

Comparison of the Four MNC Types

Table 2.1 summarises and compares a number of different characteristics for the four MNC types.

Selected Characteristics of the Four MNC Types

Table 2.1

	International	Global	Multinational	Transnational
Role of Subsidiary	sale of HQ products	implementation of HQ strategies	identification and exploitation of local opportunities	differentiated contribution to the worldwide competitive advantages of the MNC
Decentralised Federation	low	low	high	low
Centralised Hub	high	high	low	low
Integrated Network	low	low	low	high
Vertical Product Flows	high, sequential	high, sequential	low	bidirectional
Inter-subsidiary Product Flows	low	low	low	high
Centralisation of Decisions	high	high	low	medium (decentralised centralisation)
Management Transfers, Visits, Joint Working Teams	low	high	low	high
Centres of Excellence	low	low	low	high
Product Modification	low	low	high	high
Local Production	low	low	high	medium
Dependency	strong dependence	strong dependence	in-dependence	inter-dependence

Source: Summarised and adapted from Macharzina 1993, pp. 83, 102; Harzing 2000, p. 113; Bartlett/Ghoshal/Beamish 2008, pp. 202-206.

Perlmutter's EPRG Concept

A similar typology of MNCs which is also prominent in International Business research has been proposed by Perlmutter (Perlmutter 1969; Wind/Douglas/Perlmutter 1973). Perlmutter developed the EPRG scheme, distinguishing between ethnocentric, polycentric, regiocentric and geocentric

attitudes. In this scheme, he recognises that managers of MNCs have different strategic orientations or a different "*state of mind*", i.e., assumptions upon which key decisions in the MNC are made.

Ethnocentric

In the ethnocentric state of mind, the *home country* is implicitly considered to be *superior*. Key positions in foreign subsidiaries are staffed with *expatriates* from the home country and decisions are taken in the headquarters. Foreign activities are seen as less relevant than home-country activities and exports are the main entry mode. The subsidiary is highly dependent on headquarters.

Polycentric

Polycentric firms start with the assumption that host-country cultures are strongly different and *adaptation is necessary*. They acknowledge that local employees are more effective for this task and that *decentralised decisions* help to exploit local differences effectively.

Geocentric

While the polycentric attitude strives for optimal local solutions, this might be sub-optimal for the total organisation. As a further development, the geocentric attitude emphasises *interdependencies* and aims for a *collaborative approach* between headquarters and subsidiaries as well as among subsidiaries. An optimal allocation of resources and synergy effects is aimed for.

Regiocentric

The regiocentric approach is a *mix* between the polycentric and the geocentric approach. Strategies, products, processes, etc. are closely coordinated within different regions (e.g. Europe, North America) while the regions operate relatively independently from each other.

Differences and Similarities to the I/R-framework

While the similarity to the I/R-framework is obvious, and both approaches can be linked via the three network models, with the centralised hub model being ethnocentric, a decentralised federation model being polycentric and the integrated network being the organisational response in the case of a geocentric state of mind, there are two major differences: While the I/R-framework offers contingency conditions under which external industry forces influence a MNC strategy in a particular way, Perlmutter offers a more qualitative explanation which is based on the management style or on the *state of mind*. Second, Perlmutter's EPRG scheme is not systematically based on describing characteristics. The "regiocentric" approach, however, which is very common in modern MNCs and is also very prominent in recent IB literature (see, e.g. Rugman/Verbeke 2004), was identified by Perlmutter but is not considered in the I/R-framework.

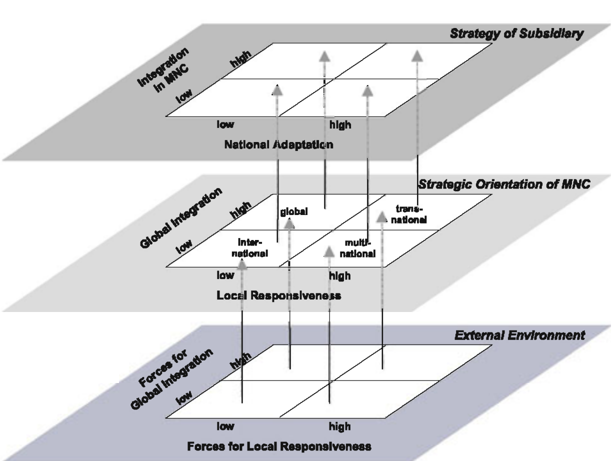
Different Levels of Integration and Responsiveness

The I/R-framework is a *contingency framework* that derives MNC strategies from a given external context. The main assumption is that a MNC in a cer-

tain industry which is exposed to a certain configuration of forces for global integration and forces for local responsiveness needs to develop a strategy in accordance with the external context. However, while the original framework clearly emphasises that MNCs have complex sets of options and that not only industry characteristics determine company strategies, management literature has often applied the framework in a deterministic manner, implying that MNCs in a certain cell of the matrix *have* to use a specific strategy. From a categorisation of industries, consequences were immediately drawn on the company level: “the primary use of the ‘I-R grid’ was to map industries, and therefore to indicate what strategy a firm should pursue“ (Westney/Zaheer 2001, pp. 356-357).

Three Levels of the I/R-Framework

Figure 2.2



Source: Morschett 2007, p. 396; Zentes/Morschett/Schramm-Klein 2008, p. 201.

For a more detailed analysis of integration and responsiveness, Figure 2.2. shows an extended model, consisting of three levels:

- the *external environment*, where the forces for global integration and the forces for local responsiveness reach different levels, depending on the industry

- the *MNC's strategic orientation*, where some MNCs prefer to use a global strategy, and others a more multinational approach, i.e., to display different levels of global integration and local responsiveness
- the *strategy of the subsidiary*, which can differ and be more or less integrated in the MNC and which can be more or less adaptable in its behaviour to the local market, as becomes evident in the role typologies (Chapter 3).

Industry Forces as External Environment

In the original concept, the I/R-framework was used "to classify MNC environments in terms of the twin demands of global integration and national responsiveness" (Ghoshal/Nohria 1993, p. 25). With the dimensions "forces for global integration" and "forces for local responsiveness", a matrix can be constructed with four different context situations, a "multinational environment", an "international environment", a "global environment" and a "transnational environment" (Ghoshal/Nohria 1993, p. 27). Which industry characteristics exert a certain force has been discussed above.

Strategic Orientation of the MNC as Internal Context

Many authors use the I/R-framework to describe not the external environment but different MNC *strategies* ("internationalisation strategies") or *organisational types* ("MNC organisations"). Kutschker (1999, p. 110) labels the four I/R-strategies "archetypes of international companies". Here, *instead of forces*, the *degree* of integration and the *degree* of localisation *of the MNC* are used. In this case, as has been described above, the four strategy alternatives are seen as typical *bundles of strategy elements*, consisting of specific coordination mechanisms, product flows, product modifications, etc. This perspective on the strategic orientation characterises it as the *vision*, philosophy and value system of the management which characterises a specific position of the MNC (Devinney/Midgley/Venaik 2000, pp. 675-678).

Externally Determined Strategy

In a normative or at least contingency-oriented perspective, these strategies are often derived from the context but most authors do not explicitly mention the distinction between context and strategy. Instead, the model is based on the assumption of environmental contingencies and that a certain match between the external forces and the company strategy is more efficient than a mismatch (De la Torre/Esperanca/Martínez 2003, pp. 67-69). Yip (1989) pointed out that, to reach balanced global and national competitive advantages, the *globalisation of the strategy* has to be aligned with the *globalisation potential of the industry*.

Strategic Choice

On the other hand, companies have a certain level of freedom in the development of a strategy, which is called *strategic choice* (Child 1972). The terminology of "state of mind" or "strategic orientation" of the management clearly indicates that the industry characteristics are important, but MNCs can choose alternative strategies, based on their internal resources, strategic priorities, and other considerations. Clearly, external characteristics are only one part of the influence factors on the company strategy and internal influences also play an important role in the determination of the strategy.

Strategy of a Specific Subsidiary

Different Subsidiary Strategies in the same MNC

Similarly, it has to be recognised that a MNC strategy does not necessarily lead to uniformity on the level of the subsidiaries. The fact that the MNC follows a global strategy or a multinational strategy alone does not fully determine the subsidiary level (Jarillo/Martinez 1990; Birkinshaw/Morrison 1995). The level of local responsiveness and the level of integration may widely differ within a particular MNC. One reason is that the forces for global integration and the forces for local responsiveness not only differ by industry but may also *vary from country to country*. For example, trade barriers might be low, technological standardisation high and consumer demand similar for most nations, but the reverse might be true for a few countries.

Contingency but not Determination

Differentiation between subsidiaries, while most prominent in the transnational organisation, is to some degree used in all types of MNCs. Thus, in the perspective of the "differentiated network" (Nohria/Ghoshal 1997) the level of the subsidiary must be planned separately. While it is evident that multinationally-oriented MNCs have a relatively high percentage of independent subsidiaries with high autonomy to exploit local market opportunities (Harzing 2000, p. 107), and most subsidiaries of a MNC with a global strategy will be dependent on the headquarters and merely implement the global strategy, heterogeneity between subsidiaries is common.

Different Subsidiary Characteristics

Subsidiaries have different value-added chains, different resources, different local contexts, different capabilities and different performance. All these heterogeneous subsidiary characteristics will have an influence on the concrete strategy of the subsidiary. There are at least four groups of *influence factors* on the strategy of a particular subsidiary:

- influence of the industry (as reflected in the I/R-framework)
- influence of the MNC strategy (e.g. in the I/R-framework)
- influence of the specific host country
- influence of the subsidiary's own characteristics, e.g. its resources.

As a consequence, even in globally-oriented MNCs, some subsidiaries will have higher degrees of freedom and might even take over strategic roles. Even in multinationally-oriented MNCs, some subsidiaries will merely be responsible for producing products for a specific market without the autonomy to change their strategy or be pipelines for production from a centralised location. In particular in transnational organisations, it is obvious that the role of *each* subsidiary is planned separately (see Chapter 3). This may lead to highly dependent units in transnational organisations with very low autonomy and, in parallel, to units which might benefit from decentralisation and whose only task is to exploit local market opportunities in addition to specialised units which contribute to the MNC's competitive advantage by playing a strategic role.

Conclusion and Outlook

The I/R-framework builds on a *tension* that is usually considered the most relevant particularity of international management: the *dual forces* for global integration and for local responsiveness. Global efficiency on the one hand and multinational flexibility on the other hand are considered primary objectives of the MNC that are difficult to achieve simultaneously. Furthermore, worldwide learning is considered crucial for the innovation capacity of a MNC and a certain level of integration is beneficial for MNC learning.

Transnational Strategies the Exception Rather than the Rule

In the I/R-framework, *four MNC strategy types* are proposed, each being suggested for a specific external context. While the transnational strategy is the dominant strategy recommendation in literature, most empirical studies show that few MNCs actually follow this strategy. Thus, it is an "idealized MNC model" (Birkinshaw/Morrison 1995, p. 737) rather than a common phenomenon and the exception rather than the rule.

Complexity only if necessary

It should be kept in mind that all of the strategy types are considered adequate – under given *circumstances*. And that the complexity of a transnational strategy is ambitious and only justified if the requirements of the external environment are complex, with simultaneously high need for global integration and local responsiveness. Unfortunately, this situation occurs more and more often and, thus, the transnational strategy will likely become more common in the future.

Finally, it has to be emphasised that the *three levels* of *external environment*, *MNC strategy* and *subsidiary strategy* have to be clearly distinguished. While the three levels are closely linked to each other, the integration and the responsiveness on the three levels can vary. With more and more MNCs as differentiated networks, heterogeneity between subsidiaries of the same MNC is likely to increase.

Further Reading

YIP, G. (1989): Global Strategy - In a World of Nations?, in: Sloan Management Review, Vol. 31, No. 1, pp. 29-41.

HARZING, A. (2000): An Empirical Analysis and Extension of the Bartlett and Goshal Typology of Multinational Companies, in: Journal of International Business Studies, Vol. 31, No. 1, pp. 101-120.

Case Study: Retailing

The Retail Industry

Retailing is one of the world's largest industries (Zentes/Morschett/Schramm-Klein 2007, p. 1). The top 10 retailers in the world alone have combined sales above 1 trillion USD. The world's largest retailer, *Wal-Mart*, employs more than 2 million people around the world and has sales of about 400 billion USD.

The Top 10 Global Retailers

Table 2.2

Rank	Company	Country of Origin	Retail Sales 2008 (in million USD)	Main Store Formats	No. of Country Markets (2008)
1	Wal-Mart	USA	401,244	Supercenters, Discount Department Stores, Hypermarkets	15
2	Carrefour	France	127,958	Hypermarkets, Supermarkets, Discount Stores	36
3	Metro AG	Germany	99,004	Cash & Carry, Electronics Speciality, Hypermarkets, Department Stores	32
4	Tesco	United Kingdom	96,210	Superstores, Supermarkets, Convenience Stores	13
5	Schwarz Group	Germany	79,924	Discount Stores (Lidl), Discount Hypermarkets (Kaufland)	24
6	Kroger	USA	76,000	Supermarkets	1
7	Home Depot	USA	71,288	Home Improvement Stores	7
8	Costco Wholesale	USA	70,977	Warehouse Clubs, Cash & Carry	8
9	Aldi	Germany	66,063	Discount Stores	18
10	Target	USA	62,884	Discount Department Stores	1

Source: Deloitte 2010, p. G14.

While retailing has traditionally been a very local business and internationalisation lagged significantly behind the manufacturing sector, the last two decades have seen a remarkable change. A wave of internationalisation has resulted in a high level of internationalisation of the largest retailers (Swoboda/Foscht/Pennemann 2009). Companies like *IKEA*, *Benetton*, *Zara*,

Carrefour or *The Body Shop* are known around the world. The largest retailers and their international activities are displayed in Table 2.2.

Forces for Global Integration and Forces for Local Responsiveness

Over the last few decades, strong forces for global integration have been influencing the retail industry:

Converging Consumer Needs

- In different retail sectors, consumer needs became more *homogeneous* around the world. This has partly been driven by cultural convergence. For example, international TV series and media have led to a convergence in the fashion industry and cross-national target segments (e.g. in fashion styles) have emerged. The convergence of consumer needs has also been pushed by the global activities of the consumer goods manufacturers, though. The products of *Apple* or *Sony* in consumer electronics and communications, of *Nike* and *Adidas* in sports fashion, of *Electrolux* or *General Electric* in appliances, and so on, are in demand by consumers around the globe. While this trend is less strong in the food retail sector (where national and regional brands still have a high market share), food multinationals like *Nestlé*, *Unilever* and *Procter & Gamble* gain market shares and also push towards globalisation.

Costs

- Given that retailing is an increasingly complex business with high costs for infrastructure (stores, warehouses, IT-systems, etc.), *economies of scale* play a major role. International companies can more easily afford the necessary investments and IT-standardisation has become common – making at least an international harmonisation of IT-systems viable. Also, in many retail sectors, retail companies are confronted with the same suppliers in different countries. Integration of activities – in particular of *procurement activities* – is necessary to gain economies of scale in procurement and to gain negotiation power towards the supplier. The necessity of international procurement leads to purchasing organisations in China or India – something which can also be realised more easily when being globally integrated (Zentes/Morschett/Schramm-Klein 2007, pp. 266-275).

Trade Liberalisation

- Governmental drivers have facilitated international integration in a number of industries. Trade barriers for textiles have been drastically reduced. Within the EU, *free trade* allows retailers to transport goods from central warehouses to their stores in different countries without custom tariffs and other hindrances. Another governmental driver, the deregulation of the telecommunications sector, has caused the emergence of shops

for mobile communications across Europe, as well as in other parts of the world.

Global Competitors

- Furthermore, since many retailers have started to internationalise, more and more often, the different actors are confronted with global competition. Whether in home improvement retailing (with the internationalisation of *Kingfisher*, *OBI*, *The Home Depot* and others), in food retailing (with most large competitors now being internationally active), in consumer electronics (with companies like *Media-Markt* and *DSG*), more and more often the same companies meet in different foreign markets as competitors. To play "global chess" effectively, a certain level of coordination is obviously necessary. The relevance of global competitors becomes evident when observing the fashion industry. Companies like *H&M*, *Zara*, *Benetton*, etc. have changed this retail sector tremendously over the last decade.

Heterogeneous Demand

On the other hand, while for many different consumer goods a trend towards convergence can be observed, consumer demand is still *heterogeneous*. This is the case due to highly *disparate incomes*. Even within the industrialised world, per capita income is still very heterogeneous, and when considering the new markets for retailers, like Eastern Europe, China or even India, the differences are enormous. Consequently, expenditure for clothing, for electronics, for appliances, etc., also differs widely. In addition, consumer tastes differ for *cultural reasons*. Whether food tastes (which obviously differ strongly between countries such as France, the USA and India, for instance) or the taste concerning interior design which influences furniture retailers and home improvement stores, consumers around the world still differ.

Figure 2.3

External Environment: Forces for Global Integration and Local Responsiveness in Different Retail Sectors

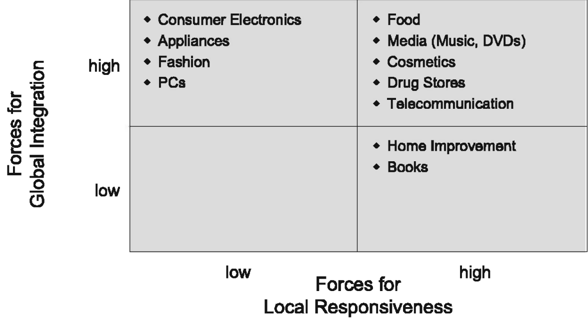


Figure 2.3 represents an attempt to categorise different retail sectors by the different I/R-forces. For example, in *consumer electronics*, consumer demand is rather similar worldwide and the standardisation of products and the existence of only a few suppliers worldwide leads predominantly to the need for global integration. On the other hand, supply for many product categories in *home improvement* is still rather local, as are consumer tastes. With "transnational" requirements, *food retailing* is experiencing enormous cost pressure and the emergence of global competitors, leading to the need for global integration. At the same time, disparate consumer income and consumer tastes, as well as remaining trade barriers (including the relevance of freshness, which hinders long logistics chains), lead to the necessity to adapt activities to the local markets. Similarly, when looking into *drug stores* and *cosmetics*, suppliers are more and more often the same (e.g. the large manufacturers of cosmetics and body-care products like *Nivea, Johnson & Johnson, L'Oréal* and *Procter & Gamble*) but consumer behaviour regarding cosmetics still differs greatly. For example, while tanning creams are sold in Western countries, whitening creams are sold in cosmetic stores in Asia. The existence of different skin types, hair colours, etc. in the human population globally requires simultaneously high global integration and local responsiveness.

Strategic Orientation of Retail Companies

External influences, like those depicted above, are not the only influence on a retail company's strategy. In addition, companies seem to have inherently different strategic orientations – even within the same industry sector. In Figure 2.4, a number of retail companies are categorised based on their dominant strategic orientation.

Global Orientation

As an example of a generally global orientation, the world's largest furniture retailer, *IKEA*, can be used. At *IKEA*, 95 % of the retail offer is the same around the world, including the famous *Billy shelf*. The company uses the same store format (large speciality stores) – big blue boxes with large car parks and a family-friendly set of services (like a children's club, restaurant, etc.). Concerning the communication strategy, *IKEA* attempts to use the same advertising messages and styles worldwide, as the catalogues from different countries reveal (see Figure 2.5).

As another example, *Media-Markt*, Europe's largest retailer of consumer electronics, follows a global strategy, where most elements of the company's business are rather standardised in the different markets in which the company is active. Currently, the company has about 700 outlets in 15 countries. The aggressive advertising focuses on the large selection within *Media-Markt*'s assortment and low prices. The German slogan, "Media-Markt – Ich

bin doch nicht blöd!" (Media-Markt – because I'm not dumb!), is used in a similar tonality in most of its foreign markets. For example, the slogan is reproduced as "Media-Markt – Parce que je ne suis pas fou!" (French), "Media-Markt – Ik ben toch niet gek!" (Dutch), "Media-Markt – Nie dla idiotów!" (Polish), or "Media-World – Non sono mica scemo!" (Italian).

Strategic Orientation of MNCs: Global Integration and Local Responsiveness of Selected Retail Companies — *Figure 2.4*

Some of the fastest growing chains in fashion apparel (like *H&M* and *Zara*) can also be considered to follow a global strategy. While some slight changes in the assortment are made, the general positioning, the store design and layout, the assortment, the advertising, the business processes, etc. are standardised across all markets internationally.

IKEA Catalogues from Selected Countries — *Figure 2.5*

Transnational Orientation

As an example of a different strategic orientation in the same retail sector, *DSG International plc* can be used. *DSG International* is Europe's second largest specialist electrical retailer, best known for its *Currys* stores in the UK. It also has a strong market position in other markets, with retail brands like *Electro World* (e.g. Greece and Central Europe), *Elkjøp* (in the Nordic countries), *UniEuro* (Italy), and *PC City* (Spain). Those chains adapt to the local market needs while some value-chain activities are still strongly integrated, for instance, by a central purchasing organisation. In the current strategy, the company seeks to strengthen global integration by simplifying processes, sharing of best practices and still more group buying.

Similarly, *Kingfisher* (with retail brands like *B&Q* in the UK and some other countries and *Castorama* in France) or the Chinese *AS Watson* (with *Watson* drug stores in Asia, *Rossmann* in Germany and Eastern Europe, *Superdrug* in the UK, *Kruidvat* in the Netherlands, *DC* in Ukraine and several other brands), use different retail brands and formats in different countries while trying to exploit synergy effects by joint purchasing and financial activities. These can be considered MNCs with a *transnational orientation*.

In food retailing, a number of companies follow a transnational orientation, having similar activities globally. For example, *Carrefour* operates – among other formats – hypermarkets with a very similar merchandise structure worldwide. This means that the number of articles is similar, the product categories that are being sold are similar, a certain share of store brands are sold, the store layout is somewhat similar, etc. At the same time, the assortment itself, i.e., the concrete products being offered, differs considerably around the world. Local brands are offered, local tastes in food are considered, the presentation of certain product categories (e.g. fish or other fresh food) is tailored to the local customers' habits', etc. Group purchasing for global brands and often for store brands is combined with a rather high percentage of local purchasing in the respective country. For a food retailer, at least 60-70 % of the assortment has to be procured locally to be cost-competitive.

On the other hand, *Aldi*, as a discounter, follows a more global approach. Since its offer consists mainly of store brands, there is no necessity to add local brands to the assortment. While procurement still has to be local to a certain degree and the assortment is slightly adapted (for example, in Switzerland, one-third of the assortment is Swiss products), the overall strategy, the number of stock keeping units (SKUs), the strict policies and the business model are transferred to most foreign markets without major adaptations.

Multinational Orientation

It is also in food retailing, however, where pure *multinational strategies* by retail companies can be found. For example, the German retail company *Tengelmann* operates – among other activities – supermarkets in Germany

(*Kaiser's* and *Tengelmann*) and supermarkets and superstores in the USA (*A&P*). Both concepts are strongly adapted to each local market and joint activities, i.e., integration, are almost non-existent. Similarly, the *Delhaize* group operates *Delhaize* supermarkets in Belgium, *Alfa-Beta* supermarkets in Greece, *Mega Image* markets in Romania, *Food Lion* (and some other supermarket brands) in the USA and *Super Indo* supermarkets in Indonesia. The activities are only loosely coupled and in some cases (like *Super Indo*), *Delhaize* does not own the activity as a wholly-owned subsidiary but only holds a stake in the subsidiary. Obviously, then, a full integration would not be possible and local responsiveness is much more likely.

Strategies for Specific Retail Subsidiaries

Even if the strategic orientation of a MNC is clear, specific country subsidiaries might follow the same or a deviating strategy (see Figure 2.6). The reasons for this can be manifold. There can be reasons internal to the company or factors in the external environment.

Strategy of Subsidiaries: Integration and Adaptation of Specific Retail Subsidiaries — *Figure 2.6*

Best Buy Canada

Best Buy, overall, follows a transnational approach. It seeks to expand its speciality "big-box" retail format (e.g. in Mexico, Canada, China) but it tries to exploit the markets even better by adding other, country-specific formats to its store portfolio. This is an interesting implementation of a transnational strategy. For example, in Canada, *Best Buy* bought the market leader, *Future Shop*, in 2001, and the stores continue to operate under this name. In addition, *Best Buy* started to open *Best Buy* stores all over Canada. As of the beginning of 2009, there are about 50 *Best Buy* stores and 130 *Future Shop* stores,

indicating that the market potential is still mainly exploited with the *Future Shop* retail brand.

Best Buy UK

In a very different but also transnational approach, *Best Buy* entered the United Kingdom in 2008 by establishing a joint venture with a local partner, *The Carphone Warehouse*. This company is the largest independent European retail chain for mobile phones and linked services. It now focuses on "the wireless world" and operates small stores with a focus on mobile phones, subscription services, notebooks (also linked to subscriptions), etc. As a main reason for the cooperation, *Best Buy* mentions the complementary skills in products, in particular the sale of subscriptions, and retail formats, but also *The Carphone Warehouse*'s knowledge of the European markets. Hence, in the UK, *Best Buy* now operates small stores under the retail brand *The Carphone Warehouse*. In Spring 2010, it also started to open large speciality stores in the UK with the retail brand *Best Buy*.

Media-Markt in Russia

Considering *Media-Markt*, the rather global approach has been described above. However, when *Media-Markt* entered Russia in 2006, a Russian competitor had copied the advertising concept, the corporate colours, etc. to establish a barrier to market entry. *Media-Markt* had to react and change its concept for this local market. Now, *Media-Markt* uses magenta instead of its usual corporate colours and has had to adapt other parts of its market appearance as well.

Tesco Japan

Tesco uses a rather standardised store format (hypermarkts or superstores) in most of its international operations. This, in general, is already a transnational strategy, since the assortments, logistics strategies, etc. are adapted to the local market. In Japan, however, a more *local strategy* is followed, with a very high responsiveness to the market. Since Japanese customers prefer to shop for small amounts of very fresh food daily, convenience stores are a very popular format there and *Tesco*'s hypermarket format is not likely to suit the local needs. In 2003, *Tesco* acquired 78 discount convenience stores that are concentrated in and around Tokyo. These stores mainly operate under the name *Tsurukame*. Further acquisitions followed and *Tesco* now operates 125 stores in the Tokyo area. The format is mainly convenience stores and the main retail brand is still *Tsurukame*. Overall, *Tesco Japan*'s competitive strategy is to compete on price in the Japanese convenience store market

ASDA by Wal-Mart

To consider a final example of a subsidiary that is tightly integrated with the rest of the MNC and still adapts closely to the local market, *ASDA*, the subsidiary of *Wal-Mart* in the UK, can be mentioned. *Wal-Mart* acquired this subsidiary and found that many elements of the existing business concept were very successful. Hence *Wal-Mart* maintained major elements (like the store fashion brand "*George*", and even the name *ASDA*) while integrating

other elements (like IT) with its other operations. Following the idea of transnational organisations that specific subsidiaries can serve as competence centres, some aspects of *ASDA*'s business have been adopted in other *Wal-Mart* subsidiaries and even in the USA. The acquisition of 193 rather small food stores from Netto Dansk in the UK, announced in May 2010, further demonstrates Wal-Mart's intention to adapt to local conditions. These stores with an average surface of only 750 sqm, compared to ASDA's 4,300 sqm, are a part of Wal-Mart's announced plan to grow in the UK by opening smaller supermarkets.

Rossmann Central Europe

AS Watson's subsidiaries may serve as an example of "global" subsidiaries in a multinationally-oriented MNC. Usually, *AS Watson* uses local retail brands in each country market. In most cases, these retail brands have been acquired and are maintained since the consumers know these local retailers and have developed loyalty to them. However, in several markets, a rather standardised approach is followed. Together with the German retail company *Rossmann* (in which *AS Watson* holds a major stake), *AS Watson* operates a 50:50 joint venture called "*Rossmann Central Europe*". This joint ventures runs a chain of more than 500 drug stores by the name "*Rossmann*" in Poland, Hungary and the Czech Republic which largely follow the store model that has been developed in Germany and which strongly integrates the international activities (like purchasing and store brand development) of this group of subsidiaries.

Summary and Outlook

"Retail is local"

Retailing is becoming increasingly international and retail MNCs are now a common phenomenon. Overall, a trend towards global integration can be observed in many retail sectors, partly pushed by the globalisation of consumer goods manufacturers and partly by the increasing global competition. At the same time, however, strong international heterogeneity remains and "*retail is local*". Thus, in many retail sectors, local responsiveness is a necessary success factor.

Overall, the dual needs of global integration and local responsiveness are posing a strong challenge, in particular in the retail industry because retailers are in daily direct customer contact – leading to the need for flexible market reactions – but they are also distribution channels for global suppliers, resulting in the requirement of a certain level of coordination. Which balance between the dual needs is optimal differs between retail sectors and is not stable over time. Thus, a dynamic development of the I/R-strategy on all relevant levels is necessary.

Questions

1. For a particular retail sector, fashion, very different strategic orientations can be observed. Analyse the strategies of *Zara*, *H&M* and *C&A* in Europe regarding the I/R-framework and discuss why the different strategies are applied.
2. Compare *Media-Markt*'s strategy with DSG International's strategy, regarding the I/R-framework.
3. *Aldi* and *Lidl*, both of German origin, are hard discounters. Evaluate their strategic I/R orientation, then investigate their operations in the United Kingdom. To what degree are their British activities integrated with the MNC's activities, to what degree are they adapting to the local context?

Chapter 3

Role Typologies for Foreign Subsidiaries

Differentiated networks consist of heterogeneous organisational units in different countries. Different subsidiaries can play different roles within the MNC network and numerous classifications of generic subsidiary strategies or roles are proposed to clarify those strategies. The aim of this Chapter is to give an overview on existing role typologies and discuss the strengths and weaknesses of the role typologies for international management.

Heterogeneous Roles of Subsidiaries

Until the mid-1980s, as Bartlett/Ghoshal (1986) observed, many MNCs treated all their foreign subsidiaries in a "remarkably uniform manner". In their critique, they labelled this the "United Nations Model" in which the MNC applied its planning and control systems uniformly worldwide, involved each subsidiary's management equally (weakly) in the planning process, and evaluated them against standardised criteria. This uniformity can be partly explained by the fact that foreign subsidiaries were long (uniformly) seen as only "market access providers", without major autonomy and without their own contributions to the company strategy (see, e.g., Vernon 1966).

However, it became increasingly obvious that this symmetrical, uniform way of international management limited the exploitation of the benefits of internationalisation (Bartlett/Ghoshal/Beamish 2008, p. 719). The conceptualisation of the *MNC as a differentiated network* (Ghoshal/Nohria 1989), in which different subsidiaries can have individual tasks to fulfil and be assigned strategically important roles, is increasingly acknowledged to be a better design to exploit the capabilities of the different subsidiaries and the advantages of their locations. As has been shown in Chapter 1, in network firms, competitive advantages do not solely stem from headquarters in the home country but can also be created by foreign subsidiaries and then transferred and exploited throughout the network. Instead of a "centre-periphery" view, this evokes a multi-centre perspective of the MNC with distributed resources, capabilities, functions and decision powers (Schmid 2004, p. 238).

Given the premise that each subsidiary has a unique role to play in the MNC (Birkinshaw/Morrison 1995, p. 732) it is a major objective of role typologies to clarify those roles. This includes: to identify the different roles of subsidi-

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aries, to distinguish them clearly, to determine the antecedents and consequences, e.g. regarding the coordination of subsidiaries in different roles and their relations with other actors in the MNC and in the host country.

Role Definition

As a starting point, though, what the "role" of a subsidiary is has to be defined. Roles are closely related to the *task* of a foreign subsidiary in the company network (Andersson/Forsgren 1996, p. 489): most role typologies see roles as *alternative strategies* of foreign subsidiaries (Couto/Goncalves/Fortuna 2003, p. 3). A role can be understood as a statement of purpose. It includes the task, the market, and the customer the division is concerned with (Galunic/Eisenhard 1996, p. 256). It can be "*defined as the business – or elements of the business – in which the subsidiary participates and for which it is recognized to have responsibility within the MNC*" (Birkinshaw/Hood 1998, p. 782). Thus, a role is the specific task of a subsidiary, e.g. "to sell the MNE's products in Australia, or to manufacture a line of products for the European market" (Birkinshaw 2001, p. 389).

Roles as Subsidiary Strategies

Some authors distinguish between a *role* (which is assigned to the subsidiary) and a *subsidiary strategy* (which is seen to suggest some level of self-determination by the subsidiary) (Birkinshaw 2001, p. 389). Usually, the distinction is difficult and the specific task and activity of the subsidiary is partly assigned by the headquarters, partly self-determined and partly negotiated between the subsidiary and its headquarters. Thus, in this book, the word "role" is seen as synonymous with the subsidiary strategy.

Different Role Typologies

A large number of role typologies have been proposed in the literature. A few overviews on those typologies can be found (e.g. Hoffman 1994; Schmid 2004; Morschett 2007, pp. 210-254). In most cases, the dimensions along which roles are described are (Morschett 2007, pp. 250-254):

- the *external context* of the subsidiary, e.g. the relevance of the host country or the complexity of the environment
- the *internal context* of the subsidiary, e.g. the strategic orientation of the MNC or the level of local resources or competences of the subsidiary
- *coordination variables*, e.g. the level of autonomy
- the *strategy* or task of the subsidiary, e.g. the primary motives for its establishment, the share of internal or external sales, the knowledge in- and outflows, the markets served, products offered or value-added activities carried out.

In addition to those, many typologies in the literature focus on specific value-added functions, e.g. on R&D or on manufacturing activities. Some of these typologies will be discussed in Chapters 16 and 17. In this Chapter,

four role typologies that represent typical examples of role typologies on the subsidiary level are presented.

Selected Role Typologies

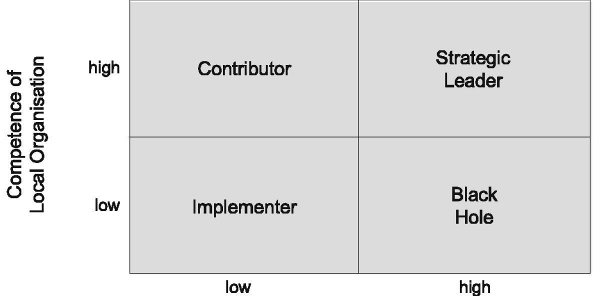
Role Typology by Bartlett/Ghoshal

Following their critical evaluation of the "United Nations Model", Bartlett/Ghoshal (1986) have proposed an organisational model of differentiated rather than homogeneous subsidiary roles and of dispersed rather than concentrated responsibilities. More specifically, they suggest a role typology with *two dimensions* (Bartlett/Ghoshal 1986, p. 90):

Dimensions of Bartlett/Ghoshal

- The *strategic importance of the local environment* in the host country is the first dimension. Strategic importance can be given due to market size, but also, for instance, due to a particularly sophisticated or technologically advanced market.
- The second dimension considers the subsidiary itself and captures the *level of internal competences* and capabilities.

Role Typology by Bartlett/Ghoshal — *Figure 3.1*



Source: Adapted from Bartlett/Ghoshal 1986, p. 90.

Four Roles of Bartlett/Ghoshal

In a typical process for role typologies, the authors assume two dichotomous scale values for each of the dimensions (high/low) and, thus, develop *four roles* by combination (see also Schmid/Bäurle/Kutschker 1998; Rugman/Verbeke 2003a):

- If a highly competent national subsidiary is located in a strategically important market, it can serve as a *partner* of the headquarters in developing and implementing strategy. In the role of *strategic leader*, the subsidiary can take the lead within the MNC, e.g. for a certain product or a certain value-added function. Other authors that identify this role use labels like "world product mandate", "active", "lead-country", "centre of excellence" for similar roles. It is particularly relevant in MNCs with a "transnational orientation" (see Chapter 2).

- A *contributor* role can be filled by a subsidiary in a small or generally less important market which nevertheless has distinctive capabilities. It can contribute to the competitive advantage of the MNC particularly well if the specialised and unique capabilities that exceed what is necessary in its own local market are used for (limited) projects that have a company-wide relevance.

Implementer as the Most Common Role of Subsidiaries

- A foreign subsidiary in a strategically less important market that has just enough competence to maintain its local operation may be assigned the role of an *implementer*, which is the most common role for subsidiaries. These subsidiaries lack the potential to contribute to the MNC strategy beyond their local function. Thus, such a subsidiary is given the task of efficiently and effectively exploiting the local market potential and *implementing the defined strategy*. This role type is also commonly considered in role typologies, with names like "local implementor", "miniature replica", "branch plant", "receptive subsidiaries", or, as a similar role, "marketing satellite". It is a role that typically results from a "global orientation" (see Chapter 2) of a MNC.

- As a fourth situation, some markets are so relevant that they would need a strong local presence to maintain the company's local and global position, however, the local subsidiary is lacking the capabilities to fulfil this requirement. In this negative situation of a *black hole*, the MNC has to find a solution and "to manage one's way out of it" (Bartlett/Ghoshal 1986). One possible strategic move here is the choice of a strong local partner which helps to evolve the subsidary's competences (Rugman/Verbeke 2003a).

Roles and Coordination

Often, role typologies indicate which *coordination mechanisms* are appropriate for subsidiaries with different roles (see also Part III). For example, Bartlett/Ghoshal (1986) emphasise that when the roles are differentiated, the MNC must differentiate the way it manages those subsidiaries, depending on the particular role. For example, implementers can be managed by formalisation and similar mechanisms to ensure tight control. Contributors may be centrally coordinated but the headquarters must be careful not to discourage and frustrate local management. For subsidiaries that act as strategic leaders,

however, control should be quite loose and decentralised, and the main task of the headquarters (HQ) is to support the subsidiary with the necessary resources and freedom needed for the entrepreneurial role it has to play.

Role Typology by White/Poynter

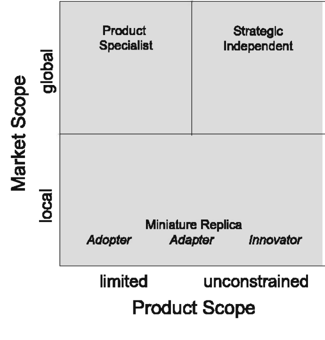
More complex is another role typology that has been suggested by White/Poynter (1984; see also Schmid/Bäurle/Kutschker 1998, pp. 9-10). They describe the role of a subsidiary along *three dimensions*:

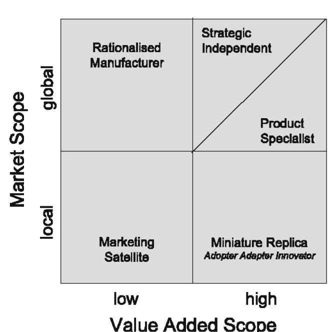
Dimensions of White/Poynter

- The *market scope* refers to the number of geographical markets on which the subsidiary is allowed to be active. In the typology, a dichotomy between "local" (i.e. a focus on the host country) and "global" is applied.
- With the *product scope* the authors capture the breadth of products a subsidiary manufactures or sells. Here, the distinction is between a limited scope with only single products and an unconstrained scope, where the subsidiary offers many product lines and often is even allowed to introduce further product extensions autonomously.
- The *value-added scope* describes whether the foreign subsidiary only carries out single value-added functions (often either marketing or production or R&D) or whether it realises a broad value-added spectrum, up to a full value chain in the host country.

Role Typology by White/Poynter

Figure 3.2





Source: Adapted from White/Poynter 1984, p. 60.

Five Roles of White/Poynter

White/Poynter (1984, pp. 59-60) explain that the dimensions are influenced, inter alia, by local and global competitive forces and the competence level of the subsidiary. The three dimensions are combined to establish five roles (see Figure 3.2):

- A *miniature replica* serves the host country market with rather comprehensive value-added functions. The product scope can vary. Miniature replicas are, as the name indicates, *very similar* in their design *to their headquarters*. Reasons for this role can be high local demand preferences, high trade barriers, production subsidies in the host country, and/or relatively small scale effects in production in the industry which allow a distributed production. Miniature replica is considered to be a very common role. Depending on the product scope, the autonomy and its own creative activity, the miniature replica might vary from *adopting* to *adapting* to *innovating*.
- A subsidiary that acts as a *marketing satellite* also serves the local market only but focuses on a few value-added functions, mainly marketing & sales. The product scope can vary. Most frequently, products which are produced in the home country are imported and sold in the host country.
- *Rationalised manufacturers* are units that are responsible for a broad geographical area but only limited value-added functions. Often this is the manufacture of a few products (or even just product components) for the world market (or at least a larger number of countries).

World Product Mandates

- *Product specialists* have the worldwide responsibility for one product or one product line within the MNC and realise the full value-added chain for this product. Regarding this product, the subsidiary has a so-called *world product mandate*. This role is emphasised in many role typologies. It is considered to have high decision autonomy, but since there is a high interdependency with other units (who might buy and sell the products in their specific countries, or who might produce other product lines and sell them to the product specialist), this autonomy cannot be unlimited (Roth/Morrison 1992, p. 718). The empirical relevance of this role is the subject of controversy. Some authors argue that many headquarters hesitate for strategic reasons to assign their foreign subsidiaries such broad responsibilities and that – besides some exceptions – this role is still mainly filled by the headquarters itself (D'Cruz 1986, pp. 84-86).
- Subsidaries that act as *strategic independents* also carry out many value-added activities and they do this for a very large number of markets. The product scope is unconstrained. Here, the subsidiary is seen to be only loosely coupled to headquarters, which in this situation acts more as a financial holding, giving very far-reaching autonomy to the subsidiary.

Role Typology by Gupta/Govindarajan

A very different role typology has been presented by Gupta/Govindarajan (1991). They understand the MNC as *"a network of capital, product, and knowledge transactions among units located in different countries"* (Gupta/Govindarajan 1991, p. 770), following the network perspective of authors like Bartlett/Ghoshal and others.

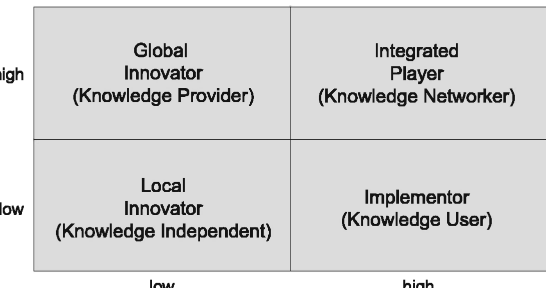
Knowledge Flows

To reduce complexity, they focus on knowledge flows for their typology. One reason for this choice is that the modern literature on MNCs has shown an increasing share of complex, transnationally-oriented MNCs (see Chapter 2), and it is specifically in the case of *transnational MNCs* that knowledge flows across subsidiaries become particularly significant. Moreover, most modern economic theories on the MNC suggest that FDI occurs predominantly because of a desire to internalise knowledge flows, and thus, an analysis of knowledge flows investigates the core of the MNC (Gupta/Govindarajan 1991, p. 772).

Dimensions of Gupta/Govindarajan

Focusing on variations in knowledge flow patterns, the authors have proposed that MNC subsidiaries could be categorised along *two dimensions*: Subsidiaries can engage in different levels of knowledge outflows to the rest of the corporation and in different levels of knowledge inflows from the rest of the MNC.

Role Typology by Gupta/Govindarajan — *Figure 3.3*



(In brackets, the terminology of Randøy/Li (1998) is displayed.)

Source: Gupta/Govindarajan 1991, 1994.

From those two dimensions they derive *four generic subsidiary roles* (Gupta/Govindarajan 1991, pp. 774-775) which were also used by Randøy/Li (1998), with a slightly different terminology (see Figure 3.3):

Four Roles of Gupta/ Govindarajan

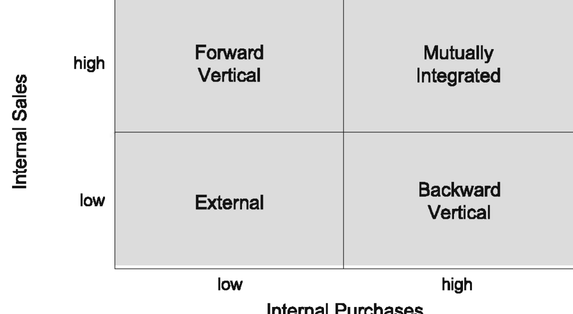
- A *global innovator* (*knowledge provider*) is predominantly a source of knowledge for other subsidiaries and the headquarters. An example of such a knowledge-providing subsidiary might be *SAP Labs US*, in which a significant portion of *SAP*'s technological innovations have originated. The subsidiary that is located in Palo Alto, California, maintains strategic relationships with local organisations such as Stanford University, and its mission is to leverage the valuable assets within Silicon Valley to drive innovation (see the motive of *strategic asset seeking* in Chapter 4).
- An *integrated player (knowledge networker*) is also responsible for creating knowledge that can be utilised by other subsidiaries: However, the knowledge networker additionally has to rely on knowledge from others and thus receives and sends high levels of knowledge to and from the subsidiary. With this bi-directional integration in knowledge flows, it can be considered a "centre-of-excellence" that is tightly embedded in the MNC and at the same time in its local environment (Frost/Birkinshaw/ Ensign 2002).
- The *implementor (knowledge user*) relies heavily on knowledge inflows from the headquarters and from sister subsidiaries, and exploits the competitive advantages stemming from that knowledge in its host market without initiating high knowledge outflows to the rest of the corporation.
- Finally, the *local innovator (knowledge independent*) role implies that the subsidiary is isolated from knowledge flows in the MNC and has to take local responsibility for the creation of the necessary know-how itself. Referring to the network models, companies with a *multinational orientation* (Bartlett/Ghoshal 1989) consist mainly of subsidiaries that can be considered as knowledge independents.

Role Typology by Andersson/Forsgren

Similar to the idea of Gupta/Govindarajan (1991), Andersson/Forsgren (1994) consider transactions between the subsidiaries and the rest of the MNC as relevant dimensions but they focus on *product flows* instead of knowledge flows.

Role Typology by Andersson/Forsgren

Figure 3.4



Source: Andersson/Forsgren 1994, p. 15.

Dimensions of Andersson/ Forsgren

Andersson/Forsgren characterise the role of the subsidiary along *two dimensions*:

- *internal sales*, i.e. share of output of the foreign subsidiary that is not sold to external customers but to the headquarters or peer subsidiaries, and
- *internal purchases*, i.e., the share of inputs like raw materials, components, semi-finished products and intangible goods, that is not delivered by external suppliers but by the headquarters and other units of the MNC.

Four Roles of Andersson/ Forsgren

From these two dimensions and the dichotomous scale values high/low, *four roles* are distinguished (see Figure 3.4; Andersson/Forsgren 1994, pp. 14-15):

- An *external subsidiary* is a subsidiary that receives and sends a low share of its inputs and outputs to the rest of the MNC. Thus, it produces with a low integration in the MNC and sells its products to external customers. Such a subsidiary role is particularly common in MNCs with a *multinational orientation* (see Chapter 2).
- Contrarily, a *mutually integrated subsidiary* is very tightly integrated in the MNC, on the sales and on the supply side.
- A *backward vertical subsidiary* supplies a major part of its inputs from the MNC and sells its products to external customers. This is the traditional role for many subsidiaries which act as sales units in the foreign market (or units with a minor value-added of their own), in particular in MNCs with a *global orientation*.

- Inversely, a *forward vertical* is a foreign unit which buys its material, products, and components from external sources in the host country and delivers its products mainly to the rest of the MNC. Here, the sales objective of the subsidiary is not dominant, but rather *efficiency-seeking* in production or *resource-seeking* in the host country (see Chapter 4).

Weaknesses and Deficits of Role Typologies

Looking at the large number of role typologies that are offered in the literature, one can consider this a proof of their relevance but one could also consider this an apparent weakness. New role typologies frequently propose new dimensions for categorising subsidiaries but they seldom discuss why those new dimensions should be superior to the dimensions previously used in other typologies. A theoretical foundation for the dimensions is often missing and the dimensions seem to be chosen by plausibility, not by a thorough analysis. A certain level of *arbitrariness in the selection of role dimensions* can be observed (see Schmid 2004, pp. 246-248 with a comprehensive critique). Consequently, publications and suggestions for role typologies are frequently non-cumultative, neglect prior research results, and are not connected to each other (Hoffman 1994, p. 82). It remains unclear which of the various dimensions that are considered for role typologies are really crucial for international management, e.g. for the coordination of the subsidiary or for its performance.

Another major point of critique is the *over-simplification of subsidiary roles* that might emerge from the typologies. With mostly two dimensions and usually two values per dimension, most typologies offer four different subsidiary roles. One important reason is obviously the easy visualisation of four-role typologies. Nevertheless, this can obviously be seen as a defect, in particular, since four roles are most likely too few to describe the great "heterogeneity of subsidiaries" which is the starting point of the models.

In particular if at least some of the many typologies really have managed to describe subsidiaries along relevant dimensions, then it becomes clear that a large number of relevant characteristics of a subsidiary exist along which the role can be fixed, and multi-dimensional role typologies might be superior.

Benefits of Role Typologies

Even when accepting their deficits, role typologies have shifted the focus of international management research to the level of the subsidiary as research unit to understand better the different strategic roles that a subsidiary can take. The typologies emphasise that MNCs consist of a large number of

organisational units in different countries in the form of a differentiated network which can take on particular roles within the MNC. Thus, role typologies contribute to a change of perspective in international management.

While the traditional perspective clearly saw the home country organisation as "centre" and the subsidiary as "periphery", new concepts of the MNC – and the related role typologies – emphasise that subsidiaries can take on highly relevant strategic tasks within the company network and develop into strategic decision centres in the MNC. While it remains open whether these roles are still assigned by the HQ in a hierarchical manner or *subsidiary initiative* is the origin of the subsidiary role (Birkinshaw 1997), most typologies focus on the dimensions and characteristics along which subsidiaries can be distinguished. One benefit of the typologies surely is to illustrate the vast dimensions of distinction.

Conclusion and Outlook

Role typologies are one way of analysing the heterogeneity of MNC networks. In doing so, all role typologies are based on similar assumptions (Schmid 2004, p. 244):

- Different subsidiaries can take on different roles.
- There is a limited number of roles for subsidiaries which can be used to describe the actual or intended behaviour of the subsidiary.
- The roles can be distinguished by a rather limited number of role dimensions.

While these assumptions obviously pose the risk of adopting a simplified perspective of a very complex problem, the exercise has contributed to a better understanding of the "differentiated network" view of the MNC.

Based on the role of the subsidiary, it becomes easier to decide other central questions of international management, e.g. the coordination of subsidiaries, or, more generally, the appropriate headquarters-subsidiary relations, since a uniform treatment of heterogeneous subsidiaries has been demonstrated to be inadequate.

The Blind Scholars and the Elephant

Considering the criticism that role typologies over-simplify, one might recall the Indian tale of the six blind scholars and the elephant. In this story, six blind scholars attempt to understand and to describe what an elephant is. The first blind man comes from the side and feels that it is sturdy, large and straight. He declares the animal a "wall". The second feels the trunk in his hand, that is round and bending and states that the elephant is like a snake. The third feels the leg and thinks the elephant is similar to a tall tree. The

other three declare the elephant as a rope (based on the tail), a sharp spear (based on the ivory tusk) and a fan (based on the ear). Mintzberg, Ahlstrand and Lampel (2005) have taken this parable about *the many-sidedness of things* to explain *the many facets of corporate strategy*. It illustrates that basically, all of them are right, and at the same time all of them are wrong, because they only see part of the truth. The same holds true for the investigation and analysis of a complex organisation like a MNC. It seems to make sense to analyse a subsidiary from very different angles and through different lenses, without forgetting that this is not the whole picture. Role typologies should thus be considered as lenses through which subsidiary strategies within a MNC can be viewed. Eventually, these lenses have to be combined into a more comprehensive analysis, but role typologies can be a good starting point for analyses in international management.

Further Reading

BARTLETT, C., GHOSHAL, S., BEAMISH, P. (2008): Transnational Management, 5th ed., Boston, MA, McGraw-Hill, Chapter 7.

SCHMID, S. (2004): The Roles of Foreign Subsidiaries in Network MNCs – A Critical Review of the Literature and some Directions for Future Research, in: LARIMO, J. (Ed.): European Research on Foreign Direct Investment and International Human Resource Management, Vaasa, Vaasan Yliopiston Julkaisuja, pp. 237-255.

Case Study: ABB[1]

Profile, History, and Status Quo

Pre-Merger History

Headquartered in Zurich, Switzerland, *ABB* is a global leader in power and automation technologies, offering a vast product portfolio ranging from light switches to robots, and from huge electrical transformers to control systems that manage entire power networks and factories. The company was formed in 1988 through a merger between *Asea AB* and *BBC Brown Boveri AG*.

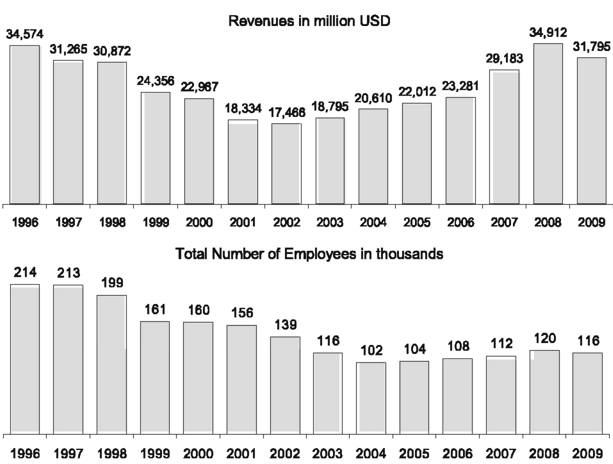
Asea AB was founded in 1883 by Ludvig Fredholm as a manufacturer of electrical lights and generators, and was a major participant in the introduction of electricity into Swedish homes and businesses as well as in the development of Sweden's railway network. In the 1940s and 1950s, *Asea AB* diver-

[1] Sources used for this case study include different country web sites of ABG, www.worldbank.com, www.cia.org, www.ec.europa.eu/eurostat, www.onvista.de, various annual and company reports as well as explicitly cited sources.

sified into the power, mining and steel industries. Initially founded as *Brown Boveri & Cie.* and later renamed *BBC, Brown Boveri AG* was formed in Switzerland in 1891 and specialised in power generation and turbines. In the first half of the twentieth century, the company expanded its operations throughout Europe and broadened its business operations, offering a wide range of electrical engineering activities. In January 1988, *Asea AB* and *BBC Brown Boveri AG* decided to combine almost all of their businesses in the newly formed *ABB Asea Brown Boveri Ltd*, of which they each owned 50 per cent. At the time of the merger, *Asea AB* generated revenues of 46 billion SKR (equals 5.7 billion USD) and employed 71,000 employees while *BBC Brown Boveri AG*generated revenues of 58 billion SKR (equals 7.3 billion USD) and employed 97,000 employees. *ABB* can therefore be seen as a *"merger of equals"*.

Revenue and Employee Development from 1996 until 2009

Figure 3.5



Source: Various annual reports of ABB.

Post-Merger History

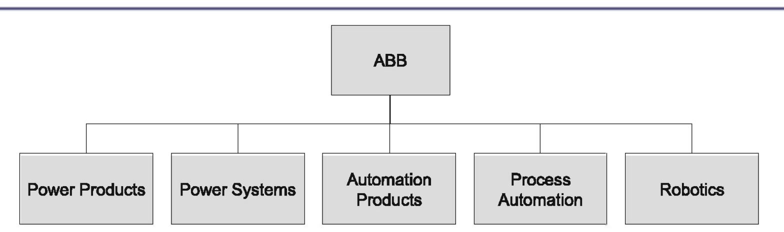
After the merger, the newly-formed *ABB* pursed an aggressive growth strategy, acquiring about 40 companies in its first year and almost simultaneously commenced an extensive expansion programme in Central and Eastern Europe following the removal of the Iron Curtain in 1989. The growth strategy was replaced by a phase of restructuring and downsizing, starting by the end of the 1990s and lasting into the first years of the new millennium. The downsizing involved, for instance, the divestment of the nuclear

power generation and rail businesses in order to focus on market strengths in alternative energies. The emphasis on alternative energies is also underpinned in the company's vision statement: "As one of the world's leading engineering companies, we help our customers to use electrical power efficiently, to increase industrial productivity and to lower environmental impact in a sustainable way. Power and productivity for a better world." However, as displayed in Figure 3.5, the reorganisation endeavours left their mark in the revenue and employee figures of the group. After successfully refocusing its operations, the company returned to a healthy growth track in 2003, generating revenues of 31.8 billion USD and employing 116,000 people in 2009. The majority of revenues were generated in Europe (41 %) followed by Asia (27 %), the Americas (19 %) and the Middle East/Africa (13 %).

Company Structure

ABB Ltd., Switzerland, is the ultimate parent company of the *ABB Group*, which principally comprises 323 consolidated operating and holding subsidiaries worldwide.

Figure 3.6 *Divisional Structure of ABB*



Source: ABB 2010, p. 59.

The operative business of *ABB* is managed through a divisional structure. *ABB* comprises five divisions: Power Products, Power Systems, Automation Products, Process Automation, and Robotics (see Figure 3.6).

- *Power Products* are key components to transmit and distribute electricity, such as switchgear. The division's primary customers are utilities, distributors, wholesalers, installers and original equipment manufacturers (OEMs) in the utilities, transportation and power-generation industries. In 2009, the division had about 33,300 employees, generated revenues of 11.2 billion USD and its EBIT was 1,969 million USD. *Power Products* is the company's most profitable division with an EBIT margin of 17.5 %.

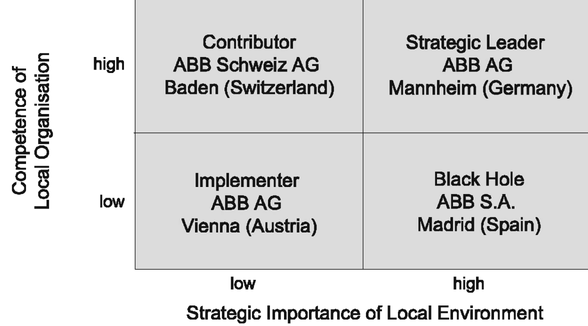
- *Power Systems* deliverables include, for example, network management, utility communication, transmission and distribution substations, and flexible alternating current transmission systems. The division sells primarily to utilities and power generation industries. In 2009, the division had about 16,000 employees, generated revenues of 6.5 billion USD and contributed an EBIT of 388 million USD to the overall financial result.
- *Automation Products* comprises a wide range of products and services including, for instance, low-voltage switchgear, breakers, and switches. As a whole, the division manufactures approximately 170,000 different products and has more than 100 manufacturing sites in 50 countries. The majority of these products are used for industrial applications, but also in buildings and in markets such as utilities and rail transportation. In 2009, the division had about 35,000 employees, generated revenues of 8.9 billion USD and gained an EBIT of 1,330 million USD.
- The *Process Automation* division delivers industry-specific solutions for plant automation and electrification, energy management, process and asset optimisation, analytical measurement and telecommunications. The industries served include oil and gas, power, chemicals and pharmaceuticals. In 2009, the division had about 25,500 employees, and generated revenues of 7.3 billion USD and an EBIT of 685 million USD.
- The *Robotics* division offers robots, services and modular manufacturing solutions for use in assembly, finishing and machine tending. *ABB* has installed more than 160,000 robots worldwide. Key markets include the automotive and manufacturing industries, in addition to applications in foundry, packaging and material handling. In 2009, the division had about 4,200 employees, and generated revenues of 970 million USD and an EBIT of -296 million USD.

Strategic Importance and Competence as Dimensions of Subsidiary Roles

The role typology by Bartlett/Ghoshal (1986) is arguably the best-known and most cited role typology in the field of International Management (Kutschker/Schmid 2008, p. 342). As a consequence, this case study aims to illustrate the role of four *ABB* subsidiaries of *ABB*[1] by using this framework (see Figure 3.7).

[1] All subsidiaries presented in this case study are wholly-owned subsidiaries of ABB.

Figure 3.7 *Selected ABB Subsidiaries According to the Role Typology by Bartlett/Ghoshal*



Strategic Leader

Germany is the world's fourth largest economy with a GDP of 3,650 billion USD in 2008. Hence, just considering the pure size of the market, Germany is doubtless a market of major strategic importance. Moreover, Germany is also well-known as a sophisticated and technologically advanced engineering market. The CIA world fact book, for instance, describes the German economy as "affluent and technologically powerful". With revenues of 3,185 million EUR and 10,600 employees in 2009, the German market is of major importance for *ABB* in terms of revenues, as well as in terms of manpower.

ABB AG (Germany) is arguably the most important subsidiary and simultaneously represents the German headquarters of *ABB*. *ABB AG* (Germany) is located in Mannheim and with a share capital of 167.5 million EUR it is one of the biggest subsidiaries worldwide. Apart from the country and functional management, Mannheim is also the location of various engineering and service units, further underpinning the competence of the subsidiary. Those units are closely connected to the corporate research centre in Ladenburg, Germany, and not only from a geographical perspective. As part of the *ABB* global automation laboratory, the corporate research centre in Ladenburg is one of seven corporate research centres worldwide. The facility supports *ABB* operations in product and system development as well as in services and consultation with basic research, new technologies and innovative solutions.

Combining the obvious strategic importance of the German market with the level of responsibility and internal competence of *ABB AG* (Germany), this subsidiary can be considered a sound and credible example of a "*strategic leader*".

Contributor

Besides the corporate headquarters, several *ABB* subsidiaries, for instance *ABB Schweiz AG* in Baden, are located in Switzerland. Although being among the richest countries in the world, when using GDP per head as a ranking tool, the total GDP of Switzerland was just 492 billion USD in 2008. Considering the limited size of the market, Switzerland is, as a market, of minor strategic importance for *ABB*. More than 95 % of the company's total revenues are generated outside Switzerland. The strategic importance of *ABB Schweiz AG*, which has a share capital of 41 million EUR, for the *ABB Group* does therefore not stem from the importance of the market, but clearly from its competence, more precisely, its R&D activities.

Like Ladenburg in Germany, Baden is home to one of the seven *ABB* corporate research centres. Founded in 1966, the Swiss corporate research centre focuses on power electronics, sensors and instrumentation, electrical insulation, simulation and software solutions for power utilities and industrial automation. From the roughly 6,300 employees of *ABB* in Switzerland, about 170 work at the corporate research centre. The corporate research centre unites employees from around 25 countries, of which almost 70 % are holding a doctoral degree. Furthermore the centre maintains strong ties with leading universities like the Massachusetts Institute of Technology (MIT), University of Cambridge and the Swiss Federal Institute of Technology (ETH). Major scientific achievements of the Swiss corporate research centre include the invention of self-blast circuit breaker technology, the first fibre laser pressure sensor, the first high-temperature superconducting fault limiter, and the world's leading generator breaker.

The importance of R&D to prevail in business is outlined by the company: "R&D is crucial for a high-tech company such as *ABB*, and our steady investment paid off in 2009 with the introduction of several new technologies" (ABB 2010, p. 3). Taking into account the competences and capabilities of *ABB Schweiz AG*, as displayed in the scientific achievements, one could categorise it as a "*contributor*" subsidiary.

Implementer

The situation of Austria is comparable to the situation in Switzerland. It is a high income country in terms of GDP per head, but has a rather small domestic market with a GDP of about 414 billion USD. Thus, solely judging by market size, the Austrian market is characterised by a low strategic importance. In contrast to Switzerland, this small market is not the home country of the MNC. *ABB* only generated revenues of about 111 million EUR in 2009, compared to 127 million EUR in 2007 and 150 million EUR in 2006 (Industriemagazin 2008, p. 35). *ABB* has about 400 employees in Austria. The subsidiary in charge of the Austrian operations is *ABB AG* (Austria). *ABB AG* (Austria) is located in Vienna and has a share capital of about 15 million EUR.

Sharply declining sales and limited share capital as well as the limited workforce indicate that *ABB AG* (Austria) has just enough competence to maintain its local operations and cannot substantially contribute to the overall strategy of the company or boost the competitiveness of the company. Hence, *ABB AG* (Austria) is a true "deliverer of the company's value added" (Bartlett/Ghoshal 1986, p. 91). Considering the low strategic importance of the Austrian market as well as the rather low competence of the Austrian headquarters, *ABB AG* (Austria) could probably be considered to fulfil the role of an "*implementer*".

Black Hole

Although *ABB* has been very successful in recent years, some subsidiaries of the company find themselves in a strategic position that is not acceptable. One example is *ABB S.A.* (Spain), the subsidiary in charge of the Spanish operations. Spain is, according to the World Bank, the ninth largest economy in the world with a GDP of 1,604 million USD in 2008. Moreover, according to Eurostat, Spain clearly exceeded other major European economies in terms of GDP growth rates in recent years. For instance, while Germany had an average annual growth rate of 0.6 % between 2005 and 2009, the Spanish GDP annually grew by 1.7 % on average in the same time period. Considering the present size of the market as well as the growth prospects of the country, the Spanish market is of major strategic importance for *ABB*.

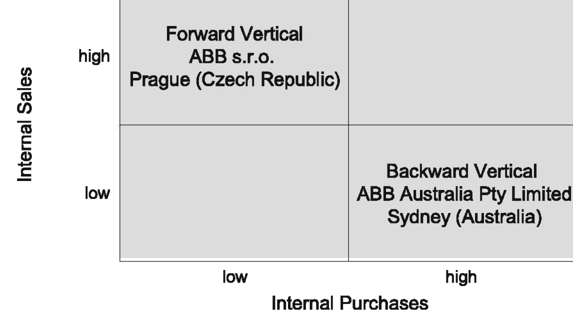
In total, *ABB* has 2,500 employees in Spain and generates revenues of about 811 million EUR in the Spanish market. *ABB S.A.* (Spain) has a share capital of about 33 million EUR, less than the Swiss subsidiary *ABB Schweiz AG*. Considering that the core market of *ABB*, in which the company generates 41 % of its total revenues, is Europe, the performance of *ABB* in Spain as one of the major and fastest growing European economies cannot be satisfactory. *ABB's* presence in Spain is based on sales offices across the country. Furthermore, *ABB* operates six production plants in Spain, most of which were founded prior to 1950. *ABB* does not run any major research operations in Spain. Considering the overall disappointing financial performance of *ABB* in *Spain*, as well as the lack of operations with company-wide impact, *ABB S.A.* might be seen as a "*black hole*" among the subsidiaries of *ABB*.

Internal Sales and Internal Purchases as Dimensions of Subsidiary Roles

Focussing on transactions between the subsidiaries and the rest of the MNC, Andersson/Forsgren (1994) distinguish four subsidiary roles. Two roles, the "*forward vertical*" role and the "*backward vertical*" will be considered with regard to *ABB* (see Figure 3.8).

Figure 3.8

"Forward Vertical" and "Backward Vertical" at ABB



Backward Vertical

Like in most MNCs, the *"backward vertical"* is the most frequent subsidiary role at *ABB* as most of the 263 subsidiaries fulfil that role. One example is *ABB Australia Pty Ltd*, located in Sydney. The subsidiary has a share capital of roughly 84 million EUR and is the headquarters of *ABB*'s operations in Australia. In order to obtain and sell the company's products effectively to external customers, and as a major part of its eBusiness strategy in Australia, the company runs a 2,200 m² logistics centre at Notting Hill (Victoria). The highly computerised facility handles dispatch operations for motors, drives, low voltage switchgear, and robotic systems businesses. By operating a centralised logistic centre, the company "reduced the time it takes for Australian customers to receive equipment imported from Europe or elsewhere" (www.abbaustralia.au). Hence, *ABB Australia Pty Ltd* is characterised by a very high percentage of internal purchases and mainly external sales (i.e., low internal sales) and can therefore be seen as a *"backward vertical"*.

Forward Vertical

In sharp contrast to the *"backward vertical"*, the *"forward vertical"* is not established to sell to external customers but to deliver products to the rest of the MNC. An example of a *forward vertical* is *ABB s.r.o.* headquartered in Prague, Czech Republic. *ABB s.r.o.* employs about 2,700 people and rests upon the "long-standing experience of traditional Czech producers" (www.abb.cz). Major manufacturing facilities are located in Prague, Brno, Trutnov, Jablonec n. Nisou, and Ostrava. The Czech subsidiary performs manufacturing tasks for all divisions of *ABB*, but focuses on the robotics division, as the European arc welding centre (EAWC) and the robotics refurbishment centre are located in Ostrava. Performing basic manufacturing tasks, such as welding for the robotics division, *ABB s.r.o.* is characterised by "high" internal sales, as well as "low" internal purchases (apart from company-wide know-how).

Summary and Outlook

By applying role typologies, one has to bear in mind that these tools are of a simplifying nature. It is, for instance, almost impossible to capture the complexity of a MNC like *ABB* by solely applying the four options of Bartlett/Ghoshal. Classifying a subsidiary as a "black hole" or "implementer" is therefore always a rather subjective decision. Hence, this case study may only serve as a starting point for further investigations and discussions.

Questions

1. The case study introduced four subsidiaries of *ABB*: *ABB AG* (Germany), *ABB Schweiz AG* (Switzerland), *ABB AG* (Austria), *ABB S.A.* (Spain) and assigned different roles to the subsidiaries, applying the role typology of Bartlett/Ghoshal 1986. Please further analyse the mentioned subsidiaries by using the terminology of Gupta/Govindarajan 1991.
2. Another wholly-owned subsidiary of *ABB* is *ABB Inc.* This subsidiary is located in Norwalk, Connecticut, in the USA. Apply the terminology of White/Poynter 1984 to determine the role of *ABB Inc.*
3. Put yourself in the position of a host country. What subsidiary roles are especially attractive for the host country? What roles are unattractive and why? (Please consider the role typologies of White/Poynter 1984, Bartlett/Ghoshal 1986 and Gupta/Govindarajan 1991).

Hints

1. Examine the respective country websites: www.abb.de (Germany), www. abb.ch (Switzerland), www.abb.at (Austria), and www. abb.es (Spain).
2. Information about the US subsidiary can be found at www.abb.us and the annual reports of the company.
3. Think not only in terms of number of employees, but also about potential benefits that stem from sophisticated, value-adding activities.

Chapter 4

Motives for Internationalisation

The aim of this Chapter is to clarify that internationalisation is not in all cases simply driven by the desire to enhance sales but that the motives for internationalisation can be manifold, with major consequences for market entry strategies, the coordination of international subsidiaries, country selection, organisation, etc.

Heterogeneous Strategic Objectives for Internationalisation

Internationalisation into specific foreign countries, whether it is via exporting or importing, via international contracts or foreign direct investment, is always driven by certain motives of the MNC. In this regard, it can be assumed that the strategic conduct of a company in a particular country is always shaped by its strategic objectives with regard to this country, as an important part of the intended strategy.

Sales Objective Traditionally in the Focus

However, the literature on internationalisation often does not differentiate between the respective objectives but rather it is assumed, often only implicitly, that sales-oriented objectives are the most relevant. The term *market entry strategy* which is often used for the foreign operation mode clearly indicates this assumption. Traditional concepts and studies on internationalisation (e.g. the theory of monopolistic advantage by Hymer (1960)) often assumed that the international activities of companies only give them the benefit of a broader exploitation of company-specific advantages. Very different objectives of internationalisation can be given, however. As has already been stated in the international *product lifecycle theory* by Vernon (1966), the *production cost advantages* of a foreign market might be an important reason for relocating production to foreign countries even if the primary sales focus is still on the home country.

In the perspective of the MNC as a "differentiated network", as discussed in Chapter 1, different subsidiaries are assigned different tasks and roles, and heterogeneous location advantages of the different foreign subsidiaries are exploited. This perspective clearly illustrates the *multi-facetedness of the motives* for being active in foreign countries.

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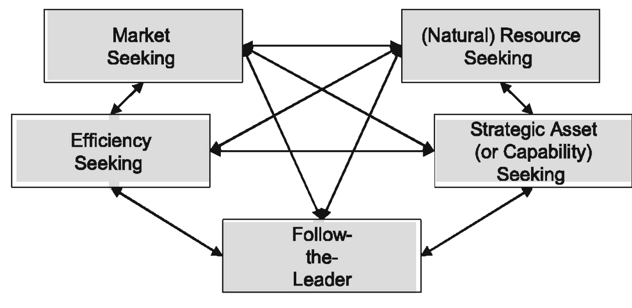
The *five motives* shown in Figure 4.1 can be distinguished as the most relevant objectives of internationalisation (e.g. Dunning 1988; Shan 1991, p. 562; Morschett 2007, pp. 310-320; Dunning/Lundan 2008, pp. 67-77).

Figure 4.1 *Alternative Motives for Internationalisation*



Market Seeking

The *primary motive* for starting activities in a foreign country is frequently the *access to new markets* and the sales potential offered by foreign markets. In particular when the home market is saturated, as is more and more often the case for the industrialised countries of Western Europe, the USA or Japan, company growth can be maintained by international sales.

Orientation on the Sales Side

If market seeking is the motive for internationalising, foreign countries are chosen by the sales potential they offer for the company. Country characteristics that are used as *selection criteria* in this case include, for example:

- market size
- market growth
- presence of attractive customer segments and
- demand for the products or services of the company.

International market-seeking objectives are not necessarily associated with foreign production but may also be reached by home-country production that is being exported to the foreign market. While *exporting* can be used to exploit excess production capacity in the home country, and it is usually less risky and can be carried out with lower initial investment, FDI in the target market can help to circumvent trade barriers, reduce logistics costs and

develop a better understanding of the market. These aspects are discussed in more detail in Chapter 16 ("International Production & Sourcing").

Cooperative Operation Modes to Improve Market Access

Given that access to a foreign market is not always easy and the market knowledge of a foreign company is usually lower than that of a local company, first market entries are often realised via *cooperative arrangements* with local companies (Erramilli/Rao 1990, p. 146). Those local companies provide the company with the necessary knowledge about the market, with access to distribution channels and with other local relations.

Vertical Integration

However, considering the high relevance of customer relations, it can be observed on a national and on an international level in recent years that companies tend to exert a *tighter control* over their foreign sales activities and are willing to use a higher level of ownership of these activities to provide the necessary coordination (Zentes/Neidhart 2006). *Internalisation* of the foreign marketing activities, i.e., vertical integration, and a full-ownership strategy instead of cooperative arrangements, are often the consequence. The reason can be seen in the fact that a foreign subsidiary acts as a "*gate keeper*" to the local market which gives it a specific power versus the company in the home country, in particular when it is controlling distribution channels, marketing activities, etc. *Relationship marketing* is becoming more important in many industries – i.e., the establishment, maintenance and enhancement of long-term relationships with customers (Zentes/Morschett/Schramm-Klein 2007, pp. 231-252) – and the customer relationship is becoming a critical asset for a company. Hence a very close and unrestricted information flow between the foreign market and the headquarters in the home country and very quick and flexible reactions become necessary.

Dynamic Changes in Operation Modes

This dynamic development, which is shaped by a low level of market knowledge in early phases of market entry (and, thus, often cooperative entry modes to facilitate the market entry), and by increasing market knowledge over time and the wish to exert a stronger control over the activities (and in consequence a preference for full ownership of the subsidiary), is theoretically explained by the "*internationalisation stages models*", which are discussed in more detail in Chapter 12.

Follow-the-Customer

With the market-seeking motive, sales in the foreign market are in focus. Usually, customers in the foreign country are consumers or companies resident in the host country. In business-to-business markets, however, customers in the foreign country might also be companies from the home country who have internationalised to this country. For instance, a Swiss company might sell in China to the Chinese subsidiary of another Swiss MNC.

Piggybacking of Service Companies

For service companies in particular it is very common to enter a foreign market as a consequence of the internationalisation of one of their main customers (so-called "*piggybacking*"). This "follow-the-customer" motive is often seen as the most relevant reason for service companies to internationalise. Following a customer overseas might be necessary to *protect existing sales* levels (if the customer relocates parts of its home country production abroad) or it can be an opportunity to enhance sales if the customer increases its production with the new foreign facility. Existing business relationships, e.g. for professional services like business consulting, advertising agencies and auditing companies, are ensured and deepened by accompanying important clients into the foreign market (Erramilli/Rao 1990, p. 141; Cardone-Riportella et al. 2003, p. 384).

Competitive Advantage through Customer Knowledge

While this motive may be seen as a *subdimension of market-seeking*, it makes a major difference whether the customer base of the company in the host country consists mainly of local customers or mainly of customers from the company's home country. In the follow-the-customer situation, the company has a strong advantage because the uncertainty of entering the foreign market is much lower. An important customer is already secured prior to the market entry and the demand behaviour of this customer is already known to the MNC from the home country. The "*liability of foreignness*", i.e., the often-stated competitive disadvantages compared with local companies due to less market knowledge, is reversed in this situation since the MNC already has accumulated knowledge and information about this customer (Erramilli/Rao 1990, p. 143).

However, following-the-customer also leads to *major interdependencies* of the international activities. Since a dominant reason for following the client is also to deepen the business relationship with this customer in the home country (Cardone-Riportella et al. 2003, p. 385), it is important that the marketing offer and the quality level of the company in the host country mirrors the offer in the home country. The strong interdependence makes centralised coordination necessary, since decisions by the MNC's headquarters must also be implemented in the foreign market. On the other hand, *centralised coordination* also becomes easier, since the headquarters might even have better information available on this customer and on its company's objectives than the specific foreign sales unit (Mößlang 1995, p. 220).

Manufacturers Following-the-Customer

While the literature assigns this objective mainly to service companies, it seems obvious that the motive can be very *relevant for manufacturing companies* as well. Industrial supplier relations are sometimes very similar and closely linked to specific customers (Ferdows 1989, p. 7; Zentes/Swoboda/Morschett 2004, p. 394). If, for instance, a large German car manufacturer establishes production facilities in Eastern Europe, this forces suppliers to consider internationalisation to these countries as well. The same phenome-

non was observed when Japanese car manufacturers established their first production facilities in the USA in the 1980s and 1990s. Consequently, more than 500 automotive suppliers from Japan established production facilities in the USA in their wake (Dunning/Lundan 2008, p. 70).

Bridgehead

In connection with the market-seeking objective in particular, the activities in a specific country can also be motivated by the opportunity to establish a bridgehead for *entering adjacent foreign countries* immediately or at a later stage.

Foreign Country as Bridgehead for Further Internationalisation

In this case, besides the activities in the host country, the company intends to identify market opportunities in other countries that are easier to enter from this bridgehead. For example, Hong Kong used to be a bridgehead for many companies to enter the attractive Chinese market, and Austria is often used by Western companies as an entry point into Eastern Europe. For example, *McDonald's*, *Aldi* and *Rewe* used their activities in Austria to enter Eastern European markets. Often, after the establishment of activities in the neighbouring countries, the bridgehead serves as a regional headquarters.

Resource Seeking

Foreign activities can also be taken up with the objective of giving the MNC access to relevant resources and securing this access to resources, such as natural resources, but also to specific components from foreign suppliers, to certain topographical sites (like agricultural land, harbours, etc.) (see Rugman/Verbeke 2001, p. 158). Companies in the *primary sector* and companies that are strongly dependent on natural resources, like oil companies, tyre producers and chemical companies, were very early internationalisers, with the aim of securing the necessary inputs for their companies (Bartlett/Ghoshal 2000, p. 5).

Orientation on the Supply Side

Country characteristics that are used as *selection criteria* in this case include primarily

- availability of important resources,
- cost of resources in the country,
- allocation of resources in the country, e.g. the extent to which the resources are controlled by a few organisations or by many.

Partnership Strategies

The resource-seeking motive is closely linked to *cooperative operation modes* (Morschett/Schramm-Klein/Swoboda 2008). The main reason can be seen in

the *first-mover advantage of local companies* with regard to local resource access (Hennart/Larimo 1998, p. 524). Local companies have often secured access to important natural resources very early, often decades ago, and major natural resources are often at least partially controlled by the host government (e.g. in Russia). So while *acquisition* might be an option theoretically, often legal restrictions hinder this operation mode. A foreign company that wants to get resources thus often needs to partner with local companies to be able to gain access to their networks, their government relations, their know-how, etc.

It is also plausible that foreign subsidiaries which are mainly established to gain access to resources in a foreign country intend to embed themselves tightly in the local environment, to tighten the relationships that they have established with the help of a cooperation partner and to enhance the security of supply of the critical resources. The company often has to adapt to processes and routines in the host country.

Resource-seeking is simultaneously linked to strong interdependence with the rest of the MNC, since the goods and resources that are acquired in the foreign market are either directly delivered to other organisational units of the MNC, e.g. a factory in the home country, or are further processed in the host country by the foreign subsidiary, to be subsequently delivered to foreign countries, at least partly. Resource-seeking thus usually leads to *one-directional, sequential flows of material* from the foreign subsidiary to the rest of the MNC.

Efficiency Seeking

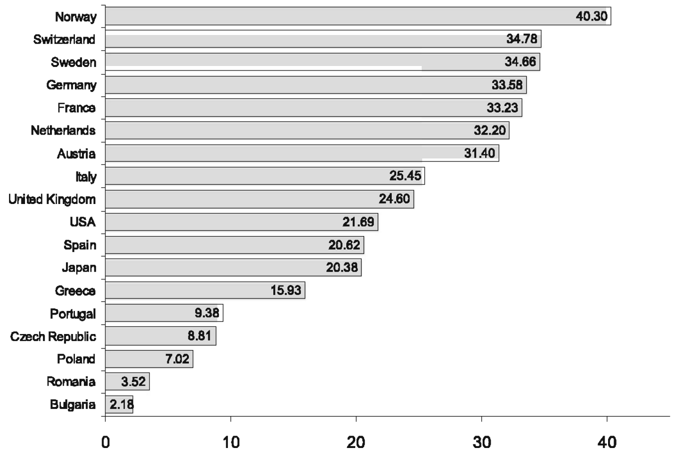
Orientation on Production Efficiency

Another major motive for internationalisation can be efficiency seeking, i.e., the quest for the *improvement of the overall cost efficiency* of the MNC. If this is a motive, then the foreign subsidiary is often part of an *internationally configured network* of production activities. The intention is to exploit specific location advantages for specific activities and design a production network that rationalises the production processes (Rugman/Verbeke 2001, p. 159). The foreign subsidiary is then often responsible for manufacturing components or final goods that are delivered to the parent company or peer subsidiaries in cross-border production processes (Martinez/Ricks 1989, p. 469). In services, the *outsourcing and offshoring* of call-centre activities to Ireland, or of IT services to India, are typical examples of efficiency seeking (see Chapter 13 for a discussion of these phenomena).

Efficiency-seeking activities can either try to exploit *differences in factor costs* (i.e., between rather heterogeneous countries) or be designed to enhance *economies of scale* by *bundling production* (i.e., between broadly similar economies) (Dunning/Lundan 2008, p. 72).

Figure 4.2

Labour Cost in Manufacturing in Selected Countries (in EUR per hour 2008)



Source: Schröder 2009.

Characteristics that are used to *select* a foreign country as a *location* in the case of efficiency seeking include, for example:

- production costs in the country, which differ tremendously (see Figure 4.2)
- distance to relevant markets (as an influence on logistics costs)
- possibilities to integrate the production process in the company's overall cross-border production processes
- the availability of good and efficient suppliers.

The possibility of integrating the production processes across borders is obviously improved by reduced tariff and non-tariff barriers between countries and this is why efficiency-seeking internationalisation often occurs in regionally integrated markets (Dunning/Lundan 2008, p. 72), such as the EU or NAFTA (see Chapter 5).

Minature Replicas and Product Mandates

If the subsidiary is producing components in a vertical supply relationship with other organisations within the MNC, then *tight coordination* is necessary to integrate the production processes in the MNC (e.g. Gupta/Govindarajan 1991). Thus, foreign subsidiaries that are mainly established as production sites for the MNC often have a rather low level of autonomy and a degree of central coordination (Young/Tavares 2004). Since their structures and proc-

esses are often similar to the parent company, they are sometimes called "miniature replicas" (White/Poynter 1984, p. 60; see Chapter 3). On the other hand, efficiency advantages in the host country can also be exploited by having the subsidiary carrying out full value chains and assigning it a "product mandate" which gives it full (regional or worldwide) responsibility for one or several products. In this case they might be able to establish specialised resources and a high level of competence which promotes their autonomy. In any case, a certain level of coordination of this subsidiary remains necessary due to the high interdependence with the rest of the MNC (Young/Tavares 2004, p. 221).

If the internationalisation is mainly due to efficiency motives, *cooperative arrangements* are sometimes chosen as the operation mode (Morschett 2007, p. 515). Manufacturing in the host country – at least compared with pure sales activities – is linked to very high capital cost and consequently a *risky engagement*. Sharing large investments and high risks with a local partner is a frequent motive for cooperative strategies. Local partners can also contribute to economies of scale in production (Heshmati 2003; Kutschker/Schmid 2008, p. 890).

Outsourcing Internationally

Alternatively, seeking cost efficiency might also lead to *outsourcing*. In particular, cost reasons are often seen to influence the "make-or-buy-decision". Arguments for outsourcing include flexibility, reduced investment of own resources, specialised know-how, economies of scale and economies of scope (Aharoni 2000, p. 17). This is discussed in more detail in Chapter 13. As an example, outsourcing production to a contract manufacturer might give a company access to a very cost-efficient international production network with high flexibility (Morschett 2005), and thus, give it the opportunity to fulfil the efficiency-seeking motive by using the configuration of the contract manufacturer without own international FDI.

Strategic Asset Seeking

Besides the motive of accessing natural resources, components or other similar inputs, a motive of the company might be *access to local knowledge*, capabilities, technological resources, and innovations. The "strategic asset seeking" motive is based on the idea that an international presence of the MNC gives it a major information advantage over other companies that is grounded in the "scanning and learning potential" of the company network (Bartlett/Ghoshal 2000, p. 8). Research institutions, but also suppliers, customers or competitors, can be important sources of technological knowledge (Ferdows 1989, p. 6). For example, it is often argued that access to specific knowledge and capabilities in the host country is an important reason for direct investment in the USA (see Randøy/Li 1998, p. 91). Related to the

motive of strategic asset seeking is the idea that the superiority of differentiated MNC networks is often attributed to the *enhanced innovation capability* of such networks (Ghoshal/Bartlett 1988; Bartlett/Ghoshal 1989).

Orientation on Know-how

If strategic asset seeking is a major motive for internationalisation, the country characteristics that are used as *selection criteria* include, for example:

- innovativeness
- sophistication of demand
- availability of related and supporting industries
- presence of innovation clusters in the relevant industry.

While obviously a company has to consider the innovation capacity of a potential host country in its specific industry, some general evaluations can be drawn from secondary sources like the World Competitiveness Report (see Table 4.1).

Innovativeness of Countries from the World Competitiveness Report 2009-2010

Table 4.1

Country	Rank	Innovativeness Score	Country	Rank	Innovativeness Score
United States	1	5.77	Korea, Rep.	11	4.84
Switzerland	2	5.56	Canada	12	4.80
Finland	3	5.53	Netherland	13	4.79
Japan	4	5.51	Belgium	14	4.62
Sweden	5	5.39	United Kingdom	15	4.60
Taiwan	6	5.28	Iceland	16	4.55
Germany	7	5.11	Norway	17	4.53
Singapore	8	5.09	France	18	4.50
Israel	9	5.06	Austria	19	4.46
Denmark	10	5.04	Australia	20	4.43

Source: Schwab/Sala-i-Martin/Greenhill 2009, p. 20.

Innovativeness (and, related to that, an adequate location for MNCs seeking strategic assets) requires an environment that is conducive to innovative activity, supported by both the public and the private sectors. In particular, this means sufficient investment in research and development, especially by private, high-quality scientific research institutions, collaboration in research between universities and industry, and protection of intellectual property (Sala-i-Martin et al. 2009, p. 7).

USA and Switzerland as Leading Innovative Nations

The leading countries for innovativeness are the USA and Switzerland. The Competitiveness Report comments, along with other dimensions of competitiveness: "Switzerland overtakes the United States this year as the world's most competitive economy [...] Switzerland's economy continues to be characterized by an excellent capacity for innovation and a very sophisticated business culture [...] The country is characterized by high spending on R&D. Switzerland's scientific research institutions are among the world's best, and the strong collaboration between the academic and business sectors ensures that much of this research is translated into marketable products and processes, reinforced by strong intellectual property protection. This strong innovative capacity is captured by the high rate of patenting" (Sala-i-Martin et al. 2009, p. 21). Innovativeness is often linked to the presence of *regional innovation clusters*, which are discussed in more detail in Chapter 6.

Innovation and Coordination

If the foreign activity is mainly targeted towards gaining know-how and access to strategic assets, this has clear implications for the *headquarters-subsidiary relationship.* For example, a very high level of centralisation has been shown to reduce motivation and creativity and thus to exert a negative influence on the innovation capability of a foreign subsidiary (Gates/Egelhoff 1986; Egelhoff 1988). However, there has to be a close link between the foreign subsidiary and the rest of the MNC, because internal communication flows (horizontal with other subsidiaries and vertical with the headquarters) are major determinants of the innovation capacity of an organisation (Nohria/Ghoshal 1997, p. 39). In particular, it is important that the foreign subsidiary in this case has not only the necessary capability to generate new knowledge, but also the necessary motivation to share this knowledge with the rest of the MNC (Nohria/Ghoshal 1997). Normative integration via a strong organisational culture has been shown to be an efficient coordination instrument which motivates and facilitates two-directional knowledge flows (see Chapter 10).

Cooperation to Acquire Knowledge

If the access to local knowledge is a primary motive for foreign activities, cooperative arrangements are often beneficial. To acquire knowledge, a *strong embeddedness* in the local environment is necessary, *local relationships* are required and a close and trustful contact with local institutions (Fisch 2001, p. 135; Morschett 2007, p. 318). Local cooperation partners, as in a *joint venture*, can support access to the necessary knowledge sources. An alternative operation mode to gain rapid access to local knowledge in foreign markets is the acquisition of a foreign competitor, including the knowledge base that is accumulated in its patents and, in particular, in its employees. In both cases, *market imperfections* in the market for knowledge can be seen as reasons for the (partial) internalisation (Williamson 1985).

Since the innovation potential is closely related to the R&D activities of the company, this aspect is discussed in more detail in Chapter 17 ("International Research & Development").

Follow-the-Leader

As early as 1973, Knickerbocker argued that companies tend to behave similarly in an oligopolistic industry situation with the objective of maintaining stability and avoiding major changes in the competitive structure. Thus, internationalisation might occur as an *oligopolistic reaction* to a competitor's move to a foreign country (Cardone-Riportella et al. 2003, p. 390). This can influence the internationalisation decision in general as well as the selection of specific foreign countries.

Exchange of Threats

This strategy-based consideration becomes more relevant with increasing levels of internationalisation of the relevant competitors and with increasing competition concentration. In this situation, international activities in particular countries can also represent an *exchange of threats* between competitors (Graham 1978; Malhotra/Agarwal/Ulgado 2004, p. 4). If the same companies compete in several countries, a MNC can use its portfolio of foreign activities in a strategically coordinated manner. For example, it can use its strength in the USA to attack a competitor there who attacked it in a European market. This strategic flexibility is particularly relevant in highly globalised industries. It can be linked to any of the four motives mentioned above. For instance, it might be necessary to have access to a specific resource, access to a specific market, or a specific access to strategic assets and know-how to react to a competitor's action.

Bundles of Motives

While often one of the five motives above is the dominant reason for activities in a particular country, they seldom exist in isolation. Generally, companies pursue a bundle of objectives simultaneously (Shan 1991, p. 562). As with any bundle of objectives, it has to be investigated whether they are concurrent or complementary. Sometimes, a MNC might have to accept a trade-off between different location characteristics that are favourable for one motive but less favourable concerning another motive.

In any case, combinations of the five aspects mentioned are very common. For example, a company might be primarily market seeking, but to address the demand in a specific country it must relocate parts of its production process into this country to enhance the production efficiency with regard to this sales market. Another company might need a local presence in a country

to gain access to relevant strategic assets which are necessary to develop an innovative product for this country market. Thus, the country characteristics that lead to a selection of a specific foreign country for company activities should be considered in combination.

Conclusion and Outlook

The motives of a company in entering a foreign country are not necessarily focused solely on expanding its markets. Moreover, the motivation is often not one-dimensional but multifaceted. Since the motives of the company for undertaking activities in a specific country are a major part of its strategy, however, other major parts of the strategy, the organisational behaviour, the company structure, etc., have to be aligned to these motives. This shows the necessity to differentiate, for example, the headquarters-subsidiary relationship according to the dominant motive for internationalisation.

In the last few decades, dynamic shifts have occurred in the principal motives for entering foreign countries. For example, China was long seen mainly as a country for cheap production, while now it is increasingly entered by companies as an attractive market. Eastern Europe opened and simultaneously became attractive as a market and for efficiency seeking. With the perceived increasing scarcity of some natural resources, like oil and gas, some countries (e.g. Russia) have become crucial for the long-term access to this necessary supply. Linked to the development of prices for natural resources, the same countries are also becoming more attractive as markets. Strategic assets can no longer be found exclusively in the USA or in Europe. For example, Korea has become one of the innovation centres of the world in consumer electronics, like TVs. Conversely, MNCs from emerging countries like China are more and more often seen to internationalise to industrialised countries to gain access to know-how. Moreover, with internationalisation in many foreign countries, the follow-the-customer trend has accelerated over the last decades (Dunning/Lundan 2008, p. 70).

Further Reading

DUNNING, J.; LUNDAN, S. (2008): Multinational Enterprises and the Global Economy, 2nd ed., Cheltenham, UK, Edward Elgar Publishing, pp. 67-77.

Case Study: British Petroleum[1]

Profile, History, and Status Quo

First Oil Discovery of Anglo-Persian

In 1901 the English entrepreneur W. D'Arcy acquired an exclusive right to search for oil in south-west Persia (modern Iran). After years of unsuccessful searching, on the morning of 26 May 1908, the chief explorer G. Reynolds could announce in a telegram sent to D'Arcy, who was about to go bankrupt, an immense oil discovery. The *Anglo-Persian Oil Company* started business within a year and would become *British Petroleum* (*BP*) in 1954. After several years constructing its refinery complex and a cross-country pipeline, the *Anglo-Persian* project almost went bankrupt again due to a lack of customers and established competitors. Fortunately, Winston Churchill, then First Lord of the Admiralty, understanding the strategic relevance of the project and the imminent need for oil, convinced the British government to become a major shareholder in 1914 – the end of the company's persistent cash crisis.

Rise of BP Brand

The brand "*BP*" was originally created by a German company to market its products in Britain, but at the time of the First World War, its assets – the distribution network – were confiscated and sold to the *Anglo-Persian Oil Company*. With the rise of the automobile, *Anglo-Persian* expanded its business to the mainland of Europe and the USA in the 1920s and 1930s, thus, the number of *BP*-labelled petrol pumps or service stations increased from 69 in 1921 to more than 6,000 in 1925. During the Second World War, the economic growth on the European continent ended and the military-related *BP* petrol was consolidated with other brands to a single petrol for sale in the UK. Since the capacity of the *Abadan* refinery in Iran (Persia changed its name in 1935, and the company changed its name accordingly) was limited and many of the company's oil tankers were attacked on their way from Iran to Britain, the *Anglo-Iranian* tried to find oil on British territory after being requested to do so by the government. The company was finally successful in an area near Nottingham, England.

In the post-war era, *Anglo-Iranian* invested mainly in refineries and new marketing efforts in Europe. It took the company several years to find new large oil reservoirs – in 1969 on the Prudhoe Bay in Alaska and in 1970 offshore in the middle of the North Sea. Those discoveries were crucial to the survival of *BP* because almost every oil-rich nation in the Middle East, including Iran where the company once concentrated its complete strategy, was about to nationalise its resources. Hence, *BP* learnt its strategy lesson for the future and became in addition fully privatised in 1987.

1 Sources used for this case study include various annual reports, press releases, the web site http://www.bp.com as well as explicitly cited sources.

Status Quo of BP

Nowadays, incorporated as *BP plc,* the company has grown into one of the largest vertically integrated energy groups in the world. It not only delivers oil, petrol and gas but also provides a large range of diverse products, from lubricants and chemicals to various types of low-carbon energy. 80,300 employees worldwide in over 100 countries generated sales of 239 billion USD in 2009,. The EBIT was about 26 billion USD,. Today, *BP* is the second largest British company with exploration, production, refining and sales operations worldwide (Figure 4.3).

Figure 4.3 BP's Worldwide Operations

Source: www.bp.com.

BP's Motives for Internationalisation

BP's Extensive Value Chain

BP operates in exploration and extraction of crude oil and gas, but also conducts transportation and construction. Furthermore, the company's activities involve selling the refined petrol through about 24,100 service stations at present. In addition, *BP* invests sustainably within its third segment, especially in its *BP Alternative Energy* unit. Thus, on the one hand the company performs *downstream* activities like refining crude oil to petroleum-based products in its 19 refineries. These activities include marketing and distribution, too. On the other hand, *BP* pursues *upstream* operations through exploration of natural resources. Thus, *BP*'s business encompasses the main activities of the *value chain* to achieve a competitive advantage through a focused superior performance.

BP – being a multinational company – operates as a differentiated network and has strongly heterogeneous motives and objectives to operate in the

respective host country. In this case study *BP*'s motives for going abroad are elaborated according to its major business segments.

Upstream - Exploration and Production

International Sourcing

The oil industry is a very good example of how intended sales are not the only motive for a company to go international with its business. Instead, in the case of *BP*, discoveries of natural resources are the primary objective. Today, the proved oil reserves of 1,333 thousand million barrels (as of 2009) are spread around the world (with a dominant part in the Middle East) as Figure 4.4. displays. Actually, finding and sourcing oil in Persia was the precondition for the start-up in London and the success in the subsequent years. Hence, the focus to market the products was on Britain, the domestic market, in the first place. As stated in the introduction, during the Second World War there was a successful attempt to detect oil on British soil, to become more independent of Iranian oil. Additionally, in 1970, a *BP* crew found the giant *Forties field* offshore in the North Sea, which could deliver 400,000 barrels crude oil per day. Just before that, the company was lucky in finding the largest oil reservoirs ever detected in North America.

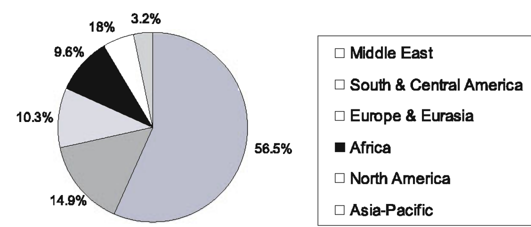
Those discoveries turned out to be the salvation of *BP* during the emerging conflicts in the Middle East in the 1950s. Almost every oil-rich country there, including Iran, was about to nationalise its resources and the associated industries. *BP* at that time still concentrated almost its complete supply strategy on the Middle East, while anti-British sentiment there escalated. After the last expatriates were forced to leave the country, the refinery was shut. As a reaction to nationalisation in Iran, governments around the globe imposed a conjunct pressure to boycott oil (which was still possible at that time) and hence, damaged Iran's economy tremendously. As a consequence of this, the Iranian government had to accept a new consortium of companies, including *Standard Oil of Indiana* (*Amoco*) and *Anglo-Iranian*. The latter held a stake of 40 % and shortly after, its name was changed to *The British Petroleum Company (BP)*.

Country Risks

One can see that the country risks that accompany doing business in unstable political regions can even lead to state expropriation. This was likewise the case in the early 1970s when Gaddafi came to power through a military coup in Libya and nationalised *BP*'s oil operation. To this day *BP* has similar struggles, e.g. with its Russian joint venture *TNK-BP*. Here the Russian shareholders have tried to take control of the company and hence over the investment and dividend decisions as well. Thus, as there are still resource-intensive countries with local companies which are quite often controlled by the government, *BP* needs to pursue strategic co-operative arrangements with those local partners. Hence, the company works closely with govern-

ment representatives and national oil companies which often have a first-mover advantage. Another mutual benefit of the collaboration is that the huge investment risks (with very late pay-offs) which are often associated with those kinds of projects can be shared.

Figure 4.4 *Proved Oil Reserves Worldwide as of 31 December 2009*



Source: BP 2010.

New Essential Oil Discoveries

The necessity to internationalise to countries where the relevant resources are available shows how strongly companies in the primary sector depend on having access to natural resources. That is why, as mentioned above, *BP* was very fortunate with the detection of the two major oil fields offshore of Scotland and in Alaska after the company had been unsuccessful in discovering additional crude oil in Malta, Australia and Papua New Guinea in the 1960s, and during its long search in the UK. Since *BP* had no infrastructure in the USA, it acquired a 25 % stake of *Standard Oil of Ohio* (*Sohio*) to get access to *Sohio*'s refining capacities and its distribution system.

Reserves Replacement

Thus, the company eventually became quite independent of Middle Eastern crude oil, its former sole resource. Therefore, the replacement of the mentioned reserves is an important strategic outlook figure in the annual reports. In 2009 *BP* replaced more than 100 % of its reported reserves for the seventeenth year in a row. Recently, *BP* has made extensive discoveries in Angola and Egypt and has gained access to new huge oil and gas fields in Iraq, Indonesia and Egypt. Furthermore, the company is exploring the ultra deepwater off the Gulf of Mexico, where, at the time of the writing of this book, a dramatic catastrophe occured. An explosion on a drilling rig caused an oil spill that is estimated to be up to 60,000 barrels per day. While this incident will certainly influence the future of BP, at least in the exploration, the effects are not clear at all at the time of the writing and will therefore not be considered in the remainder of this case study.

Summing up, the key strategy within the *upstream* activities comprises *BP*'s focus on very prolific resource basins globally and its extension through further findings and successful exploration to sustain production of at least 4 million barrels per day by 2020.

Midstream - Bridge to more Efficiency

Technology as BP's Driver

Technological progress has always been an important driver for *British Petroleum* – especially for oil exploration, transportation and refining. For example, to extract the crude oil from the *Forties Field, BP*'s engineers had to construct production platforms able to withstand the rough waters of the North Sea in every season. *BP* plant can operate in water depths up to 1,450 metres with its innovative deepwater technology. In addition, *BP* is the operator and largest shareholder of the 1,768-kilometre *Baku-Tbilisi-Ceyhan* pipeline (BTC) from Azerbaijan at the oil-rich Caspian Sea through Georgia to a terminal at the Turkish coast. The *BTC* pipeline, which could also be considered as a *midstream* activity, was a challenging engineering project justified by the aim of bypassing the politically unstable territories of Russia and Iran – a cost-efficient logistic to the Western markets. Moreover, the company has acceded to a promising joint venture to explore Canadian oil sands and also uses new technology to enhance production from current fields which would otherwise suffer from a decline in production.

Efficient Operations

Even in its early days, *BP* used the advantage of location by constructing its first high-technology refinery complex in Persia, which was connected with the oil-well through a sophisticated pipeline more than 200 kilometres long. Rationalisation is still an objective today when operating abroad and hence, cost advantages can be utilised. Thus, another company's motive to go international with both its production and transport business arises from a more profitable operation prospect. In doing so, subsidiaries are often responsible for manufacturing more efficient components, which is additionally the case with its refining of crude oil. *BP* utilises cross-border product and process specialisation and takes advantage of different factor endowments and market structures.

Downstream - Refining and Marketing

BP's Complex Value Chain

BP not only concentrates on finding and extracting oil and gas, but also on extending its business down the *value chain* to the consumer. Thus, *BP*'s product, refining, distribution and service departments can be found within this segment. As stated above, with technological changes, the demand for petrol increased year by year and, within five years, *Anglo-Persian* could call over 6,000 service stations its own by 1925. Those *BP*-labelled petrol pumps

appeared not only in Britain, but also in continental Europe, accompanied by an increase in marketing efforts, including advertisements in magazines. Thus, in those countries, *BP* was mainly pursuing the "classic" motive for a company's internationalisation efforts, i.e., looking for *new sales markets*.

After the Second World War, *BP* invested in new marketing efforts in Scandinavia, the Netherlands and Switzerland and even sold petrol to New Zealand. Moreover within what is today its second major business segment, new investments in refineries in Germany, but also in France and Italy have followed. Today, *BP* is *one of the leading companies* in refining petrol and hydrocarbon products in Europe, the USA and Australia. Its total refining capacity comprised about 2,700 thousand barrels a day in 2007. The company serves millions of customers every day with about 24,100 service stations around the globe at present.

Merger & Acquisitions

To achieve this, *BP* sought several big M&As. In 1987 the company acquired the remaining shares of *Sohio*, an American oil company with refineries and a service station network, which was incorporated into *BP America*. In 1998 *BP* merged with *Amoco* to deal with the tough competition by combining their global operations and hence, the largest producer of oil and gas in the USA was formed. Soon, *Amoco*'s service stations were re-branded as *BP*. Furthermore in 2000, *BP* was joined by *ARCO*, an American oil company with a large network of pipelines, chemical plants, refineries and over 900 outlets trading as "*ampm*". Thereafter, all the service stations of the *BP Group* on the west side of the Rocky Mountains were branded as *ARCO*.

Figure 4.5 *BP Brands*

Source: www.bp.com.

Castrol, a producer of lubricants especially for automotive and aeroplane engines, was bought in 1966 by the *Burmah Oil Company*, which joined the *BP Group* in 2000. The operations of *Burmah Oil* were incorporated within the group, while the famous lubricant brand *Castrol* was retained. *Aral*, with its very modern service station network, became part of the *BP Group* in 2002 and *BP* decided to keep the *Aral* brand. The 630 German *BP* stations were rebranded with the familiar *Aral* blue and white.

New Markets

With these main brands, it is obvious that *BP* concentrates most of its activities on Europe and the USA. The company is also looking for new markets, however, and was planning to build and operate around 1,000 retail stations in China by 2007 with its partners *Sinopec* and *Petrochina*. All in all, *BP* is very active in China as the leading importer of liquefied petroleum gas (LPG), being the only foreign company involved in the aviation fuels market and a seller of lubricants, etc. In addition, *BP* is very active with its *Aromatics & Acetyls* unit within the marketing segment in China.

New Assets and Know-How

With the new millennium, two major challenges for humanity appeared. On the one hand, there has been a dramatic rise in the prices of oil and gas, followed by a sharp drop in prices. However, in the medium term, prices are expected to continue to rise. On the other hand, scientists from all over the world warn about the threat to the earth through climate change. *BP* feels responsible for addressing the challenges of reducing carbon in the atmosphere by establishing a third major business segment: *Gas, Power and Renewables*. Through its *Alternative Energy* unit, the company invests heavily in low-carbon energy sources, including wind farms, solar energy and hydrogen energy, to be well prepared for the future. For example, *BP* has developed three wind-farm projects in the USA (Colorado and Texas) and in India, and it plans to extend its wind capacity from 370 MW in 2007 to more than 1,000 MW by the end of 2008. Hereby, the company seeks competitive strength in an unfamiliar market to augment its global product portfolio. It is important to have access to local (technological) knowledge due to multinational engagements in terms of foreign direct investments like acquisitions or partnerships.

Research Activities

Therefore, *BP* also has its own research facilities to enlarge innovative abilities and to gain an edge on information. For example, Germany has a very advanced solar industry, therefore *BP* signed a co-operation agreement with an institute on the spot, the *Institute of Crystal Growth* (*IKZ*). The same is the case with universities and research institutes in the USA, e.g. the *California Institute of Technology*. Through the merger with *Amoco*, *BP* also gained access to an American solar power company. Now, *BP* has become a leader in the solar power industry and is about to more than triple its cell production due to further expansion in the USA, Spain and India by 2008. Moreover, the company runs several laboratories worldwide to foster its research, not only in alternative energy but also within its whole product portfolio. For example, in 2006 the company founded the *Energy Biosciences Institute* (*EBI*) for the development of petroleum substitutes.

BP's key strategy concentrates on better performance within the *Refining & Marketing* segment, with more efficient operations for an increased output of its key refining facilities and chemical plants, hence margin capture. In particular, with its service stations, the company covers the entire value chain.

In the *Alternative Energy* segment, *BP* pursues a growing equity value by investing in low carbon technologies for long-term strategic growth. Thus, *BP* has become an organisation which embodies energy in all its dynamic forms.

Summary and Outlook

Since 1989, *BP* has been pursuing a strategy for a long-term sustainable *upstream* business in order to extract a cumulative amount of low cost oil and gas from the fields, year by year and, thus, to achieve an impressive through-cycle return (see Datamonitor 2008a, p. 5). To do so, having access to resources is essential to stay competitive.

Within its *downstream* activities, over the years *BP* has created a diverse product portfolio – even down to petrol stations – which is marketed worldwide and balances the company's risks. With its new *Alternative Energy* unit, *BP* founded an auspicious business which will support humanity to bear the upcoming climate change. The large and geographically diverse project portfolio is thus likely to grant a good long-term production outlook.

The reason for *BP's wide* geographical spread resides in its utilisation of most of the value chain due to global advantages. Therefore, the company has different motives for internationalising its activities at the particular chain link. Thus, the core managing board identifies opportunities in challenging markets for the *BP Group* to grow both upstream and downstream.

In Spring 2010, the mentioned catastrophe on an offshore oil platform in the Gulf of Mexico spilled millions of litres of oil into the ocean and on the shores of the USA. This environmental desaster was a top priority not only for BP but even for the US president. Crisis management by BP was highly criticised and most severe, the leak could not be closed for months. At the time of the writing of this book, it is expected that the spill could ultimately cost BP tens of billions of dollars. The full effect of this crisis on the company, its existence but certainly the further exploitation of oil reserves, in particular offshore in the USA, remains to be seen.

Questions

1. Explain the main motives for going international with a company's business. In a second step, apply those objectives by focusing on *BP* in detail.
2. In 2003 the joint venture *TNK-BP* was formed, which is an example of all the associated challenges within the petroleum industry in a politically unstable country. Describe and analyse the recent struggles *BP* is experi-

encing in its Russian engagement. Furthermore, this merger is a good example of certain motives of *BP* to internationalise. Demonstrate the strategic ideas behind the partnership.

3. Climate change is the challenge of the new millennium, not only for humankind but also for *BP*. Identify how the company is dealing with this situation, particularly by focusing on its international new business arrangements. Furthermore, elaborate accompanying motives for those international operations.

Hints

1. Media articles about the struggle within TNK-BP can be found, inter alia, at www.ft.com.
2. Concentrate particularly on *BP*'s *Alternative Energy* unit. Its website will reveal additional information.

Part II

The External Environment

Chapter 5

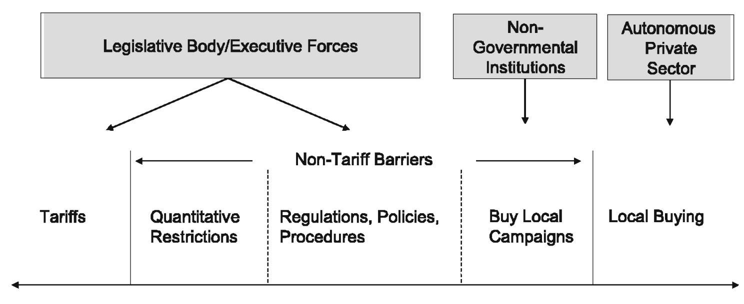
Market Barriers, Global and Regional Integration

International activities of companies are closely related to trade liberalisation on a global level. The most important institution concerned with the rules of trade liberalisation has been GATT, substituted by WTO. The remarkable level of world trade today has another driving force: regional economic cooperation or regional economic integration. The objective of this Chapter is to describe the different types of market barriers and the forms of regional economic cooperation.

Types of Market Barriers

The major artificial barriers to trade are classified in Figure 5.1 as tariffs and non-tariff barriers.

Categories of Market Barriers — *Figure 5.1*



Trade Barriers

Tariffs, i.e., taxes placed on goods that are traded internationally, have traditionally been used to protect domestic industries by raising import prices. Because trade liberalisation has progressed, governments are increasingly using *non-tariff barriers* to protect some of their countries' industries: "Governments are very creative when it comes to the invention or virtuous use of non-tariff barriers to protect their countries' industries from international competition" (Mühlbacher/Dahringer/Leihs 2006, p. 147).

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Non-tariff barriers can take three basic forms:

- quantitative restrictions, i.e., barriers that impose a limit on the quantity of a good that may be exported or imported
- laws, regulations, policies or procedures that impede international trade
- "buy local" campaigns.

Quotas and VER

Quotas are a very popular example in the first category. These limit the quantity of a good that may be exported or imported during a certain time period, such as a year. Another example of numerical limits is the *voluntary export restraint* (VER), i.e., a promise by a country to limit its exports of a good to another country to a defined amount. This is often announced to avoid import restrictions by the target country.

Selected forms of the second category are (Griffin/Pustay 2010, pp. 279-280):

- public-sector procurement policies
- local-purchase requirements
- product and testing standards.

Policies, Procedures, Campaigns

Public-sector procurement policies prefer domestic firms in purchasing. *Local-purchase requirements* impede foreign firms by requiring domestic firms to purchase goods from local suppliers. *Product and testing standards* of a country have to be met by foreign products before the products can be sold in that country. *"Buy local" campaigns* (e.g. "BuyAmerican") are sometimes conducted by non-governmental (or even governmental) institutions "to persuade their nationals to buy locally made products and services rather than those of foreign origin" (Bradley 2005, p.130). *"Local buying"* can also be the expression of a specific behaviour of individuals as consumers, seeking to protect domestic producers because of *patriotic* or *chauvinistic* motives.

Trade Sanctions and Trade Embargos

Besides permanent tariff and non-tariff barriers, international trade is also influenced by temporary barriers which arise because of reactions to specific events in intergovernmental relations: *trade sanctions* and *trade embargos*.A sanction is, generally speaking, the reaction of a state to retaliate against the international-law-violating behaviour of another state. Trade sanctions are also associated with the term *retorsion*. The trade embargo is an example of a trade sanction. A trade embargo implies governmental, sovereign orders to prevent trade with a specific state. Basic variants of the trade embargo are the *export embargo, import embargo* and *capital embargo* (e.g. blockage of payments or prohibition of asset transfers) (Altmann 2001, pp. 616-617).

Restricting Foreign Direct Investment

Government Policy Instruments and FDI

Besides establishing barriers to trade (export or import), a government can deter foreign investments. FDI occurs when a company invests in a foreign subsidiary or joint venture with a partner firm in a foreign country, takes over a foreign company (acquisition/merger) or has a share in a foreign company. Foreign direct investment entails some degree of control in contrast to "pure" financial investments. Besides *ownership restraints*, e.g. where foreign ownership is restricted to 25 %, *operation requirements* (e.g. local content) are another important instrument which influences foreign direct investment decisions. They are controls over the behaviour of the local subsidiary, such as local participation in top management.

Global Integration

Trade Liberalisation

GATT Rules

The most important institution which has opened up new markets in almost all regions of the world has been GATT – the *General Agreement on Tariffs and Trade*. Founded in 1947, its objective was to liberalise international trade by eliminating tariffs, subsidies, import quotas, and the like. According to this multilateral agreement, the international trading system should be (WTO 2007):

- *without discrimination* – a country should not discriminate between its trading partners (giving them equally "most-favoured-nation" or MFN status) and it should not discriminate between its own and foreign products, services or nationals (giving them "national treatment")
- *freer* – barriers coming down through negotiation
- *predictable* – foreign companies, investors and governments should be confident that trade barriers (including tariffs and non-tariff barriers) should not be raised arbitrarily
- *more competitive* – discouraging "unfair" practices such as export subsidies and dumping products at below cost to gain market share
- *more beneficial for less developed countries* – giving them more time to adjust, greater flexibility, and special privileges.

Uruguay Round

Eight *rounds of trade negotiations* have led to significant reductions in tariffs and non-tariff barriers. The eighth round of negotiations, the *Uruguay Round*, created the *World Trade Organization* (WTO), which operates as an umbrella organisation that encompasses the GATT along with new bodies, including one on services and one on intellectual property rights. Since 1 January 1995,

the WTO has been responsible for monitoring the *trade policies* of member countries and arbitrating *trade disputes* among member countries.

GATS and TRIPS

The Uruguay Round also led to liberalisation in trade in services (GATS – *General Agreement on Trade in Services*) as well as agricultural goods, improvement in the protection of intellectual property rights (TRIPS – *Agreement on Trade-Related Aspects of Intellectual Property Rights*) and *anti-dumping rules*, prohibiting sales in foreign countries below cost.

Doha Development Round

The latest round, the *Doha Development Round*, which began in 2001, collapsed in July 2008. The Trade Negotiations Committee failed to agree on blueprint agreements in agriculture and industrial products. Eventually, the talks broke down over the *special safeguard mechanism* (SSM). The SSM would allow developing countries to raise tariffs temporarily to deal with import surges and price falls. Most topics on the agenda had seen positions converge, however, and the further progress of the Doha Round has to be awaited. In any case, as a result of the activities of GATT/WTO since 1947, world trade increased from 1,998 billion USD in 1980 to 12,147 billion USD in 2009 (see Table 5.1).

Table 5.1 *Increase in World Trade between 1980 and 2009 (in billion USD)*

Year	World	Europe	Asia
1980	1,998	965	504
2009	12,147	4,995	3,566

Source: WTO 2010.

Investment Liberalisation

TRIMS

The liberalisation of trade is accompanied by a policy of the WTO members gradually allowing foreign direct investment, such as the establishment of subsidiaries and joint ventures or the takeover of companies. The TRIMS agreement (*Trade-Related Investment Measures Agreement*) in the Uruguay Round is an important step towards eliminating national regulations on FDI. "To this end, an illustrative list of TRIMs agreed to be inconsistent with these articles is appended to the agreement. The list includes measures which require particular levels of local procurement by an enterprise (local content requirements) or which restrict the volume or value of imports such an enterprise can purchase or use to an amount related to the level of products it exports (trade balancing requirements)" (WTO 2008).

For example, some important steps of the timeline of relations of China and the WTO are illustrated in Table 5.2. China has become one of the most popular destinations for foreign direct investment, attracting nearly 230 billion USD between 2002 and 2005.

China's Steps to Open the Market

Table 5.2

Year	Event
July 2001	PRC (People's Republic of China) State Council brings China's Equity Joint Venture (JV) Law into compliance with WTO rules. PRC State Economic and Trade Commission (SETC) approves first foreign-invested wholesale enterprise, Shanghai No. 1 Department Store Co. Ltd.
August 2002	MOFTEC (Ministry of Foreign Trade and Economic Cooperation) allows two types of foreign-invested logistics companies: international and third-party logistics companies.
November 2002	China removes 75 % cap on foreign investment in packaging, storage and warehousing, courier, and road transport JVs. China approves first foreign-majority investement in vehicle manufacturing, though not required to do so under its WTO obligations.
May 2003	MOFCOM (Ministry of Commerce) and the General Administration of Press and Publication (GAPP) allow wholly foreign-owned enterprises (WFOEs) in retail book, magazine, and newspaper distribution (seven months early).
June 2003	China National Tourism Administration and MOFCOM allow wholly foreign-owned travel agencies (two years early).
December 2003	PRC State Administration of Radio, Film, and Television permits foreign investment in film-production and film-technology companies.
March 2004	State Administration of Industry and Commerce and MOFCOM allow WFOEs in advertising services.
April 2004	MOFCOM allows foreign-invested wholesale, retail, and franchise companies, as well as commercial-based agencies.
July 2004	China Insurance Regulatory Commission (CIRC) lowers minimum registered insurance companies and eases restrictions on number of offices opened yearly.
December 2004	MOFCOM lifts all equity, geographic, and quantity restrictions on franchising operations.
February 2005	MOFCOM allows WFOEs in the leasing sector.
December 2005	MOFCOM allows WFOEs in freight forwarding agency services and applies national treatment to capitalisation requirements.

Source: WTO.

Regional Integration

One important exception to the *most favoured nation principle* is comprehensive *trade agreements* that promote economic integration.

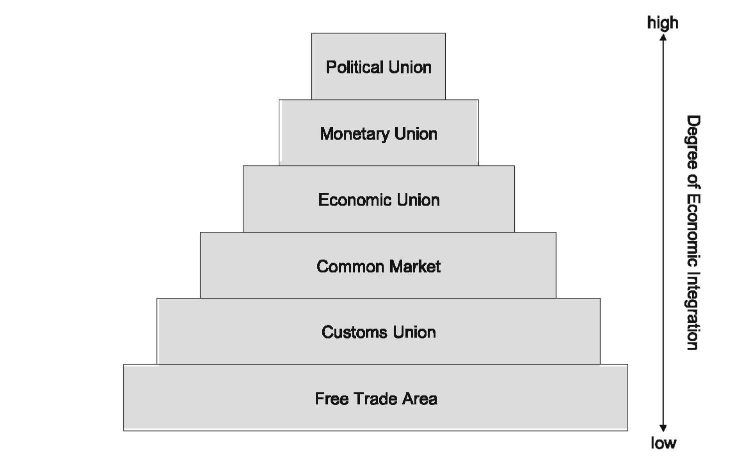
Trade and foreign investment liberalisation are reinforced by economic co-operation among countries, mostly within a geographical region. Economic cooperation can take the form of *bilateral agreements* or *multilateral agreements*, reaching from simple contracts on tariff reduction to political integration.

Stages of Economic Integration

A *preliminary stage* of economic integration is bilateral or multilateral agreements between countries concerning the reduction or abolition of tariffs or other barriers to trade in one or a few product groups. The different stages of economic integration are summarised in Figure 5.2. From the least inte-

grated level to the most integrated level they are: free trade area, customs union, common market, economic union, monetary union, political union.

Figure 5.2 *Different Levels of Economic Integration*



Free Trade Area

A *free trade area* is characterised by the fact that all formal barriers, especially tariffs, are abolished between the member states for a broad group of products or for all products (and services). Examples of existing free trade areas are:

- *European Free Trade Association* (EFTA), focussing on free trade in industrial goods, including Iceland, Liechtenstein, Norway and Switzerland.
- *North American Free Trade Agreement* (NAFTA), including Canada, Mexico and the USA, which led to 90 % of all the trade of Canada and Mexico occurring within the NAFTA countries, while for the USA, its trade with NAFTA countries accounts for one-third.

Custom Union

While the individual member countries of a free trade area maintain their independent external trade policy with regard to non-members, in a *customs union*, the member countries are committed to eliminating trade barriers corresponding to the free trade area, and adopting a common external trade policy. The most familiar and most important example of a customs union is the *European Union* (EU), although similar efforts exist in other regions too, such as MERCOSUR (*Mercado Común del Sur*) in the southern part of Latin America. With regards to transaction costs, a customs union has a great advantage compared with free trade areas: *Certificates of origin* are not

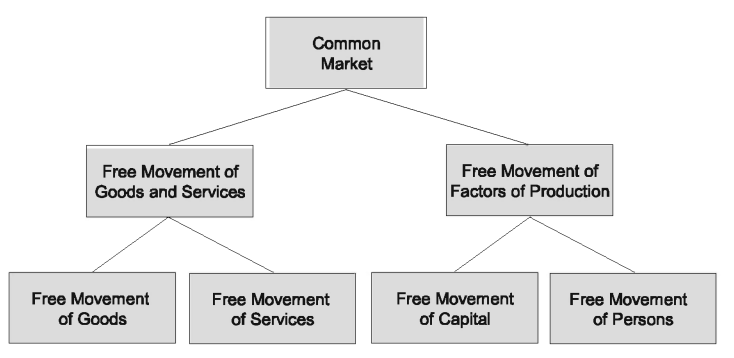
needed in intra-trade transactions. In free trade areas, there is always the possibility of realising *arbitrage effects* by importing goods to a "low tariff" country and then transferring the goods to "high tariff" countries within the area. To avoid these arbitrage businesses, certificates of origin are necessary.

Common Market

A common market has abolished internal tariffs and non-tariff barriers, standardised external tariffs and allows the free movement of factors of production (see Figure 5.3). The only existing common market is the *European Union* (EU), already mentioned as a customs union.

Characteristics of a Common Market

Figure 5.3



Economic Union

In an *economic union*, the next level of economic integration, the member states harmonise their tax and subsidy policies in order to unify their fiscal policy. In this type of union all member nations are fully integrated economically. The European Union intends to realise this stage of economic integration (*Maastricht Treaty, Amsterdam Treaty, Nice Treaty*). However, the implementation process is subject to political and economic difficulties.

Monetary and Political Union

Despite these difficulties, a common currency (*Euro*) has been implemented, as of 1 January 1999. At the time of writing (July 2010), 16 countries were members of the "*Eurozone*". The dramatic debt crisis in Greece and other countries like Spain, Portugal, Ireland and Italy, revealed deep problems in the Eurozone and it became evident that the monetary union needs to be modified to prevent future economic crises. In Figure 5.2., it is pointed out that an economic union should preceed a monetary union. The current proposals from France and Germany point this direction: Both countries demand a "more integrated economic governance" for the EU to ensure the stability of the monetary union (Walker/Gauthier-Villars 2010).

The most advanced form of economic integration is a *political union*. In a political union, a body coordinates the economic, social, and foreign policy of its member states. This objective was the basic element of the *Maastricht Treaty* in 1992. In anticipation of this step, the former *European Community* agreed to rename itself the European Union, a truly optimistic sign.

Effects of Economic Cooperation

Cecchini Report

The effects of economic cooperation are diverse. For example, the macroeconomic effects of the implementation of a common market (within the European Community) can be observed. According to the so-called *Cecchini Report* (Cecchini 1988, p. 97), the following macro-effects had been expected:

- relaunch of economic activity, adding on average 4.5 % to GDP
- deflation of consumer prices by an average of 6.1 %
- improving the balance of public finances by an average equivalent to 2.2 % of GDP
- boosting the EC's external position by around 1 % of GDP
- creating 1.8 million new jobs.

Interim Balance

An *interim balance* (a report titled "10 years of common market: 1993–2002") identifies many important advantages which could be put down to economic integration (Kommission der Europäischen Gemeinschaft 2003, pp. 2-3):

- The GDP of the European Union in 2002 has increased by 2 % percentage points or 165 billion EUR in comparison with 1993.
- Since 1992, 2.5 million new jobs have been created.
- Prosperity has increased during the 10 years by 877 billion EUR. This corresponds to 5,700 EUR per household.
- The competitiveness of the EU companies has increased. For example, exports to third countries (non-member countries) have increased from 6.9 % of GDP (1992) to 11.2 % (2001).
- The common market has become much more attractive for foreign investors. Foreign direct investment, in terms of percentage of GDP, has more than doubled.

Intra-EU Trade

The effects of the common market with regard to trade within the European Union *(intra-EU trade)* are illustrated by Table 5.3. All member states of the EU-27 have an intra-EU trade share of at least 55 %.

Shares of Intra-EU Trade for the EU Member States 2008 (in %)

Table 5.3

State	Quote	State	Quote
Austria	75	Latvia	73
Belgium	73	Lithuania	59
Bulgaria	58	Luxembourg	81
Cyprus	68	Malta	63
Czech Republic	81	Netherlands	64
Denmark	71	Poland	75
Estonia	76	Portugal	74
Finland	59	Romania	70
France	66	Slovakia	79
Germany	63	Slovenia	70
Greece	57	Spain	63
Hungary	73	Sweden	64
Ireland	66	United Kingdom	55
Italy	56		

Source: EUROSTAT 2009.

Impact of Economic Integration on Firms

New Markets and Cross Border Value Creation

The political efforts of GATT/WTO to liberalise trade and foreign direct investment and the different regional alliances eliminating trade barriers, adopting a common external trade policy and allowing factors of production to move freely between members, have led to new markets with regard to sourcing and selling and to new sites for production, logistics and so on (see Part V). Firms can reduce their production costs by capturing *economies of scale* when expanding their customer base within the trading bloc. The lower cost structure will also promote the firm's *international competitiveness* outside the trading blocs. "However, elimination of trade barriers also exposes a firm's home market to competition from firms located in other member countries, thus threatening less efficient firms" (Griffin/Pustay 2010, p. 301).

Conclusion and Outlook

The remarkable level of world trade and foreign direct investment can be attributed to the political efforts of GATT/WTO and to the fact that regional integration has extensified and intensified. This results in far-reaching liberalisation within regional cooperations, but also in discrimination vis-à-vis third countries, which is at first glance in conflict with free trade worldwide.

Trading Blocs vs. Free Trade

In the next few years, there will be strong efforts to create new regional co-operations or to intensify the stage of integration, for example in North and South America and Asia. This offers many opportunities for companies with regard to exports and imports, to outsourcing, offshoring, strategic alliances, and greenfield and brownfield investments. If *regional agreement areas* will merge gradually, regional economic cooperation will finally lead to free trade worldwide.

Further Reading

GRIFFIN, R.; PUSTAY, M. (2010): International Business, Global Edition, 6th ed., Upper Saddle River, NJ, Prentice Hall, pp. 292-320.

HILL, C. (2008): Global Business Today, 5th ed., Boston, MA, McGraw-Hill, pp. 261-287.

WOYKE, W. (2002): The European Union after Nice – A Community Facing a New Century, in: SCHOLZ, C.; ZENTES, J. (Eds.): Strategic Management – A European Approach, Wiesbaden, Gabler, pp. 3-21.

Case Study: Nissan[1]

Profile, History, and Status Quo

The origins of *Nissan Motor Co., Ltd.* date back to 1933, when *Jidosha Seizo Co., Ltd.*, the predecessor of *Nissan Motor Co., Ltd.*, was established in Yokohama. After changing its name to *Nissan Motor Co., Ltd.* in 1934, the company commenced the mass production of automobiles in Japan.

Due to shortage of material during the Second World War the company focused its production on trucks, aeroplanes and engines for the Japanese military and significantly reduced the number of cars produced. After World War II the increasing household penetration of cars in Japan, beginning in the 1950s, benefited *Nissan's* sales of small-sized cars for personal use. In the 1960s the company started its overseas activities by establishing the *Nissan Motor Corporation* in USA, the *Nissan Mexicana, S.A. de C.V.* as well as the *Nissan Motor Co. Pty. Ltd.* in Australia. After moving into the marine engine field in 1970 and establishing several production and design facilities over-

[1] Sources used for this case study include the web site http://www.nissan-global.com and various annual and interim reports, investor-relations presentations as well as other cited sources.

seas, *Nissan* began its activities in the European market, mainly by acquiring an equity interest in *Motor Ibérica, S.A.* in Spain and establishing *Nissan Motor Manufacturing Ltd.* in the United Kingdom.

Today *Nissan Motor Co., Ltd.* is engaged in planning, developing, manufacturing and selling passenger automobiles as well as automobile parts, forklifts and marine engines, and operates in Japan, North America and Europe. In addition, the company also provides financial services, such as credit cards, loans to purchase vehicles, car leasing, car rental or car insurance – primarily in Japan and North America – through its wholly-owned subsidiary *Nissan Financial Services (NFS)*.

Wide Geographical Base of Business

The company has a wide geographical base with operations in regions including Japan, the USA, Europe, Canada, Mexico, Australia, New Zealand, South Africa, the Middle East and Asia. In addition, the group is diversified in terms of revenue generation from those geographic regions: In 2008 the group generated 35.3 % of its total revenues from North America, 27.7 % from Japan, 16.9 % from Europe and 20.1 % from other regions (Nissan 2009a). This geographical spread is one of the strengths of the company as it aids in catering to different markets and reaping the benefits of emerging markets (Datamonitor 2007a). Table 5.4 shows the major offices and facilities (besides the sales network) of *Nissan* in Europe.

Major Offices and Facilities in Europe ***Table 5.4***

<table>
<tr><th>Function</th><th>Company / Office / Facility</th><th>Operations Commenced</th><th>Vehicle Production</th><th>Number of Employees</th><th>Major Operations / Products</th></tr>
<tr><td>Regional Headquarters</td><td>Nissan International SA (Switzerland)</td><td>Jan 2008</td><td></td><td>148</td><td>Management of European operations</td></tr>
<tr><td>R&D</td><td>Nissan Technical Center Europe (UK)</td><td>May 1988</td><td></td><td rowspan="3">4,825</td><td>Vehicle development</td></tr>
<tr><td>Design</td><td>Nissan Design Europe (UK)</td><td>Jan 2003</td><td></td><td>Vehicle design</td></tr>
<tr><td rowspan="2">Production</td><td>Nissan Motor Manufacturing (UK) Ltd.</td><td>Jul 1986</td><td>315,297</td><td>Qashqai, Micra, Micra C+C, Note</td></tr>
<tr><td>Nissan Motor Ibérica, S.A. (Spain)</td><td>Jan 1983</td><td>193,605</td><td>4,250</td><td>Primastar, Pathfinder, Navara, Atleon, Cabstar</td></tr>
</table>

Source: Nissan 2009b.

Over the years *Nissan* has succeeded in creating new product lines, expanding its production volume and reaching the production milestone of the 100 millionth vehicle in 2006. It became one of the leading companies in the Japanese automobile industry with total net sales of 8,437 billion Yen in 2008 (Nissan 2009a).

Table 5.5 *Corporate Data Nissan Motor Co., Ltd. 2004–2008*

	2004 March 31, 2005	2005 March 31, 2006	2006 March 31, 2007	2007 March 31, 2008	2008 March 31, 2009
Net Sales (billion Yen)	8,576.3	9,428.3	10,468.6	10,824.2	8,437.0
Net Sales (billion EUR, approx.)	64.19	70.69	78.49	81.16	76.22
Global Retail Sales (units)	3,388,592	3,569,477	3,483,128	3,769,886	3,411,048
Retail Sales Japan (units)	848,267	842,063	739,925	721,000	612,482
Retail Sales Overseas (units)	2,540,325	2,727,414	2,743,203	3,048,886	2,798,566
Global Production (units)	3,378,578	3,509,595	3,267,001	3,657,629	3,084,027

Source: Nissan 2009a; Nissan 2009b.

Since 1999 the company has had a global partnership with *Renault* for automobile manufacturing and sales as well as for automotive financing. *Renault* holds a 44.3 % stake in *Nissan*, while *Nissan* owns 15 % of *Renault* shares. The alliance jointly operates *Renault Nissan*, in which both *Nissan* and *Renault* have a 50 % interest, as well as *RNPO (Renault-Nissan Purchasing Organization)* and *RNIS (Renault-Nissan Information Services)* (Datamonitor 2007b, p. 18).

Regional Integration in Europe

The origin of European integration goes back to 1950, when French Foreign Minister *Robert Schuman* presented a plan for deeper cooperation between six countries in Europe after the Western European nations created the *Council of Europe* in 1949 as a first step towards cooperation after World War II. Based on the *Schuman plan*, the six founding member states – Germany, France, Italy, the Netherlands, Belgium and Luxembourg – signed a treaty to run their heavy industries – coal and steel – under a common management.

History of the European Community

Building on the success of the *Coal and Steel Treaty*, the six countries expanded their cooperation to other economic sectors and signed the *Treaty of Rome*, creating the *European Economic Community (EEC)*, or "common market" with the goal of free movement of people, goods and services across borders. The six removed customs duties on goods imported from each other, allowing free cross-border trade for the first time. They also applied the same duties on their imports from outside countries with the effect that trade among the six founding members and between what is now the *EU* and the rest of the world has grown rapidly (European Commission 2010).

The foundation of European economic integration is the liberalisation of internal trade. Up to 1993, this process of trade liberalisation within the *EC* passed through three major phases. The first phase, started in 1958, was the elimination of customs duties and quantitive restrictions, which was completed in 1968 with the introduction of a common external tariff. The successive enlargement from six to twelve members between 1973 and 1986 represented the second major phase. The last phase, ending in 1992, was the completion of the internal market for goods, services, capital and labour (Sapir 1992).

Barriers to Entry

Conditions or circumstances that make it very difficult or unacceptably costly for outside firms to enter a particular market to compete with established firms are characteristics of barriers to entry. These barriers may derive from several causes, e.g. legal, regulatory or other clearly political barriers to entry are historically very common. In the context of barriers to entry, Porter (1980, pp. 7-17) mentioned some major sources like government policies or capital requirements. Simon (1989, col. 1441) differentiates three main categories: protective, economical, and behaviour-based barriers which are described briefly as follows.

Categories of Barriers to Entry

- *Protective* or *institutional barriers* are mainly concerned with tariff and non-tariff barriers. Such barriers may appear with different characteristics. Regarding exports, they may appear in terms of customs duties. Another form is specific licence requirements. Furthermore, the host country may raise strict local content regulations to protect the domestic industry (Kutschker/Schmid 2008, p. 959). Other widespread types of protection by dint of barriers are subventions. These are arrangements which do not count among tariff barriers but are regarded as non-tariff. All such restrictions and instructions are based on state determinations.

- One of the *economic barriers* to entry is economies of scale of companies which are already established within a market. Porter (1980, p. 7) mentioned in this context that "economies of scale deter entry by forcing the entrant to come in at large scale and risk strong reaction from existing firms or come in at a small scale and accept a cost disadvantage, both undesirable options". Furthermore he cites the product differentiation of established firms (Porter 1980, p. 9) which generates, among other things, a higher customer loyalty, as an undeniable barrier.

- *Behaviour-based barriers* arise from customer behaviour and other stakeholder interests which are based on special preferences, cognitions or habits. Reasons for the occurrence of such barriers do not necessarily

have to be found beyond the companies. The emergence of behaviour-based barriers may also be based on the personality of management itself, which represents an internal source for such a barrier. Paucity of information about foreign markets, mental barriers or risk aversion of the management represents other behaviour-based barriers which occur inside the firm.

The Strategy of Nissan Motor Co., Ltd. in the 1980s for Developing the European Market

Japanese Carmakers Hitting the European Market

In the late 1970s and the beginning of the 1980s there was a general movement of Japanese carmakers trying to develop foreign markets, mirroring a global expansionary trend. For example, the market share of Japanese firms in the US automobile industry rose from 5.7 % in 1971 to 19.1 % in 1980 (Berry/Levinsohn/Pakes 1999, p. 414). In the European region, Japanese carmakers had to face two main problems in seeking to increase their share of European markets by exports. On the one hand a problem was that the strongly appreciating yen made exports difficult, and on the other hand political resistance to growing imports, reflected in voluntary export control arrangements, limited the share of the European market which could be acquired via exports of Japanese carmakers.

In the 1970s the global car industry was under pressure from Japanese exports and a reduced demand for cars in the wake of 1973 oil crisis. In response to the Japanese expansion, allegations of dumping and subsequent representations were made by a number of European countries attempting to persuade the Japanese car makers themselves to limit their export volume. Formal discussions between the Japanese and the UK industry led to the voluntary export control arrangements mentioned above (Walker 2004).

Import Restrictions for Japanese Car Manufacturers

The penetration of some important European countries, like France, Italy and Spain proved to be difficult due to significant import restrictions. For example, the French car market limited the imports of Japanese cars to five manufacturers with a total market share of 3 %. In Spain, one of the fastest growing car markets in the late 1980s with more than one million units in 1988, there was a quota which allowed just 3,200 units to be imported by Japanese carmakers, including imports via other EC countries. The Italian car market had been highly restricted since 1957 and in 1988 Japanese car imports were restricted to only 3,300 units. In other European countries, such as Ireland, Denmark, Finland, Norway and Austria, lacking a historical domestic automobile industry and without any restrictions on motor vehicle

imports, Japanese carmakers held more than a 30 % market share. This fact shows that the possibilities for gaining greater market shares in the other European markets were strictly limited (Quelch/Ikeo 1989).

Local Production of Japanese Carmakers in UK in the Late 1980s

Table 5.6

Company	Outline
Nissan	manufacturing 57,000 upper-medium-sized cars a year in 1988
Toyota	planning to manufacture 200,000 upper-medium-sized cars a year from 1992
Honda	manufacturing 84,000 medium-sized cars a year (in 1987) jointly with the Rover Group
Isuzu	manufacturing 5,400 commercial vehicles a year in 1987 in joint venture with General Motors

Source: Quelch/Ikeo 1989, p. 13.

As a result, the Japanese companies were compelled to establish production facilities within the *European Community* by FDI, via acquisitions, mergers or joint ventures, to increase their market share and to secure a long-term position in this market (Hudson 2002, p. 15).

Several Japanese carmakers, in anticipation of the *European Community* market integration to the European Single Market in 1993, searched for production sites within the European region where they could implement their high volume flexible production methods. This was difficult to introduce in regions with a history of automobile production with existing working practices and wage arrangements. Consequently a number of the Japanese companies decided to invest in the United Kingdom because of national government policies, fixed capital investment subsidies and adequate labour markets.

Entry and Operating Strategy of Nissan Motor Co., Ltd. in Europe

In 1959 *Nissan* started its European market penetration with exports to Finland because there was a major focus on northern Europe until the late 1960s. At this time, protectionism against the increasing car exports of Japanese carmakers occurred in several countries, as shown above, so that the Japanese companies decided to implement local production in the European market to develop the European region. *Nissan´s* decision to start assembly operations in Europe was not only a response to growing protectionism but also reflected its problematic position within the Japanese domestic market, where *Toyota´s* market share was roughly double that of *Nissan*. *Nissan* was

driven to seek competitive advantage overseas because of its difficulty in maintaining market share in Japan (Hague 1989, p. 5).

Decision for Sunderland, UK

Nissan became the first Japanese firm to set up a plant in the UK. *Nissan* made the final decision to locate its first production facility in Europe at a location near Sunderland, in the North-east of England, in 1984, after many years of searching and negotiating for the ideal location.

The final decision was influenced by three deciding factors:

- First, *Nissan Motor Co., Ltd.* required a greenfield site to build up its production facilities with enough space for further expansion in the future. A coalition of the local council and development corporation were able to offer *Nissan* a 930-acre site, the former Sunderland airport.
- The second factor which influenced the decision in favour of Sunderland was that the negotiating council could offer the site as a single-union plant.
- The third reason for choosing the North-east region of England was the similarity of this region to the Ohio-Tennessee region of the USA, where most of the Japanese automobile transplants were located and *Nissan* and other Japanese carmakers had gained experiences before. The similarities mainly included the high unemployment rate, a relatively ethnically homogenous population, necessary logistical criteria and the availability of government subsidies.

Nissan received a total of 112 million GBP in subsidies from the British government as an incentive for locating the production plant in Britain. Because the activities of *Nissan* promised jobs and some prospect of industrial renewal in a region with long-standing high unemployment rates, the company was pursued with total commitment by North-eastern development agencies and by representatives of major regional political and economic interests acting in a united and highly coordinated way (Crowther/Garrahan 1988).

Initial plans to invest 330 million GBP to build the factory with an output of 200,000 cars were drastically reduced in the beginning. The Sunderland plant started with an investment of 50 million GBP and a production of 24,000 vehicles. The company quickly agreed to major expansions resulting in a production of 100,000 cars and the creation of nearly 3,000 jobs for the region (Rehder/Thompson 1994, p. 97).

In the following years the Sunderland factory became the UK's biggest car plant and was widely recognised as the most productive in Europe. Today the Sunderland plant employs 4,000 people and produces around 350,000 cars per year.

Local Production of Japanese Carmakers in the European Union

Following the initial operations in the late 1980s, the strategy of implementing local production facilities proved to be a general concept of the Japanese car manufacturers within the European market. Japanese manufacturers have been progressively establishing ties in various countries of the *European Union* over the past two decades to develop Europe as the second largest automobile market after the USA. *Nissan* was the first to establish its own independent operations in the United Kingdom and other manufacturers quickly followed. Outside the UK, operations included a *Toyota-Volkswagen* tie-up in Germany, a *Nissan* tie-up and a *Suzuki* tie-up in Spain, a *Toyota* joint venture and a *Mitsubishi* tie-up in Portugal, and a *Mitsubishi* joint venture in the Netherlands, *Suzuki* has also established a joint venture operation in Hungary (JAMA 2008).

Selected Production Facilities of Japanese Carmakers in the European Union

Table 5.7

Manufacturer	Company	Location	Start of Operation	Units Produced in 2008	Employees
United Kingdom					
Nissan	Nissan Motor Manufacturing (UK) Ltd.	Sunderland	1986	386,555	4,352
Toyota	Toyota Motor Manufacturing (UK) Ltd.	Burnaston Deeside	1992	213,000 -	4,280 570
Honda	Honda of the U.K. Manufacturing Ltd.	Swindon	1992	230,423	3,400
Spain					
Nissan	Nissan Motor Iberica S.A.	Barcelona, Avila	1983	156,961	5,540
Suzuki	Santana-Motor, S.A.	Linares	1985	3,189	558
Portugal					
Toyota	Toyota Caetano Portugal, SA	Ovar	1968	-	360
Mitsubishi Fuso	Mitsubishi Fuso Truck Europe S.A.	Tramagal	1996	10,856	357
Hungary					
Suzuki	Magyar Suzuki Corporation	Esztergom	1992	281,686	3.774
Poland					
Isuzu	Isuzu Motors Polska Sp.zo.o	Tychy	1999	142,932	632
Toyota	Toyota Motor Manufacturing Poland Sp.zo.o	Walbrzych	2002	-	2,070
Toyota	Toyota Motor Industries Poland Sp.zo.o	Jelcz Laskowice	2005	-	1,070
Czech Republic					
Toyota	Toyota Peugeot Citroen Automobile Czech, s.r.o.	Kolin	2005	108,000	3,410

Source: JAMA 2009, p. 5.

Furthermore there are numerous supply and marketing alliances between Japanese and European manufacturers. Within the time period between the first expansion of the European Union and its development to the current state, the strategy and the operations of Japanese car manufacturers fol-

lowed this path. For example, the accession of Southern European countries such as Spain and Portugal to the EU in 1986 led to the Japanese carmakers *Nissan*, *Suzuki* or *Mitsubishi* making huge investments in local facilities there. In the course of the Eastern enlargement of the European Union in 2004, these developments continued. For example, when Hungary, Poland and the Czech Republic became members of the EU, plants were set up by *Suzuki*, *Isuzu* and *Toyota*. There has been a similarly strong involvement of Japanese carmakers within the newer members of the EU located in Eastern Europe. Table 5.7 shows selected production facilities of Japanese carmakers in the EU. Today Japanese carmakers operate 15 production facilities in ten EU countries. In 2008 these manufacturers produced 1.69 million vehicles in the EU, so that the production has nearly tripled since 1995 (JAMA 2009, p. 4).

Questions

1. Summarise the main problems for Japanese car makers in the late 1980s concerning the development of the European market. Describe the political and economic environment they had to deal with.
2. Describe which main factors led to the decision of *Nissan* to implement a local production plant, and especially which circumstances led to the choice of Sunderland, UK.
3. Generally Japanese carmakers had different options concerning their market entry and operating strategy. Discuss why *Nissan Motor Co., Ltd.* decided for FDI and which other possibilities it had. What are the main advantages and disadvantages of other modes of market entry? Compile factors that influence a company's choice of entry mode.
4. Define different types of market barriers and show their effect on the entry mode. Explain different strategies a company can use to deal with entry barriers in the context of the internationalisation of its business. Give some examples.

Hints

1. See Part IV of this book for a description of different market entry modes and see Luo 1999 for an explanation of factors affecting entry mode selection.
2. See Kotabe and Helsen 2008 and Johansson 1997 for details of market entry barriers.

Chapter 6

Competitive Advantage of Nations and Regional Clusters

This Chapter gives an overview of the main sources of national competitive advantages, based on Porter's diamond model, and discusses the role of regional clusters of industries. In this context it is explained, how MNCs can benefit from locating their operations in country markets with a high level of national competitive advantage or in regional industry clusters.

National Competitive Advantage

Multinational corporations can benefit from favourable environmental conditions by locating their operations in countries with expedient market conditions. As globalisation of international markets increases and the liberalisation of markets simplifies cross-border transactions, MNCs have a broad selection of potential locations from which to select. Most attractive for MNCs are locations with a high level of national (or regional) competitive advantage. The level of a country's competitiveness reflects the extent to which it is able to provide rising prosperity to its citizens. A nation's prosperity is intimately linked to the productivity of the economy. If a nation is able to improve its productivity, it can improve prosperity.

In this context, Porter (1990, p. 73) argues that: "National prosperity is created, not inherited". Thus, not only firms compete internationally, but, as global competition is increasing, countries also need to position themselves as attractive places to invest and to do business. Following this view, each country needs to explore its potential *sources of competitive advantage* to achieve the sustainable growth which is the basis for long-term economic wealth and prosperity of the nation.

Global Competitiveness Index

Each year, the *World Economic Forum* publishes the Global Competitiveness Report in which countries are ranked according to their competitiveness (see Table 6.1). The ranking builds on the *Global Competitiveness Index (GCI)* which is developed based on the "12 pillars of competitiveness" that are regarded as sources of national competitive advantage. In this regard, factors such as the institutional environment in a country, its macroeconomic stability, the educational system or the infrastructure are analysed as well as a country's market size or its level of (technical) innovation (Sala-i-Martin et al. 2009).

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Thus, the determinants of competitiveness are manifold and countries need to explore which dimensions are important to build on to improve the nation's competitiveness.

Table 6.1 *Global Competitiveness Index Ranking 2009-2010*

Country/ Economy	Rank	Score	Country/ Economy	Rank	Score
Switzerland	1	5.60	France	16	5.13
United States	2	5.59	Austria	17	5.13
Singapore	3	5.55	Belgium	18	5.09
Sweden	4	5.51	Korea, Rep.	19	5.00
Denmark	5	5.46	New Zealand	20	4.98
Finland	6	5.43	Luxembourg	21	4.96
Germany	7	5.37	Qatar	22	4.95
Japan	8	5.37	U. Arab Emirates	23	4.92
Canada	9	5.33	Malaysia	24	4.87
Netherlands	10	5.32	Ireland	25	4.84
Hong Kong SAR	11	5.22	Iceland	26	4.80
Taiwan	12	5.20	Israel	27	4.80
United Kingdom	13	5.19	Saudi Arabia	28	4.75
Norway	14	5.17	China	29	4.74
Australia	15	5.15	Chile	30	4.70

Source: Schwab/Sala-i-Martin/Greenhill 2009, p. 13.

Porter's Diamond Model

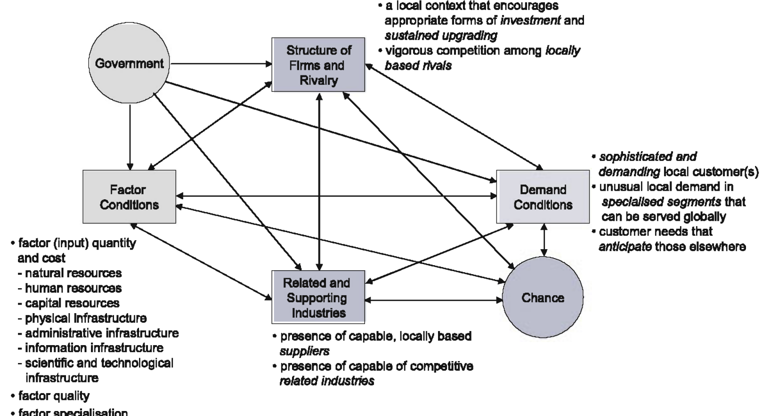
Sources of Competitive Advantage

While the underlying understanding of competitiveness in the GCI relates to the economy as a whole, there are differences in the patterns of competitiveness relating to each particular industry. No nation will be competitive in all or most industries. At the *industry level*, Porter (1990a, 1990b) tried to explain why a nation achieves international success in a particular industry. Based on an intensive investigation of 100 industries in ten nations, he identified four attributes that promote or impede the creation of competitive advantage: (1) factor conditions, (2) demand conditions, (3) related and supporting industries, and (4) firm strategy, structure, and rivalry.

These four attributes shape the environment in which local firms compete and determine the success of nations in international competition. They constitute the *diamond* (see Figure 6.1), a mutually reinforcing system in which the effect of one attribute is contingent on the state of the other attributes. Each of the four determinants of national competitive advantage is briefly discussed below.

Figure 6.1

Determinants of National Competitive Advantage: Porter's Diamond



Source: Porter 1990a, p. 127.

Factor Conditions

The first element of the diamond is the nation's possession in factors of production. Consistent with the *factor proportions theory* (Heckscher-Ohlin), every country has a relative abundance of certain factor endowments. In his diamond model, Porter distinguishes between basic factors and advanced factors.

Basic Factors and Advanced Factors

Basic factors are factors such as land, climate, natural resources or demographics, while *advanced factors* relate to more sophisticated factors, including, for example, the nation's stock of knowledge resources (e.g. scientific, technical or market knowledge), the transportation and communication infrastructure or a sophisticated and skilled labour force (Rugman/Collinson 2009, p. 458).

In the diamond model, the *advanced factors* are regarded as being most significant for competitive advantage. These factors can be created through training, research and innovation and thus are a product of investment by individuals, companies or the government. The basic assumption is that a nation must continually *upgrade* or adjust its factor conditions. The basic factors provide the country with an initial advantage that subsequently can be reinforced by investing in *advanced factors*. On the other hand, disadvantages in basic factors entail that countries need to invest in advanced factors (Porter 1990b). Thus, upgrading a nation's advanced factors, such as the

educational system or infrastructure, is regarded as a means to improve a nation's competitive advantages.

Demand Conditions

Home Market Demand

Demand conditions refer to the *nature and the size* of the home demand for an industry's products and services. Here, the main characteristics of its nature are the strength and *sophistication* of domestic customers' demand. Porter argues that companies are most sensitive to the needs of their closest customers (Porter 1990b, pp. 79-80). Thus, home market demand is of particular importance in shaping the attributes of the companies' products. The more sophisticated and demanding their local customers, the more pressure is created for innovation, for efficiency and for upgrading product quality. Therefore it is assumed that with increasing consumer sophistication in their home markets and, consequently, with increasing pressure on local sellers, their competitive advantage will escalate (Hill 2009, p. 190).

Size of Home Market

While the nature of home market demand mainly relates to the pressure to improve local companies' performance, the size of the home market is important as it enables companies to achieve economies of scale and experience curve advantages. This is even more important when scale economies limit the number of production locations. In this case, the size of its market is an important determinant of the country's attractiveness as a potential location. Additionally, empirical evidence shows that efficient firms are often forced to look for international opportunities at stages when their early large home market becomes saturated. Their home markets provide these companies with scale advantages that can be used in the global marketplace (Hollensen 2007, pp. 99-100).

Related and Supporting Industries

Industrial Cluster

The presence of a business environment comprising related suppliers, competitors and complementary firms is regarded as highly supportive for an industry to build competitive advantages. Such a (geographical) concentration of companies, suppliers and supporting firms at a particular location is labelled an *industrial cluster* (Porter 2000, p. 254).

Firm Strategy, Structure, and Rivalry

This element of the diamond relates to the firm-based theories of internationalisation that focus on the actions of individual firms. National context and national circumstances influence strongly how companies are created,

organised and managed and what the nature of domestic rivalry will be (Porter 1990b, p. 81).

Domestic Competition

Domestic competition affects companies' ability to compete in the global marketplace. Not only does the presence of *local competitors* automatically cancel advantages that come from a nation's factor endowment or characteristics of home market demand, but the higher domestic competition is, and the more strong rivals are present on the home market, the more companies are forced to become more efficient and to adopt new technologies. The high pressure in a competitive home market leads to *selection processes* and leaves only the most efficient firms as survivors. At the same time it is associated with a continuous pressure on companies to innovate and to improve (Griffin/Pustay 2010, pp. 188-192).

Managerial Systems

Not only does the competitive pressure vary between countries but also managerial practices, organisational modes, company goals and individual achievement goals differ significantly between countries. These differences lead to *dissimilar international strategies* of the firms. Additionally, Porter argues that specific managerial systems are needed to be successful in each of the diverse industries. Thus, if a nation's firms follow a specific managerial system this only can be successful in selective industries. Thus, such differences also play an important role in the diamond model because different management ideologies influence the ability to build national competitive advantage (Porter 1990b, pp. 81-82).

Evaluation of the Diamond Model

Each of the four elements of the diamond model has an influence on the nation's competitive advantage in a specific industry with all of these attributes depending on the state of the others. Usually, the presence of all four components is required to increase competitive advantage with weaknesses in any one determinant constraining an industry's potential for advancement and upgrading. While the diamond is regarded as a *self-reinforcing system*, the role of two additional forces is important: *government* and *chance* (see Figure 6.1). A controversial debate centres on the role of MNCs in the diamond model. Several researchers have argued that *multinational activity* should be included as a third outside variable because MNCs are influenced in their competitiveness by the configuration of the diamond in other than their home countries and this in turn influences the competitiveness of the home country (e.g. Dunning 1993b).

Role of Multinational Companies

The Role of Chance and Government

Government Interventions

As already mentioned, the basic underlying view of the diamond model is that competitive advantage can be created. Therefore nations can influence competitive advantage by systematically improving each of the elements of the diamond. In this connection it is important to note that *government interventions* must be considered in terms of their impact on domestic company activities as the underlying view in the diamond model is that "firms, not nations, compete in international markets" (Porter 1990a, p. 33).

Governments can, for example, cultivate new and superior *factor endowments*, influence the nature of *local competition*, home market *demand* or *clustering of firms* by using measures such as subsidies, investing in the educational system, monetary and fiscal policy (e.g. tax incentives or low interest loans), the development and maintenance of a strong infrastructure (e.g. IT, communication systems, transportation), antitrust regulations or enforcing product and safety standards. However, one must not forget that such well-intentioned government actions also can *backfire* and lead to the creation of a "sheltered" domestic industry that is unable to compete in the global marketplace (Rugman/Collinson 2009, p. 459).

Role of Chance

Additionally, the role of *chance* in building competitive advantage is recognised in the diamond model. However, this influence of chance is *not predictable*. For example, chance influences the creation of new ideas or new inventions. Also wars, significant shifts in world financial markets, discontinuities in input costs (e.g. oil price shocks) or major technological breakthroughs can have a significant impact on a nation's competitive advantage.

Stages in National Development

The diamond model can be used to distinguish three growth stages of national competitive development (Porter 1990a, pp. 555-565):

- *Factor-driven stage*: The first stage, the factor-driven stage, relates to industries that draw their advantages solely from the nation's factor endowments, mainly from basic factors of production such as natural resources (e.g. mineral deposits). These industries can be successful internationally but they compete primarily on price.
- *Investment-driven stage*: This stage implies efforts of upgrading of the nation's industry as companies invest in modern technology and more efficient facilities.
- *Innovation-driven stage*: While in the second stage investment in modern, but already existing technology dominates, the third stage, the innovation-driven stage, is characterised by the creation of new technology or

(production) methods. These improvements are yielded by internal innovation as well as by innovation in cooperation with, or with assistance from, suppliers and companies in related industries.

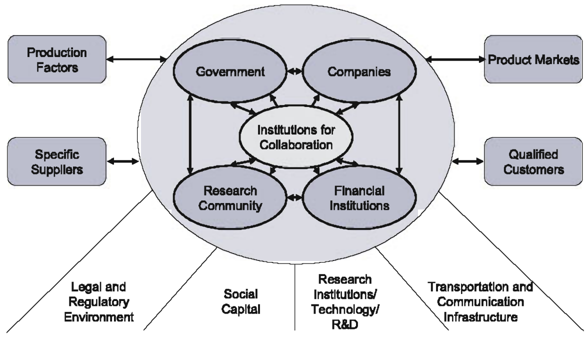
This model mainly relates to the stages of a nation's industries. Usually, countries span two or more stages in this model because there are likely to be industries (or companies) in all countries that are operating at each stage.

Regional Clusters

In the diamond model, the regional clusters have a prominent role. "A cluster is a geographically proximate group of interconnected companies and associated institutions in a particular field, linked by communalities and complementarities" (Porter 2000, p. 254). Therefore, clusters are closely linked with the dimensions "related and supporting industries" and "firm strategy, structure, and rivalry" of Porter's diamond model.

Actors in Regional Clusters

Figure 6.2



Source: Adapted from Sölvell/Lindquist/Ketels 2003, p. 18; Andersson et al. 2004, p. 31.

Competition and Cooperation

Clusters can include, for example, *suppliers* of specialised inputs (e.g. components, machinery, and services) or providers of specialised *infrastructure* (see Figure 6.2). They are usually extended downstream to customers and laterally to complementary industries and companies in industries related by technologies, common inputs or skills. Often, clusters also encompass governmental and other institutions (e.g. universities, think tanks, or stan-

dard-setting agencies) that provide specialised research, education, training, and technical support (Porter 1998, p. 78).

This nature of clusters leads to an internal constellation that promotes both competition and cooperation. *Competition* occurs between the rival companies located in geographical proximity while *cooperation* mainly relates to vertical channel relationships with related companies, related industries or local institutions.

Advantages of Regional Industry Clusters

The advantages from such clustering of firms mainly stem from the presence of a specialised *infrastructure*, industry-sector-specific *factors of production* and *skilled labour* in the specific professional field, from *information and knowledge synergies*, and the access to appropriate or *superior inputs*.

If an industry is located close to its suppliers it will enjoy better *communication* and the exchange of cost-saving ideas and inventions with those suppliers. This is mainly a result of geographical proximity which enables close working relationships in which advantages from short lines of communication and a quick and constant flow of information with companies having the opportunity to influence their suppliers' technical efforts can help to accelerate the pace of innovation (Cavusgil/Knight/Riesenberger 2008, p. 105).

The nation's industry benefits most from clustering if the suppliers or the complementary firms themselves are internationally competitive (Porter 1990b, p. 81).

Cluster Lifecycle

Cluster development can be explained as an ongoing process with clusters passing through a number of stages. Even though the patterns of cluster development may not be identical and the pace of cluster evolution may vary, it is possible to discern certain characteristic patterns. In the ideal *lifecycle of cluster development*, six phases (see Figure 6.3) can be distinguished (Schramm-Klein 2005; European Commission 2002; Sölvell 2008, pp. 39-44):

1. *Emergence of pioneers*: Cluster development is usually stimulated by several causes, including a combination of basic or advanced factors in a region, such as natural resources, specific knowledge (e.g. in universities or research institutions), specific customer demand or technological innovation. According to the *diamond model*, these diverse drivers can be regarded as sources of competitive advantage. Primary companies emerge that focus on the deployment of these advantages. In the initial stage of

cluster development, more and more companies emerge that focus on these specific competitive advantages, often they are *spin-offs* of these primary companies. Thus, an agglomeration of companies with similar production structures evolves. This increases local competition which in turn drives improvement and innovation among the local competitors.

2. *Development of specialised suppliers*: In the second stage of the lifecycle specialised suppliers and service companies locate close to the core companies. Partly, this may be a result of (local) *outsourcing* activities. Additionally, in this stage of cluster development, the development of a specialised employment market occurs. The *specialisation* of companies and suppliers, which is associated with lower *transaction costs*, access to lower-cost and more *specialised inputs* (e.g. components, machinery, or business services), as well as access to highly *specialised personnel* lead to quality improvements and increased efficiency in the industry. These advantages are not available for competitors located in less agglomerate regions and are an important source of competitive advantage stemming from the external effects of firm clustering.

Outsourcing and Specialisation

3. *Emergence of related institutions*: In the next stage, institutions such as *universities, research institutes* or *governmental institutions* locate in the cluster. These institutions foster local cooperation, mutual learning processes, and the local diffusion of technological developments. Thus, a cluster-specific knowledge base is established.

Local Cooperation

4. *Attraction of related companies and specialised workforce*: The cluster externalities attract related firms and specialised personnel to locate in the cluster region. This in turn leads to an additional enhancement of cluster attractiveness and of cluster externalities.

Informal Cooperation

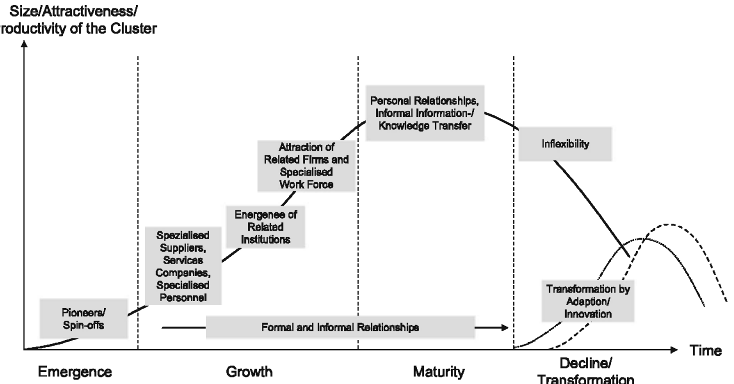
5. *Development and upgrading of informal and personal relationship quality*: This stage is characterised by the development of relationships between cluster members on an *informal* and personal level. Such relationships foster informal cooperation and knowledge transfer between companies and institutions in the cluster. In this context the transmission of *tacit knowledge* is of main importance.

6. *Decline or transformation of the cluster*: After a period of positive development, most regional clusters enter the *declining stage*. Often, the further advance of clusters is inhibited by technological, institutional or socio-cultural factors that initially fostered positive development but in the long term can cause *inflexibility* or even *inertia*. In this case, clusters are trapped in their specialisation and further innovation is impeded. On the other hand, if such stages of inflexibility can be avoided, clusters at some stage of their development will need to adapt to change in market, proc-

Inertia and Inflexibility

ess or technology. This leads to a *transformation* of the clusters into new forms, such as by focusing on new or diverse activities.

Figure 6.3 *Cluster Lifecycle*



Source: Adapted from Schramm-Klein 2005, p. 542.

Cluster Initiatives

Clusters can emerge and develop without any governmental influence, simply as a result of specific beneficial constellations of a region (e.g. factor endowment or specific technology). On the other hand, the diamond model implies that governments can try to influence cluster development and to initiate clusters by providing specific benefits in a region to improve the competitive advantage of the nation (or specific regions).

Cluster initiatives (CI) are organised efforts to enhance the growth and competitiveness of a cluster. They involve private industry, public authorities and/or academic institutions (Sölvell/Lindqvist/Ketels 2003, p. 9). Public authorities can make use of different means to enhance and improve cluster development, such as, for example (Sölvell 2008, pp. 53-54):

- *Human resources upgrading*: enhancement of the available skills pool, e.g. by vocational training or management education
- *Cluster expansion*: measures to increase the number of firms, e.g. through incubators that are designed to promote new business formation or by promoting inward investment within the region

- *Internationalisation*: promotion of firm internationalisation, e.g. export promotion
- *Promotion of commercial cooperation*: encouraging firms to communicate and interact with each other
- *Promotion of innovation*: promotion of product, services and process innovation, e.g. through enhanced cooperation and networking between firms or through cooperation between firms and research institutions (e.g. university spin-offs)
- *Enhancement of environmental conditions*: enhancement of conditions for business, e.g. through improving the legal and institutional setting or the physical infrastructure.

These means are mainly meant to create a favourable environment that promotes the conditions for operating in the cluster to improve competition, growth and innovation in the cluster. In this connection, the enhancement of the attractiveness of a cluster for all (potential) actors in the cluster is one of the main motives of public authorities.

Conclusion and Outlook

Nations as well as companies strive to build competitive advantage to improve their role in the global marketplace. An important model to explain competitive advantage for specific industries of a country is *Porter's diamond model.*

National Circumstances and Company Strategy

The main idea of this diamond model is that the *characteristics of the home country* play a central role in a company's international success. A firm's competitive advantage results from an effective combination of national circumstances and company strategy. The specific conditions in their home base may create an environment in which firms can attain international competitive advantage, but it is important to notice that it is up to each company to seize the opportunity (Hollensen 2007, p. 98).

Cluster Externalities

In this connection, the role of regional clusters is stressed. Competitive advantage in regional clusters can be explained by basically three forms of *cluster externalities* (Porter 1998, p. 80):

- *Enhancement of productivity and efficiency*: The sophisticated nature of competition forces companies continually to improve productivity. Additionally, synergies resulting from specialised inputs, specialised personnel, specialised infrastructure and information transfer between cluster companies reinforce such improvement.

- *Facilitation of innovation processes and pace of innovation*: Potential areas for innovation are often detected earlier and proceed faster in regional clusters because of the access to specialised resources, information sharing, close communication and cooperation between cluster members.
- *Stimulation of the foundation of new businesses*: The foundation of new businesses is fostered because of the favourable site-related factors in regional clusters such as specialised suppliers, infrastructure or customers. Additionally, outsourcing and specialisation lead to new business cluster actors realising new business opportunities earlier and therefore, for example, spin-offs are brought forward.

Further Reading

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Case Study: Basel Region Cluster[1]

History

Located in the heart of Europe, Basel is situated at a relatively short distance from nearly all the important cities as well as transhipment points in Europe. The Region of Basel is one of the most dynamic economies and marks a perfect gateway to the EU market. Therefore, it is a very interesting location for diverse industries. The "*Basel Region Cluster*" which is discussed in this case study benefits strongly from these site-related factors and belongs to the world's top three pharmaceutical clusters today.

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1 Sources used for this case study include the web sites www.isc.hbs.edu, www.swissbiotech.org and www.basel.ch as well as explicitly cited sources.

Development of the Pharmaceutical Cluster

Nevertheless, the primary reason behind the birth of the *Basel Region Cluster* has been the related and supporting industries. With Basel being the centre of the silk and ribbon industry of Switzerland in the past, the demand for the dyestuff industry was high. In addition, in the nineteenth century, French scientists and industrialists fled France after the French government prohibited the use of synthetic dyestuffs to protect the domestic natural dye industry and the dependent farmers. As a result, around 1860 the so-called dyestuff cluster was established in Basel. Due to the close connection of this industry with the pharmaceutical sector, pharmaceutical companies started to settle around Basel as well. Therefore, in the 1890s, the pharmaceutical cluster grew out of the dyestuff industry.

Chemistry education in Switzerland was very strong, guaranteeing both the dyestuff and the pharmaceutical industry high competitiveness. The river Rhine aided Basel as well, providing a route of transport and allowing the discharge of effluent. Furthermore, the two World Wars cut off Germany as the main competitor from the world markets and therefore pushed the expansion of the Swiss pharmaceutical producers.

Nowadays, Basel impresses with its world-renowned research and innovation capabilities which reflect in its large number of Nobel Prize winners, one of the highest densities of patent registration and leading-edge medicine at the University Hospital.

Profile

The literature often uses different terms for the cluster around Basel. Besides the *Basel Region Cluster*, terms like *"metrobasel"*, *"BaselArea"*, *"BioValley"* and *"Life Science Cluster Basel"* are used. While most terms include the whole economic region around Basel, *Basel Region Cluster* contains the main parts of the cluster which are presented below.

Metrobasel

Metrobasel, for instance, covers the functional trinational economic region (Switzerland, Germany and France) around Basel (BAK Basel Economics 2008, p. 3). As such, Basel belongs to the most successful economic regions worldwide. *Metrobasel* generated approximately 219,000 USD added value per employee in 2006 and put itself in second place amongst the regions compared, while New York is No. 1. Looking at the increase in real gross value added, *metrobasel* is No. 4 of all regions behind Geneva, New York and Øresund. Besides, *metrobasel*, along with the clusters in Munich and Zurich, belongs to the top three concerning patents in all fields of knowledge.

Life Science Cluster Basel

The high share of the total employment in the life sciences sector already points to the existence of another description of the *Basel Region Cluster*. However, the term *"Life Science Cluster Basel"* only encompasses the life

sciences industries. The term "Life Sciences" is used to cover development and manufacturing in the fields of pharmaceuticals (active pharmaceutical compounds, medicines and medicinal diagnostic products), agricultural inputs and medical technologies, including institutions that devote the majority of their efforts to the various stages of research, development, technology transfer and commercialisation.

BaselArea and BioValley

In addition to the diversity and density of the life sciences companies, the plurality of various organisations is another characteristic of the *Basel Region Cluster*. *BaselArea* and *BioValley Basel* illustrate such organisations that support companies and institutions by providing access to the member's network as well as its broad range of knowledge and expertise especially in the field of life sciences. Thereby, small Swiss start-ups and spin-offs benefit from the powerful multinationals. *BaselArea* covers biotech, nanotechnology, medical equipment, pharmaceuticals, agribusiness and specialty chemicals. *BioValley* is a trinational network that combines the already recognised centres in North-western Switzerland, Southern Baden (Germany) and Alsace (France). It is funded following the American model of Silicon Valley, but with the aim to establish a cross-border biotechnology cluster.

Besides those networks, the companies of the *Basel Region Cluster* cooperate with partner organisations like the *Messe Basel, Basel Banks, i-Net Basel* and *Basel Tourism* as well as universities and training institutions. Consequently, this implicates one of the world's highest densities of research specialists in life sciences, with about 10,000 researchers at work.

Industries in the Basel Region Cluster

Nowadays, the so-called "*Basel Region Cluster*" composes the following industries:

- Pharmaceuticals & Biotechnology
- Chemicals & Nanotechnology
- Agribusiness & Food
- Medical Technology
- Commerce & Logistics
- Microtechnology & Mechanical Engineering
- Finance
- IT
- Art, Fashion, Design & Architecture.

To demonstrate the success of these industries it is important to have an overview of the resident companies. Among these are pharmaceutical com-

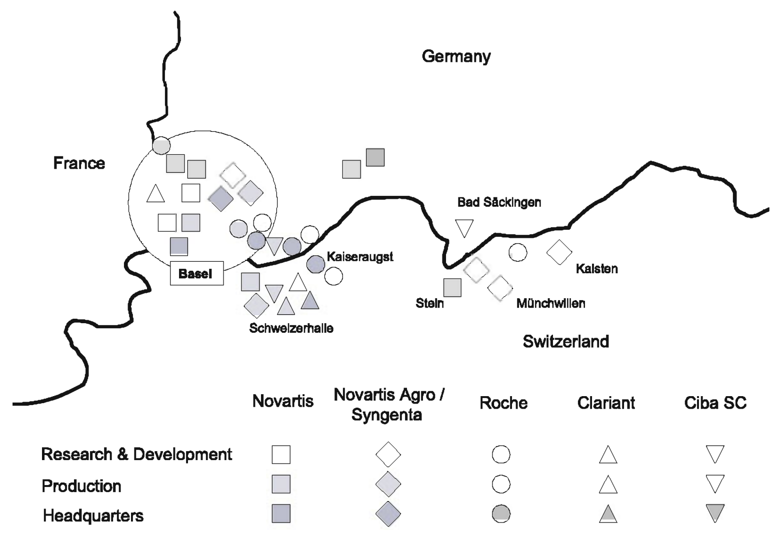
panies such as *Novartis,* the third largest pharmaceutical company in the world, *Roche,* one of the most highly capitalised Swiss companies at the market, and *Syngenta,* which is listed in the Financial Times Global 500 Index as one of the most important companies worldwide. In addition, chemical and nanotechnological companies like *Ciba* and *Clariant,* as well as microtechnology and mechanical engineering companies, with multinationals like *Endress+Hauser,* are strongly represented. Nevertheless, besides the headquarters of those global players, several young, internationally ambitious and growing small and medium-sized companies are located in the Basel area, such as *Actelion,* which is amongst the fastest growing biopharmaceutical companies in the world. In addition, suppliers and small related concerns are based around Basel.

Success of the Pharmaceutical Cluster

Despite the high importance of the variety of industries for the *Basel Region Cluster,* the focus of this case study will be the life sciences sector, especially the pharmaceuticals. With 900 companies, Basel has one of the highest per capita concentrations of successful life science businesses worldwide.

Location of Important Pharmaceutical and Chemical Companies in Basel 2001

Figure 6.4



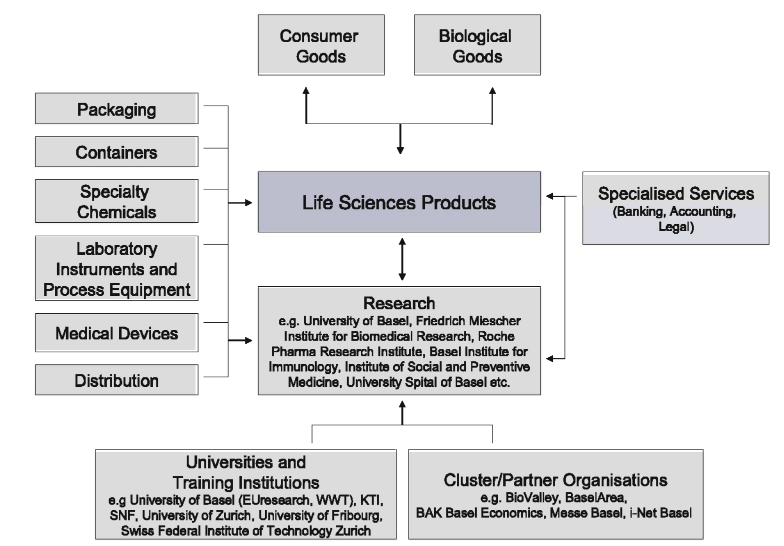
Source: Adapted from Zeller 2001, p. 27.

These companies achieve annual revenue of 100 billion USD and annual profit of close to 20 billion USD (BaselArea 2008, p. 2). *Novartis* describes the

Basel Region Cluster as the most important and successful location in Europe for the pharmaceutical industry.

To sustain this image, *Novartis* created the *Novartis Campus* which should offer an optimal environment for innovation and central functions. This working district is organised like a campus, which comprises the whole plant area, to facilitate communication and teamwork as well as recruiting the best talents. Likewise, *Roche* has shifted its main efforts in R&D, production and administration of the Pharmacy and Diagnostics division to the headquarters in Basel. Regarding the location of these companies (see Figure 6.4) it has to be affirmed that the expansion of R&D, production and headquarters has proceeded in the urban region of Basel as well as along the Rhine. The reasons for this development, in particular the advantages of the Basel region, will be illustrated within the description of the diamond model of Porter. The whole competitive position of *Basel Region Cluster* (see Figure 6.5) shows that the Basel area is a vibrant environment for life sciences, with the best conditions for success and growth.

Figure 6.5 *Competitive Postition of Basel Region Cluster*



Source: Adapted from Porter 2001, p. 40.

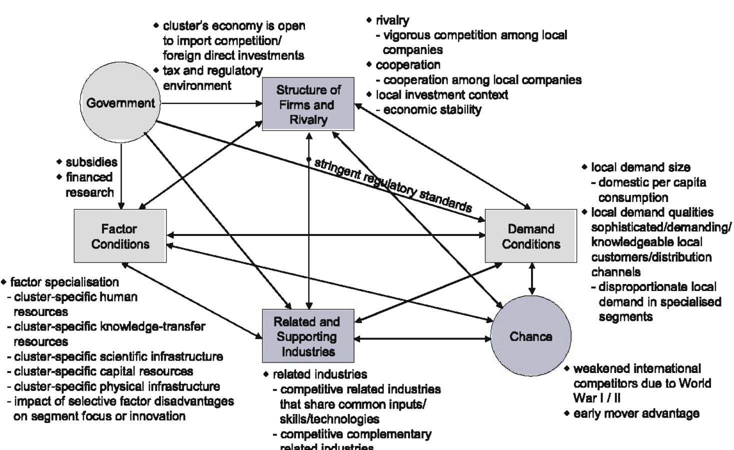
Driving Forces of the Cluster Formation

Based on Porter's Diamond Model, the main attributes that promote or impede the creation of competitive advantage could be divided into: (1) factor conditions, (2) demand conditions, (3) related and supporting industries, (4) structure of firms and rivalry, and (5) other advantages.

Based on the work of the *Institute for Strategy and Competitiveness* of the *Harvard Business School*, these assumptions are transferred to the *Basel Region Cluster*, especially the pharmaceutical industry (see Figure 6.6), and presented in the following. The context for strategy and rivalry can be declared as the primary reason behind competitiveness. The order of importance in this case is context for strategy and rivalry, factor conditions, related and supporting industries, demand conditions and other reasons.

The Basel Region Cluster in the Porter Diamond Model

Figure 6.6



Source: Adapted from Porter 1990a, p. 127.

Factor Conditions

The factor conditions in general are advantageous for the pharmaceutical cluster in the Basel region. In addition, the cluster benefits from the existing specialised factors:

Cluster-specific Factor Conditions

- *The cluster-specific human resources* are distinguished by a highly specific skilled labour. Additionally, Switzerland excels as the most rewarding work environment and has the most motivated workers in Europe. Nevertheless, the industry is fighting a shortage of available personnel.
- The *Basel Region Cluster* is amongst the world's best for *cluster-specific knowledge-transfer resources*. In Basel as well as Zurich there are very good universities with world-leading teaching programmes. The IMD (*Institute for Management Development*) worldwide report even declared Switzerland as being the best nation for basic research and knowledge transfer between industry and academia.
- The *cluster-specific scientific infrastructure* counts among the world's best. Several world-leading research institutes such as the *Tropical Medicine Institute*, the *Basel Institute for Immunology*, the *Miescher Institute* and the *Sandoz Institute* are located in Basel, as well as the *Swiss Pharmacy and Pharmaceutical Museum* and the *Swiss Academy of Medicine*. Since 1950 five Nobel Prizes have been awarded to Basel-based chemical researchers.
- The *cluster-specific physical infrastructure* is one of the world's best. While heavy goods can be transported by ship along the Rhine from the North Sea to Basel, Basel airport is built for air freight. Long-haul flights for American and Asian cities leave from Zurich airport, an hour away from Basel. The main road and rail routes for Europe all intersect in Basel and connect Basel with cities including Paris, Frankfurt and Milan.
- The *government* never offered any direct subsidies but financed some specialised research projects. In addition, life sciences companies are able to raise more money in Switzerland than elsewhere.
- Switzerland's lack of easy access to *raw materials* is detected as being beneficial. Because of the need to import raw materials, Switzerland focused on high quality from the start on. Therefore the impact of selective factor disadvantages on segment focus or innovation turned out to be an advantage.

Demand Conditions

Local Demand, Size and Qualities

The demand conditions have to be subdivided into two relevant factors. On the one hand, the local demand size is important for a cluster, on the other hand, the local demand qualities play a decisive role. As both display only weak advantages, the demand conditions are not the fundamental criteria for the *Basel Region Cluster:*

- The local demand size is an advantage in a paradoxical way because the Basel Region is so small that the industry had to focus on exports from early on.
- Concerning the local demand qualities, three major assumptions stand out. The Basel region is distinguished by having very sophisticated end customers and hospitals, disproportionate local demand in specialised segments and stringent regulations for product, energy, safety and environment by the government.

Related and Supporting Industries

As described in the "History" section, the *Basel Region Cluster* is not solely composed of the pharmaceutical industry. Several related industries, such as dyestuffs, are also located around Basel. These industries, the Swiss hospital industry for instance, share common inputs, skills and technologies and thus they are strongly linked. These industries are supplementary in that they attract not only domestic but also foreign clients. A very advantageous factor for the *Basel Region Cluster* is the competitive complementary and related industries. Switzerland has a strong position in hearing aids, orthopaedic devices, medical instruments, sterilisation equipment, hospital planning and hospital building. Indeed, Switzerland is the second most competitive economy in the world, behind the USA (see Table 6.1).

Structure of Firms and Rivalry

The "Structure of Firms and Rivalry" attribute includes several conditions that result in strong advantages of the *Basel Region Cluster*. The vigorous competition among the local companies and individuals is a very important driver for innovation. Government does not restrict imports. The economy is almost open for import competition and foreign direct investments, leading to a high percentage of imports in total consumption.

Co-opetition

Besides the strong competition in the Cluster Region, several resident companies cooperate with local companies, for instance, in joint research institutes in outside laboratories. Such cooperation between competitive companies is called "co-opetition", and leads to further advantages. The participating companies learn from each other, increase their economies of scale as well as economies of scope, and are more competitive in certain fields. Therefore, co-opetition usually results in a win-win situation and is a strong advantage for the *Basel Region Cluster*.

The government encourages risk investing by its tax and regulatory environment while economic stability lowers hurdle rates. In summary, the local

investment context of the *Basel Region Cluster* strongly encourages investment.

Other Advantages

Alongside the strong benefits of the four categories, *Basel Region Cluster*, especially the established pharmaceutical industry, has some more advantages that are noteworthy. On the one hand, the industry was not severely damaged in both world wars, different to other European locations. On the other hand, Basel benefits from being an early mover, particularly with respect to the international distribution infrastructure which cannot be built from scratch anymore today.

Basel as a Major Location for the Pharmaceutical Industry

In summary, it has to be maintained that the *Basel Region Cluster*, especially for the pharmaceutical industry, records some strong advantages concerning the factor conditions as well as other attributes described in the diamond model. The pharmaceutical industry around Basel is a consistently growing market which deserves to belong to the top three pharmaceutical clusters in the world today.

Questions

1. What are the conditions for cluster formation in general and especially in the case of *metrobasel*? Elaborate in this context on the diamond model of Porter.
2. Describe the influence of clusters on innovation with regard to the different types of organisation and cooperation of clusters.
3. Discuss the advantages and disadvantages of the cluster location for the participant companies in a cluster. Reflect which consequences the location of Basel has for the resident businesses.

Hints

1. See Porter and Linde 2004.
2. See the OECD Proceeding, Boosting Innovation: The Cluster Approach 1999.
3. See BAK Basel Economics 2008 and Baselarea 2008.

Chapter 7

The Role of Country Culture for International Management

Cultural differences within and between countries affect the way business is practised. The consideration of these cultural differences and sensitivity are crucial factors in cross-cultural management. This Chapter aims to give an overview on the core characteristics that differentiate cultures and their meaning for international business.

The Concept of (Country) Culture

Human thought processes vary between different parts of the world. There is a general understanding that *culture* (and cultural differences) is one of the main reasons for such variation. However, culture as a concept is difficult to define and many different definitions have been given in the past. Perhaps the best known definition in international management is that by Hofstede (1980, p. 21): "Culture is the collective programming of the mind which distinguishes the members of one human group from another. [...] Culture, in this sense, includes systems of values; and values are among the building blocks of culture."

In this connection, it is important to notice that culture includes both *conscious and unconscious* values, ideas, attitudes and symbols that shape human behaviour (Terpstra/David 1991). Additionally, culture can be thought of as consisting of both *visible and invisible* elements (see Figure 7.1) (Schein 1992, pp. 15-20):

Levels of Culture

- *Artefacts and creations*: The most external level is the tangible aspects of culture, i.e., visible and audible behaviour and the constructed physical and social environment.
- *Values and ideologies*: A deeper level is that of values that reflect convictions about the nature of reality and what should be done to successfully cope with reality.
- *Basic assumptions and premises*: The deepest – and invisible – layer of culture consists of the basic assumptions and beliefs about human nature and relationships to the environment.

D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_8,
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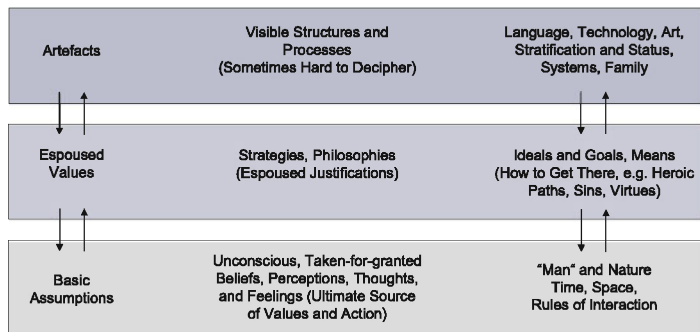
Figure 7.1 *Levels of Culture*



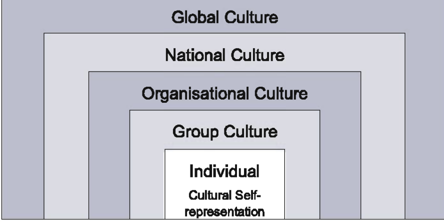
Source: Adapted from Schein 1992, pp. 15-20; Schein 1981, p. 64.

Layers and Characteristics of Culture

Main Levels

The individual decision-making process is influenced by different layers of culture. These levels are nested into each other, constituting a system of interrelated cultural aspects of different cultural layers (see Figure 7.2). The main levels of this nest are: the *national culture*, which constitutes the overall framework of cultural concepts and legislation for business activities, the *industry culture*, which is characterised by specific norms and ethics that in some cases may be similar across borders, and the *company culture* (organisational culture), which is expressed through shared values, beliefs, or meaning of the members of an organisation (Hollensen 2007, pp. 219-220).

Figure 7.2 *Layers of Culture*



Source: Adapted from Erez/Gati 2004, p. 588.

Individual Behaviour

The *individual behaviour* is affected by these different cultural layers because the individual interacts with the other actors of his or her cultural surroundings. Culture is an outcome of past (and present) actions of a group or its members and it can be considered the result of a group's actions and the origin of its actions at the same time. Cultural values are *shared* by members and they are *transmitted* from one generation to another through social learning processes of modelling and observation or through the effects of individual actions (e.g. eliciting rewards or avoiding punishments) (Bandura 1986). Cultural elements such as daily behaviours, religion or fairytales are interdependent, i.e., *connected* to each other.

Summing up, a culture is defined as a group of people that share a common set of values and norms. It is the ways in which a society understands, decides and communicates, and it is characterised as being *learned*, *shared*, and *interrelated* (Hollensen 2007, p. 217).

Culture vs. Nation

Culture is reinforced by its components such as language, behaviour, and often the "nation". However, it can be below or above the *nation level* because there is not a strict correspondence between a society and a nation-state. Nation-states are political creations that can contain a single culture or several cultures (Hill 2008, p. 91). Thus, cultures may be defined by national borders, especially when countries are isolated by natural barriers, but a nation also may contain *subcultures* that have little in common with one another.

Influence of Culture in Different Business Contexts

A range of business contexts, both within individual firms and between two or more firms, are influenced by the different cultural backgrounds of the individuals involved (see Figure 7.3).

Environmental Influences on International Management Functions

Figure 7.3

Source: Adapated from Phatak/Bhagat/Kashlak 2009, p. 115.

Cross-cultural Business Encounters

Cross-cultural proficiency is important in many managerial tasks in international business, including, among others (Cavusgil/Knight/Riesenberger 2008, p. 131):

- communicating and interacting with *foreign business partners*
- screening and selecting *foreign distributors* and other *partners*
- negotiating and structuring *international business ventures* or *international alliances*
- interacting with *customers* from abroad
- dealing with *national institutions* in host countries
- developing *products* and *services*
- preparing *advertising* and *promotional materials*.

Cross-cultural differences may complicate *communication* within the individual firm, for example, when managers from a foreign parent company communicate with local employees. In *cross-border partnerships*, alliances, or ventures, there needs to be an understanding of the *organisational and cultural differences*. Often, *cultural compromise* is required to establish successful partnerships (Rugman/Collinson 2009, p. 133).

Elements of Culture

There are many components that can be considered integral elements of culture. These components are *interrelated* with one another. The elements of culture that are most likely to matter in international management are: language, social structure, religion, and values and attitudes.

Language

Language is considered a *primary discriminant* of cultural groups as – in an obvious way – countries differ in the languages used within them. Both spoken and unspoken language is an important means for communication.

Spoken Language

Spoken language refers to the vocal sounds or written symbols that people use to communicate with one another (Kotabe/Helsen 2008, pp. 114-115). Spoken language structures the way the members of a society perceive the world. It can direct the attention of its members to certain features of the world rather than others (Hill 2008, p. 108) by *filtering* observations and perceptions and thus affecting the messages that are sent when individuals communicate with one another (Griffin/Pustay 2010, pp. 113-115).

Multiple Language Groups

If a country is dominated by one *language group*, it tends to have a homogeneous culture in which nationhood is important to define the culture. Conversely, countries with more than one language tend to be heterogeneous. For example, Canada has an English-speaking culture and a French-speaking culture, or in Switzerland, mainly three languages are spoken, going along with other (sub-)cultural differences (Hill 2008, p. 108).

Nonverbal Communication

Unspoken or *nonverbal communication* includes gestures, facial expression, moving, touching, and other forms of *body language* that supplement spoken communication. Many of these "silent" cues are culturally bound and can lead to misunderstandings in cross-cultural communication.

Social Structure

The social structure determines the roles of individuals in a society. Cultures differ in the way they define *groups* and the relative importance they place on the *individual's role* within a group. While human life is generally viewed as group life, cultures differ according to the degree to which they regard groups as the primary means of social organisation (Hill 2008, p. 92). Cultural value systems, for example, differ in terms of their emphasis on *individual performance*. In many Western societies, the social standing of individuals is a function of their individual performance and not so much of which group they belong to. In many other cultures, *social status* is determined by the standing of the group to which an individual belongs, and commitment and attachment to *group membership* is much more important.

Social Stratification

Additionally, cultures differ in their degree of *social stratification*. In all cultures, people to some extent are categorised into *hierarchies* on the basis of elements such as income, occupation, family background, educational achievement, or other attributes. However, not only does the importance of these categories in defining how individuals interact with each other within and between groups differ between cultures. Also, the *social mobility*, i.e., the extent to which individuals can move out of the strata and change hierarchical status, is distinct between cultures (Griffin/Pustay 2010, p. 112).

Religion, Values and Attitudes

Most of the world's ethical systems, i.e., sets of moral principles or values that guide and shape individuals' behaviour, are a product of religion. *Religion* shapes the attitudes toward aspects such as work, consumption, or individual responsibility (Hill 2008, p. 98). Religion plays an important role in many societies with its impact differing from country to country. The impact of religion depends on the country's legal system, the *homogeneity* of

religious beliefs, and the *toleration* of other religious viewpoints (Griffin/Pustay 2010, p. 122).

World Religions

Religion does not always contribute to divergence between cultures, however. It can also provide the basis for *trans-cultural similarities*. Approximately 75 % of the world's population adhere to one of the four dominant *religions*: Christianity (2.1 billion adherents), Islam (1.5 billion adherents), Hinduism (900 million adherents), and Buddhism (376 million adherents) (www.adherents.com 2008).

In addition to religious value systems, all cultures are characterised by secular value systems and attitudes. *Values* are understood as principles and standards that are accepted by the members of a culture. *Attitudes* relate to actions, feelings, and thoughts, as a result of those values (Griffin/Pustay 2010, p. 122).

Value Systems

Value systems are deeply rooted and intrinsic to the individual's identity. They influence people's *attitudes* towards factors such as time, age, status, or education. The underlying *norms*, i.e. accepted rules, standards and models of behaviour, direct the individual's behaviour. Thus, values determine what actions are regarded as appropriate, important, or desirable in a culture.

Dimensions of Culture

Several conceptualisations exist to classify cultures according to the underlying values. The most prominent *cultural frameworks* are the work of Hall, Hofstede, and the GLOBE project (Global Leadership and Organisational Behaviour Effectiveness).

Hall's Low Context and High Context

In this conceptualisation, cultures are classified according to the *context* relatedness of communication. The extent to which communication partners rely on the context for determining the meaning of what is said is relevant for both direct (e.g. face-to-face) communication and indirect communication (Mühlbacher/Leihs/Dahringer 2006, p. 212).

High Context – Low Context

"A high context communication or message is one in which most of the information is already in the person, while very little is in the coded, explicit, transmitted part of the message. A low context communication is just the opposite, i.e., the mass of the information is vested in the explicit code" (Hall/Hall 1990, p. 6).

Thus, the interpretation of messages in *high context cultures* rests heavily on the context. It is important to use and interpret the elements surrounding the

message to be able to understand the message. In *low context cultures*, on the other hand, clear communication modes dominate. These cultures rely on spoken and written language for meaning (Hollensen 2007, pp. 220-221). In Table 7.1, some aspects in which high and low context cultures differ are summarised.

Comparative Characteristics of High Context and Low Context Cultures — *Table 7.1*

Characteristic	Low Context/Individualistic (e.g. Western Europe, US)	High Context/Collectivistic (e.g. Japan, China, Saudi Arabia)
Communication and Language	explicit, direct	implicit, indirect
Sense of Self and Space	informal handshakes	formal hugs, bows and handshakes
Dress and Appearance	dress for individual success, wide variety	indication of position in society, religious rule
Food and Eating Habits	eating is a necessity, fast food	eating is social event
Time Consciousness	linear, exact, promptness is valued, time = money	elastic, relative, time spent on enjoyment, time=relationships
Family and Friends	nuclear family, self-oriented, value youth	extended family, other oriented, loyalty and responsibility, respect for old age
Values and Norms	independence, confrontation of conflict	group conformity, harmony
Beliefs and Attitudes	egalitarian, challenge authority, individuals control destiny, gender equity	hierarchical, respect for authority, individuals accept destiny, gender roles
Mental Process and Learning	linear, logical sequential, problem solving	lateral, holistic, simultaneous, accepting life's difficulties
Business/Work Habits	deal oriented ('quickly getting down to business'), rewards based in achievement, work has value	relationship oriented ('first you make a friend, then you make a deal'), rewards based on seniority, work is a necessity

Source: Hollensen 2007, p. 220.

Hofstede's Five Dimensions

One of the most influential schemes of cultural classification is the work of Geert Hofstede. Hofstede's findings are based on a study of 116,000 people working for *IBM* in about 40 countries that was carried out in the late 1960s and early 1970s. Although this work has been criticised for several methodological weaknesses and cultural biases resulting from the fact that only one company with a strong organisational culture has been analysed, it remains the largest and most comprehensive work of its kind. Hofstede identified five important *dimensions* along which people differ across cultures (Griffin/Pustay 2010, p. 126).

Power Distance

The first dimension is labelled *power distance*. It refers to the extent and acceptance of unequal distribution of power. *Power respect* means that people in a culture tend to accept power and authority on the basis of positions in the hierarchy. Thus, societies that are high in *power distance* believe that everyone has a rightful place in society and they tolerate relatively high social

inequalities (Kotabe/Helsen 2008, p. 128). Conversely, cultures with low power distance are characterised by *power tolerance*. They attach less significance to a person's position in the hierarchy and tend to question decisions or mandates from someone at a higher level (Griffin/Pustay 2010, p. 130). These cultures tend to be more egalitarian.

Individualism vs. Collectivism

The second dimension is the *social orientation* in a culture. This relates to the beliefs about the relative importance of the individual and the groups to which an individual belongs. *Individualism* describes the degree to which individuals view themselves as independent of groups and are motivated by their own preferences, needs, or rights (Phatak/Bhagat/Kashlak 2009, p. 120). *Individual independence* plays an important role. The opposite of individualism is *collectivism*. Collectivistic cultures are characterised by people giving priority to the goals of the group to which they belong over their own personal goals. Identity is based in the *group* to which the individual belongs and he or she shows long-term loyalty to that group (Hollensen 2007, p. 229).

Uncertainty Avoidance

A third dimension is *uncertainty avoidance* which relates to the *risk taking attitude* in a culture. It thus relates to the feelings people have regarding uncertain and ambiguous situations. In a culture which is characterised by uncertainty avoidance, people dislike change and ambiguity and try to avoid it. On the other hand, in cultures with high levels of *uncertainty acceptance*, people are stimulated by change (Griffin/Pustay 2010, pp. 131-135).

Masculinity vs. Femininity

Masculinity and *femininity* relates to the degree to which "masculine" values or "feminine" values dominate. In *masculine cultures*, masculine values, such as achievement, performance, competition, success and money, are important (Hollensen 2007, p. 229). Additionally, in these cultures, social gender roles are clearly distinct. In *feminine societies*, gender roles tend to overlap. Thus, both men and women are supposed to follow feminine values, such as care for others, the quality of life, maintaining personal relationships, and service (Hofstede 1991, pp. 82-83).

Time Orientation

The fifth dimension, *time orientation,* was identified in a follow-up study to Hofstede's original work. It refers to the distinction between cultures with a long-term orientation and those with a short-term focus (Kotabe/Helson 2008, p. 129). Cultures with a *long-term orientation* are characterised by values such as perseverance and thrift. In *short-term oriented* cultures, personal steadiness and stability are important (Hollensen 2007, p. 229).

Table 7.2 gives an overview of how countries differ in terms of these five Hofstede dimensions.

Table 7.2

Hofstede's Culture Dimensions in Selected Countries

Country	Power Distance	Individualism	Masculinity	Uncertainty Avoidance	Long-Term Orientation
France	68	71	43	86	-
Germany	35	67	66	65	31
Hong Kong	68	25	57	29	96
India	77	48	56	40	61
Japan	54	46	95	92	80
Malaysia	104	26	50	36	-
Netherlands	38	80	14	53	44
Singapore	74	20	48	8	48
South Korea	60	18	39	85	75
Sweden	31	71	5	29	33
Switzerland	34	68	70	58	-
United Kingdom	35	89	66	35	25
United States	40	91	62	46	29

Source: Hofstede 1992, pp. 312-313.

GLOBE - Global Leadership and Organizational Behavior Effectiveness

Global Leadership and Organizational Behavior Effectiveness (GLOBE) is a large-scale research programme which comprised a network of 170 social scientists and management scholars. The study is based on a survey of 17,000 managers from three industries (banking, food processing, and telecommunications) in 62 cultures. The GLOBE researchers identified nine dimensions of culture (House et al. 2002; Magnussen et al. 2008, p. 186):

GLOBE Dimensions

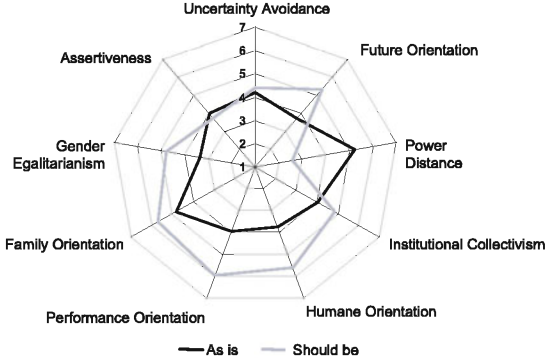
1. *Uncertainty avoidance*: The extent to which a society tries to avoid the unpredictability of future events, e.g. by relying on rituals, or bureaucratic practices.
2. *Power Distance*: The degree to which members of a culture expect and accept power to be distributed unequally.
3. *Collectivism I (Societal Collectivism):* The degree to which organisational and societal institutional practices encourage collective distribution of resources and collective action.
4. *Collectivism II (In-Group Collectivism)*: The degree to which individuals express loyalty and cohesiveness in their organisations or families.
5. *Gender Egalitarianism*: The extent to which a society minimises gender role differences and discrimination.

6. *Assertiveness:* The degree to which individuals are assertive, confrontational, and aggressive in social relationships.
7. *Future Orientation*: The degree to which individuals engage in future-oriented behaviours such as delaying gratification, planning, and investing in the future.
8. *Performance Orientation*: The extent to which a society encourages and rewards group members for performance improvement and excellence.
9. *Humane Orientation*: The degree to which individuals encourage and reward individuals for being fair, altruistic, friendly, generous, caring, or kind.

The purpose of the project was to find out which *leadership behaviours* are universally accepted and which are culturally contingent. While there is some overlap between Hofstede's and the GLOBE dimensions, the GLOBE study goes beyond Hofstede's approach, assessing culture from two angles: *cultural practices* (culture "as is") and *cultural values* ("what should be").

Figure 7.4 displays the societal culture scores of the "Latin Europe cluster" which comprises Italy, Spain, France, Portugal, the French speaking part of Switzerland and Israel.

Figure 7.4 *Latin Europe Cluster's Societal Culture Scores*



Source: Jesuino 2002, p. 85.

Cultural Sensitivity

Cultural sensitivity refers to the state of *awareness* of the values and frames of reference of host country cultures. In this context, the extent of a manager's cultural parochialism, ethnocentrism, polycentrism, or geocentrism is crucial (Phatak/Bhagat/Kashlak 2009, pp. 116):

- *Cultural parochialism*: The belief that there is no alternative to doing things the way they are done in one's own culture.
- *Cultural ethnocentrism*: Ethnocentrism is related to parochialism, but it reflects a sense of superiority. Thus, ethnocentricity involves the attitude that one's own way of doing things is the best, no matter in which cultural environment.
- *Cultural polycentrism*: Polycentric managers tend to adapt to local cultural norms. They accept the need for differentiation, for example, in terms of procedural norms, reward systems, organisation design. Thus, polycentrism involves adaptation to each local cultural context.
- *Cultural geocentrism*: Geocentrism reflects the belief that responsiveness to local cultures is necessary but that there is the need to develop courses of action that can be employed in most (or all) cultural environments.

Emic vs. Etic

This understanding of cultural sensitivity is related to the emic and the etic views of culture. The *etic perspective* assumes that business practices can be applied universally and thus are relevant in all cultures and not specific to the context in which they were developed. Contrarily, the *emic approach* to international business argues that each culture has specific requirements (Sue/Sue 2007). Therefore business practices need to be adapted to each cultural context. Typically, the etic approach to international business is anchored in the domestic market context and thus reflects either *cultural parochialism* or *ethnocentrism*.

Organisation Types

According to these diverse *cultural predispositions*, firms can respond with diverse organisation types (see Table 7.3). The *imperialist firm* corresponds to cultural parochialism and involves a common organisational culture wherever the company is present. The *independent company* is associated with the polycentric orientation. In this structure, each national subsidiary bases its own culture on local norms and values, thus constituting a *federalist structure*. Both of these extremes are associated with problems, resulting from either an etic cultural perspective that involves standardisation in all subsidiaries or the complexity of differentiated, polycentric systems. Therefore, often firms try to strike a balance between *standardisation* and *differentiation*. Some elements are centralised across the whole organisation while others

are adapted to the local cultural context (Rugman/Collinson 2009, pp. 147-148).

Table 7.3 *Organisation Types Reflecting Cultural Predispositions*

	Imperialist	Interventionist	Interactive	Independent
Organisation	ethnocentric	ethnocentric	geocentric	polycentric
Structure	steep hierarchy	flat hierarchy	network	federation
Strategy	dictated	centrally decided	jointly specified	locally specified
Decision making	centralised	distributed	shared	devolved

Source: Rugman/Collinson 2009, p. 147.

Conclusion and Outlook

Cultural Convergence

While culture is considered to be *relatively stable* and cultural differences are important in international management, there is an ongoing debate on the question whether *cultural convergence* is taking place or not. The starting point of this debate was Levitt's *"Globalisation Thesis"* (Levitt 1983), which argued that issues such as increased and better communications worldwide, including international media consumption, travel patterns of consumers and the spread of multinational companies lead to a cultural convergence. This is beneficial for international operations because it offers the potential to standardise global operations: "The global corporation operates with resolute constancy – at low relative cost – as if the entire world (or major regions of it) were a single entity; it sells the same things in the same way everywhere" (Levitt 1983, pp. 92-93). With *standardisation*, producers obtain global scale economies and experience curve benefits in production, distribution, marketing and management.

Cultural Diversity

However, even though cross-border operations of multinational companies integrate the world's economies, there are many counterarguments against the assumption that a homogenisation of cultures is happening. Even within most countries, great *diversity* of behaviours and tastes co-exist. The internationalisation of companies widens the options available to local people.

Cross-Border Segments

Nevertheless, *cross-border segments* exist. They include consumers with homogeneous consumption patterns across cultures. Typically, these cross-border segments are younger, richer and more urban than the rest of the population (Quelch 1999, p. 2). Thus, *cultural homogeneity* and *heterogeneity*

are not mutually exclusive alternatives or substitutes, but they may co-exist, simultaneously (Cavusgil/Knight/Riesenberger 2008, p. 148).

Cultural Clash

Cross-cultural management involves cultural differences between groups of people in different business situations both inside one firm and between several firms, e.g. suppliers, partners in strategic alliances or M&As, or with the customers. Such cultural differences are not necessarily a problem. However, they can create *difficulties* in terms of communication, motivation, coordination, or teamwork. They can lead to *cultural clash*, which means that differences in values, beliefs, and styles of communication or behaviour can lead to miscommunications and misunderstandings, antagonism or other problems (Rugman/Collinson 2009, pp. 148-151).

Acculturation

Companies need to respond to these challenges of managing across cultural boundaries. In this context, acculturation plays an important role. *Acculturation* involves the process of understanding foreign cultures and modifying and adapting the company's or the manager's behaviour to make it compatible with other cultures (Cavusgil/Knight/Riesenberger 2008, p. 130).

Further Reading

HOFSTEDE, G. (2001): Culture's Consequences: Comparing Values, Behaviors, Institutions and Organizations Across Nations, Thousand Oaks, Sage Publications, pp. 1-36.

DERESKY, H. (2008): International Management, Managing Across Borders and Cultures, 6th ed., Upper Saddle River, Prentice Hall, pp. 102-216.

Case Study: China[1]

History and political system

On 1 October 1949, Mao Zedong, chairman of the Central People's Government, proclaimed the foundation of the People's Republic of China (PRC). During the period of the first five-year plan (1953–1957) the average annual *increase in national income surpassed 8.9* % and, with a time delay compared with already industrialised countries, basic industries such as aviation and

[1] Sources used for this case study include the web sites, http://www.bmz.de, http://www.itim.org, http://ec.europa.eu/eurostat, http:// www.chinability.com, www.china-embassy.org.eng, http:// www.china.org.cn, http://www.un.org as well as explicitly cited sources.

motor vehicle production, indispensable for full industrialisation, were finally initiated. Between 1956 and 1966 the nation's total industrial fixed assets quadrupled and the national income increased by 58 % in constant prices.

Cultural Revolution

The ensuing *"cultural revolution"* (1966–1976), initiated by Mao himself in order to consolidate his power, caused the state and its people to relapse. The time of the Cultural Revolution is strongly connected to the term *"Maoism"*. Maoism refers to Mao's theories about how China and the world should be transformed in revolutionary ways. Mao thereby embraced the teachings of Marx and Lenin and made additional contributions (Chai 2003, p. 164), as, for instance, he emphasised the agrarian countryside. As a result of the Cultural Revolution, millions of people were forced into manual labour, and thousands were executed.

End of Maoism

The death of Mao in 1976 marked the end of *"Maoism"* and the beginning of a new area in Chinese history under the guidance of the CPC (Communist Party of China). The CPC, under the leadership of General Secretary Deng Xiaoping "turned its attention to 'righting the wrongs' it had experienced during the cultural revolution" (Chai 2003, p. 167). As a consequence, the CPC instituted a policy of *"reform and opening"* to the outside world in 1979, and China followed a path of socialist modernisation.

China Today

Succeeding Jiang Zemin, Hu Jintao took over the position as general secretary of the CPC Central Committee in 2002 as well as president of the state in 2003. In 2008, the CPC had more than 67 million members.

China at a Glance

Geographic Profile

China is the world's most populous country with a total population of about 1.35 billion people in 2010. After Russia, Canada and the USA of America, China is the fourth largest country in the world. Governmentally, China is divided into 22 provinces (China considers Taiwan its 23rd province), five autonomous regions (Guangxi, Nei Mongol, Ningxia, Xinjiang Uygur, Xizang) and four municipalities (Beijing, Chongqing, Shanghai, Tianjin) which are directly supervised by the central government as well as the special administrative regions of Hong Kong and Macao. The capital of China is Beijing.

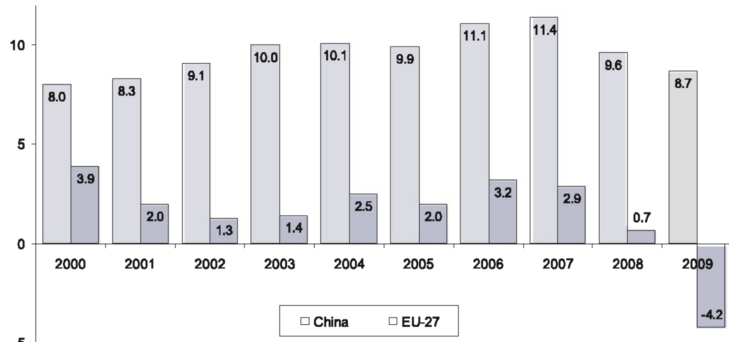
Economic Profile

Immediately after the end of *"Maoism"*, as Deng Xiaoping focused on market-oriented economic development, China started to catch up economically with the industrialised Western World. The pace of China's economic development in recent years is outstanding, as China's GDP growth rates, for instance, by far exceeded the average GDP growth rate of the EU-27 coun-

tries (see Figure 7.5). In 2009, China passed Germany to become the world's largest exporter.

Annual GDP Growth Rates of China and the EU-27 (in %)

Figure 7.5



Source: www.chinability.com, http://ec.europa.eu/eurostat.

However, the rapid industrialisation also caused serious problems for the largest market in the world. Problems include widespread poverty, as China is economically a very heterogeneous country (Holtbrügge/Puck 2005, p. 31), corruption and a very high level of environmental pollution.

China's Culture According to the GLOBE Study

As described in this Chapter, the GLOBE study identified nine dimensions of culture. By comparing the respective scores to the mean value of all 62 cultures examined in the GLOBE study, Figure 7.6 displays the results of the study for China (refering to *cultural practices*, i.e. culture "as is").

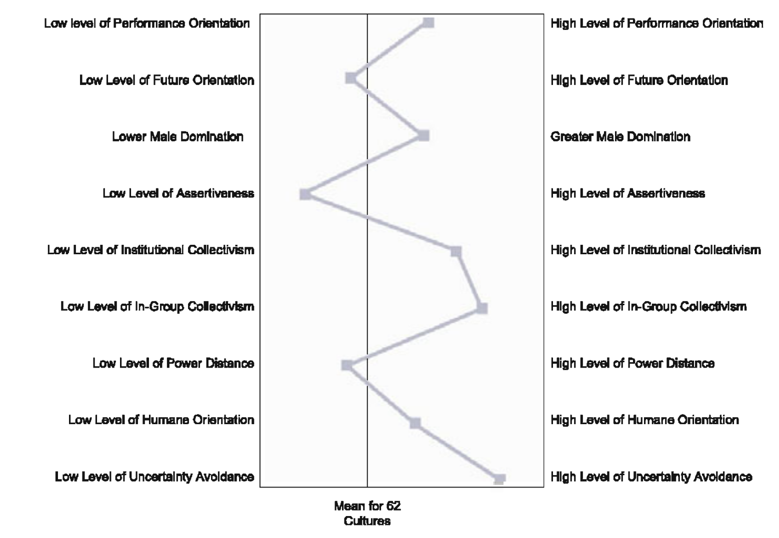
China's scores are very heterogeneous regarding numerous dimensions of the Globe study. The results indicate that inhabitants of China score heavily on performance orientation, collectivism (institutional and organisational), humane orientation, and especially on uncertainty avoidance, all of which are above the mean of all countries. Scores on future orientation and power distance are close to the mean, scores on assertiveness and gender egalitarianism are below the mean.

Collectivism

Across all the GLOBE dimensions, China exhibited the highest scores on the *collective dimensions*. Chinese people are influenced by a collective culture that deemphasises the self in deference to the group (Neubert/Wu 2006, p. 362). The collectivistic attitude of Chinese people is happily accompanied by a high level of humane orientation, as well as low level of assertiveness. As Chinese people tend to be strongly group oriented, they do not strive to be assertive, confrontational or aggressive in social relationships. Research outlines the importance of *interpersonal harmony* in collectivistic cultures (Ling/Chia/Fang 2000, p. 737).

Another reason for the low level of assertiveness is that Chinese are influenced by their concerns for notions such as *guanxi* (social relationships) (Fu et al. 2007, p. 889).

Figure 7.6 Results of the GLOBE Study: China



Collectivistic Performance Orientation

Although Chinese people are highly collectivistic, they are also characterised by a *high performance orientation*. However, Chinese employees are likely to focus on the performance of the group over concerns about individual performance. Hence, in collectivist cultures, achievement motivation is generally socially oriented (Neubert/Wu 2006, p. 362). This feature becomes evident, for instance, in a comparison between Chinese and US employees in the information technology sector. In contrast to the US employees, Chinese

employees place less value on rapid career advancement and having a motivating boss, but place greater emphasis on receiving project milestone bonuses (King/Bu 2005, p. 46).

Gender Egalitarianism

Until modern times, men in China were always superior to women and being a woman in China meant being a servant to the men in one's life: first father, then husband, then son (Fu et al. 2007, pp. 889-890). That is because the majority of the population was, and is still, poor and heavily dependent on farming. In these places, women still have major disadvantages in terms of education or employment. Hence, *gender egalitarianism* many not happen until China becomes more economically developed across the whole country (Fu et al. 2007, pp. 890).

Uncertainty Avoidance

The high score for the *uncertainty avoidance* dimension is consistent with the traditional Chinese value of order. The Chinese seek peace and security by clinging to the past and for centuries, Chinese people felt secure only when they "played it safe" (Fu et al. 2007, p. 891). Especially during the Cultural Revolution, people in China were led to seek "unity and order" to such a degree that they would run their businesses in the same way year after year without change, "maintaining the same structure, the same products, the same everything" (Fu et al. 2007, p. 891). The long tradition of order may serve as an explanation for the high intolerance of uncertainty.

Subcultures

Although the Chinese culture emphasises collectivism, one can observe subcultures within the country (King/Bu 2005, p. 46). Such subcultures are not surprising, in a country with 1.3 billion inhabitants that is heavily segmented in terms of income and consumer behaviour. The strongest regional disparities in China exist between the rural areas in the North and South of the country and the rich and well developed coastal regions around Shanghai (Holtbrügge/Puck 2005, p. 9).

Roots and Rationale of Chinese (Business) Culture

Confucianism

Of all the ideologies that have influenced the thinking and life of traditional and agricultural China, *Confucianism* should account for the most influence (Fu et al. 2007, p. 878). Even today, 2,500 years after the time of Confucius, his traditional ethics continue to have a tremendous impact on Chinese people (Ling/Chia/Fang 2000, p. 736). Hence, in order to understand Chinese culture, one must first understand *Confucianism.*

The Confucian Understanding of Intellectual Property

Confucius assumed the existence of a proper way for humans to behave and for society to be organised (Langenfeld 2007, p. 32). Confucian teachings include the emphasis on learning through a hierarchical, family-modelled institution, which teaches principles such as diligence, self-sacrifice, and delayed gratification. The *Confucian* model of a family includes the strong but compassionate father, the loyal child who can never fully repay a deep dept to the parents, and the ancestors who are to be respected and worshipped (Gupta/Hanges 2004, p. 189). The *Confucian* philosophy is a helpful tool to decode the Chinese understanding of immaterial goods and intellectual property. The copying of foreign products and technologies, for instance, is an expression of appreciation for the intellectual performance of somebody else. Products and innovations of limited quality are not worth copying. To use the intellectual performance of somebody else is considered a smart move and desirable, according to the Confucian philosophy. The belief that an immaterial value is solely the property of a single person or group is contradictory to the *Confucian* idea that everyone should strive for education. As long as it serves the community, knowledge is considered common property (Fuchs et al. 2006, p. 65). The *Far Eastern Economic Review*, a business newspaper from Hong Kong, therefore relabelled the People's Republic of China the "People's Republic of Cheats" (Fuchs et al. 2006, p. 22). However, *Confucianism* is not only suited to illustrate the Chinese attitude towards intellectual property, but to explain the basic rationale and "lifeblood" (Davies et al 1995, p. 209) of Chinese business: *"guanxi"*.

Guanxi

In contrast to the more fact-based Western business culture, Chinese business culture relies much more on relationships and personal networks (Holtbrügge/Puck 2005, p. 20). Best translated by the term "relationship", *guanxi* basically describes a friendship between two persons that rests on a continued exchange of favours (Pye 1992, p. 101). Hence, "the currency of *guanxi* is normally favors, not cash" (Seligman 1999, p. 65).

A key component in a *guanxi* system is the Chinese interpretation of face (*"mianzi"*). As an intangible form of personal identity, *mianzi* is closely linked with dignity, self-esteem, vanity, and is therefore comparable to the Western concept of prestige (Langenfeld 2007, p. 92). Individuals in China have a strong interest in keeping their face because it is a major source of intrinsic satisfaction. It is the worth that people claim for themselves based on their position in the social network. Hence, threats to one's *mianzi* constitute threats to one's identity (Langenfeld 2007, p. 92).

When dealing with Chinese managers or officials, it is important to consider that good *guanxi* depends on a strict system of reciprocity and that the Chinese generally expect foreigners to speak and understand *guanxi* and to act according to its rules (Seligman 1999, p. 65; Graham/Lam 2003, p. 86).

The Impact of China's Culture on Human Resource Management and Marketing

Human Resource Management

Recruitment activities in China are comparable to those in Western countries. The most frequently used recruitment methods are employment advertisements in newspapers and magazines. However, in general, specialised staffs are found through *guanxi* rather than advertisements in newspapers or professional headhunters (Holtbrügge/Puck 2005, p. 131). Moreover, employees that have been recruited through *guanxi* often have an additional motivation to perform well, as they do not want to disappoint the intermediary who vouched for them. Further benefits may be derived from coordinated salary and non-labour benefits paid to specialists (Langenfeld 2007, p. 140). One major problem that comes along with this recruiting technique becomes evident in case of redundancies. The layoff of an employee who has been recruited through a *guanxi* network might result in conflicts with the remaining workforce (Holtbrügge et al. 2003, pp. 15-21).

Chinese companies are characterised by a hierarchical and patriarchic leadership style with the top leader of a company is being regarded as the head of a family. Employees are consequently regarded as part of the family and they expect to be taken care of. Chinese leadership is thus modelled on the father's role as household head. This leadership concept is well in line with the Chinese societal cultural perceptions and values of low gender egalitarianism, as observed in the GLOBE study (Fu et al. 2007, p. 903). In reverse, employees expect that important decisions are made by the management. There is no delegation of responsibility. Chinese employees are used to the fact that decisions are made by their supervisor and therefore they hardly take any initiative (Holtbrügge/Puck 2005, p. 139).

Leadership in Subcultures

Research shows that social groups that differ in age, occupation or education level (e.g. urban Eastern China vs. rural Southern China) differ in their perceptions of implicit leadership traits. For instance, people with more education in China, tend to be more idealistic and want their leader to have a higher standard (Ling/Chia/Fang 2000, p. 737).

Marketing & Sales

The vast segmentation of the country does not only have an impact on leadership and human resource management, but also on marketing issues. Marketing content and messages cannot be standardised for the whole country, but have to be tailored to the respective market segments. At this point, especially, foreign companies face the problem that detailed and reliable

market information is relatively rare (Holtbrügge/Puck 2005, pp. 100-102). Being confronted with this scenario, a *guanxi* network might serve as a company's primary source of in-depth information.

Guanxi in Marketing and Sales

Apart from the possibility of gathering information through the network, *guanxi* also has important implications for quality and price related issues. *Guanxi*-based selling can produce impressive results if products are of poor quality or the level of service is bad, because unexpected drops in quality are less difficult to accept from a *guanxi* partner than from a stranger. Even fake goods are sold through *guanxi* bribes (Langenfeld 2007, p. 136). *Gunaxi* can also be required when it comes to obtaining after-sales service (Langenfeld 2007, p. 138).

Guanxi in marketing & sales is most applicable when serving a few customers like, for instance, in the investment goods industry. However, *guanxi*-based selling cannot be used when serving millions of customers in the fast moving customer goods (FMCG) industry. That is because the number of personal relationships is limited (Langenfeld 2007, p. 137). In order to prevail in such industries the responsible marketing department has to emphasise other topics, such as the outstanding status of children in China and advertising.

Children

In order to reduce the rate of population growth, the PRC has – since 1979 – put into effect the one-child policy, which prescribes that each family should only have one child. The only child in China is thereby frequently regarded as a *"little emperor"* or a *"little sun"* (Zhang et al. 2000, p. 726). Wang Ying, the director of a kindergarten, reports about little emperors: "They're attended to hand and foot by adults so protective that if the child as much as stumbles, the whole family will curse the ground". Consequently, the little emperor has an enormous impact on buying decisions. Especially young families in the urban areas of China undertake remarkable efforts to ensure their only child a beautiful life. The wishes of the child are therefore on top of the agenda. That is not only true for FMCG but for a wide range of goods including products like computers or mobile phones (Holtbrügge/Puck 2005, pp. 103-104).

In general, there are strong differences between the preferences of Chinese consumers born before 1980, who are more likely to seek out products that help them arrange their lives in a more secure and orderly way, and those born after the one-child policy, who are striving to project themselves, establish their uniqueness, and make a positive impression on others. In order to win over young consumers, marketing consultancies advise foreign firms to stress values of individuality, freedom and physical attraction (Chandler et al. 2004, pp. 138-150).

Rather than emphasising individuality and exclusivity, as German or American advertising frequently does, Chinese advertising messages generally focus more on group and collectivistic values. One can thereby identify "mouth-to-mouth" propaganda as the primary advertising medium in China, as personal relationships, family and friends have a huge impact on the buying decisions of Chinese customers. Apart from relationships, TV advertising is the most important advertising tool. This is not only because of the wide availability of television, but also because TV spots fit the Chinese habit of *pictorial thinking* (Holtbrügge/Puck 2005, p. 113).

Summary and Outlook

With more than 1.3 billion inhabitants, China is the largest market in the world. However, as huge as is the market, equally huge is the challenge to prevail in China's competitive environment. Some weird characteristics of the Chinese culture, at least for Westerners, like, for instance, *guanxi*, constitute numerous pitfalls that can seriously handicap a company's engagement in China. As a result, "Western theories of leadership cannot be very effective when directly transposed to Chinese people" (Ling/Chia/Fang 2000, p. 738). Hence, it is mandatory for Western companies, not only to be aware of these characteristics, but also to adjust their management systems and procedures accordingly.

Questions

1. The case study discussed the influence of China's culture on two management functions: "marketing & sales" and "human resource management" and especially emphasised the role of *guanxi*. How can *guanxi* further influence R&D as well as procurement operations?

2. Consider an English company that plans and arranges weddings. The advertising slogan of the company is: "We make your wedding a truly unique experience". Should this company adapt or change this slogan for an advertising campaign in China? If yes, what are your suggestions?

3. A Western European manufacturer of the highest quality motor cars plans to set up a production facility in China and consequently to shift major parts of its production to China. What are the potential problems and challenges for the company?

Hints

1. See, for instance, Langenfeld 2007, pp. 131-145.
2. Refer to the GLOBE study results for China and England for the "In-Group Collectivism" dimension. See Gelfand et al. 2004, p. 469.
3. Think not only in terms of culture, but also consider issues regarding product quality, technology, marketing and human resource management, as well as inherent geographical and political problems.

Part III

International Coordination

Chapter 8

Formal and Informal Coordination Mechanisms

As has been shown in the preceding Chapters, MNCs are characterised by internationally dispersed activities. To integrate all these activities and organisational units of the MNC under a common strategy, coordination is necessary. In this Chapter, an overview of different coordination mechanisms is given, including the strengths and weaknesses of each mechanism. Also, theories that are used to explain the choice of certain coordination mechanisms are discussed.

Introduction

The successful implementation of international strategies depends strongly on the adequate coordination of the dispersed activities by the MNC (e.g. Andersson/Forsgren 1996, p. 487), mostly by the MNC's headquarters. To solve the challenge of how to coordinate the *heterogeneous and geographically distant subsidiaries* is essential for international management.

Coordination and Coordination Mechanisms

Coordination can be defined as the process of integrating activities that remain dispersed across subsidiaries (Martinez/Jarillo 1991, p. 431). "A mechanism of coordination is any administrative tool for achieving integration among different units within an organisation, i.e. to align a number of dispersed and yet interdependent international activities" (Jarillo/Martinez 1989, p. 490).

The core task of coordination for a MNC is to ensure that all subsidiaries strive towards *common organisational goals* and the actions and behaviour of the subsidiaries are conform to the MNC's overall strategy. At the same time, coordination has to contribute to the necessary capabilities, *motivation* and entrepreneurship of the subsidiary management to adapt to the local environment of their host countries (Macharzina 1990, p. 372). This should be achieved at the minimum management costs (or "agency costs"). Following the so called "administrative rationality" (Thompson 1967), it is argued that in each situation, the most efficient type of coordination is to be chosen.

Usually, many coordination mechanisms are used simultaneously. In a very illustrative way, Bartlett/Ghoshal/Beamish (2008, p. 343) suggest an analogy between the MNC and the human body with its different parts. In this perspective, they argue that three different types of mechanisms are necessary to coordinate the MNC:

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- The "anatomy" of the organisation, i.e., the formal organisational structure, which is necessary but not sufficient.
- It has to be accompanied by the "physiology", i.e., a company's systems and decision processes.
- And third, the "psychology", i.e., the organisation's culture, is a crucial component.

Formal and Informal Coordination Mechanisms

A broader categorisation groups the coordination mechanisms into two sets of mechanisms: formal mechanisms and informal, more subtle mechanisms. Table 8.1 gives an overview of the most common coordination mechanisms.

Table 8.1 *The Most Common Coordination Mechanisms*

Formal Mechanisms	Informal Mechanisms
◆ organisational structure: departmentalisation or grouping of organisational units	◆ lateral or cross-departmental relations: direct managerial contact, temporary or permanent teams, task forces, committees, integrators, and integrative departments
◆ centralisation or decentralisation of decision making through the hierarchy of formal authority	◆ informal communication: personal contacts among managers, management trips, meetings, conferences, transfer of managers, etc.
◆ formalisation and standardisation: written policies, rules, job descriptions, and standard procedures, through instruments such as manuals, charts, etc.	◆ normative integration: building an organisational culture of known and shares strategic objectives and values by training, transfer of managers, career path management, reward systems, etc.
◆ planning: strategic planning, budgeting, functional plans, scheduling, etc.	

Source: Adapted from Martinez/Jarillo 1989, p. 491.

Formal Coordination Mechanisms

Structural Coordination Mechanisms

The formal organisational structure is concerned with how the company decides to *divide itself into subunits* (Hill 2009, p. 455). This has far-reaching consequences for the information flow in the organisation, decision processes and the allocation of resources. The formal organisational structure is discussed in detail in Chapter 9.

Organisational Structure a Rather Crude Coordination Mechanism

However, the *macro-structure* of integrating subsidiaries in the organisational structure of a MNC is a "very crude" instrument to control the activities (Birkinshaw/Morrison 1995, p. 737). The basic organisational types describe the general structure of the organisation on the highest organisational level. Considering the heterogeneity of subsidiaries that act in diverse external contexts with unique constellations of characteristics and resources and different tasks, a uniform organisational structure is hardly sufficient to consider this heterogeneity (Nohria/Ghoshal 1997, p. 4). Structural coordination mechanisms are rather *symmetrical* and *not tailored* to the needs of a specific subsidiary. Hence, they are chosen instead due to the overall requirements of the MNC.

Centralisation/Decentralisation

Centralisation refers to *the locus of decision power.* It determines the degree to which decision-making authority is concentrated in the higher hierarchy levels of the organisation (e.g. Lawrence/Lorsch 1967a). Regarding international business, it indicates to what degree decisions are taken by the company HQ in the home country or by the subsidiary itself. It also determines how strong the subsidiary's influence on the decisions is (Morrison/Roth 1993, p. 802).

Advantages of Centralisation

Obviously, a strongly integrated behaviour of different organisational units can be achieved if all decisions are taken by the HQ and the subsidiaries are only implementing those strategies without any autonomy. Decisions taken centrally are based on a good overview of all the different parts of the MNC and they fully reflect the requirements of the HQ. Centralisation is particularly adequate to enforce *global strategies*.

Disadvantages of Centralisation

However, a strong centralisation has a set of drawbacks. First, centralisation has *negative effects on the motivation* of the subsidiary managers. Resistance against a high degree of centralisation is common. Also, centralised decisions are taken on the basis of the knowledge of the HQ. While HQ has a total picture of all parts of the MNC, its knowledge of each specific host country is limited. If the situation of a subsidiary is complex and the environment and requirements are very different from those in the home country, the knowledge of the HQ is likely to be insufficient to make adequate decisions. Since centralisation also needs *intensive information flows* across hierarchies, such decisions are often slow and decentralisation is better suitable to quick and flexible reactions to changes in the local environment and to exploit local market opportunities (Nohria/Ghoshal 1997, pp. 97-98). MNCs with a *multinational orientation* are more likely to use decentralisation.

Centralisation and decentralisation of MNCs is influenced by many factors (see the overviews by Welge 1987, c. 1539; Bufka 1997, pp. 60-61; Young/Tavares 2004). Decision centralisation is high if a subsidiary

- belongs to a large MNC that is active in many countries,
- is part of an interdependent international network with intensive product flows between the different subsidiaries,
- is responsible for more than the local host market,
- is located in a host country with rather stable political conditions.

On the other hand, subsidiaries are usually granted a high level of autonomy, if

- they belong to a MNC with a high growth strategy,
- they are oriented towards the local host market,
- they are tightly embedded in a local cluster in the host country,
- local investors hold a substantial capital share,
- the products and services that the subsidiary offers are not related to the products and services offered by the parent company,
- the geographical distance between home country and host country is large, and/or
- the local environment of the subsidiary, in particular market and competitive conditions, are very dissimilar from the home country.

Different Centralisation of Different Functions

The level of centralisation might also differ by the functional areas of the MNC. While financial management and R&D decisions are often highly centralised, human resource management has been shown to be the least centralised. Manufacturing and marketing are in between (Young/Tavares 2004, p. 218).

Strategic Decisions Stronger Centralised

Frequently, it has been found that strategic decisions are rather centralised while operational decisions are often decentralised. The different availability of information necessary for these decisions is likely to be one important reason. While the knowledge necessary for long-term and strategic decisions is often more available at the HQ, subsidiaries are granted more autonomy for operational decisions in which they have better information availability and which need quick decisions without having far-reaching consequences for the overall MNC (Young/Tavares 2004, p. 218).

Centralisation AND Decentralisation

More recent literature does not see centralisation and decentralisation as purely opposing mechanisms. In particular transnational strategies might require "avoiding the simplistic centralization-decentralization dichotomy" (Martinez/Jarillo 1989, p. 500). As has been explained in Chapter 1, networks can be coordinated via a so-called *decentralised centralisation*, where activities are globally integrated and aligned but, in some cases and for some products, not the HQ but a foreign subsidiary acts as a strategic leader for the worldwide activities (Birkinshaw/Morrison 1995, p. 734).

Formalisation and Standardisation

Formalisation and standardisation refer to the extent to which *written policies*, rules, job descriptions, standard procedures, etc. are established and written down in manuals and other documents, and procedures are established through *standard routines*. The intention is to provide clear and formal behavioural guidelines to the subsidiaries (Lawrence/Lorsch 1967a; Pugh et al. 1968; Martinez/Jarillo 1989, p. 491). Formalisation, as a bureaucratic mechanism, can be seen as a *routinisation* of decision behaviour (Hedlund 1981). It defines impersonal rules and standard processes, independent of specific persons or situations. Standardisation refers to binding rules for uniform procedures and programmes that lead to a homogeneous task completion. In management practice, standardisation and formalisation have gained considerably in importance due to procedures of *quality management* (e.g. ISO 9000), but also due to compliance rules for corporate governance and *codes of conduct* for corporate social responsibility (see Chapter 11).

A high level of product flows and cross-border production usually requires higher levels of standardisation and formalisation for production processes and also for products and product components that need to be integrated in one worldwide supply chain.

Advantages of Formalisation/ Standardisation

The basic advantage of formalisation and standardisation as a coordination mechanism is that they identify certain routine situations that occur repeatedly and establish generalised decision rules before the situation occurs. Their coordination effect is particularly strong if they do not refer to one specific situation but group potential decisions and activities into categories. Thus, they help to replace a direct, centralised coordination by an indirect form and they reduce coordination costs (Morrison/Roth 1993, pp. 802-803). Compared with decision centralisation, formalisation and standardisation provokes less resistance since it refers to a generally valid set of rules instead of potentially "unfair" decisions (Nohria/Ghoshal 1997, pp. 99-100).

Adequate in Stable Task Environments

However, formalisation and standardisation, since they have to solve problems ex ante (i.e., before the decision is taken) are only adequate for static problems and not suitable for highly dynamic tasks in complex environments. They lead to standardised solutions which might be a *barrier for flexibility* and for innovative and new solutions. They also reduce the ability to adapt to local conditions and might thus reduce the motivation of the local management.

Basis for Horizontal Relations

On the other hand, formalisation and standardisation might help to establish a stable context for bilateral communication and coordination between subsidiaries. Even in inter-company cooperation (e.g. in supply chain management), *common standards* (for data and processes) are increasingly seen as necessary *"enabling technologies"* for true cooperation (see Zentes/Morschett/Schramm-Klein 2007, pp. 304-305). In the MNC context, formalisation and standardisation are certainly insufficient for the management of complex situations but they can provide fertile ground for the use of other coordination mechanisms (Morschett 2007, pp. 507-511). Lateral agreements, horizontal cooperation, etc. are facilitated if formalisation and standardisation provide standards that help to exchange products, data and information and facilitate cross-border production processes, marketing strategies, etc.

Planning

Planning, understood as the *periodically repeated establishment of goals* and objectives of the HQ towards the subsidiaries, is a process of *ex ante coordination*, in which higher-ranking objectives of the organisation are broken down to lower hierarchies and specified stepwise. It refers to systems and processes like strategic planning, budgeting, establishment of schedules, and goal setting (Martinez/Jarillo 1989, p. 491). Qualitative strategic objectives are transformed into quantitative objectives, and those objectives are linked to specific resources and organisational units and given a specific time frame. Thus, subsidiaries receive concrete objectives from the HQ that are established to guide and channel the activities and actions of independent units.

Informal Coordination Mechanisms

Lateral Relations and Informal Communication

Lateral relations are established *across the formal hierarchical structure*. They directly link persons in the organisation who share common problems and might develop joint problem solutions together, without having to use clear

vertical lines of authority. The top management's decision and information task is reduced by those direct horizontal relations. They include direct contact among managers of different organisational units, temporary or permanent task forces, teams, cross-national committees, integrating roles integrative departments, etc. (Martinez/Jarillo 1989, p. 492). These lateral relations establish common procedures, internal discussion, knowledge sharing, etc. in the organisation.

Lateral relations also enhance informal communication by creating a *network of informal and personal contacts* among managers across different units of the company (Martinez/Jarillo 1989, p. 492). Such *informal communication* can be stimulated by corporate meetings, management trips, personal visits, manager transfers, intensive use of expatriates, etc. They are associated with intensive direct communication, whether personal or via electronic media (e.g. video-conferencing). Frequent meetings and visits by representatives of the HQ to the subsidiary or vice versa are commonly employed (Kieser/Walgenbach 2003, pp. 109-110).

Normative Integration

Organisational Culture

Normative integration (also called socialisation) refers to building a strong *organisational culture* of known and shared strategic objectives, perspectives and values. This is often achieved by a *socialisation process*, openly communicating the way of doing things and the decision-making style, training, transfer of managers, career path management, measurement and reward systems, etc. to generate identification with the organisation, developing incentive systems, etc. (Egelhoff 1984).

One tremendous advantage of this subtle and indirect mechanism is that the subsidiary can act autonomously without direct orders by the HQ in its daily operations, with a very *high flexibility* and opportunity to adapt to the local context, and its conduct will still be aligned with company goals (Birkinshaw/Morrison 1995, p. 738). Normative integration as a coordination mechanism is discussed in detail in Chapter 10.

Evolution from Formal to Informal Mechanisms

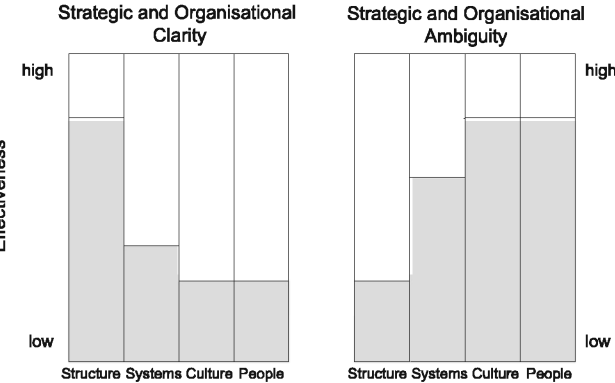
From Simple to Complex Strategies

Simple strategies need little coordination and are easily implemented by using structural and other formal mechanisms. More *complex strategies* need a much higher coordination effort, and are therefore implemented through a more complex set of coordination mechanisms. In particular, network oriented, transnational strategies are more complex strategies since they focus on the dual need of achieving global synergy effects and exploiting local

market differences. Thus, in addition to the structural, formal and relatively simple tools, the informal, more subtle and sophisticated instruments are used. However, since those instruments are very costly and rather slow to implement as well, a MNC usually only applies those informal instruments if they are really necessary to implement the strategy (Martinez/Jarillo 1989, p. 492).

In an early study by Hamel/Prahalad (1983), it was argued that in a situation of relatively stable and clear external conditions, structural coordination instruments have the highest effectiveness. In situations of ambiguity, complexity and dynamic environments, however, normative integration and other personal coordination instruments, like informal communication, offer the highest effectiveness (see Figure 8.1).

Figure 8.1 *Effectiveness of Different Coordination Mechanisms*



Source: Hamel/Prahalad 1983, p. 349.

Patterns of Evolution

Over time, a *pattern of evolution* can be observed. More and more MNCs have put a focus on subtler and informal mechanisms, abandoning their unidimensional focus on structural issues (Martinez/Jarillo 1989, p. 489). This can obviously be the result of a change in the external environment and in the MNC's strategies towards greater complexity, which shifts the relative effectiveness of the different coordination mechanisms.

Adaptation of Coordination to the Subsidiary

Furthermore, if coordination mechanisms have different strengths and weaknesses and the effectiveness and efficiency of certain coordination mechanisms is at least partly dependent on the role of the subsidiary (see Chapter 3), then it follows that the use of coordination mechanisms should vary between different subsidiaries (Young/Tavares 2004, pp. 220-221). Since the organisational structure cannot be adapted to the specific subsidiary roles, informal mechanisms (but also formal ones like the level of centralisation or autonomy) are necessary for the adaptation of coordination.

Theoretical Explanations for the Selection of Coordination Mechanisms

From an economic perspective on coordination, based on so-called "*administrative rationality*" (Thompson 1967), it is argued that in each situation the most efficient type of coordination must be selected. Besides effectiveness, this means considering the *cost of each instrument*.

Normative Integration more Costly than Formalisation

Normative integration is a powerful instrument that is costly to implement, since comprehensive administrative resources (e.g. visits by managers) have to be invested, for initial socialisation as well as for the maintenance of the relationships. Formalisation and standardisation, on the other hand, are usually implemented at low cost. Centralisation is also rather inexpensive to establish, since it is based on the hierarchical authority of the HQ. On the other hand, centralisation might require comprehensive resources in the HQ to be able to make the decisions adequately (Nohria/Ghoshal 1997, pp. 102-103). These and other cost aspects have to be *balanced* with the differing effectiveness in different situations to decide on the optimal coordination.

Contingency Approach and Configurational Approach

The contingency approach argues that there is *no universally optimal organisational structure* (and no universally optimal set of coordination mechanisms) but that the organisational coordination should be differentiated with the characteristics of the external environment in which the organisation acts (Lawrence/Lorsch 1967b; Thompson 1967; Kieser 2002, p. 169).

"It All Depends"

Which coordination method is optimal depends on the specific situation. The argument that which coordination method is optimal strongly depends on the specific context follows directly from a perspective of *organisations as open systems* that have to interact with their external environment (Kieser/Walgenbach 2003, p. 215). Contingencies that have been investigated in their influence on the coordination have been: the company size, the dynam-

ics of the technological and market conditions, and the uncertainty of the environment.

Strategic Choice Instead of Deterministic Relationship

However, one point of critique considering the contingency approach is the *quasi-mechanistic relationship* between the situation and the conduct of organisations. This implies a very deterministic perspective, while in practice, companies have a "*strategic choice*" (Child 1972) as how to act in their MNC as a reaction to different external situations. However, the general assumption of the contingency approach, that the effectiveness and efficiency of coordination mechanisms (and other organisational variables) are influenced by the external environment and there is no universally best solution but rather situation-specific differences, is widely accepted. For example, it is argued that the complexity of a firm's coordination process must match the complexity of its environment (Ghoshal/Nohria 1993, p. 23).

Internal and External Fit

While the contingency approach focused mainly on the relation between context and company, the *configurational approach* adds that the internal consistency between the organisational variables also has a strong influence on the efficiency of the organisation (Khandwalla 1973, p. 493). The "*gestalt*" of the organisation is more than the sum of its parts and the configurational approach argues that an organisation is effective if *consistency* or "*fit*" between the organisational variables (like the coordination instruments) as well as between internal variables and external environment is given (Mintzberg 1981, p. 107). The configurational approach postulates that a rather low number of "typical constellations" of organisational variables exist that can represent the majority of all combinations of organisational characteristics that exist in practice (Miller/Friesen 1984). With regard to coordination, this implies that an isolated use and analysis of each coordination instrument does not suffice but that the combination of coordination instruments applied is crucial for success.

Information Processing Approach

The information processing approach by Egelhoff (e.g. Egelhoff 1991) considers the *MNC as an information-processing system*. Information processing refers to the *gathering of data,* the transformation of data into information, the communication and diffusion of information in the company and the storage of the information. Coordination has to consider the information processing requirements and capacities required.

Uncertainty as a Lack of Information

This approach assumes that different companies have different requirements for their information processing, partly based on the uncertainty of tasks. This *uncertainty* is defined as the difference between the amount of information necessary to perform a specific task and the information that is already

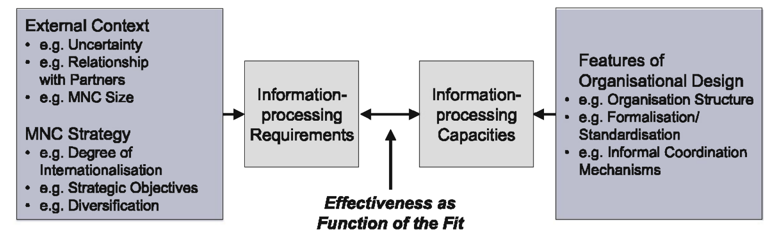
available in the organisational unit. Internal and external information flows are used to reduce uncertainty (Egelhoff 1991, p. 343). Strong influences on the uncertainty (i.e. the information processing requirements of the organisation) are exerted by the size of the MNC, the company's growth as well as the diversification of the company. Other external factors, like the technological dynamics of the industry, or internal factors, such as the degree of internationalisation, also affect the level of uncertainty (Wolf/Egelhoff 2001, pp. 121-122).

Different Types of Information

Different *qualities of the information* to be processed stem from a distinction between *primarily strategic* or *primarily tactical* information, between routine and nonroutine information processing, between *sequential* and *reciprocal* information flows (Egelhoff 1991, pp. 350-353). These require different communication channels.

The Information-Processing Approach

Figure 8.2



Source: Adapted from Egelhoff 1991, p. 345; Wolf/Egelhoff 2001, p. 122.

Different features of the organisational design, including the coordination mechanisms, have different information processing capacities. The core argument of the information processing approach is that companies have to achieve a good *"fit"* or alignment *between* their *information processing capacity and* their specific *information processing requirements*. Based on this approach, it can be argued, for example (Egelhoff 1991, p. 344; Wolf/Egelhoff 2001, p. 120):

- If information processing is routine and simple, *rules and programmes* (i.e. formalisation and standardisation) are sufficient to overcome the low uncertainty of the decision situation. For example, reporting systems of the subsidiaries can be designed following standards by the HQ so that comparability is given. Such *standard reports* can eliminate the need for other forms of HQ-subsidiary communication.

- With increasing uncertainty, flexible and rapid decisions must be taken closer to the local host environment. *Planning*, including goal-setting, allows for more decisions to be made at lower levels in the organisation as long as they comply with the plan.
- With further increasing uncertainty, the organisation's information processing capacity must be further enhanced, including coordination processes that are based on *vertical information systems and central departments*. *Informal communication* flows must be added to manage the increased uncertainty.
- With very high complexity, HQ might have problems processing all the necessary information. Thus, the use of *lateral relations* allows more information processing to be decentralised to disburden the limited information processing capacity at the higher levels of the organisation. Direct contact between executives, e.g. through project teams, linking pins, etc., also directly between peer subsidiaries, enables effective information processing throughout the whole organisation (Egelhoff 1991, pp. 343-344).

Agency Theory

Agency theory (also called *principal-agent theory*) deals with *delegation relationships* in which a principal delegates certain tasks and decisions to an agent on the basis of an explicit or implicit contract. The actions by the agent influence the welfare of the principal (but also the welfare of the agent). Contracts between the principal and the agent are always incomplete due to *limited information*, unpredictability of future situations and the (prohibitively) high cost of complete contracts. Furthermore, the principal-agent theory argues that usually there is *information asymmetry* in favour of the agent. Before closing a contract, the principal is not able to identify fully the capabilities and characteristics of the potential agent (*"hidden characteristics"*) and this might lead to a bad selection (*"adverse selection"*) (Richter/Furubotn 2003, pp. 218-219). More serious (and more relevant for the case of MNCs), after the contract has been closed, the principal cannot completely observe the behaviour of his agent (*"hidden action"*) and the result of the delegation is also influenced by external conditions that the principal also cannot fully observe (*"hidden information"*) (Elschen 1991, p. 1004; Woratschek/Roth 2005, p. 152).

Risk of Opportunistic Behaviour

All this leaves room for *opportunistic behaviour of the agent*. Agency theory assumes that the agent intends to maximise his individual utility and that the objectives (and the risk preferences) of principal and agent may diverge. Thus, conflicts of interest may emerge. With the assumption of *"moral haz-*

ard", it is assumed that the agent will even carry out actions that influence the welfare of the principal negatively if it enhances his own benefit.

The Subsidiary is an Agent of the HQ

Transferring this consideration to the HQ-subsidiary relationship, the HQ cannot make all decisions itself since it does not have the necessary information and resources. When delegating decisions and actions to the subsidiary, however, it has to be aware that the interests of the foreign subsidiary might diverge from the interests of the HQ. Principal-agent theory attempts to suggest mechanisms for information, incentive and control ("governance mechanisms") that *align the interests of the subsidiary with those of the HQ*, i.e. mechanisms that motivate the subsidiary to contribute to the overall objectives of the MNC (Nohria/Ghoshal 1994). In this case, even without close monitoring, adequate actions by the subsidiary can be expected. A simple example can be the possibility for a subsidiary to re-invest its profits locally instead of having to transfer profits to the HQ or variable incomes by managers, based on their profit contribution.

Usually the HQ cannot observe and control all the actions that a subsidiary carries out and the performance of the subsidiary (e.g. the sales success of the subsidiary) is influenced by many aspects beyond the control of subsidiary management ("hidden information"). Thus, controlling the outcome is also not sufficient to evaluate the subsidiary management completely, and in many cases, e.g. considering knowledge generation or innovation in the subsidiary, the performance is not readily measured. Here, *normative integration* is seen to be effective to establish close relationships between the subsidiary and the HQ to reduce the propensity to behave opportunistically and to influence the subsidiary to contribute to the overall company benefit "voluntarily" without explicit performance measurement (Gupta/Govinda-(Gupta/Govindarajan 2000).

Expatriates Sometimes Better Agents

Using *expatriates* as an informal coordination mechanism can well be argued from an agency perspective (O'Donnell 2000). Expatriates are more likely to act on behalf of the HQ and to consider the objectives of the HQ when making decisions than are host-country nationals. This is due to the fact that the career of an expatriate is more strongly linked to the HQ's evaluation of his performance, and the expatriate is often identified more strongly with the HQ than with the local subsidiary, since he or she was socialised in the HQ.

Market Elements as Coordination Mechanisms

On the other hand, the mentioned mechanisms all carry a cost ("*agency costs*") and the costs of a potentially opportunistic behaviour and the cost of control have to be balanced when deciding on the use of a coordination mechanism. Hierarchical coordination can be replaced to some extent by *market elements*. With externalisation, i.e., outsourcing activities to external partners, or "quasi externalisation", i.e., using market principles between organisational units within the company, market prices replace hierarchical

authority. Considering agency theory, this is particularly appropriate when information asymmetry is strong, e.g. if the socio-cultural distance between home country and host country is high. The competitive market pressure partly helps to reduce agency costs. The threat of an organisational unit not to choose another organisational unit as supplier reduces the incentive to act opportunistically since it would threaten the (internal) relationship (Woratschek/Roth 2005, pp. 153-154).

Resource-dependency Theory

Resource-dependency theory is an *environmental interaction approach* (Pfeffer/Salancik 1978). The core idea is that *companies need to exchange resources with their environment* and that they need certain resources from external sources to survive. This creates dependencies from other organisations and, thus, a risk for the company. Resource-dependency highlights the situations in which resource dependency is strong and the relevance of the resources for company survival is high. It suggests strategies to minimise the risk of resource supply.

Subsidiaries with Access to Critical Resources

In the perspective of a MNC, not only relationships between different companies but also relationships between different organisational units within the MNC can be considered from a resource-dependency perspective. Subsidiaries are often strongly dependent on resources from the HQ, which facilitates coordination. However, subsidiaries may be able to obtain resources that are difficult for other actors, including HQ, to access, which affects the potential for central coordination within the MNC and sometimes diminishes the possibility of enforcing a strategy-conforming behaviour of the subsidiary (Andersson/Forsgren 1996, p. 488).

In this perspective, the differential access to resources that have different relevances for the MNC can be a key determinant in the internal relationships in the MNC (Pfeffer 1981; Nohria/Ghoshal 1997, p. 95). With increasing relevance of the subsidiary's resources for the MNC's performance, with lower substitutability of the resource and with the uniqueness of the access to the resource by this specific subsidiary, its *internal power* increases.

Powerful Subsidiaries Resist Strong Centralisation

Thus, resource dependency can be a source of conflict in the MNC. With increasing dependency on resources from the subsidiary, it becomes more difficult to enforce top-down decisions (Doz/Prahalad 1981; Nohria/Ghoshal 1997, pp. 96-97). On the other hand, limiting the autonomy of the subsidiary might reduce the effectiveness of the MNC network because this might reduce the subsidiary's access to the strategic resource.

In this situation, decision centralisation has to be replaced by other mechanisms. Formalisation and standardisation might still be adequate to coordi-

nate the internal relationships and to promote the resource exchange. Normative integration can also facilitate the "negotiation process" between parent company and foreign subsidiary (Nohria/Ghoshal 1997, pp. 100-101).

Conclusion and Outlook

Coordination mechanisms are administrative tools for achieving integration among different units within a MNC, i.e., to align a number of dispersed and yet interdependent international activities. They are used to ensure that all subsidiaries strive towards common organisational goals (Martinez/Jarillo 1989).

With increasing complexity of MNC strategy and heterogeneous environmental contexts, managerial practice has moved from the use of simple instruments like the organisational structure to more complex instruments like normative integration. The informal mechanisms do not substitute for the formal mechanisms but they supplement them. Thus, MNCs increasingly apply multi-dimensional combinations of coordination mechanisms instead of a uni-dimensional focus on company structure as in the past. Following the configurational approach, it is important to consider the coordination of a MNC to be realised via a combination of coordination mechanism. These specific patterns of the use of coordination instruments build on an optimal bundle of instruments that supplement each other's strengths and weaknesses.

Network-oriented Perspective

In particular the modern network-oriented perspectives of the MNC strongly favour the informal and more subtle mechanisms. In this context, Bartlett, Ghoshal and Beamish (2008, p. 449) argue that a process of change within a modern MNC is better initiated with the corporate culture rather than with the formal structure. They argue that using the formal structure as a coordination instrument is a rather blunt and slow mechanism which might take years to fully implement. To start a process of change, instead of installing a new structure, the establishment of an organisation should comprise other instruments. Following their analogy with the human body, they recommend starting a process of change by altering the company's "psychology", i.e., the corporate culture. After changing beliefs, norms and attitudes, changing the "physiology", e.g. communication and decision processes, can reinforce the cultural change. Later on, companies might consolidate and confirm their progress by realigning organisational anatomy through change in the formal structure.

However it has to be kept in mind that more complex coordination systems are only adequate when the situation requires it. "Simplicity, wherever possible, is a virtue" (Ghoshal/Nohria 1993, p. 24).

Further Reading

MARTINEZ, J.; JARILLO, C. (1989): The Evolution of Research on Coordination Mechanisms in Multinational Corporations, in: Journal of International Business Studies, Vol. 20, No. 3, pp. 489-514.

Case Study: Würth[1]

Profile, History, and Status Quo

Origin and Internationalisation

The *Würth Group* was founded in 1945 as a screw wholesale business by Adolf Würth in Künzelsau, a small village located in South-western Germany. After the early death of Adolf Würth, his son Reinhold Würth took over in 1954 when he was 19 years old. Reinhold Würth initiated a business success story almost unmatched in post-war German history as he has turned his father's two-man business into a global trading group, serving more than three million customers from the trades and the service industry.

In order to achieve his goal of becoming a global player, Reinhold Würth rapidly started to expand his business beyond the borders of Germany by opening sales and distribution companies. In 1962, the company entered the neighbouring markets of the Netherlands, Austria and Switzerland that are close in terms of distance, but also close in terms of business culture and values, and therefore suited as a starting point for an international expansion strategy. By the end of the 1960s and in the early 1970s, the *Würth Group* expanded its operations overseas and entered important markets in North and South America. In the 1980s, using Vienna (Austria) as a bridgehead, the company started business in the Eastern Europe. In 1994, Reinhold Würth withdrew from operative business and assumed the chair of the advisory board of the *Würth Group*. In 2006, his daughter Bettina Würth became his successor in this position. However, Reinhold Würth continues to be the chairman of the supervisory board of the family trusts. With the succession in place and every major market being occupied, the company nowadays strives to boost business in existing markets and to enter niche markets like, for instance, Pakistan, in 2007. Despite the international scope of its operations, the headquarters of the *Würth Group* is still located in Künzelsau.

Company Data

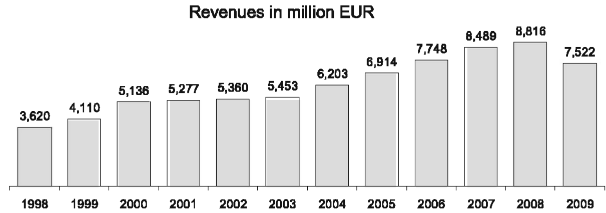
For years the group has been on a steady growth track, with the German home market being the single most important market, accounting for about 40% of the group's total revenues. Figure 8.3 reveals the company's revenue development from 1998 onwards. Sales in 2009 suffered strongly from the

[1] Sources used for this case study include the web site www.wuerth.com, various annual and company reports as well as explicitly cited sources.

financial crisis which hit most of Würth's customers (e.g. in the industry) heavily, leading to a reduced sourcing volume.

Würth Group: Development of Revenues

Figure 8.3



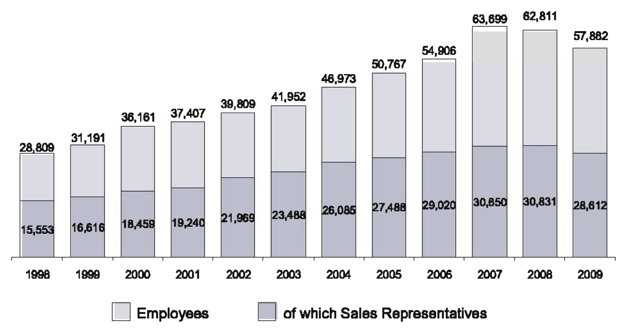
Source: Würth Group 2010.

By the end of 2009, the group had about 58,000 employees (see Figure 8.4). By maintaining a sales force of more than 28,000 sales representatives, the *Würth Group* is the largest employer of salaried sales staff in the world.

Largest Employer of Salaried Sales Staff Worldwide

Würth Group: Employee Development

Figure 8.4

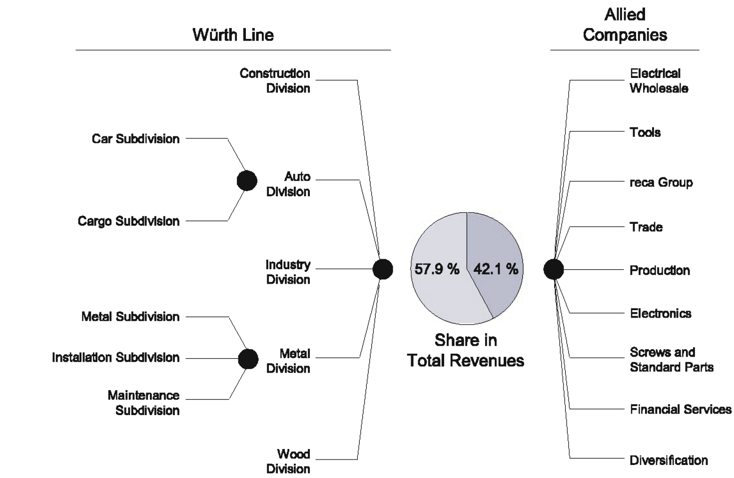


Source: Würth Group 2010, p. 41.

Company Structure and Management Principles

Figure 8.5 illustrates the organisational structure of the company.

Figure 8.5 *Würth Group: Company Structure*



Source: Adapted from Würth Group 2010, pp. 16-17.

Company Structure

By the end of 2009, the *Würth Group* operated 397 companies in 84 countries. The companies are divided into two business units: "*Würth Line*", with a total of 128 companies of which three are German, and "*Allied Companies*", with a total of 269 companies. The *Würth Line* unit comprises five divisions that represent the core business of the *Würth Group* – the global trade of fastening and assembly materials and technology. The *Allied Companies*, which do not operate under the name of *Würth*, are divided into nine strategic business units. Apart from the diversification group, which consists of service companies operating at regional level (e.g. hotels and restaurants) and a small number of manufacturing firms, the majority are sales companies operating in related areas.

Management Principles

The management style of the *Würth Group* is best described by two major management principles: *leadership technique* and *leadership culture* (Würth 2008, pp. 111-112). Roughly, these two principles refer to formal and informal coordination mechanisms. The leadership technique principle includes state-of-the-art methods in the areas of marketing and organisation, as well

as finance and accounting. Methods like management information systems and forecast tools are, in most cases, well known and increasingly common among its competitors. Thus, leadership techniques cannot serve as a source of differentiation for a company and cannot constitute a source of competitive advantage. Rather, they are a fundamental requirement to stay in business. The minor importance of leadership technique is in sharp contrast to the basic competitive edge given by the second management principle – leadership culture. While leadership technique captures the fact-based core functions of management, leadership culture comprises the "soft" and abstract elements of management. Among others, leadership culture covers topics like corporate culture, motivation, myth and symbols. *Würth's* corporate culture, for instance, is described "by terms of dynamism, performance-orientation, openness, honesty, reliability and responsibility" (Würth Group 2008b, p. 1). Leadership culture can be used to drive the uniqueness of a company and, as a result, to outperform competitors.

By using the *Würth Group* as paradigm, this case study aims to illustrate how formal and informal coordination mechanisms as described in this Chapter can be put into practice.

Formal Coordination Mechanisms at the Würth Group

Formal Structure

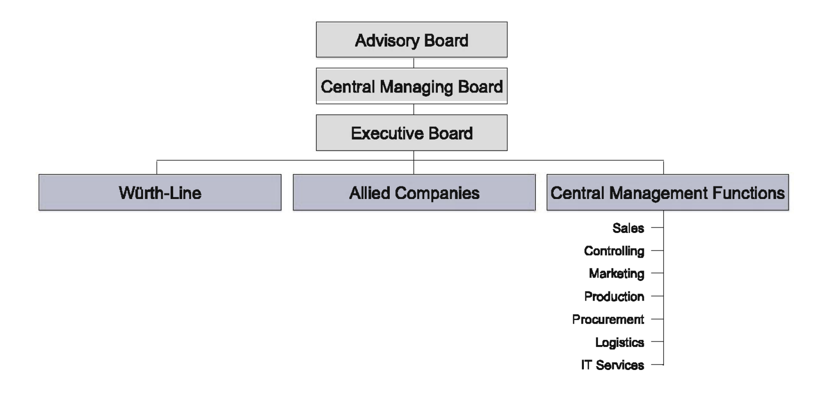
As described above and depicted in Figure 8.5, the *Würth Group* is differentiated into two business units: *Würth Line* and *Allied Companies*. Referring to Figure 8.5, the business units are further separated into product divisions. Although the various divisions are motivated to operate as independently as possible, they are backed up by a number of central management departments. The services of these departments are basically meant for businesses without the critical size to build up the required competences. However, every business has the opportunity to gain management support from the various departments (Venohr 2006, p. 121).

Top-Management of the Würth Group

The top management of the company is split into three parts: advisory board, central managing board and executive board (see Figure 8.6). The advisory board is the supreme supervisory entity within the *Würth Group*. In addition to advising on strategic matters, it is responsible for approving corporate planning and the use of funds, and appoints the members of the central managing board and the managing directors of the major companies. The central managing board is the top-level decision-making body of the *Würth Group* and consists of five members. Its most important tasks include strategic planning, the appointment of executive personnel, and the operative management of strategic business units and functional areas. The 20 members of the executive board constitute the operational management of the *Würth Group*. Apart from representatives of group-wide core manage-

ment functions like marketing and logistics, each member is in charge of a specific division, allied company segment or geographic region.

Figure 8.6 *Simplified Formal Structure of the Würth Group*



Centralisation or Decentralisation of Decision Making

As a result of the early international expansion and the parallel processing of the domestic German and international markets, the *Würth Group* is a very decentralised company. To ensure a maximum level of decentralisation, the divisions of the *Würth Group* are managed as strategic business units (SBU) and the respective SBU management is fully responsible for the financial performance of its entity. Within the SBU structure, the 400 *Würth Line* and *Allied Companies* operate as self-dependent, legally independent units.

Maximum of Local Decision Making Power

By allowing a maximum level of decentralisation, the group aims to boost the spirit of entrepreneurship across all companies. The chairman of the central managing board, Robert Friedmann, reports: "Continuous advancement of the *Würth Group* requires a flexibility of minds and operations. We ensure this through entrepreneurship, which is promoted through all our entities. Equipped with a maximum of local decision-making powers, the companies of the *Würth Group* serve their markets. This even extends to the practise that profits are essentially retained by the entities so that they can be invested there" (Würth Group 2008a, p. 32). This approach is supported by Reinhold Würth himself, who acknowledges that local country management and local sales forces know best how to prevail in their respective markets (Würth 2008, p. 110).

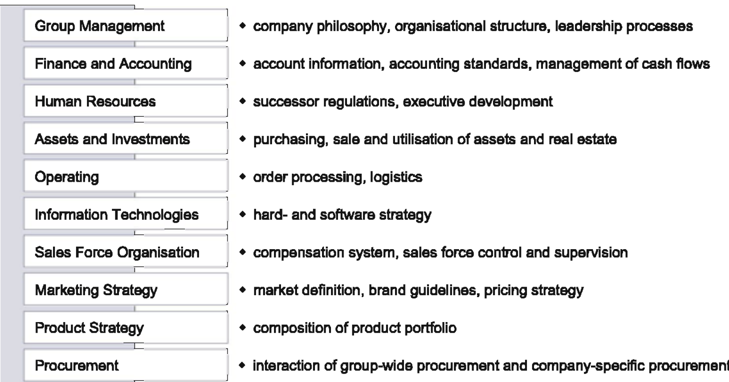
Formalisation and Standardisation

Building on corporate philosophy and corporate culture, the *Würth Group* developed the PAP (*Policy and Procedure Manual*) rules to set out a code of conduct to guide employees and to standardise terms and rules worldwide

(Würth Group 2008b, p. 1). Initiated in the 1970s and intended as a simple manual for basic rules and instruments, the PAP evolved into a knowledge database for state-of-the-art management know-how (Venohr 2006, pp. 78-79). Figure 8.7 displays the major parts and contents of the PAP, but one has to bear in mind that neither the PAP nor its contents are finalised and carved in stone. In fact the PAP is constantly reviewed and adjusted as necessary.

Elements of the Policy and Procedure Manual PAP

Figure 8.7



Source: Adapted from Venohr 2006, p. 80.

Informal Coordination Mechanisms at the Würth Group

Lateral Relations

An example of an integrative department at the *Würth Group* is "*Würth Logistics*" (*WüLo*). Established in 2002 and located in Chur, Switzerland, WüLo operates as an independent logistics service provider which organises roughly 60% of the worldwide procurement volume of the *Würth Group* (Großer 2006, p. 19), which equals about 400,000 logistics orders annually. *WüLo* does not operate its own plants or transport but performs the planning, organisation and control of logistics chains and purchases transport and logistics services on the free market.

Within the *Würth Group*, *WüLo* manages the transportation from an estimated 20,000 suppliers (Schlachter 2008, p. 2) to the different companies of the group. Thus, the department acts as a link between the different *Würth* companies and their suppliers and therefore cuts across the formal structure of the company (Martinez/Jarillo 1989, p. 492). By combining and coordinat-

ing orders of the various *Würth* companies, *WüLo* manages to realise economies of scale as well as economies of scope and consequently achieves cost savings for the *Würth* companies (Großer 2006, pp. 20-22).

Informal Communication

To enable and encourage informal communication among the managers, the *Würth Group* has established management congresses. The first congress of this nature took place in London in 1977. Other locations have included: New York, Nice, Istanbul, Budapest, Helsinki, Saint Petersburg, Stockholm, Prague, Scottsdale (Arizona, USA), Lisbon, Dubai and Miami. *Accompanied by their partners*, 800 managers from all around the world and across all businesses units and divisions attended the last congress which took place from 20 to 28 April 2008 in Cape Town, South Africa. The theme of the congress was "1000| 100| 1" – thousands of employees, hundreds of companies, one spirit. The congresses are not only meant to provide a platform for discussions, knowledge sharing and networking, but, arguably even more important, to give the company's top mangers the chance to spend some time in a relaxed and laidback atmosphere. According to Reinhold Würth, about 80 % of the success of a *Würth Group* management congress rests upon informal events and activities, offside formal conferences and presentations (Würth 2008, p. 115).

Organisational Culture

The organisational culture as a mechanism of coordination is reflected and emphasised in the second management principle of the *Würth Group* – leadership culture. As the *Würth Group* identified leadership culture as a source of competitive advantage, numerous approaches to clarify and communicate the objectives and values of the company can be identified, for instance, the successful *Würth Group* management congresses as a platform for informal communication. Reinhold Würth moreover describes the congresses as an opportunity to shape the corporate culture, the "corporate spirit" (Würth 2008, p. 115). Almost enthusiastically, he reports about the management congress in Dubai in 2003: "When, at the end of a desert trip, the residents of a Bedouin camp ride through the night on their magnificent camels, a more than three-foot high '*Würth-congress*' in melting ice-letters drops away into the 40-degree Celsius night, when delicious couscous is being served while the audience is simultaneously entertained by performances and belly dancing under a crystal-clear starry Arabian sky, then we talk about unforgettable moments that will influence the company for decades" (Würth 2004, p. 116).

Sport Sponsorship

The *Würth Group's* engagement in sport sponsorship is another tool of the company to communicate its values. "Teamwork and enthusiasm, commitment and striving for success are fundamental elements of sports, with these values also characterizing and defining *Würth's* corporate culture. For that reason, we support sports as a sponsor in many ways" (www.wuerth.com). Thus, the sponsoring activities are directly connected to the corporate culture of the group and the beneficiaries are chosen accordingly. For instance,

the *Würth Group* is an "official supplier" of the *Panasonic Toyota* Formula One racing team. Given the high level of professionalism and technical know-how it requires, Formula One racing appears to be the perfect choice for the *Würth Group* to communicate its willingness to deliver outstanding performance. Furthermore, the company supports the German Touring Car Championship ("DTM") and is a sponsoring partner of five football teams playing in major German leagues, including Bayern Munich.

Corporate Videos

Another instrument applied by the *Würth Group* to communicate values and objectives is corporate videos. These videos are recorded in the German and English languages and distributed within the whole company. The videos contain a certain amount of business information as well as content about the group's vision, objectives and cultural values. The videos enable the group to reach employees who cannot attend the management congresses (Würth 2008, p. 115).

Summary and Outlook

The *Würth Group* works with a broad range of different formal and informal coordination mechanisms. In order to cope with the complexity that automatically comes along when operating 400 companies in 86 countries, the group clearly emphasises informal coordination mechanisms and even outlines their corporate culture being the competitive advantage of the group. This is also due to Reinhold Würth himself who, despite officially retiring in 1994, still has a tremendous impact on the company's strategy, activities and development and who still pursues a "management by wandering around" (Venohr 2006, p. 60) in the headquarters of the company in Künzelsau.

Questions

1. The case study has shown that organisational culture can be used as a powerful mechanism of coordination. Explain why organisational culture can be a source of sustained competitive advantage. Can a strong organisational culture also constitute a threat for a company?

2. According to Martinez/Jarillo 1989, informal coordination mechanisms are best suited to cope with complex strategies. What are potential disadvantages or risks that are associated with informal coordination mechanisms? Illustrate those disadvantages using the *Würth Group* as an example.

3. The driving force behind the corporate culture of the *Würth Group* has always been Reinhold Würth. Würth left his operative function in the

company in 1994. Discuss critically how the corporate culture can be maintained if the focal person is less visible for the employees.

Hints

1. The issue whether organisational culture leads to competitive advantages is extensively discussed in the academic literature. See, for instance, Barney 1986.
2. See also Martinez and Jarillo 1991.
3. To answer this question, it is important to develop a deeper understanding of what a "corporate culture" actually is. Schein developed a frequently cited model of organisational culture. Schein's model is presented in Chapter 7.

Chapter 9

International Organisational Structures as Coordination Mechanism

Organisational structures can be understood to represent the "anatomy" of the organisation. They describe the formal design of the organisation's resources and responsibilities. Different organisational structures lead to different behaviours of the employees because the structure and the subordination in hierarchies define the focus of an employee's work as well as the official channels of knowledge transfer. The aim of this Chapter is to give an overview of organisational structures and to discuss the strengths and weaknesses of each structure.

Introduction

The *formal organisational structure* is concerned with how the company decides to *divide itself into subunits* (Hill 2009, p. 455). The structure is the result of a departmentalisation or grouping of activities within organisational units, following the principle of *labour division* as a mechanism of organisational influence (Martinez/Jarillo 1989, p. 489). A basic consideration concerning the organisational structure of companies can be based on an argument by Thompson (1967, p. 70). Thompson argued that – under *administrative rationality* – companies that are active in heterogeneous task environments are attempting to identify more homogeneous subsegments in those tasks and are creating organisational units that have responsibility for one of those more homogeneous tasks. Compared with a purely national organisation, MNCs are facing an *additional heterogeneity*, namely the different conditions in different host countries (Nohria/Ghoshal 1997).

The organisational design can be seen as the *anatomy* of the organisation which describes the formal structure of its resources, assets and responsibilities (Bartlett/Ghoshal/Beamish 2008, p. 343). The organisational structure of a company has a number of functions (see, e.g., Griffin/Pustay 2010, p. 415):

- It defines the *activities* that are *grouped together* and *assigns tasks* to its employees.
- It defines the *hierarchical structure*, including lines of authority, subordination and responsibilities within the organisation.
- It designs the *allocation* of its *organisational resources*.

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- It establishes official *lines of communication* to transfer information necessary for problem solving, *decision making* and effective organisational control.

Balance Responsiveness and Integration

In particular, for a MNC, the organisational structure helps to influence the balance between responsiveness and integration. The need for differentiation and responsiveness stems from diverse requirements that exist due to heterogeneity between countries, but also between product lines and between organisational functions. The need for integration comes from the need to coordinate the activities of the MNC in order to ensure strategy implementation and to exploit synergies and to have optimal resource allocation (Shenkar/Luo 2008, p. 314). This *integration* may also be, inter alia, *across countries, across product lines, and/or across functions*. In selecting a specific organisational structure, companies influence the level of differentiation and integration. As with international management in general, it is the goal of the company to find a structure that balances the needs for (external) effectiveness and (internal) efficiency.

Types of Organisational Strucutres

The *most relevant organisational structures* for internationally active companies are (Griffin/Pustay 2010, pp. 415-424; Deresky 2008, p. 266):

- domestic structure with export department
- international division
- global functional structure
- global area structure
- global product structure
- matrix structure
- hybrid structure.

Structures at Early Stages of Internationalisation

In the early stages of internationalisation, an organisation is often split into functions reflecting the company's most relevant value chain activities (e.g. production, marketing & sales, finance, HRM). When companies commence their international involvement with their first exports, this does usually not change the organisational structure. Instead, these *exports* are often realised as part of the activities of the *marketing & sales department* of the company.

Export Department

In the next stage, with increasing exports, the domestic structure may be expanded by adding a specific *export department* (Deresky 2008, p. 267). Such

a structure is often realised via a *direct reporting structure*, since the export manager reports directly to the top management of the company.

International Division

With further international expansion, *operation modes* often change. Sales subsidiaries are common and exporting is often supplemented by foreign production. Thus, the complexity and relevance of international activities lead to the need for internal specialists in those activities. The company may then decide to *bundle all foreign activities* in an international division which is *largely independent*. In this structure, the various foreign subsidiaries and activities, from sales offices to production plants, are organised in the international division and the subsidiary managers report to its head. This manager, in turn, often has a *direct reporting relationship* to the CEO of the company. The *internal organisation* of the international division may be based on function, product, or geography.

Characteristics of the International Division

The international division allows the MNC to allocate and coordinate resources and it accumulates all knowledge for foreign activities in one organisational unit, facilitating flexible response to changes in the international environment, such as the emergence of new market opportunities. It leads to *clear responsibilities*. On the other hand, the separation of all international activities might lead to *conflicts* for additional resources and it runs the risk of reducing the knowledge flow and the synergy effects between the international business and the domestic business. *Redundant effort* might also pose a problem (Zentes/Swoboda/Morschett 2004, pp. 757-761; Deresky 2008, p. 267; Shenkar/Luo 2008, p. 315).

Integrated Structures

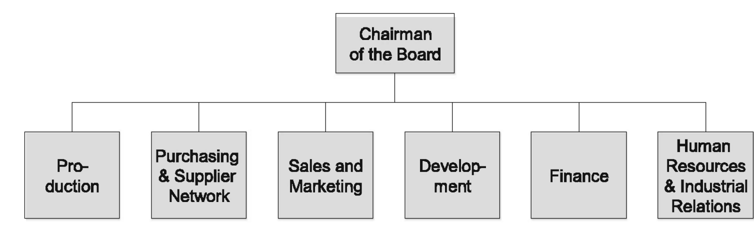
When the relevance of foreign activities grows further, that is, the percentage of foreign revenues increases and the complexity of foreign activities rises due to different types of value-added activities abroad, the deficits of structures in which international and domestic operations are separated become more evident. In this case, a company may choose to develop an *integrated global structure* in which *domestic and foreign operations are combined* in the same organisational units and are led by the same top managers (Deresky 2008, p. 267). This structure can be organised in various ways, including along functional, geographical or product lines.

Global Functional Structure

In a global functional structure, the activities of the MNC are organised around specific functions: production, marketing, finance, etc. Departments are created that have *worldwide responsibility* for the specific function.

Figure 9.1

Global Functional Structure at BMW Group



Source: BMW 2010.

Advantages of the Functional Structure

Foreign operations are integrated into the activities and responsibilities of each department to gain *functional specialisation* and *accumulate functional expertise*. Furthermore, function-related *know-how transfer* is facilitated (Deresky 2008, p. 267). Usually, functional structures lead to *centralised decision making* and companies that intend to impose *uniform standards* on all their worldwide activities can do that via a functional structure. Thus, this organisational form is sometimes called a "*U-form organisation*", where the "U" stands for "unitary". For subordinates, a clear line of responsibility and authority is given and duplication of effort can be mostly avoided. Further advantages are given in Table 9.1.

Table 9.1

Strengths and Weaknesses of a Global Functional Structure

Strengths	Weaknesses
◆ intensive knowledge transfer concerning the function ◆ focus on key functions ◆ functional expertise ◆ centralisation/standardisation ◆ helps to "unify" the corporation ◆ one line of responsibility ◆ avoidance of double work	◆ knowledge transfer concerning other fields rather low ▪ specific requirements of certain product groups, regions, customer groups often neglected ◆ potentially low motivation due to centralisation ◆ slow reaction to changes in certain countries due to standardisation and formalisation ◆ high requirements for information processing at the top management ◆ potentially lack of market orientation ◆ difficult for subsidiaries with whole value-added chains

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 765.

Disadvantages of the Functional Structure

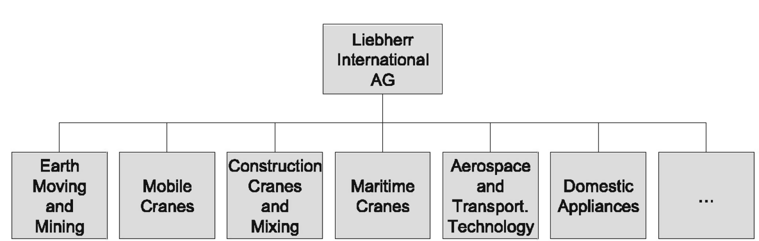
However, the *specific requirements* of certain product groups and regions might be *neglected* in this structure. There is the risk of a *lack of market orientation* in the organisation and *high requirements for information processing* at the top where all major decisions for a function are taken.

The structure is mainly *adequate* if the company has rather *homogeneous product lines*, i.e. a low level of diversification, and if markets for its products are not strongly heterogeneous. For example, a *global strategy* which intends to exploit economies of scale and international synergies by strongly integrating activities around the world can be implemented with a functional structure.

Global Product Structure

In a global product structure, the activities of the MNC are organised around specific products or product groups. Departments or divisions are created that have worldwide responsibility for all functions concerning the specific product. This structure is frequently used by MNCs. It is often called a "*M-form*" structure, where "M" stands for "multi-divisional".

Global Product Structure at Liebherr — *Figure 9.2*



Source: Liebherr 2007.

Advantages of the Product Structure

The product structure allows managers to *accumulate knowledge on their specific product* and develop high expertise. Knowledge transfer concerning the product is high. The structure aids *efficiencies in production*, e.g. to achieve economies of scale and to exploit synergy effects fully. Similarities in needs across different markets are usually emphasised. Managers have the *responsibility for all value-chain activities* for the product, i.e. production, marketing, development, which strongly increases the cross-functional collaboration. This facilitates the establishment of *cross-border value chains* for a product

where development might take place in highly developed countries, the manufacturing of most components be located in low-cost countries and other, more sophisticated production steps in industrialised countries (Shenkar/Luo 2008, p. 320). Furthermore, a *rapid and flexible response* to changes in market conditions is facilitated by this structure.

Disadvantages of the Product Structure

On the other hand, all *functions* (e.g. marketing, sales, production) are *duplicated* in this organisational structure. Each product group needs to develop functional skills and often even its own physical facilities for operations. Economies of scope, e.g. knowledge concerning certain production processes or cross-use of new technological economies, are not fully considered. Regional knowledge needs to be developed in each product unit on its own and *divisional egoism* is a common source of conflict. A more detailed list of advantages and disadvantages in shown in Table 9.2.

Table 9.2 *Strengths and Weaknesses of a Global Product Structure*

Strengths	Weaknesses
• intensive knowledge transfer concerning the product/product groups • focus on differences between products • expertise for specific products • usually high market orientation of product divisions • coordination in companies with heterogeneous products facilitated • holistic view on the value chain • promotion of entrepreneurial behaviour • economies of scale easily exploited • flexible response to changes in product requirements	• duplication of functions • knowledge transfer concerning other fields (e.g. functions, regions) rather low • coordination and cooperation between different product divisions more complicated • risk of divisional egoism • difficult for foreign subsidiaries with more than one product line • lack of economies of scope

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 767.

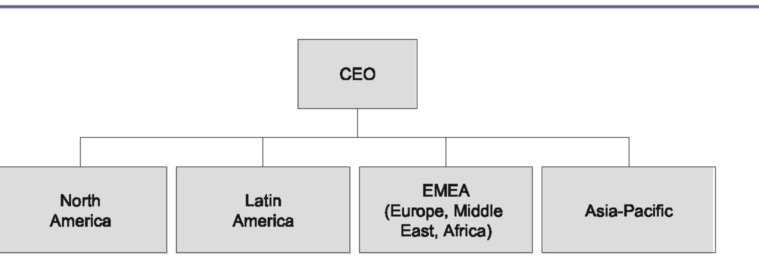
Usually, a global product structure is *adequate* for companies with *very heterogeneous product lines* and technological requirements for those product lines because in this case common expertise for all product lines would be too complex. In particular, the structure can be applied when knowledge exchange and coordination between different product lines are not very important. Furthermore, the product structure is also adequate to implement a *global strategy* in which product-specific decisions are standardised worldwide.

Global Area Structure

In a global area structure (also called *global geographic structure* or *regional structure*), the activities of the MNC are organised around specific areas (or regions). An area may be a country or *a group of countries*. Departments or divisions are created that have responsibility for all functions and all products concerning the specific region.

Example of a Global Area Structure

Figure 9.3



Geographic divisions may be based on country borders but also on cultural similarities (for example the D-A-CH region (Germany-Austria-Switzerland)), regional integration agreements (like the EU), or logistical requirements (Shenkar/Luo 2008, p. 316). Following a trend from globalisation to regionalisation (Rugman/Verbeke 2003b), a *trend to geographic organisational structures seems likely to re-emerge* (Shenkar/Luo 2008, p. 316).

Advantages of the Global Area Structure

Divisions with responsibility for one region facilitate a flexible and rapid response to changes in the local environment and help to *exploit local market opportunities* by enhancing responsiveness. *Coordination is easier,* not least due to geographical proximity. *Lines of authority* are very clear and they are local, providing easy channels for communication. The structure provides a holistic view on all business activities in the region, thereby also helping to develop a uniform image in the region. Market and marketing-oriented companies often use this structure. Regional knowledge is accumulated and regional particularities fully acknowledged in the organisation. In this case, each area tends to be self-contained.

Disadvantages of the Global Area Structure

However, integration across the other organisational dimensions is weaker and often, the complexity of heterogeneous product offers is not fully considered. *Functions are duplicated* in the different regions and due to a *lack of worldwide synergy effects*, resources are often also accumulated and established in each region. The risk of *regional egoism* emerges and it might be

difficult to transfer knowledge across regions. Thus, the diffusion of technological innovations in the organisation might be slow and the "not invented here" syndrome might also be a barrier to knowledge transfer. Synergy effects as well as economies of scale are often not fully exploited in this structure (Zentes/Swoboda/Morschett 2004, pp. 769-771; Shenkar/Luo 2008, p. 318). A list of strengths and weaknesses is displayed in Table 9.3.

Table 9.3 *Strengths and Weaknesses of a Global Area Structure*

Strengths	Weaknesses
• intensive knowledge transfer concerning the region • focus on differences between regions • regional expertise • communication and coordination advantages: personal communication as coordination instrument easy to use due to geographic proximity • holistic view on the business in the region • uniform company image in the region • flexible response to changes in local environment (local responsiveness easy)	• duplication of functions • duplication of resources • coordination and knowledge transfer across regions might be difficult and slow • risk of regional egoism • risk of overemphasis on regional differences • risk of low cost efficiency and low economies of scale due to local adaptation • diffusion of technology might be slowed down • "not invented here" syndrome • problems in technologically dynamic environments

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 770.

Thus, this structure is most *adequate* for companies that intend to *adapt to foreign markets* (such as companies in the consumer goods sector) and that accept low information flows between different regions. In the I/R-framework (see Chapter 2), a *multinational strategy* seems to correspond closely to the strengths of a global geographic structure.

Other Dimensions for Structures: Customers or Projects

Besides functions, products or areas, other dimensions for global structures are possible. The question for a company is which object of its business is so relevant and at the same time so heterogeneous that it demands specific attention, specific expertise and specific treatment. This can be, e.g. in construction companies, specific projects.

More and more often, this object is the customer. If a company has very heterogeneous customer groups (such as commercial customers and private customers) or just a few, but very powerful customers (as for example, some automotive suppliers or companies that sell their products via independent retailers), a company organises around customers, with specific departments

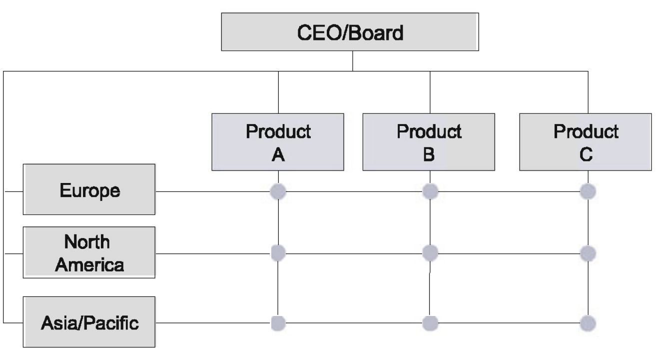
being responsible for a customer group or even a specific customer on a worldwide basis. In the latter case, the *global customer structure* is equivalent to *key account management*.

Global Matrix Structure

While the organisational structures that have been discussed above are *uni-dimensional*, i.e., they structure the top level of the organisation based on one single dimension (e.g. functions, areas, or products), the matrix design is *multi-dimensional*. A global matrix structure is the result of applying (at least) two structural dimensions *simultaneously* at the highest level of hierarchy.

Example of a Global Matrix Structure

Figure 9.4



For example, a global area structure and a global product structure could be used at the same time (see Figure 9.4), but any other combination of areas, functions, regions, customers, etc., is possible. The managers in the matrix cells (nodes in the grid above) which represent, for example, managing directors of specific foreign subsidiaries, are simultaneously responsible to two executives in the two given lines of authority.

Advantages and Disadvantages of the Matrix

The main advantage of this structure can be seen in the *access to all advantages of the two underlying dimensions* without combining all the caveats. For example, the MNC can build on both the product and the regional expertise of the two different lines of authority. *Knowledge transfer* is intensive and the simultaneous considerations of the specific requirements of at least two dimensions makes decision processes complex but often very balanced between the different needs. This forced consideration of two aspects of the business

should lead to an efficient allocation of resources. *Conflicts* in the organisation (which are based on the two-dimensional lines of authority) are intended, but are assumed to enhance the efficiency. Usually, this structure is *flexible* and easily adapted to changing external conditions. The structure is intended to *promote coordination* among the different structural dimensions. At the intersection of two lines of authority, a subsidiary manager has to report to two different supervisors. This enhances the information flow and the consideration of different aspects for a decision, however, it can also lead to *ambiguity*, slow decision processes and conflicts which, in this situation, result in pressure on the subsidiary manager. Often, to overcome this problem, a matrix structure is accompanied by decentralisation of decision power to lower levels in the hierarchy. Advantages and disadvantages of the matrix are also listed in Table 9.4.

Table 9.4 *Strengths and Weaknesses of a Global Matrix Structure*

Strengths	Weaknesses
◆ provides access to advantages of the other organisational structures ◆ combination of two or more areas of expertise ◆ good knowledge transfer throughout the organisation ◆ simultaneous consideration of product, region and/or function ◆ better allocation of resources due to forced consideration of multiple aspects simultaneously ◆ good opportunity to decentralise the decision process	◆ complex and costly ◆ high requirements for information and communication behaviour ◆ high requirements for cooperative behaviour ◆ potential ambiguity of orders ◆ decisions may take longer, often extensive meeting culture ◆ risk of power struggles ◆ appropriate for firms with many products and unstable environments

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 783; Griffin/Pustay 2010, pp. 422-423.

Internal and External Complexity

In particular, in dynamic and heterogeneous industries, a multi-dimensional organisation might be well suited to respond to the *external complexity* (Bartlett/Ghoshal/Beamish 2008, p. 449). On the other hand, the problems of the internal complexity are not worth tackling in the case of rather stable markets and rather homogeneous products (Griffin/Pustay 2010, p. 423).

Hybrid Global Structures

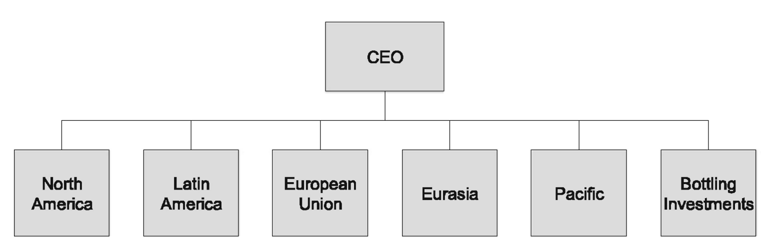
Mix of Other Structural Types

Companies with hybrid global structures do not apply the “ideal types” or pure types of structures that have been described above, but *mix elements of*

different pure types. For example, a company might decide to organise around products but one specific product might be so important that the company divides the responsibility for this product among three regional managers. Another example is given in Figure 9.5.

Hybrid Organisation at Coca-Cola

Figure 9.5



Source: Coca-Cola 2010.

Hybrid Structures Widely Used

Most MNCs are likely to use – to some degree – hybrid structures and blend elements of all the structures discussed (Griffin/Pustay 2010, p. 423). The advantages of this mix are that companies can differentiate between those elements of their business that need *differentiation* while they can combine and integrate the dimensions that are better suited for *common leadership*. Since these dimensions are often not uniform across all products, functions and/or regions (or customers), a differentiated, hybrid approach might be more suitable. Taking the example of the *Coca-Cola Group*, obviously different geographic areas should be treated differently (and unified within) for most of the business. However, in addition, the organisational unit "bottling investments" is managing all of the company's consolidated bottling investments to drive growth and improve operating performance in this field across all markets in which *Coca-Cola* owns fully or partly the bottling operations. So these operations should be treated uniformly across the world – with the responsibility for it worldwide given to one division of the *Coca-Cola Group*.

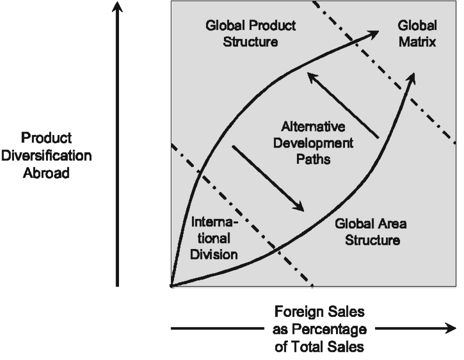
Structure follows Strategy

As the descriptions of the different organisational structure types have shown, different structures are more or less adequate for certain MNCs. Based on studies by Chandler (1962), it was proposed that *structure follows*

strategy. In this perspective, organisational structure is seen as a mechanism to implement a certain strategy. And since each strategy has specific requirements, the choice of an organisational structure must be adapted to these requirements to maximise the success of the respective strategy.

Well-known studies on organisational structure, many of them from the late 1960s and early 1970s, investigated the structure-strategy relationship. The best-known of these studies, by Stopford and Wells (1972), empirically showed a relationship between different elements of the international strategy of the MNC (the degree of international diversification and the percentage of foreign sales) and the likelihood of certain organisational structures (see Figure 9.6).

Figure 9.6 *The Stages Model of Stopford and Wells*



Source: Adapted from Stopford/Wells 1972, p. 65.

Strategic Choice

However, the statement that "structure follows strategy" has been criticised for being *too simplistic*. First, it seems to be too deterministic. In reality, companies have some *degree of choice* which organisational structure they want to implement and the strategy does not force the MNC to choose one particular structure. Furthermore, a certain organisational structure also influences resource allocation in the company, as well as company objectives and decision processes within the company. Thus, the strategy process is also influenced by the organisational structure, and sometimes "*strategy follows structure*".

Fit between Structure and Strategy

In a *contingency perspective*, companies have to align their strategies to the external environment, e.g. the industry requirements, and, as has been discussed above, differences in the external environment (e.g. between regions) might imply certain organisational structures. Thus, some recent literature argues that there is no unidirectional influence of strategy on structure or vice versa but that corporate strategy and corporate structure have to be aligned to each other with existing degrees of freedom, and corporate strategy and corporate structure both have to *fit* to the external environment.

Furthermore, different organisational structures have different information processing capacities and since different MNC strategies result in different information processing requirements, different organisational structures might also be argued from the information perspective (the *information processing approach* is explained in Chapter 8).

Dynamic of Structures

Studies on organisational structure often identify *patterns of development* (see, e.g., Figure 9.6). In an *evolutionary perspective*, companies may change their structure over time, for instance, as a consequence of learning. While MNCs develop and grow, they might have to change their structure. As has been shown in this Chapter, early internationalisation is often implemented with an international division while the growing importance of international activities might lead to globally integrated structures.

Changing Structure when Changing Strategy

Even a mature MNC must make structural changes from time to time, such as to facilitate changes in strategy. For example, if the company changes its strategy from global standardisation to regionalisation, an adequate organisational structure (e.g. a global area structure) strongly supports the implementation of the new strategy (Deresky 2008, p. 266). Thus, following the *structure-follows-strategy thesis*, MNCs might adapt their structure when they change their strategy.

However, the simple patterns proposed by Stopford/Wells are often seen as too simplistic and deterministic, and more recent studies have identified development paths from "simpler" types of organisations to more complex ones and vice versa (Buckley 1996, p. 43; Wolf 2000, p. 349). Changes in the external environment might be another reason for structcure switches.

Conclusion and Outlook

Organisational structures are an important *mechanism to coordinate* the international activities of a company. While it has been mentioned that the "*anat-*

omy" of the organisation is not sufficient as a coordination mechanism, it is undoubtedly a necessary component.

Fit between Strategy, Context and Structure

The adequateness of certain organisational structures for certain MNC strategies and particular businesses has been discussed in this Chapter. In a dynamic perspective, it becomes evident that the choice of a structure is complex and deterministic selection models tend to oversimplify the problem. Generally, however, a *fit between strategy, context and structure* is seen to be necessary to exploit fully the potential of a strategy.

While switches between organisational structures are a very common element of strategic change in organisations, a uniform trend cannot be identified. Some authors observe a trend away from globalisation to regionalisation. As a consequence of this trend, global area structures seem to emerge more often, but within regions, differences often seem rather small. Thus, companies with regional structures often seem to integrate their activities across a larger group of countries. For example, the consumer goods manufacturers like *Unilever* or *Procter & Gamble* nowadays often combine all their activities in the German-speaking countries – Germany, Austria and Switzerland – into one organisational unit. Similarly, operations in a number of Asian regions or in Latin America are more and more often bundled into one organisational unit.

Further Reading

WESTNEY, D.; ZAHEER, S. (2001): The Multinational Enterprise as an Organization, in: RUGMAN, A.; BREWER, T. (Eds.): Oxford Handbook of International Business, Oxford, Oxford University Press, pp. 349-379.

WOLF, J.; EGELHOFF, W. (2001): Strategy and Structure: Extending the Theory and Integrating the Research on National and International Firms, in: Schmalenbach Business Review, Vol. 53, April, pp. 117-139.

Case Study: Deutsche Post DHL[1]

Profile, History and Status Quo

Founded in 1950 as a government agency, *Deutsche Bundespost* was initially responsible for national and international postal and telecommunication

[1] Sources used for this case study include the web site www.dpwn.de, various annual and company reports as well as explicitly cited sources.

services, and operated for nearly 40 years as a state-owned monopoly. A law that came into effect on 1 July 1989 concerning the structure of the organisation and of post and telecommunications, however, initiated a tremendous change in the organisational structure of the company and resulted in the separation of *Deutsche Bundespost* into three sectors:

- *Deutsche Bundespost Postdienst* (postal services)
- *Deutsche Bundespost Postbank* (financial services)
- *Deutsche Bundespost Telekom* (telecommunication services).

In the following years the loss-making company entered a period of consolidation, rationalisation and restructuring. The successful turnaround was accompanied by the incorporation of the East German postal service in 1990.

In 1995 the three companies that emerged from *Deutsche Bundespost* were converted into private stock companies under private law and *Deutsche Bundespost Postdienst* changed its name to *Deutsche Post*. Although the federal government initially retained all shares, they were gradually offered for sale to private shareholders, with the federal government retaining the majority stake for at least five years. The federal post and telecommunications agency was founded at the same time to represent the government's interests as a shareholder in the three stock corporations and to perform supervision as well as coordination tasks.

Rapid Internationalisation

From 1997, when a new statute was passed to introduce greater competition into the German postal market and after successfully restructuring its domestic operations, *Deutsche Post* started a period of extensive international expansion with the aim of becoming the leading global provider of express and logistics services. Starting with an establishing presence in Europe, the internationalisation strategy also included the acquisition of some key players in the international transport and logistics market, namely: *DHL* (initial purchase of 25 % share in 1998, full acquisition in 2002), *Global Mail* (1998), and *Danzas* (1999).

From Deutsche Post to Deutsche Post World Net

On 20 November 2000 *Deutsche Post* finally went public and an initial share of 29 % of the capital was sold. The initial public offering (IPO) of *Deutsche Post* was the largest of that year in Germany and the third largest in the world. In the run-up to the IPO, in response to the rapid internationalisation process and the evolution into a global player, *Deutsche Post* decided to change its name to *Deutsche Post World Net*. Furthermore, in 2003 *Deutsche Post World Net* bundled its entire express and logistics business under the internationally renowned brand, *DHL*. The consolidation of the worldwide parcel and logistics business under the *DHL* brand was the result of the company's global *"one stop shopping"* concept, offering the whole range of services from a single source.

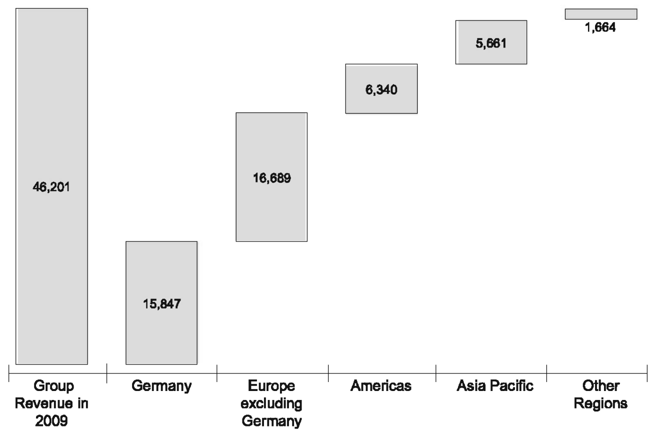
Name Change to Deutsche Post DHL

In March 2009, Frank Appelt, the newly appointed CEO of the company, unveiled his *Strategy 2015* "aimed at making the company fit for the future". The presentation of the strategy was accompanied by another change of name to *Deutsche Post DHL (DPDHL).*

The World's Largest Logistics Company

With a total revenue of about 46.2 billion EUR and more than 436,000 employees in more than 220 countries and territories by the end of 2009, *Deutsche Post DHL* is the world's leading mail and logistics services group. To further illustrate the international scope of the company, Figure 9.7 reveals the worldwide revenue distribution by regions.

Figure 9.7 *Revenue Distribution by Regions (in million EUR)*

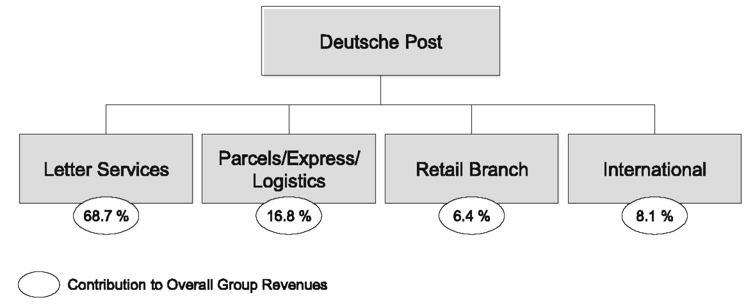


Source: DPDHL 2010, p. 130.

Organisational Structure of Deutsche Post DHL in 1998

In 1998, *Deutsche Post DHL* (still operating as *Deutsche Post* at that time) undertook two of its most important acquisitions, namely *DHL* and *Global Mail*. Until that time, the business of the company had been focussed on the German market and solely relied on the *Deutsche Post* brand. The organisational structure of the company reflected the minor importance of foreign operations as *Deutsche Post DHL* bundled all of its foreign activities in an independently operating international division (Figure 9.8).

Company Structure as of 1998 — *Figure 9.8*



Source: Adapted from DPWN 1999, pp. 19-53.

In 1998, *Deutsche PostDHL* was heavily dependent on the domestic letter services division which accounted for 68.7 % of the group's total revenue. The international division only contributed 8.1 % to the group's revenue. In contrast, in 2009 the company realised more than 65 % of its revenues outside Germany.

Scope of the International Division

The international division served the global letter mail, parcel mail and logistics market. Internally, the international division followed a product structure and distinguished between four major product lines:

- The *international mail service* unit developed services for international letter mail business customers and marketed the company's letter products worldwide.
- The *international parcel post* unit included a Europe-wide parcel mail service for business customers.
- The *international postal service* unit offered products and services to help domestic and foreign companies enter international markets. The product range included services that extend from direct marketing campaigns, order management, filling orders, and dispatch management to receivables, returns, and complaints management.
- *Deutsche Post Consult International GmbH* offered consulting services and assistance in the launch and continued development of postal services. Parallel to these activities, the unit also explored and developed international postal markets by preparing and implementing strategic cooperation agreements, management contracts, and joint ventures.

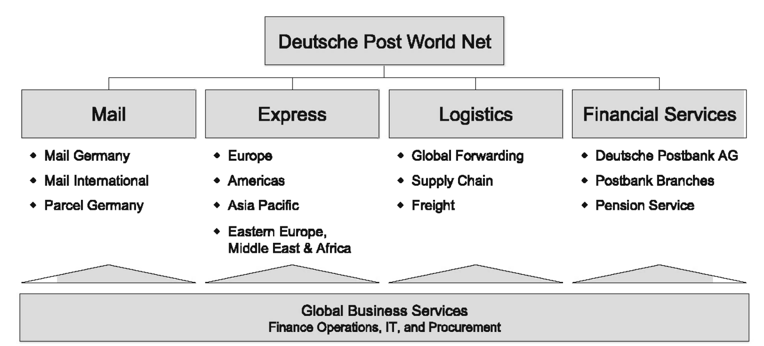
Structure Follows Strategy

The equity investment and subsequent cooperative agreement with *DHL* enabled the company to consolidate its position in the express mail service. Moreover, the acquisition of *Global Mail* equipped the company with a bridgehead in the USA for serving international letter mail business customers. However, consequent to the "structure follows strategy" thesis by Chandler (1962), the expansion strategy of *Deutsche Post DHL*, necessitated some major adjustments to the organisational structure.

Organisational Structure of Deutsche Post DHL until 2008

As the relevance of foreign activities rose sharply due to the international expansion of the company in the late 1990s, *Deutsche Post DHL* (operating as *Deutsche Post World Net* at that time), combined domestic and foreign operations. In order to enhance knowledge flows and to achieve synergy effects between the international and the domestic business, the company has implemented an integrated product structure.

Figure 9.9 *Company Structure until 2008*



Source: Adapted from DPWN 2008, p. 22.

As depicted in Figure 9.9, *Deutsche Post World Net* operated with four divisions: mail, express, logistics, and financial services, which constituted a global product structure. Each division was controlled by its own divisional headquarters and supported by a global business services unit. Internal services included finance operations, IT, and procurement.

- The *mail division* has comprised the mail and parcel transport business in Germany as well as the international mail business. While the German mail business has operated under the *Deutsche Post* brand, the international mail and German parcel business apply the *DHL* brand. The division further serves as an expert provider in direct marketing as well as newspaper and magazine distribution. The segment also offers mail and communication services through direct links to more than 140 countries across the globe, and end-to-end corporate communication solutions.
- The *express corporate division* has included *Deutsche Post World Net's* national and international courier, express, and parcel activities under the *DHL* brand. The company has drawn on the world's most extensive network, embracing 220 countries and territories. The business is structured according to the regions in which the company is operating.
- The company has ranked among the world's leading providers of air and ocean freight, contract logistics and overland freight transport in Europe. The mentioned services were summarised in the *logistics division* that operated under the *DHL* brand.
- The *financial services division* chiefly consisted of *Deutsche Postbank Group* activities. *Deutsche Postbank Group* offered a wide range of standardised banking services, including payments, deposits, retail and corporate banking, fund products and investment securities services.

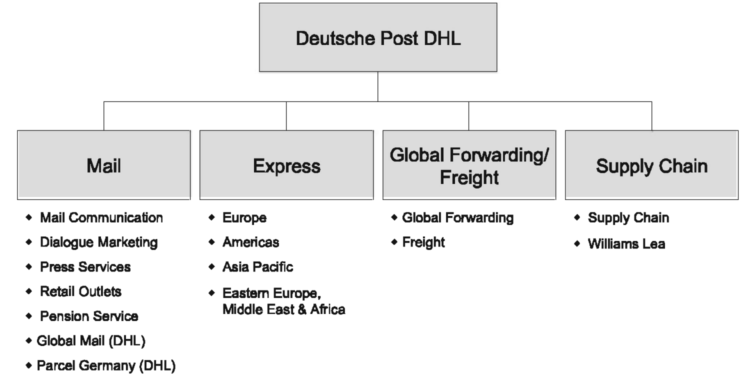
Global Product Structure

The global product structure is most suitable for companies with very heterogeneous product lines that are characterised by diverse technological requirements. In the case of *Deutsche Post World Net*, the mail, express and logistics division were comparable in their nature as they all constituted logistical services. Consequently, these divisions had similar requirements in terms of competencies (e.g. coordination and networking skills) and resources (e.g. a sophisticated delivery network). However, technological and structural differences existed, for instance, in terms of product size and structure (e.g. letter mail vs. parcel). The fourth operative division, financial services, represented the "outsider" in the organisational structure of the company, as banking has almost nothing in common with logistical services in terms of competences and resources. Hence, knowledge exchange or coordination between the financial service division and the other three product divisions was not essential for the success of the group. The limited link of *Postbank* with the core business of the company, as well as the write-down on *Postbank's* exposure to *Lehman Brothers* investment bank, motivated the company to rethink its financial services division and to gradually withdraw from the banking business by selling a minority interest of Postbank to Deutsche Bank in January 2009. Consequently, this strategic move led to another reorganistion of the group and the development of *Strategy 2015.*

The Impact of Strategy 2015 onto the Organisational Structure of Deutsche Post DHL

The new group strategy, that was accompanied by the company's decision to not longer offer domestic air and ground products in the USA, comprises in essence a structure focused on the *Deutsche Post* and *DHL* brands and a tighter interlinking of the DHL divisions. Figure 9.10 illustrates the current organisational structure of the company.

Figure 9.10 *Company Structure as Result of Strategy 2015*



Source: Adapted from DPDHL 2010.

As depicted in Figure 9.10, the company still operates a global product structure with four divisions. Compared to 2008, the tasks and structure of the *Mail* and *Express divisions* remained unchanged. However, the company replaced the *logistics* and *financial services divisions* by *Global Forwarding/Freight* and *Supply Chain*. Both divisions are operating under the DHL brand.

- The *Global Forwarding/Freight division* consists of the respective business units *Global Forwarding* and *Freight. The Global Forwarding* business unit is the industry leader in air and ocean freight. The *Freight* business unit is the second-largest overland freight forwarder in Europe and the Middle East.

- The *Supply Chain* division includes the *Supply Chain* business unit which provides services along the entire supply chain. This includes warehousing, distribution as well as managed transport. The *Williams Lea* business

unit is an outsourcing partner and offers corporate information management services. Solutions include office document solutions, marketing solutions and customer correspondence management

Table 9.5 summarises the financial performance of the *Deutsche Post DHL* divisions for the year 2009.

Financial Performance of DPDHL Divisions in 2009

Table 9.5

Year 2009	Mail	Express	Global Forwarding Freight	Supply Chain
Revenue (in million EUR)	13,502	10,008	10,257	12,362
Revenue development compared to 2008	-4.82 %	-24.09 %	-23.76 %	-8.78 %
EBIT (in million EUR)	1,383	-807	191	-208
Employees	146,021	99,494	40,254	136,135
Brands	Deutsche Post/DHL	DHL	DHL	DHL

Source: DPDHL 2010, p. 130.

Summary and Outlook

Deutsche Post DHL has moved far beyond its origins as a mere mail-carrying and delivery company. *Deutsche Post DHL* has evolved into a provider of end-to-end services at every link in the logistics value chain. As presented in this case study, this transformation process was inevitably accompanied by major organisational changes. Hence, *Deutsche Post DHL* is a sound example of the principle that even established market leaders have to constantly reassess their structures in order to stay on top.

Questions

1. With the start of its international expansion in 1997/1998, *Deutsche Post DHL* faced some crucial questions regarding the integration of the acquired companies and the overall coordination of the growing enterprise. One initiative of the company to cope with the situation in Europe was the so called *"Euro Express Network"*. How did the network change the structure and the competitive position of the company?

2. The express division of *Deutsche Post DHL* is segmented into different regions (Figure 9.10). What are important advantages and disadvantages for *Deutsche Post DHL* that result from this organisational structure.

3. *Deutsche Post DHL* changed its organisational structure frequently from 1998 to 2009. What are potential problems that can accompany organisational changes of this kind?

Hints

1. The homepage of the company (www.dp-dhl.com) may serve as a first source of information about the network.
2. See Table 9.3 for a collection of potential advantages and disadvantages.
3. See, for instance, Folger and Skarlicki 1999, pp. 35-50.

Chapter 10

Corporate Culture as Coordination Mechanism

The concept of corporate culture gained attention in international management practice and research from the late 1970s. It was particularly the success of Japanese companies with their different management style that brought awareness to the so-called "soft factors" that were strongly contributing to companies' success. In this Chapter, the phenomenon of corporate culture is explained, its contribution to the coordination of a MNC is described and the development of corporate culture is discussed.

Introduction

While the traditional model of the MNC primarily focused on coordination by formal (or so-called bureaucratic) mechanisms, where the performance and the behaviour of managers of foreign subsidiaries is tightly controlled and supervised, modern network-oriented models of the MNC propose the use of "normative integration" as the dominant coordination mechanism. Here, coordination is mainly provided by a broad organisation-wide culture. The employees and managers of the MNC accept and adopt the values and objectives of the company and, thus, act in accordance with them (Birkinshaw/Morrison 1995, p. 738).

Corporate Culture

Normative integration (also called *socialisation*) refers to building a strong *organisational culture* or *corporate culture* of known and shared strategic objectives and values (Egelhoff 1984). Corporate culture can be defined as "a pattern of shared basic assumptions that was learned by a group as it solved its problems of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems" (Schein 2004, p. 17).

When considering corporate culture as a coordination mechanism, the focus is on the power of culture to shape behaviour and on the active and conscious socialisation of members of the organisation, in particular the managers of the HQ and the foreign subsidiaries, in a system of joint values, objectives and perspectives (Birkinshaw/Morrison 1995, p. 738). Coordination by normative integration refers to the situation where functional behaviours and rules for determining them were learned and internalised by individuals thereby obviating the need for procedures, hierarchical orders, and sur-

D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_11,
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veillance. These formal mechanisms become less required because individuals chose to do what the hierarchy would have ordered or what was prescribed by the procedures (Edström/Galbraith 1977, p. 251).

Corporate culture is a particularly important organisational attribute for companies operating in an international environment (Bartlett/Ghoshal/Beamish 2008, p. 345). First, the employees come from a variety of different national and cultural backgrounds. Thus, management cannot assume that they will all automatically share common values and relate to common norms. Second, since subsidiaries and HQ management are separated by large distances, formal coordination mechanisms are often limited in their effectiveness. Therefore, shared values might be a more powerful coordination tool.

Levels of Corporate Culture

As with all cultural phenomena (see also Chapter 7 on country culture), most scholars emphasise that corporate culture has different levels. While the well-known model by Schein includes three levels of culture (see Figure 7.1), most authors distinguish only two levels (Sackmann 2006, pp. 26-27; Kutschker/Schmid 2008, p. 673):

- On the surface there is the level of visible *artifacts* which include all cultural phenomena that are easily perceived and can be empirically observed. It is also called the *percepta level*. The main *manifestations* of culture are the *behaviour* of the organisation's members and *symbols. Material symbols* include the buildings of the company, the interior design, the work places, the dress-code, etc. *Interactional symbols* include traditions, customs, rites and rituals as well as taboos, etc. *Verbal symbols* include the company's specific language, stories, myths, slogans, etc. (Schmid 1996, pp. 145-151).
- More profound is the underlying foundation of corporate culture, its real cultural core. This level of *concepta* includes the basic assumptions, values, norms and attitudes that are prevailing in the organisation.

Several components of the core of the culture can be distinguished (Muijen 1998, pp. 113-132; Kutschker/Schmid 2008, pp. 686-687).

Basic Assumptions

Basic assumptions are the deepest level of a corporate culture. They refer to general and abstract basic beliefs about reality, humans, society, etc. Usually, these basic assumptions are unconscious and become taken for granted. "In fact, if a basic assumption comes to be strongly held in a group, members will find behaviour based on any other premise inconceivable" (Schein 2004, p. 31).

Values

Values express essential meanings of basic assumptions. They define a set of normative and moral anchors that guide the behaviour of organisational members and provide a sense of common direction for all employees (Deal/Kennedy 1982, p. 21). Values reflect assumptions about what is right or wrong. The current shift of company practices and visions to include corporate social responsibility (see Chapter 11) can be seen as an enhanced relevance of certain values.

Norms

Norms are informal principles about what actions are expected in a particular situation. They are embedded in values and provide standardised behavioural rules with a binding character to group members. Compared with values, they are less abstract and more instrumental. They link basic assumptions and values to actual behaviour and offer guidelines for specific situations.

Frequently, the levels of culture are compared to an *iceberg*. The artifacts form the part of the iceberg that sticks out of the water. However, only the "tip of the iceberg" is visible and this tip rests upon a much larger and hidden basis – the assumptions, values, norms, etc. (Kutschker/Schmid 2008, p. 673). This fact makes it very difficult for researchers, but also for the management of a company, to capture the corporate culture completely and to understand it fully. This is particularly true since many cultural phenomena are subconscious, even the members of the organisation itself are not fully aware of them.

Types of Corporate Cultures

Given the complexity of corporate cultures, there are plenty of categorisations to be found in literature. A well-known categorisation by Deal and Kennedy (1984) describes cultures in a contingency perspective. It is argued that external factors render a certain corporate culture successful or not. In particular, the model includes four culture types (see Figure 10.1):

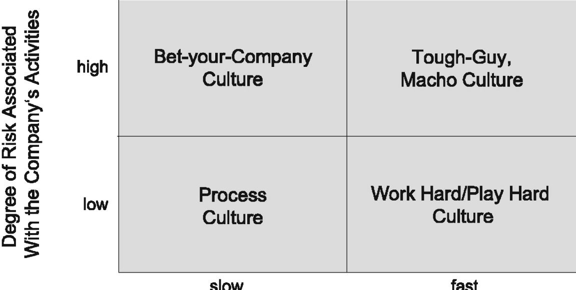
- In the *tough-guy, macho culture*, success and failure come very quickly. The risk involved with single decisions is very high and feedback from the market as to whether decisions were right or wrong comes very rapidly. An example could be venture capital companies, the media industry, or management consulting. The focus is mainly on speed, not endurance.
- In a *bet-your-company culture*, managers have to take very big decisions and years may pass before the company knows whether these decisions pay off. This high-risk, slow-feedback environment occurs, for example, in the oil industry, in mining companies, in capital-goods companies, etc.

The company needs to invest vast sums in projects that take years to develop, before it finds out whether they will work or not.

- *Work-hard/play-hard cultures* are often found in sales-oriented organisations, e.g. automotive distribution or retailing in general, similarly in fast-moving consumer goods. The employees of these companies live in a world of rather small risks, since no single sale, product or even new store will usually bring a huge success or a dramatic failure for the MNC. Feedback is very rapid, however, often on a daily basis. Activity and dynamic change is highly important in this world and more than other corporate cultures, this culture relies on competition and internal contests, resulting in motivational events, company parties, etc.

- Finally, companies in industries where little or no feedback on the performance of the employees comes from the market and risks are small, tend to develop a *process culture*. The public administration is a typical example of a sector in which this occurs. The financial stakes for each single decision are rather low, but unlike in the work-hard/play-hard culture, the employees here obtain virtually no feedback. As a result, they have no idea how effective they are until someone complains. This lack of feedback forces employees to focus on *how* they do something, not *what* they do. The values in this culture focus on technical perfection, i.e., getting the process and the details right.

Figure 10.1 Generic Corporate Cultures



Source: Adapted from Deal/Kennedy 1982, pp. 107-108.

Effects of Corporate Culture as Coordination Mechanism

Organisational culture greatly influences the way the MNC operates. Clearly expressed, "normative integration is the glue that holds differentiated networks together as entities called firms" (Nohria/Ghoshal 1997, p. 6). More practically, normative integration and shared values that are accepted and understood by the different members of an organisation guarantee that "the actors want what they should want and act as they should act" (Nohria/Ghoshal 1997, p. 118).

Decentralisation and Integration

A tremendous advantage of normative integration, as a subtle, indirect and implicit mechanism is that the subsidiary can act autonomously without direct orders from the HQ in daily operations, with a very *high flexibility* and opportunity to adapt to the local context, and yet its conduct is still aligned with company goals. Instilling shared values and beliefs among the managers of the subsidiaries and the HQ makes it more likely that, even in the absence of formal control by the HQ, the subsidiaries will use their specific local knowledge and resources to pursue the interests of the MNC as a whole and not just their own partisan interests. It provides common rules for encoding, decoding and interpreting information and for achieving mutual understanding. The direction that is provided to organisational members – in contrast with formal coordination instruments – is of an aggregate rather than specific nature. Overall, normative integration allows a more decentralised decision-making process (Baliga/Jaeger 1984, p. 27; Martinez/Jarillo 1989, p. 498; Birkinshaw/Morrison 1995, p. 738).

Monitoring through Interpersonal Interactions

Also, monitoring by normative integration occurs through interpersonal interactions. Since all members of the culture are familiar with and share its expectations, performance and compliance with the culture are observed by many members of the organisation and feedback is given verbally, often in informal conversations (Jaeger 1983, p. 94; Baliga/Jaeger 1984, p. 28).

The positive effect is also argued from the perspective of the *principal-agent theory* (see Chapter 8). Here, common values can be seen as one tool to reduce the risk of opportunistic behaviour of the agent since, through normative integration, the congruence between the objectives of the principal and the agent is enhanced (Ouchi 1980, p. 138). Similarly, the phenomenon of corporate culture can be expected to influence the negative assumption of opportunism in *transaction cost theory* (see Chapter 12). From the perspective of behavioural theory, a positive feeling for the organisation that is created by normative integration may reduce opportunism (Ghoshal/Moran 1996, p. 21).

More concretely, corporate culture serves a number of functions in a company (Sackmann 2006, pp. 29-31; Kutschker/Schmid 2008, pp. 674-675):

- *Reduction of complexity*: Culture facilitates the daily business of the MNC. It serves as a perception filter and the collective thought patterns provide situation-specific guidelines that link to established and proven behaviour patterns. It also supports the cooperation of individuals in an organisation by offering guidelines for behaviour and helping to understand and interpret the actions of others.
- *Providing a source of meaning and motivation*: The specific content of the basic assumptions will influence the extent to which employees derive meaning from their work. Thus, the MNC's culture affects the motivation of employees and their willingness to put effort into the business since it provides a legitimate base for and a deeper purpose of actions.
- *Ensuring continuity*: Given the stability of a strong corporate culture, it protects the organisation from sudden, unplanned changes.

Commitment to the MNC

A further objective of normative integration is to create *commitment* to the MNC as a whole. In this context, "commitment" can be defined as consisting of three elements (Edström/Galbraith 1977, pp. 255-256): *Identification*, i.e., adoption as one's own the values and objectives of the MNC, *involvement*, i.e., psychological immersion or absorption in the activities of one's work role, and *loyalty*, i.e., a feeling of affection for and attachment to the organisation.

Developing a Strong Corporate Culture

The main characteristic of a culture is that it deals with aspects and thoughts that are shared or held in common by the members of a group (Schein 2004, p. 12). The prime task of a company that intends to coordinate by normative integration, thus, is to create a strong corporate culture by inducing individuals to internalise the values and objectives of the organisation (Ghoshal/Moran 1996, p. 25). In the following paragraphs, some tools that are considered to be particularly important to affect normative integration in a MNC are presented (Bartlett/Ghoshal/Beamish 2008, pp. 345-346, 449-453).

Building a Shared Vision

The first instrument to reach an effective normative integration in a MNC is a clear, shared understanding of the MNC's vision and objectives. One problem in a complex organisation like a MNC can be that every manager's frame of reference may be limited to their specific responsibilities. Only by

developing a clear sense of corporate purpose, which every manager and employee understands and shares, can the specific responsibilities be integrated in a broader frame and each individual's roles and responsibilities given a context. Such a shared vision for the MNC should fulfil three criteria: clarity, continuity and consistency:

- *Clarity* To reach *clarity* of a corporation's vision, it has to be *simple* (like *Nokia*'s "Connecting People"). The vision has to be *relevant* and important to the people concerned. The vision should not be too abstract but the broad objectives of the vision have to be linked to concrete agendas and actions. Also, it has to be permanently *reinforced*, for example by always referring to the vision when annual plans or budgets are developed.
- *Continuity* *Continuity* of purpose underscores the enduring relevance. Despite changes in the company's management and short-term adjustments, the broad line of strategic objectives and organisational values must remain constant over a longer period of time. Only over time, may managers and employees in different parts of the world develop a shared understanding of the company's vision.
- *Consistency* Finally, to be effective, *consistency* has to be ensured, i.e., that all people in the MNC share the same vision. Inconsistency, or strong subcultures, brings the risk of confusion and might even lead to chaos, with different units of the organisation pursuing policies and behaviours that are mutually conflicting. *Inconsistency* may involve differences between what managers of different organisational units consider to be the MNC's primary objectives.

Role Models

The second tool is the visible behaviour and public actions of senior management. They represent the clearest role models of behaviour and give a signal of the company's strategic and organisational priorities. A well-known example is Akio Morita, the CEO and founder of *Sony Corporation*, who moved to New York for several years to establish the US operations of *Sony* and thereby clearly emphasised the relevance of this overseas business. Another example is Richard Branson, founder of the *Virgin Group* (see the case study to this Chapter).

Many strong corporate cultures are shaped by company founders or long-term managers. Often, this is done through *charisma*, which can be seen as a particular ability to capture the subordinates' attention and to communicate major assumptions and values in a vivid and clear manner (Schein 2004, p. 245). However, there are also more systematic ways for leaders to embed

the organisation's culture in individuals. The following are the primary embedding mechanisms (Schein 2004, p. 246):

- What leaders pay attention to, measure, and control on a regular basis.
- How leaders react to critical incidents and organisational crises.
- How leaders allocate resources.
- How leaders deliberately act as role models, teach and coach their subordinates.
- How leaders allocate rewards and status.

Heroes

Role models can be *founders*, *managers* or any other important person in the present or past of the MNC. Sometimes these are seen as "heroes" that personify the culture's values. Jack Welch or Thomas Edison at *General Electric*, Ferdinand Porsche at *Porsche*, Thomas Watson at *IBM* and many others are high achievers who are known to virtually any employee in the company (Deal/Kennedy 1982, p. 14)

Initial Socialisation

The development of an organisational culture through a process of socialisation of individuals includes the communication of the way of doing things, the decision-making styles in the MNC, etc. (Martinez/Jarillo 1989, p. 492). Thus, an organisation has to pass elements of its culture on to new members of the organisation. Initial socialisation is particularly relevant since it provides the individual with an ordered view of the work context, guides experience, and orders and shapes personal relationships. It educates new organisational members to the range of appropriate solutions to the problems they encounter in the work situation, the rules for choosing particular solutions and the goals and values of the organisation (Maanen/Schein 1979, p. 212; Nohria/Ghoshal 1997, pp. 158-159).

Compared with organisations in which formal coordination instruments are dominant, MNCs with predominantly cultural coordination give a higher relevance to training and socialisation. A new member of the organisation must not only learn a set of explicit, codified rules and regulations, but he or she must also learn and become a part of a subtle and complex coordination system which consists of a broad range of values and norms. Thus, the orientation programme for new employees is usually intensive and new employees of foreign subsidiaries are more frequently sent to HQ or other subsidiaries for training (Jaeger 1983, pp. 94-96).

Human Resource Policies

To build common norms and values, a strong emphasis is placed on human resource (HR) policies such as the selection, promotion and rotation of managers (Edström/Galbraith 1977).

Members of an organisation that attempts to build a strong corporate culture must be integrated into the organisational culture in order to be functional and effective actors in the organisation. Therefore, *selection* of members is of prime importance. In addition to having the necessary hard skills for the job, a candidate must be sympathetic to the organisational culture and must be willing to learn and to accept its norms, values and behavioural prescriptions (Jaeger 1983, p. 94). *Promotion* policies can emphasise, for instance, the relevance of technical skills or more the relevance of interpersonal skills and personal flexibility. *Measurement and reward systems* (see Chapters 19 and 20) can be built on different performance indicators, thus indicating a higher relevance of those indicators.

Intensive Employee Transfers

Continued international transfer throughout an employee's career is seen as a key tool for achieving normative integration, and at the same time, it is a powerful means for facilitating the necessary information flow within the MNC (Martinez/Jarillo 1989, p. 498). Those job transfers also help individual managers to understand the functioning of the MNC network, to increase knowledge of the network, to develop multiple contacts within it and to increase the likelihood that these contacts will be used in a way that supports the overall strategy (Edström/Galbraith 1977, p. 251). This is automatically linked to a high proportion of expatriates in upper and middle management positions in foreign subsidiaries (Baliga/Jaeger 1984, p. 26).

Long-term Employment

Another element of the HR strategy that facilitates the establishment of a strong corporate culture is *long-term employment*. It is generally emphasised that stability of membership in a group is necessary for the existence and continuity of a culture. Thus, a "hire and fire" strategy weakens the corporate culture since only the prospect that a new employee will remain for a long period of time in the organisation will allow the MNC to make an investment in the socialisation of the individual (Baliga/Jaeger 1984, p. 27).

Other Measures and Tools

In addition to the abovementioned instruments, additional tools can be used to strengthen the corporate culture. These are essentially all instruments that are also used to promote formal and informal lateral communication between managers and employees in different organisational units. These include:

- direct managerial contact by regular visits of the HQ management to the subsidiaries and vice versa
- regular meetings and conferences
- permanent or temporary cross-country teams (like committees or task forces)
- integrating roles (e.g. managers serving as linking pins between different organisational units).

Together with the substantial use of expatriates, these activities can be seen to create informal and interpersonal communication networks between dispersed organisational units, which contribute to the creation of a strong corporate culture and lead to normative integration (Edström/Galbraith 1977, p. 258; Nohria/Ghoshal 1997, p. 6).

Caveats of Normative Integration

Compared with bureaucratic control, the explicit *costs* for normative integration tend to be greater, involving, for example, the greater use of expatriates and frequent visits between headquarters and subsidiaries, meetings, international task forces, etc. associated with strengthening the internal cultural coherence. In addition, the intensive initial socialisation requires long and expensive training sessions (Baliga/Jaeger 1984, pp. 29-31).

Another concern is the limited ability of MNCs that are dominantly based on cultural coordination to handle employee turnover. This is a particular problem in industries with very volatile demand. Here, if a company needs to adapt its workforce accordingly, this would limit its potential to establish a strong corporate culture (Baliga/Jaeger 1984, p. 36).

Culture is also a stabilising factor which might be valuable, but which at the same time might cause difficulties when adjusting to major environmental changes. Most changes in a corporate culture must be incremental in nature because one cannot change people's beliefs in a short time (Baliga/Jaeger 1984, p. 36).

Three Culture Transfer Strategies

Finally, a major question for a MNC is whether it is possible and effective to transfer a corporate culture into a host country which may be strongly divergent from the home country culture. The organisational culture is very often embedded in the national culture of the home country (see Chapter 7). In the case of a MNC, however, the organisational culture has to spread across different national cultures. Generally, three strategies for culture transfer are possible for MNCs (Scholz 2000b, pp. 98-101), namely:

- a *monoculture strategy* in which the corporate culture of the parent company is transferred to all foreign subsidiaries
- a *multiculture strategy* where all foreign subsidiaries are allowed to develop their own organisational cultures which can then be closely aligned to the host country cultures
- a *mixed culture strategy* where a homogeneous or at least harmonised corporate culture develops as a *synthesis* between the parent company culture and the cultures of the different foreign subsidiaries.

In the case of a multicultural strategy, the MNC consciously avoids using normative integration as a coordination mechanism. Only the monoculture strategy and the mixed culture strategy actively use corporate culture as a unifying mechanism. In the case of cultural coordination, it is necessary that the internal values and behaviour patterns of the subsidiary are rather similar to those of the headquarters and to those of other subsidiaries, and that a rather *homogeneous culture* exists throughout the MNC (Jaeger 1983, p. 96). Differences between subsidiaries do not have to be completely avoided. To a certain degree, these might even help to exploit the advantages of being a MNC, but at least harmonisation has to be ensured to avoid intercultural communication barriers and diverging sets of values in the MNC.

Conclusion and Outlook

Every company has a specific corporate culture – whether intentionally or not (Sackmann 2006, p. 26). If actively used, the coherence in the values and objectives that is created by a strong and adequate corporate culture can be a powerful coordination mechanism, giving all managers and employees of a MNC a common direction for their decisions and actions.

Overall, corporate culture is seen to be a particularly important coordination mechanism in *transnational organisations*. To ensure enough flexibility for each subsidiary to remain responsive to local differences, and, at the same time, to have enough consistency to benefit from global opportunities and synergies, requires more than formal coordination alone can provide (Martinez/Jarillo 1989, p. 500). Only with an effective normative integration, can the foreign subsidiaries be granted a high level of autonomy and the MNC can still be assured that their conduct is aligned with the company's objectives and strategies.

Further Reading

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MUIJEN, J. van (1998): Organizational Culture, in: DRENTH, P.; THIERRY, H.; WOLFF, C. de (Eds.): Organizational Psychology – Handbook of Work and Organizational Psychology, 2nd ed., London, Psychology Press, pp. 113-132.

Case Study: Virgin Group[1]

Profile, History, and Status Quo

The *Virgin Group* is one of the United Kingdom's largest and most admired companies, with an annual turnover estimated at 17 billion USD in 2008. A recent independent research study has shown that the UK public vote *Virgin* as their most admired brand. The group spanned over 200 companies worldwide, ranging from financial services to mobile phones from entertainment megastores and credit cards to insurances. Originally, *Virgin* was a mail-order record business. Developed as a private company in music publishing and retailing, *Virgin* was established in 1970 by Richard Branson. Today the group consists of more than 200 companies worldwide which operate in different business lines. Approximately 50,000 people are members of *Virgin's* staff in 29 different countries.

Virgin Records

Richard Branson is the founder and head of *Virgin Group*. His first successful entrepreneurial venture was in 1967 when, as a 17 year-old school pupil, he started a magazine called *Student*. The same year, Branson dropped out of school to concentrate on his business affairs. Later on he introduced the V*irgin* mail-order service, named *Virgin Records*, in which he sold records to customers who placed their orders through his magazine. This invention symbolised a new culture of music retail shopping, and grew significantly. The expansion into record publishing was actually the idea of one of *Virgin´s* record buyers, which resulted in the *Virgin* record label. The most successful milestone in the history of the *Virgin* record label was the signing of the notorious punk-rock group, the *Sex Pistols*, in 1977. The band remained with *Virgin* until they broke up in 1978. During the following years, the company

1 Sources used for this case study include the web site http://www.virgin.com, and various annual and interim reports, investor-relations presentations as well as explicitly cited sources.

signed many recording contracts with famous musicians and bands, to name Phil Collins as just one.

The common thread through the company's history is its name – *Virgin* – which was devised by one of Branson´s associates who saw a correlation between the name and their commercial innocence. The name represented the idea of being a virgin in every business they entered.

From a glance at *Virgin's* values one can easily figure out six main statements the brand name stands for. Table 10.1 outlines the brand's most important values. By his own account, Richard Branson came up with these principles in the 1970s and they still define what *Virgin* is all about.

Brand Values

Table 10.1

Brand Values	Characteristics
Value for Money	simple, honest, transparent pricing
Good Quality	high standards, attention to detail, being honest and delivering on promises
Innovation	challenging convention with big and little product/service ideas; innovative, modern and stylish design
Competitively Challenging	„sticking two fingers up to the establishment and fighting the big boys – usually with a bit of humor“
Fun	entertainment for the customers

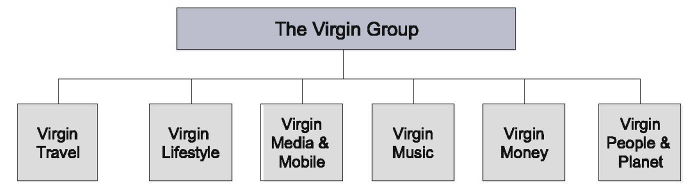
Source: Adapted from Virgin 2010a.

Corporate Structure

Virgin Group is not a single entity but a congeries of several holding companies and over 200 operating institutions which are basically located in the United Kingdom. Historically, *Virgin Group* had been controlled mainly by Richard Branson and his loyal partners. The group has often been compared to a brand franchising operation and to Japanese *"keiretsu"* organisation systems. It is usually described as a group of seperately run companies that are connected via financing and via the common Virgin brand.

Virgin is split into several sectors, each of which serves a completely different branch of enterprise. Figure 10.2 delivers a simple insight into the structure of *Virgin Group*.

Figure 10.2 Structure of the Virgin Group



Source: Adapted from Virgin 2010b.

Each sector consists of several different companies, as illustrated in Table 10.2.

Table 10.2 Selected Companies within the Different Sectors

Sectors	Companies
Virgin Travel	Virgin Atlantic Airways, Virgin Holidays, Virgin Trains, Virgin America, Virgin Galactic
Virgin Lifestyle	Virgin Active, Virgin Balloon Flights, Virgin Racing Virgin Experience Days, Virgin Spa
Virgin Media & Mobile	Virgin Media, Virgin Mobile, Virgin 1, Virgin Connect
Virgin Money	Virgin Money
Virgin Music	Virgin Megastore, Virgin Festivals, Virgain Radio International
Virgin People & Planet	Virgin Unite, Virtin Earth Challenge, Virgin Green Fund

Source: www.virgin.com.

Looking back in history, *Virgin* had always been a private managed company before it went public in 1986 and became listed on the stock exchange. However this corporate structure was not very auspicious and lasted for just a short period of time. As a reason for the premature ending, the stock market crash in 1987 when *Virgin's* share prices almost halved can be mentioned. Thereupon, Branson decided to take the business back into private ownership and the shares were bought back at the original offer price.

During the following years, Branson entered one area of business after another in which he perceived that customers were being underserved. He attached great importance to high standards, i.e., that the *Virgin* brand was only given to a product or service that met some basic conditions, such as

high quality or innovation. Based on the fact that Branson identified numerous business opportunities where customers were being treated badly, it becomes easy to recognise that *Virgin Group* unifies many different branches and visions under one umbrella.

Growing through *organic growth* rather than through acquisitions is one of the company's slogans. As far as possible, Branson and his team try to avoid takeovers and prefer reestablishments. In order to manage this clutter of hundreds of different companies within several business lines, Branson uses his own kind of *management style*, which has been discussed controversially over the years.

Management Through Empowerment

Branson's idea of minimal management layers, no bureaucracy and a tiny board are nowadays characteristics of *Virgin Group*, while a massive global headquarters is an anathema to the company and its team. The companies are all empowered to run their own affairs. For this reason, *Virgin* is one of the real life examples of *management through empowerment* by giving each single company a high grade of flexibility. This is only possible because each one feels like a part of the family rather than a part in the hierarchy.

Generally it is difficult to separate the success and the functionality of the *Virgin* brand from the flamboyant man behind it. Above all, *Virgin* is a very unusual brand – it is more a way of life than an inflexible company with strict conceptions. In fact, *Virgin* is often cited as *the* answer to silence those who claim that no brand can be everything to everyone.

Corporate Culture

Corporate culture is aimed at a harmonisation of every kind of company interaction regarding the internal and external environment, in terms of corporate philosophy. Regarding the organisational structure of *Virgin* and the independent character of the single companies, it is obvious that the group needs a strong corporate culture as a coordination mechanism.

The first thing to mention when speaking of corporate culture at *Virgin* is that all companies from all different businesses under the *Virgin* umbrella have the typical *Virgin* identification. This means aiming for high quality, innovation, providing value for the money, excellent customer service, having a sense of fun and being challenging to existing alternatives. These are the hallmarks of *Virgin Group*. All employees should feel they are part of the big family. Arranging such a vast formation of hundreds of companies situated in different countries all over the world requires a sure instinct and smoothly running communications between the employees as well as between the employees and the management. Barrier-free communication with the customers is also a matter of course for *Virgin*.

Highest Priority for the Staff

One of the most important activities regarding the corporate culture as a coordination mechanism is that the employees' interests are always given the highest priority in the *Virgin Group* to get the business started. Branson's disrespect for hierarchy and bureaucracy, but moreover his commitment to his staff, guarantees easy access to the chairman himself and to the top managers when they have new ideas. *Virgin's* employees are valued as individual human beings who bring in their innovative ideas and commitment and, resulting from the appreciation on the part of the company, their loyalty. Demonstrating respect for the staff glues the dislocated and various companies together and motivates them to play an active part at *Virgin*. Despite the independence of the companies within the group, there is a strong desire to work together for the benefit of the group. In turn, there is a strong sense of community amongst the people working within these companies. As a result it can be stated that bringing the corporate philosophy to the employees is a central point regarding corporate culture as a coordination mechanism. Members of an organisation must share certain values specific to the group and everyone is expected to be familiar with the corporate culture.

Capturing Ideas

Another factor of success is that *Virgin* encourages its staff to bring in new ideas and to experiment with their creative imagination. *Virgin* lives on its employees and their ideas. Involving them in the organisational process delivers them a sense of belonging to the *Virgin* family and makes them feel like an important element of the "machinery". Employees often get frustrated if they have no chance to be heard or if the company does not care about their ideas. Unlike other companies, *Virgin* captures every single idea offred by its staff and checks if something is promising and realisable.

Virgin Community

Branson has developed a level of trust with his top managers by setting the direction of the company's future and then stepping back to let them navigate independently. Regarding the fact that all *Virgin* companies are empowered to run their own affairs, assisted by the absence of a strict hierarchy, *Virgin's* staff are more enthusiastic and more engaged. Not only the employees but also the companies help one another, and solutions to problems come from all kinds of sources. In a sense, *Virgin* is like a community, with shared ideas, values, interests, and goals. The close teamwork of all divisions as a corporate culture attribute is part of the coordination mechanism.

Be the Best, not the Biggest

Virgin is always looking for opportunities, wherever it can offer something better and with better value to the customers. The best prospects for success are projects in which consumers are underserved or confused, and where an appropriate tradeoff between risk and reward can be made. The group is passionate about running the businesses as well as it can, which means treating the customers with respect, giving them good value and high quality, and making the whole process as much fun as it can be. Regarding this

statement, it becomes clear why one of *Virgin's* core elements considering its corporate philosophy can be explained as "be the best, not the biggest".

Virgin pursues an organic growth strategy. Branson advances the view that this kind of growth leads to more effort than adopting already existing companies. The corporate philosophy is that building up and attending to a new business from the beginning on, with specially recruited staff, is more effective than a takeover. This supports Branson's goal of turning *Virgin* into "the most respected brand in the world".

Resuming the Corporate Culture Elements

The following sums up all core elements of the corporate culture at *Virgin* discussed above:

- Employees enjoy the highest priority, they are not just numbers on a payroll.
- Encourage the employees to bring in their innovative ideas and suggestions, capture every fleeting idea and check if it might be promising.
- Give priority to the customers.
- Wake the enthusiasm of people for new ideas.
- *Virgin's* slogan is "being the best, not the biggest".
- Sculpture the business around the people, the staff and the customers.
- Create a new business instead of taking over an already existing company.
- Meeting challenges.
- "Sticking two fingers up to the establishment and fighting the big boys".

Doing business should be fun, for the staff at *Virgin's* and as well for the customers. All the aforementioned facts symbolise the company's philosophy and represent the corporate culture. The elements of the corporate culture keep the single companies together and support them to work for the same targets, vision and mission, and beyond that it acts as a coordination mechanism.

Questions

1. Show the business activities of the different *Virgin* companies in detail and discuss how far these activities create synergy effects.

2. Explain the organisational structure of the *Virgin Group*.
3. Have a look at the human resource management at *Virgin*. What are the success factors?
4. Find out more about the several divisions of *Virgin*. Have businesses failed? If so, explain why!
5. How does *Virgin* encourage its staff to work with as much ambition and engagement as they do. Look for microeconomic theory and explain the method. Propose new instruments *Virgin* could use to encourage its staff in the future.

Hints

1. See the company's website for further information.
2. See Mintzberg 1989.
3. See Skinner´s theory 1974, Lattal and Chase 2003 and Watson's classic theory 1913.

Chapter 11

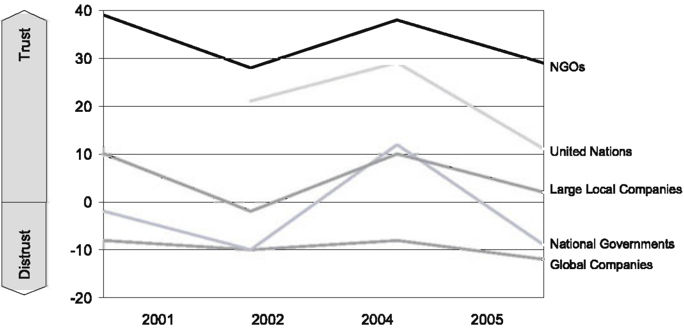
Corporate Social Responsibility of MNCs

The interface between business and society is changing in a world in which new environmental and social risks emerge and the challenge of sustainability is apparent. The roles, responsibilities and functions of business, especially with regard to MNCs in the context of globalisation, have to be redefined. This discussion has led to the development of the concept of corporate social responsibility (CSR) in the last few years. In this Chapter models and instruments to explore and organise CSR within MNCs are presented.

Loss of Confidence, Challenge of Responsibility and Sustainability

Global companies and even large local companies are suffering a crisis of confidence (see Figure 11.1). Contemporary society expects sustainability and responsibility from the companies, which means that the traditional role of companies ("the only business of business is to do business", ascribed to Milton Friedman) has to be rewritten.

Trust in Institutions (Average of 14 Tracking Countries) — *Figure 11.1*



Source: World Economic Forum 2006.

D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_12,
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"Corporations are challenged to go beyond the predominantly economic view and take into account a wider context" (Jonker/de Witte 2006, p. 2). Sustainability refers to the (external) environment and demands care in using resources, such as water, primary materials, energy, etc. Companies are not only held responsible for the environment. The new normative perspective includes topics such as human rights, child labour, etc. Organisations have to meet the needs of a wide range of internal and external *stakeholders*. A stakeholder can be defined, according to Freeman (1984, p. 46), as "any group or individual who can effect or is affected by the achievement of the organization's objectives". Stakeholders include customers, suppliers, stockholders, employees, banks, non-governmental organisations (NGOs), and the society in general.

Corporate Social Responsibility and the Stakeholder View

Historical Roots

The concept of corporate social responsibility has gained in importance in the last few years. In academic discussion, however, it is by no means a new idea: the concept itself and the debate about CSR dates back to the 1930s. For example, Dodd (1932, p. 1149) argues that managers are not only responsible to their shareholders but they are also responsible to the public as a whole because a company is "permitted and encouraged by the law primarily because it is a service to the community rather than because it is a source of profit to its owners". Since then, the concept has developed and many more facets of responsiveness have been added to the understanding of CSR.

According to Mohr, Webb and Harris (2001, p. 47), corporate social responsibility relates to "a company's commitment to minimizing or eliminating any harmful effects and maximizing its long-run beneficial impact on society".

Triple Bottom Line Concept

Profit, People, Planet

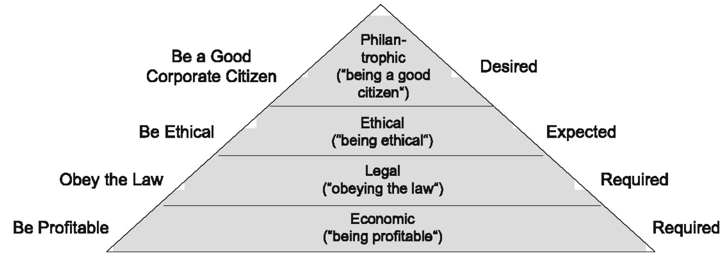
Based on this approach, firms are becoming responsible for their social and environmental effects on society, in addition to generating profits. On the most basic level, the triple bottom line concept (TBL) "states that companies should simultaneously be held accountable for their social, environmental, and financial performances" (Mellahi/Frynas/Finlay 2005, p. 109; see Elkington 1997). In a catchy phrase, the triple bottom line concept refers to "profit, people, planet" and hence can be seen as the "PPP approach".

Pyramid of Corporate Social Responsibility

Carroll (1979; 1991) developed the concept that has been widely used: the *"pyramid of corporate social responsibility"* (see Figure 11.2).

Pyramid of Corporate Social Responsibility

Figure 11.2



Source: Carroll 1991.

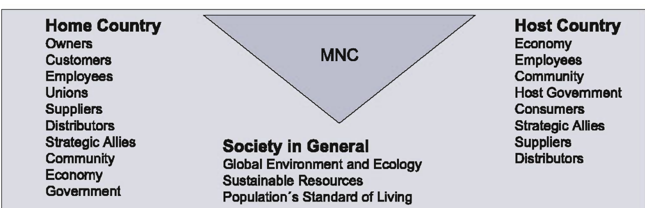
Stakeholder Map of a MNC

Stakeholders and Shareholders

The concept of CSR is seen within the *stakeholder approach*. According to this view, a firm should not only maximise profit for *shareholders*, but should satisfy the aspirations of all stakeholders (Mellahi/Frynas/Finlay 2005, p. 107). The wide variety of stakeholders, which have different issues and concerns, are shown in Figure 11.3. Multinational firms have to pay attention not only to the stakeholders of their *home country* but also to the stakeholders of a multitude of *host countries*.

MNC Stakeholders

Figure 11.3



Source: Adapted from Deresky 2008, p. 35.

CSR Management Model

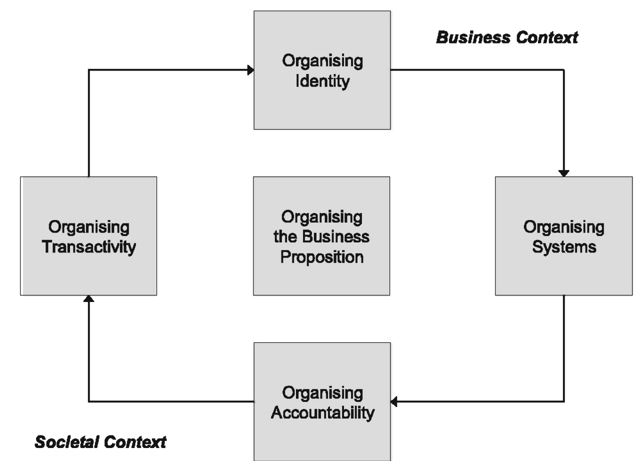
CSR Activities

The variety of CSR activities or practices of companies can be classified in different ways (see, e.g., Wagner/Bicen/Hall 2008; Maignan/Ferrell/Ferrell 2005). According to Sen and Bhattacharya (2001) the activities can be categorised into six broad fields:

- community support (e.g. health programmes, educational initiatives)
- diversity (e.g. family-, gender-, disability-based initiatives)
- employee support (e.g. job security, safety concerns)
- environment (e.g. waste management, pollution control, animal testing)
- non-domestic operations (e.g. overseas labour practice, operations in countries with human rights violations)
- product (e.g. product safety, antitrust disputes).

The CSR activities or practices of a corporation have to be embedded in the organisation, i.e., linked to the business proposition and to every added value in the value chain (Jonker/de Witte 2006, p. 4). Based on this approach, an *integrated management model* can be developed (see Figure 11.4).

Figure 11.4 *The CSR Management Model*



Source: Jonker/de Witte 2006, p. 5.

The starting point of the CSR model is the *business proposition* of a company, comprising vision, mission and the overall competitive strategy. Under the "umbrella" of the business proposition four interlinked domains have to be defined in a business or competition context and societal context (Jonker/de Witte 2006, p. 6):

- *Organising identity*: This covers issues such as core values, branding, image and corporate identity.
- *Organising systems*: This refers to internal and external communication, design of primary and supporting processes.
- *Organising accountability*: This aspect is focusing on auditing, reporting, monitoring performance and standards.
- *Organising transactivity*: This includes developing partnerships, organising dialogues, etc.

International Codes of Conduct

With regard to auditing and monitoring performance and standards (*"organising accountability"*), for instance, in production and sourcing, a considerable number of organisations have developed codes of conduct which provide consistent *guidelines* for multinational corporations.

Business Social Compliance Initiative

BSCI

As an example, the *Business Social Compliance Initiative* (BSCI) of the European *Foreign Trade Association* (FTA) can be used to demonstrate how retail and wholesale companies follow codes of conduct, implement and run audits and react by corrective actions in global purchasing:

- The BSCI Code of Conduct is built on internationally recognised labour standards protecting workers' rights, in particular the *ILO Core Labour Conventions.*
- The practical implementation of the Code is controlled by independent auditing companies accredited by the international organisation *Social Accountability International (SAI),* which has issued the SA8000 standard. To control the BSCI process, the members share the results of the audits in a common database. This also avoids multiple audits thus reducing audit fatigue.
- The BSCI does not rely solely on audits but is based on a development approach. It aims at continuously improving the social performance of

suppliers, encouraging them to apply for SA8000 certification. The BSCI develops follow-up measures such as implementation controls and training measures in order to support suppliers.

- The whole BSCI process is accompanied by local and European stakeholder networks which bring their expertise to the initiative and help to ensure the long-term local ownership of the process. Cooperation with governmental authorities, trade unions, NGOs and associations also facilitates social acceptance and independence of the system.

Social Accountability 8000 (SA8000)

The Social Accountability Standard 8000 (SA8000), published in late 1997 and revised in 2001, is a credible, comprehensive and efficient tool for assuring human rights in the workplace. The SA8000 system includes (Social Accountability International 2008):

Overview

- factory-level management system requirements for ongoing compliance and continual improvement
- independent, expert verification of compliance by certification bodies accredited by Social Accountability Accreditation Services (SAAS)
- involvement by stakeholders including participation by all key sectors in the SA8000 system, workers, trade unions, companies, socially responsible investors, non-governmental organisations and government
- public reporting on SA8000 certified facilities and Corporate Involvement Programme (CIP), annual progress reports through postings on the SAAS and SAI websites
- harnessing consumer and investor concern through the SA8000 Certification and Corporate Involvement Programme by helping to identify and support companies that are committed to assuring human rights in the workplace
- training partnerships for workers, managers, auditors and other interested parties in the effective use of SA8000
- research and publication of guidance in the effective use of SA8000
- complaints, appeals and surveillance processes to support the system's quality.

SA8000 Elements

The SA8000 Standard is based on the *international workplace norms* of the International Labour Organisation (ILO) conventions, the Universal Declaration of Human Rights and the UN Convention on the Rights of the Child.

The main elements of the SA8000 Standard are (Social Accountability International 2008):

- *Child Labour*: No workers under the age of 15; minimum age lowered to 14 for countries operating under the ILO Convention 138 developing-country exception; remediation of any child found to be working.
- *Forced Labour*: No forced labour, including prison or debt bondage labour; no holding of deposits or workers' identity papers by employers or outside recruiters.
- *Health and Safety*: Provide a safe and healthy work environment; take steps to prevent injuries; regular training of workers in health and safety; system to detect threats to health and safety; access to bathrooms and potable water.
- *Freedom of Association and Right to Collective Bargaining:* Respect the right to form and join trade unions and bargain collectively; where law prohibits these freedoms, facilitate parallel means of association and bargaining.
- *Discrimination:* No discrimination based on race, caste, origin, religion, disability, gender, sexual orientation, union or political affiliation, or age; no sexual harassment.
- *Discipline:* No corporal punishment, mental or physical coercion or verbal abuse.
- *Working Hours:* Comply with the applicable law but, in any event, no more than 48 hours per week with at least one day off for every seven-day period; voluntary overtime paid at a premium rate and not to exceed 12 hours per week on a regular basis; overtime may be mandatory if part of a collective bargaining agreement.
- *Compensation:* Wages paid for a standard work week must meet the legal and industry standards and be sufficient to meet the basic needs of workers and their families; no disciplinary deductions.
- *Management Systems:* Facilities seeking to gain and maintain certification must go beyond simple compliance to integrate the standard into their management systems and practices.

CSR and Profitability

Conflicting Results

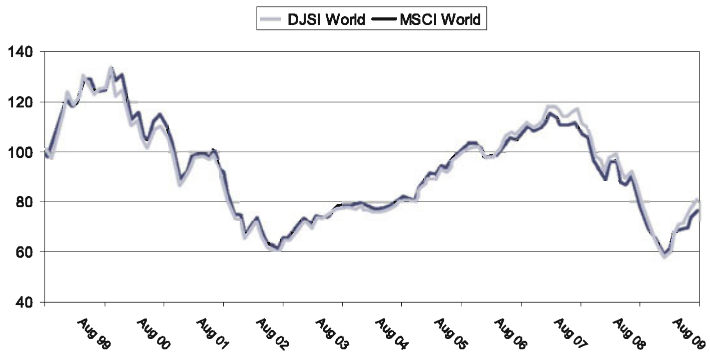
Many studies have addressed the impact of CSR activities on companies' performance with the focus, for example, on companies' market value or on corporate financial performance. Despite the number of studies on this rela-

tionship, there still is limited understanding of whether and how CSR actions have a positive impact on firms' performance (Luo/Bhattacharya 2006). This is mainly due to the *conflicting results of empirical studies*. For example, Margolis and Walsh (2003) with their descriptive overview of empirical studies, as well as Orlitzky, Schmidt and Rynes (2003) and Wu (2006), show in their *meta-analyses* that the returns to CSR activities are positive in some studies but non-significant or negative in others. Wu (2006) argues that these differing results are mainly due to the lack of consistency regarding the conceptualisation of the CSR construct and due to the variability in measures that were used to capture financial performance in the different studies.

DJSI World vs. MSCI World

For example, Figure 11.5 illustrates a comparison of the development of the Morgan Stanley Capital International Index (MSCI World), which includes 1,500 stocks in 23 developed countries worldwide with no expressed commitment to sustainability, and the Dow Jones Sustainability Index (DJSI World). This index refers to more than 300 global companies that are committed to sustainable development. This comparison shows a (modest) advantage in total return for the second group. "Companies that balance the interests of multiple stakeholders do as well or better than their peers when it comes to financial performance" (Gossen 2007, p. 17; see also Scholz/Zentes 2006, pp. 288-300).

Figure 11.5 *Development of DJSI World and MSCI World*



Source: Sustainable Asset Management 2009, p. 17.

Sustainability Ranking and Reporting

Environmental responsibility is a measure increasingly used in public rankings of companies. For example, Table 11.1 shows the ranking of the German DAX-30 companies with regard to sustainability. These rankings underline the growing public interest in the environmental and social activities of companies.

Sustainability Ranking of German DAX-30 Companies

Table 11.1

Rank 2009	DAX-30 Companies	Points	Rank 2009	DAX-30 Companies	Points
1	BMW	74.3	16	Daimler	58.7
2	Henkel	73.3	17	Infenion	58.8
3	Deutsche Telekom	71.4	18	Commerzbank	58.0
4	Münchener Rück	67.7	19	Siemens	57.6
5	Metro	67.6	20	Eon	57.3
6	BASF	66.9	21	Bayer	56.7
7	Lufthansa	66.6	22	K+S	56.3
8	RWE	66.4	23	Fresenius Medical Care	55.1
9	Adidas	64.9	24	Linde	54.6
10	Deutsche Bank	64.6	25	Beiersdorf	53.6
11	Merck	63.4	26	Deutsche Börse	53.6
12	Deutsche Post	62.0	27	Thyssen-Krupp	52.0
13	Volkswagen	61.8	28	Fresenius	48.4
14	Allianz	61.1	29	MAN	47.4
15	SAP	59.9	30	Salzgitter	44.0

Source: Sustainalytics.com.

CSR and Corporate Governance

Corporate social responsibility is an important aspect in the field of *business ethics*. Besides the responsibility towards the environment and the observance of human rights, other ethical issues refer to the appropriate moral behaviour with regard to *bribery* (corruption), especially in the international arena of competition (see e.g. Deresky 2008, pp. 41-47), and to good and responsible *governance*.

German Corporate Governance Codex

Corporate governance rules clarify the rights of shareholders with regard to the general meeting (of stockholders), the supervisory board, and the management board, they establish guidelines for *transparency* and the treatment of *conflicts of interest* in order to promote the *trust* of investors, customers, employees and the general public in the company's management and supervision. For example, the "German Corporate Governance Codex" comprises the following rules concerning these conflicts with regard to the supervisory board:

- Each member of the Supervisory Board shall inform the Supervisory Board of any conflicts of interest which may result from a consultant or directorship function with clients, suppliers, lenders or other business partners (Article 5.5.2).
- Advisory and other service agreements and contracts for work between a member of the Supervisory Board and the company require the Supervisory Board's approval (Article 5.5.4).

Conclusion and Outlook

New Societal Balance

Under a variety of headings, such as corporate social responsibility, corporate citizenship, stakeholder engagement or corporate governance, lively debates emerge worldwide, referring to the roles, functions and balance of and between institutions in contemporary society (Habisch/Jonker 2005, p. 1). In this context, the acceptable *social behaviour* of companies will be redefined in order to achieve a new *societal balance*.

This is of great importance for MNCs, which operate not only in their developed home country, but also in a multitude of host countries, frequently in less developed (transition) countries with low wages and low standards with regard to environment and labour conditions.

Opportunistic Behaviour

Ethical behaviour of MNCs, in the sense of corporate social responsibility, raises the problem of potential competitive disadvantages due to the *opportunistic behaviour* of competitors. *Non-compliance* of social and environmental standards can lead to advantages with regard to costs and therefore better competitive positions in the global arena.

This opportunistic behaviour is probably a short-term approach, because corporate social responsibility is an investment in the competitiveness of companies, true to the motto "What is good for society, is also good for business" (Jack Welch, the former CEO of *General Electric*).

Further Reading

GODFREY, P.; HATCH, N. (2006): Researching Corporate Social Responsibility: An Agenda for the 21st Century, in: Journal of Business Ethics, Vol. 70, No. 1, pp. 87-98.

HABISCH, A.; JONKER, J.; WEGNER, M.; SCHMIDPETER, R. (Eds.) (2005): Corporate Social Responsibility Across Europe, Berlin, Springer.

JONKER, J.; DE WITTE, M. (Eds.) (2006): Management Models for Corporate Social Responsibility, Berlin, Springer.

Case Study: Goodyear[1]

Profile, History, and Status Quo

The *Goodyear Tire & Rubber Company* was founded in 1898 by Frank A. Seiberling in East Akron, Ohio. With just 13 employees, *Goodyear* began production on 21 November 1898, with a product range of bicycle and carriage tyres, horseshoe pads and poker chips.

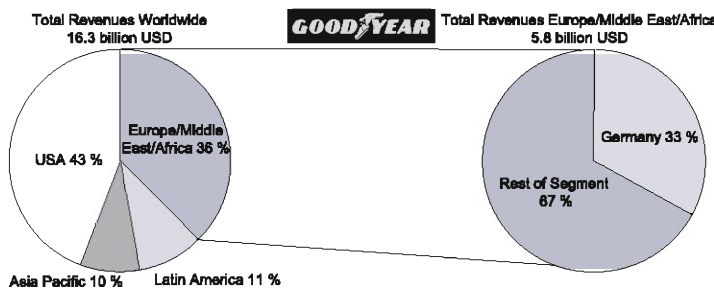
Today, *Goodyear* reaches sales of nearly 16 billion USD, being the market-leading tyre company in North and Latin America, as well as the second largest in Europe. The US market, accounting for about 43 % of sales, is still responsible for the largest part of *Goodyear's* revenues (see Figure 11.6). The European Union is *Goodyear's* second largest market. *Goodyear Dunlop Tire Germany* is the clear market leader in the German tyre industry, and accounts for about 33 % of *Goodyear's* sales in the Europe/Middle East/Africa segment.

Products

Goodyear employs 69,000 people and has more than 50 production facilities in 23 countries all over the world (see Table 11.2). It develops, manufactures, markets and distributes tyres for automotive and off-road applications. In 2009, 167 million tyres were produced for motor cars, trucks, tractors, aircraft and other vehicles. About 23 % of these (39 million tyres per year) are original equipment units, while the largest part (128 million tyres per year) is meant for the replacement market. Through four strategic business units, *Goodyear* products are sold in more than 185 countries worldwide (Goodyear 2010a).

Figure 11.6

Sales by Region 2009



Source: Goodyear 2010a.

1 Information used for this case study includes various annual reports, press releases, the web site http://www.goodyear.com as well as explicitly cited sources.

Table 11.2 Goodyear's Worldwide Facilities 2009

Country	Locations
United States	Akron, Asheboro, Bayport, Beaumont, Carson, Danville, Fayetteville, Gadsden, Houston, Huntsville, Kingman, Lawton, Niagara Falls, Pompano Beach, San Angelo, Social Circle, Statesville. Stockbridge, Tonawanda, Topeka, Union City, West Amherst
Canada	Medicine Hat, Napanee, Valleyfield
France	Amiens, Mireval, Montlucon
Germany	Fürstenwalde, Fulda, Hanau, Philipsburg, Riesa, Wittlich
Luxembourg	Colmar-Berg
Netherlands	Tilburg
Poland	Debica
Slovenia	Kranj
United Kingdom	Birmingham, Wolverhampton
Brazil	Americana, Santa Barbara, Sao Paulo
Chile	Santiago
Colombia	Cali
Peru	Lima
Venezuela	Valencia
South Africa	Uitenhage
Turkey	Adapazari, Izmit
China	Dalian, Shanghai
India	Aurangabad, Ballabgarh
Indonesia	Bogor
Japan	Tatsuno
Malaysia	Kuala Lumpur
Taiwan	Taipei
Thailand	Bangkok

Source: Goodyear 2010a.

Global Alliance with Sumitomo Rubber Industries

In 1999, *Goodyear* formed a global alliance worth 1 billion USD with *Sumitomo Rubber Industries Ltd.*, which holds the rights to the Dunlop tyre brand in most of the world. Six joint ventures were formed in Europe, Japan and North America. Besides *Goodyear* and *Dunlop*, the company also produces and manages several other brands such as Fulda, Sava and Debica.

"Protect Our Good Name" as Basic Principle

The Goodyear Tire & Rubber Company is listed on the New York Stock Exchange and for that reason has to comply with a number of rules concerning principles of corporate governance. *Goodyear* has realised, though, that, for a global company, fulfilling the legal requirements concerning corporate responsibility does not suffice by far. Therefore, the company has developed its own environmental, health and safety (EHS) standards which in many respects exceed by far the requirements of the national legislation as well as those of the New York Stock Exchange.

"Protect Our Good Name"

Since 1915, *Goodyear's* activities have followed the credo "Protect Our Good Name". The good reputation of the company is to be defended towards all stakeholders, that is to say, customers, associates and shareholders, as well as suppliers and the communities where the company is operating. *Goodyear* is constantly striving to be a good corporate citizen in all the local markets in which it operates. Therefore the company always strictly complies either with the highest legal standards concerning corporate responsibility or – where legal requirements are insufficient – with the company's code of conduct.

Goodyear's ethical business conduct is based on a number of core values that are the foundation of the company's activities all over the world. The first set of values is directed towards all stakeholders, and comprises the company's dedication to responsible and ethical conduct on a global basis. The other three sets of core values refer to the particular importance of *Goodyear's* customers, employees and associates as well as shareholders. Based on these core values, global EHS principles have been formulated (see Table 11.3).

Goodyear's Global EHS Principles

Table 11.3

Goodyear Environmental, Health and Safety Policy
Goodyear is committed to protecting the environment, as well as the health and safety of our associates, our customers and the communities in which we operate. As a global, socially-responsible corporate citizen, we shall conduct our business in accordance with the highest applicable legal and ethical standards and strive to contribute to economic development and environmental protection, while seeking to improve the quality of life for our associates, families, communities and society in general. We want our associates to have a work environment where they feel safe and secure. *To accomplish this we shall*
... comply with all applicable environmental, health and safety laws and regulations as well as Goodyear's global EHS standards,
... establish environmental, health and safety management systems based on recognized standards, and set company-wide goals and objectives that seek to obtain continuous improvement,
... integrate environmental, health and safety considerations into all continuous improvement efforts and key business decisions, including the design, production, distribution and support of our products and services,
... work with suppliers and customers to promote responsible use of our products,
... reduce environmental impact and conserve natural resources by minimizing waste and emissions, reusing and recycling materials and responsibly managing energy use,
... encourage and educate all associates to take personal accountability for protecting the environment and maintaining a safe and healthy workplace.

Source: Goodyear 2010b.

Business Conduct Manual

On the basis of the core values and the EHS principles, specific guidelines for ethical behaviour have been deduced. These guidelines are summarised in the "*Goodyear Business Conduct Manual*", which serves as a reference point for all employees. A copy of the Business Conduct Manual is given to all associates and everyone must agree to act in accordance with it. The first chapter in the Business Conduct Manual is dedicated to the commitment to protecting the workforce, the workplace and the environment. These are the

three main issues that are also dealt with in the EHS standards and that *Goodyear* considers its prime responsibility.

Corporate Responsibility in a MNC

The fact that *Goodyear* is a truly global company, producing in as many as 23 countries and exporting to as well as sourcing from many more, poses unique challenges to the company's corporate responsibility activities that would not be encountered in a national context. On the one hand, legal requirements concerning business activities that affect the environment or the society vary considerably. Especially in developing and transition countries, laws concerning the behaviour of MNCs towards their employees, as well as towards the communities in which they are located, are frequently missing or make only very basic requirements. Even where such legal requirements are in place, they might not be pursued and enforced with the necessary vigour. On the other hand, a society's views and expectations towards the responsible conduct of MNCs has been found to be strongly influenced by cultural aspects (Jamali/Mirshak 2006, p. 245).

Global Policy

Goodyear strives to be the leader in EHS matters and a good corporate citizen in all the communities it calls home. The company has therefore developed its own corporate environmental, health and safety standards that meet international guidelines. These standards are applicable for all facilities worldwide. The company always enforces either legal or corporate requirements, depending on which are more stringent. In many countries, these corporate standards are stricter than the legislation adopted by governments (Rondinelly/Berry 1998, p. 78).

Local Implementation

Underneath the common roof of the global EHS standards, *Goodyear* has the policy of being a good corporate citizen in all communities where the company has facilities through local activities which demonstrate corporate responsibility. Efforts concerning corporate responsibility are carried out on a regional as well as on a national and a local level. Every employee is encouraged to engage in local community initiatives and every branch supports national social and environmental programmes.

External Corporate Responsibility

Environmental Responsibility

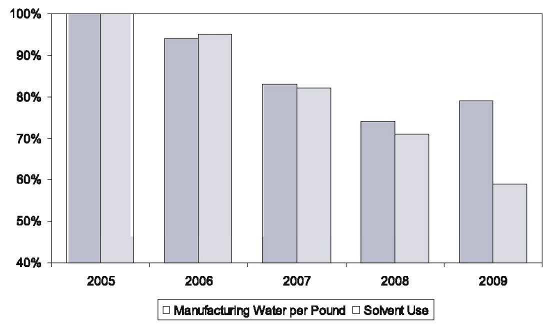
Goodyear's corporate responsibility activities are directed towards internal as well as external stakeholders. As rubber manufacturing and processing requires the use of various environmentally hazardous materials, protecting the environment is one of *Goodyear's* key concerns in terms of corporate responsibility. Natural and synthetic rubber mixes are used in manufacturing rubber products, and the processing can result in volatile organic com-

pound emissions. Organic solvents that need to be used in tyre production also cause a considerable threat to the environment, so that *Goodyear* continuously seeks to reduce the usage of these perilous substances in the manufacturing process.

3-R Principle

Solvent usage and waste to landfill are tracked globally as key indicators for minimising the company's environmental impact. Pursuing the goal of eliminating disposal in landfill completely, *Goodyear* is using the 3-R Principle (reduction, reuse, recycling). All potential waste is assessed first in terms of reduction, then reuse, and finally recycling. Only if none of these options is available is material sent to landfill. By the end of the year 2007, 55 of 58 *Goodyear* plants had already achieved the goal of zero waste-to-landfill. In *2008, Goodyear* achieved zero waste to landfill and has maintained this goal since (Goodyear 2010b, p. 31). Using a number of different principles, for example Six Sigma, *Goodyear* also managed to reduce the usage of water and solvent in the production process (see Figure 11.7).

Figure 11.7 *Continuous Reduction in Manufacturing Water per Ton and Organic Solvent Use*



Source: Goodyear 2010b, pp. 31-33.

Goodyear operates a number of further programmes in order to protect the environment. Aside from diverse energy conservation initiatives that are in place in all *Goodyear* locations, various product stewardship programmes are maintained to address the potential health and environmental concerns of customers, associates and communities related to all operations and products. These programmes include showing preference for suppliers that meet strict guidelines for effectiveness and purity. *Goodyear* is always searching for and testing potential substitute materials that have less impact on health and the environment without compromising product quality (2010b, pp. 28-29).

By this means, the company shows responsibility not only for its own operations, but also for the actions of partners in the global supply chain.

Auditing Processes

In order to assess the plants' environmental efforts independently, since the late 1990s *Goodyear* has been continuously undergoing various auditing processes. On top of the quality management principles of ISO 9000, the manufacturing facilities apply ISO 14001 as their formal environmental management system. As a supplement to the ISO 14001 environmental management systems audit process, *Goodyear* has voluntarily chosen to analyse comprehensively all processes that assure the continual manufacturing of high-quality products at high standards of environmental and workplace safety. In 2000, the company developed its own product and process quality audit (PPQA) system to address aspects such as engineering, training and communication, rubber mixing, component preparation, building and curing, final finish, product testing and analysis of the technical organisation that serves customers (Goodyear 2007, p. 25).

Social Responsibility

Concerning the social aspect of corporate responsibility, *Goodyear* is striving to be a good and active corporate citizen in all the communities where the company has facilities. As a multinational enterprise, the company's headquarters only give general guidelines about which kind of initiatives are supposed to be supported. *Goodyear* typically fosters programmes that improve cities, social programmes, and educational opportunities in communities where *Goodyear* associates live and work. The initiatives in question, however, usually take place at a very local level and therefore every regional, national and local office is responsible for actively putting the company's social responsibilities into practice.

Internal Corporate Responsibility

While *Goodyear* carries out and supports a large number of activities to live up to its responsibility to customers and communities, the company also has a strong focus on showing responsible behaviour to its internal stakeholders, i.e., its employees or associates.

Global Human Rights and Diversity

First of all, the company has a very strict policy on global human rights that spans associates in all its global operations. The basic principles of this policy strictly reject all forms of involuntary employment and child labour. *Goodyear* also grants all its employees freedom of association as well as the right to refrain from joining organisations. These rights, which might sound self-evident for an American company, are highly important to protect employees in less developed countries. *Goodyear* also has a zero-tolerance policy towards any form of harassment or discrimination. A global company like *Goodyear* that is working in a diverse marketplace has to embrace the advantages that can be gained from a diverse workforce. Therefore, it is *Goodyear's*

policy to support actively an inclusive workforce throughout all its facilities worldwide. In pursuit of common objectives, personal bonds are to be created beyond racial, ethnic or cultural differences, so that it is possible to conduct business successfully in multi-cultural marketplaces.

Workplace Safety

Of utmost importance in a company where most employees work in manufacturing is the safety of the workplace and the protection of the health of the workforce. In late 2004, *Goodyear* therefore launched an initiative to change and improve its safety culture worldwide. The goal is to drastically reduce injuries and health threats in the workplace, so that by the end of 2007 the self-evident goal of the programme, "No One Gets Hurt", will be achieved. While for the most part there is strict government regulation on working conditions and workplace safety in the USA and other developed countries, such legislation is not as detailed, or even existent at all, in developing and transition countries. "Local leadership is held accountable to include safety goals as part of annual operating plans, and make on-the-spot corrections of unsafe conditions and acts" (Goodyear 2006, p. 2). Site visits by *Goodyear's* executive leadership team focused attention and resources on how to reduce incidents occurring at locations around the world. Since launching the "No One Gets Hurt" safety initiative, *Goodyear* has driven a steady improvement in reducing global incidents each year, and the trend continued in 2009. *Goodyear* achieved a 22 percent decrease in the number of incidents of illness and injury compared to 2008 (Goodyear 2010b, p. 25).

Organisational Integration and Communication of CSR

In an organisation that is as complex as *Goodyear*, adoption and enforcement of ethical business practices all through the company poses a challenge to management. This is why in 2005 *Goodyear* established a Department for Compliance and Ethics, responsible for compliance, ethics and privacy issues on a global basis. To maintain accountability, the Committee on Corporate Responsibility and Compliance of the Board of Directors is updated on a regular basis on ethics and compliance activities. Committee members are expected to take an active role in reviewing the activities and processes designed to uphold commitment to ethical behaviour.

"The Network"

Since all employees are requested actively to pursue responsible corporate behaviour, a central ethics hotline, called "The Network", has been established. The Network is an independent telephone answering and intake service that has been engaged for this purpose. Associates from anywhere in the world can call this hotline 24 hours a day, seven days a week. They can report anonymously any actual, suspected or potential misconduct or raise any question they might consider relevant for the company's ethical business conduct. Every allegation is investigated to make sure that every employee

has the chance to take part in the active pursuit of *Goodyear's* corporate responsibility.

Corporate Responsibility Reports

Any company has to make sure that its activities and efforts in terms of corporate responsibility are communicated openly to internal and external stakeholders. This serves the purpose of fostering employees' identification with their employer and aligning their efforts concerning ethical behaviour, on the one hand. On the other hand, the trust of external stakeholders in the company is increased and the company's image benefits. While *Goodyear's* Business Conduct Manual serves to communicate the ethical standards to employees, the company also summarises its global CSR activities in a yearly Corporate Responsibility Report. This report conveys achievements as well as future objectives to the global workforce as well as to the public.

Questions

1. In September 1970, the *New York Times Magazine* published an article by the economist Milton Friedman titled, "The Social Responsibility of Business is to Increase its Profits". Discuss Friedman's statement critically. What does social responsibility mean in the context of business? Does CSR really contradict profit-maximisation? How can corporate responsibility support *Goodyear's* business objectives?

2. *Goodyear* is headquartered in the USA with Europe as its second largest regional market. How does the understanding of CSR differ between North America and Europe? What impact can these different perceptions of the concept have on *Goodyear's* corporate responsibility activities?

3. *Goodyear* is operating in a large number of countries all over the globe. What particular challenges do MNCs face concerning their CSR activities? How does *Goodyear* accommodate the different stakeholders whom MNCs have to take into account? Consider the fact that *Goodyear* is operating in industrialised as well as in transition and developing countries.

Hints

1. See Friedman 1970. Consider the evolution of CSR activities over time.

2. See Matten and Moon 2008 for the concepts of "implicit" and "explicit" CSR.

3. See, e.g., Blowfield 2005 for the role of CSR in developing countries.

Part IV

Foreign Operation Modes

Chapter 12

Basic Types and Theoretical Explanations of Foreign Operation Modes

The choice of a foreign operation mode is considered one of the most important components of an internationalisation strategy, since the operation mode determines the type and intensity of control over the foreign market activity, the necessary resource transfers as well as the associated risks. In this Chapter, an overview of different operation modes is given, characteristics of operation modes are highlighted and theoretical explanations for the choice of a foreign operation mode presented.

Introduction

A company planning to conduct any business activities in a foreign market must choose an appropriate operation mode for this activity. Each task can be performed in various ways, including by vertically integrated organisational units in the foreign country (wholly-owned subsidiaries), by external organisational units (e.g. distributors in the foreign market), or jointly (cooperative arrangements).

The foreign operation mode can be defined as an institutional arrangement for organising and conducting international business transactions (Andersen 1997, p. 29). The choice of a foreign operation mode is strategically highly relevant. It is a core component of the internationalisation strategy and it exerts a strong and lasting influence on many other activities and options of the company. It is seen as a crucial success factor, also because it is not easily reversible in the short- and mid-term.

Market Entry Modes vs. Foreign Operation Modes

In many textbooks, the issue of foreign operation modes is discussed under the heading of *market entry modes*. For two main reasons, throughout this book, the term "foreign operation mode" is used instead: First, the issue is also of relevance when the entry context no longer applies (Welch/Benito/Petersen 2007, p. 10). In the last decades, the focus has shifted from "going international" to "being international" (Bäurle 1996, p. 123). Thus, for a MNC, the initial market entry mode is often less important than the operation mode chosen at a certain point in time. Second, the term "market entry" suggests that the international activities are sales-related. Even though this Chapter mainly focuses on this dimension, foreign operation modes are broader, and also apply to procurement activities, R&D activities, production activities, etc.

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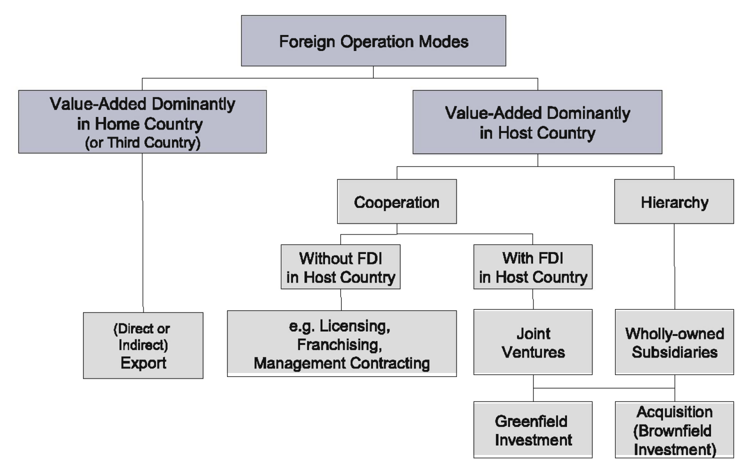
The Basic Types of Foreign Operation Modes

To classify foreign operation modes, different schemas can be found in the literature. Very commonly, a distinction is made between

- export modes (indirect export, direct export via agents, etc.)
- contractual modes (e.g. licensing, franchising, contract manufacturing)
- investment equity entry modes (e.g. joint ventures, wholly-owned subsidiaries).

Here, generally, an increasing level of vertical integration can be seen: Export modes are – at least when intermediaries in the host country are used – market modes (see Chapter 13), contractual and equity alliances are cooperative modes (see Chapter 14) and wholly-owned subsidiaries constitute the highest level of vertical integration (i.e. "hierarchy") (see Chapter 15). It has to be noted, though, that export modes can significantly differ. If, e.g., a MNC exports with a direct customer relationship to a foreign customer, this allows a very high level of control by the MNC over this transaction.

Figure 12.1 *Classification of Selected Foreign Operation Modes*



Source: Adapted from Zentes 1993, p. 67.

More concretely, the choice of a foreign operation mode involves several different dimensions: *Where* to locate production whether to *cooperate* and

whether an *investment* abroad by the MNC should be undertaken. Considering the *establishment process*, joint ventures and wholly-owned subsidiaries can be established by a greenfield investment, i.e., the (joint) building of a new facility in the host country, or by acquisition of existing facilities.

Location of Value-Added

Considering the location decision, different determinants have been investigated in the literature. In the early economic approaches, international trade (and, thus, the location of value-added) was explained, e.g., with *comparative cost advantages* (Ricardo) or, building on these, with *relative factor endowments* in a country (Heckscher-Ohlin).

International Product Lifecycle

Later, dynamic approaches were developed. In the *international product lifecycle theory* of international trade, Vernon (1966) argued that *new product innovations* are usually developed and produced in the home country of a company, even if factor costs are high. In the early stage, cost is of secondary importance due to the monopoly situation of the innovating company. Also, demand is difficult to predict. In the later stage of a *maturing product*, competition rises, foreign demand also and cost pressure by new competitors. Production is partly shifted to foreign countries, closer to the new sales markets. Finally, in the third stage (*standardised product*), industrialised countries may still the most important markets, but they have become too expensive for production. Thus, production is shifted to emerging countries. From there, the MNC (or competitors) exports the product to the relevant markets.

Generally, location theories of internationalisation assume that the decision for value-added in a specific country is determined by location characteristics. Relevant characteristics are *market factors* (e.g. market size, market potential) and *cost-related factors* (e.g. differences in labour costs, input goods, taxes). Another relevant location factor is the *country risk*. In cases of high risk, exporting or contractual arrangements reduce the risk exposure of the MNC compared with a wholly-owned subsidiary where the commitment of the MNC's own resources is substantial.

The configuration decision is discussed in more detail for the different value-chain activities, i.e., production (Chapter 16) and R&D (Chapter 17).

Cooperation vs. Hierarchy

The decision whether to establish foreign value-added via cooperation or in a hierarchical operation mode depends on many influence factors. A comprehensive study by Morschett, Schramm-Klein and Swoboda (2008a, 2008b) has shown that a number of aspects have a strong influence on this decision.

The likelihood that a MNC uses a wholly-owned subsidiary instead of a cooperative arrangement increases with:

- the *number of employees* of the MNC, because larger MNCs can more easily afford to establish a subsidiary on their own and have the necessary management capacity to coordinate that subsidiary
- *experience* of the MNC in the host country, because increased knowledge about the country decreases the uncertainty in the market and makes a partner less necessary
- *advertising intensity* of the MNC, since a partner in a foreign country may "free-ride" on the high reputation of the MNC which can best be avoided by exploiting the good reputation of the MNC with a wholly-owned subsidiary (advertising intensity is usually seen as having high specificity)
- *export intensity* of the MNC, because a higher percentage of foreign sales indicates that the MNC has substantial knowledge about foreign markets, and thus is less dependent on a partner.

On the contrary, MNCs seem to prefer cooperation over a wholly-owned subsidiary, if

- *country risk* is high,
- *legal restrictions* in the host country are tight,
- the *market size* of the foreign market is large (which might be explained by the high investments that is necessary in large markets),
- *resource intensity* of the foreign activity is high, since often, host-country companies have a first-mover advantage regarding local resources which can only be tapped in a partnership
- the subsidiary is active in a business field that is *not closely related* to the business of the parent company, thus, leading to the necessity of external (partner) knowledge for this subsidiary.

Additional arguments for cooperative operation modes and hierarchical operation modes are discussed in Chapters 14 and 15.

Characteristics of Foreign Operation Modes

To make a rational decision on a foreign operation mode, several partly interconnected characteristics have to be regarded. In Table 12.1, these are listed and evaluated for selected operation modes.

Table 12.1

Characteristics of Selected Foreign Operation Modes

	Export	Contractual Cooperation	Equity Cooperation	Wholly-owned Subsidiary
Control	low/medium/high	low	medium	high
Resource Commitment	low	low	medium	high
Flexibility	high	medium	medium-low	low
Knowledge Dissemination Risk	low	high	medium	low

Source: Adapted from Driscoll/Paliwoda 1997, p. 60.

Control

The ability to exert tight control over foreign operations is seen as the main advantage of the stronger internalised operation modes. Control refers to the authority over strategic and operational decisions concerning the foreign operations. Compared with cooperative operation modes, "maintaining decision-making control allows the MNC to determine its own destiny" (Driscoll/Paliwoda 1997, p. 64), and control is "the single most important determinant of both risk and return" (Anderson/Gatignon 1986, p. 3). As Table 12.1 illustrates, different operation modes imply different levels of control. While wholly-owned subsidiaries allow a tight coordination ("full-control modes"), most cooperative modes lead to limited and to a joint control ("shared-control modes"). In the case of contractual agreements (like licensing), the control over the foreign markets is – against payment – largely shifted to the licensee.

Resource Commitment

Often, the trade-off between control on the one side ("benefit of integration") and the necessary resource commitment ("cost of integration") is highlighted as the main decision for a MNC. Resource commitment refers to the assets that a MNC needs to dedicate to the foreign market operations. Obviously, a high resource commitment of a MNC enhances its risk exposure. In the case of export and contractual cooperations, it is rather low. In the case of wholly-owned subsidiaries, the resources have to be invested by the company on its own. Equity cooperations fall between these two extremes. Sharing equity investment with a cooperation partner allows to reduce the own risk.

Flexibility

Flexibility is closely linked to resource commitment. It refers to the ability of a company to switch the chosen operation mode rapidly and with rather low cost or even to withdraw from a foreign market when external conditions have changed (Anderson/Gatignon 1986). High resource commitment acts as market exit barrier and thus reduces strategic flexibility of the MNC.

Dissemination Risk

A fourth characteristic of foreign operation modes is the so-called "dissemination risk", i.e., the risk that knowledge is absorbed by another company who uses this knowledge against the interest of the MNC (Agarwal/Ramaswami 1992). Since the technological know-how and the marketing know-how are seen as crucial competitive advantages of a company, it is important to secure the company against uncontrolled knowledge outflows, since this may reduce the income a company can generate from its knowledge. Protection against knowledge dissemination is, thus, a main criterion for the choice of an operation mode (Driscoll/Paliwoda 1997, p. 66). In particular, cooperative operation modes, where a partner company (e.g. a licensee) is actively provided with the company's knowledge, are characterised by a high risk of knowledge dissemination. The lowest risk exists in the case of wholly-owned subsidiaries (or by direct exports to a foreign customer).

Theoretical Explanations

To explain the choice of international market entry mode, a number of different theories are used in the literature. The most important ones will be discussed briefly in the following part of this Chapter.

Stages Models of Internationalisation

The stages models of internationalisation (in particular the "Uppsala model" by Johanson and Vahlne (1977)) are rooted in the *behavioural theory* of the firm. These models propose an association between the knowledge of the decision makers in the company and the level of resource commitment in a foreign market. The core assumption is that companies with low market knowledge about a specific foreign market prefer a low commitment in this market, i.e., market-based operation modes. Once in the market, the company accumulates experiential knowledge and this, in turn, leads to the willingness to commit additional resources. In the so-called *establishment chain*, the model proposes that foreign operation modes in a specific foreign country are switched along a certain path:

- no international activities
- export activities via agents
- export activities via own sales subsidiaries
- establishment of production subsidiaries in the foreign country.

Psychic Distance Chain

In addition, the Uppsala model suggests that companies often select foreign markets based on the psychic distance to that market and that internationalisation often occurs along a "psychic distance chain", with psychologically

close markets being entered first and then, subsequently, more distant countries.

In general, the common assumptions of all stages models are (Swoboda 2002, pp. 72-73):

- Internationalisation is a slow and gradual process.
- The process of internationalisation is not the result of a long-term strategic planning, but of incremental decisions.
- Internationalisation is an adaptive process, and with time, resource commitment in the foreign market and changes in the management of the foreign organisational unit occur.
- Internationalisation is a process occurring in stages, characterised by different speed of change and un-steady development.
- During internationalisation, companies accumulate experiential knowledge which facilitates foreign activities and further internationalisation.

In all, the stages models explain foreign operation modes mainly with the country-specific knowledge of a company that determines the perceived uncertainty and, thus, the willingness of the company to invest resources in that country.

While the stages models have a high level of plausibility, criticisms have emerged over the years. First, the models neglect that management has a strategic choice and that the operation mode decision is not only determined by a single influence factor. In particular, external influence factors (like host country conditions) are neglected. Second, the models over-simplify a complex process and certain operation modes – in particular cooperative modes – are not considered. Cooperations (and acquisitions) offer the possibility to gain knowledge without the MNC having long-term experience of its own in the host-country. Finally, MNCs often leap over certain stages in the establishment chain. In particular the observation of *"born globals"* in the last two decades, i.e., companies that internationalise immediately after their foundation without slow and incremental processes (Oviatt/McDougall 1994; Knight/Cavusgil 1996), has challenged the theory. However, for many companies, the stages models of internationalisation offer a good explanation of their observed behaviour.

Born Globals

Transaction Cost Theory and Internalisation Theory

The dominant theory to explain choice of foreign operation mode over the last decades has been the *transaction cost approach* (Williamson 1985) and the closely related *internalisation theory* (Buckley/Casson 1976). These approaches

argue that companies choose operation modes that minimise the cost of cross-border transactions.

Transaction Costs

Transaction costs refer to: *search and information costs,* i.e., costs such as those incurred in determining that the required good is available on the market, who has the lowest price, etc., *bargaining costs,* i.e. the costs required to come to an acceptable agreement with the other party to the transaction, drawing up an appropriate contract, etc., *monitoring and enforcement costs* to ensure the other party sticks to the terms of the contract, and taking appropriate action if this turns out not to be the case. For example, monitoring costs might include the measurement of the output (e.g. quality control in the factory of a supplier). If conditions change, contracts might have to be adjusted which causes *adjustment costs.*

The two basic assumptions of the transaction cost approach are:

- *Bounded rationality,* i.e., actors might intend to act rationally but are only capable of doing so in a limited way, partly because they have incomplete information, partly because they have limited processing capacity.
- *Opportunistic behaviour,* i.e., business partners are expected to use the incompleteness of contracts and changing circumstances for their own self-interest and they only stick to the contract if they are monitored.

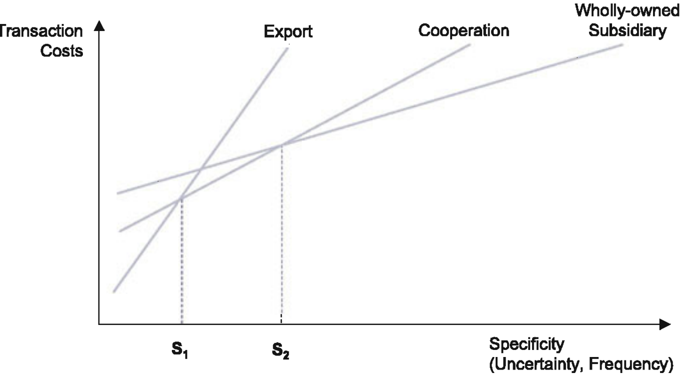
Imperfect Markets

If markets function well, with a large number of potential business partners, competition ensures efficient results. In these cases, a MNC will favour low control modes. Business partners can be replaced easily and this threat protects the companies from opportunistic behaviour. In other cases, markets may fail. This may be the case for different types of transactions (Malhotra/Agarwal/Ulgado 2004, p. 4):

- *Imperfect markets for goods* that are caused by brand names, marketing capabilities, product differentiation.
- *Imperfect markets for intermediate goods,* such as knowledge. Here, it is assumed that the cross-border transfer of knowledge is less efficient among separate companies than within one MNC.
- *Imperfect markets for production factors* that may be caused by exclusive procurement capabilities, particular management know-how or certain technologies.
- Imperfect competition through *economies of scale* that lead to cost advantages of internalisation.

Figure 12.2

Transaction Cost Reasoning for Foreign Operation Mode Decisions



Source: Adapted from Welch/Benito/Petersen 2007, p. 26.

However, it is mainly three characteristics of a transaction that may cause market imperfections:

Asset Specificity

First of all, *asset specificity*, the degree to which an asset loses its value when put to an alternative use, may cause a situation where the actor who has carried out specific investments runs the risk of being exploited by its partner. In this case, market transactions between independent actors might not offer sufficient protection for the business partners. Thus, the MNC might decide to carry out the transaction internally, i.e., with a wholly-owned subsidiary. Similarly, *uncertainty* may lead to market imperfections (Welch/Benito/Petersen 2007, pp. 24-25). If all future eventualities were known in advance, contract parties could plan ahead and develop comprehensive contracts. The stronger the uncertainty (e.g. changes in the external environment), the more likely it is that contracts are incomplete and have to be adjusted. These renegotiations, however, are costly and lead to high transaction costs. Again, the necessary flexibility to adapt to changing situations may be better granted with internalised operation modes. Third, the *frequency of transactions* plays a role. Setting up a wholly-owned foreign subsidiary is often linked to relatively high fixed costs but the subsequent variable costs are usually lower than in the case of cooperative or market modes. Thus, with an increased number of transactions, the relative costs of a wholly-owned subsidiary are reduced.

Uncertainty

Frequency

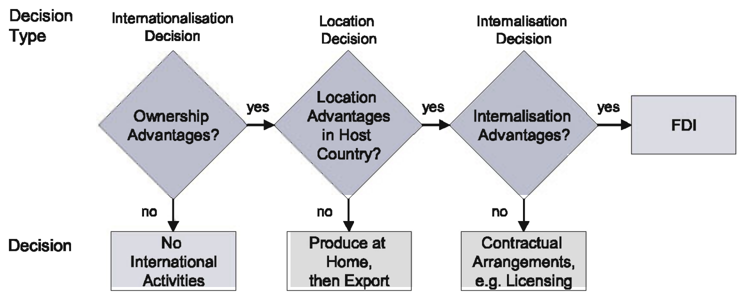
To summarise, the transaction cost approach compares the costs of internalisation of external markets with the costs of market transactions and the costs of cooperation (see Figure 12.2). Under certain circumstances, markets are

imperfect and in this case, companies are forced to internalise transactions to substitute imperfect markets by internal transactions.

Dunning's OLI Paradigm

Since the existing approaches (e.g. the location theory or the internalisation theory) alone did not suffice to fully explain the choice of a foreign operation mode, *John Dunning* developed a comprehensive approach, the so-called *Eclectic Paradigm* that seeks to offer a general framework to determine which operation mode is the most appropriate.

Figure 12.3 *The OLI Decision Tree for Foreign Operation Modes*



Source: Adapted from Sudarsanam 2003, p. 201; Welch/Benito/Petersen 2007, p. 31.

It specifies a set of three *conditions* that must prevail simultaneously to stimulate FDI by a company (Rugman/Collinson 2009, pp. 68-70; Dunning/Lundan 2008, pp. 96-108):

- *Ownership-specific advantages (O)*: The firm must own some unique competitive advantages (*firm-specific advantages*, FSA) that overcompensate the disadvantages of competing with local firms in their home market (“*liability of foreignness*“). Often, ownership-specific advantages take the form of the possession of intangible assets, which (at least temporarily) are specific to the firm. Examples of firm-specific advantages are proprietary technology (e.g. due to R&D activities), product differentiation or brands.

- *Location-specific advantages* (*L*): If foreign direct investment is to take place, it must be more profitable for the company to undertake the activity in the foreign country than in the home country. Otherwise foreign markets would be served by other internationalisation modes. Location-specific advantages can include, for example, labour cost, efficient and skilled labour force, tariffs, transport cost, or natural resources.

- *Internalisation advantages (I)*: Companies that possess specific advantages can either exploit them themselves (*internalise* them) or they can sell the advantage to other companies. The internalisation choice can be explained by the *transaction cost theory*, as pointed out above.

The decision as to whether foreign direct investment is favourable depends on which types of advantage prevail. For an internationalisation via wholly-owned subsidiary, all three types of benefits, O, L and I, have to be present simultaneously. This case is illustrated in Figure 12.3, along with other situations that lead to different operation mode decisions.

Corporate Strategy Approach

An influence factor on choice of foreign operation mode that has been largely neglected in the described approaches is the *corporate strategy*. For example, the concrete motive of a MNC to enter the host-country (see Chapter 4) is likely to have an effect on the chosen operation mode.

Structure and Strategy

The corporate strategy approach puts its focus on the competition and the required characteristics of the operation mode that stem from the corporate strategy and the specific role of the foreign subsidiary in its host-country. Following the general idea that *structure and strategy* should be aligned, they investigate strategy variables and their influence on the operation mode choice. More particularly, "the strategy approach regards the issue of ownership structure primarily as a question of the level of control that is needed in order to coordinate global strategic action" (Benito 1996, p. 164). Strategy variables that can exert an influence are manifold (Kim/Hwang 1992; Malhotra/Agarwal/Ulgado 2004, p. 19):

- *Synergy effects* emerge if companies can use certain resources and processes like R&D, production or marketing to achieve economies of scale and economies of scope across different host countries. Usually, a tight control and the corresponding operation modes are considered to be favourable to achieve synergy effects.

- *Global strategic motives* refer to the question whether the MNC follows a global or a multinational orientation (see Chapter 2). Obviously, a multinational orientation allows for low-control operation modes and – for

example – partnerships in the host countries while a global strategy implies wholly-owned and tightly controlled subsidiaries.

- *Market concentration* is a relevant external factor since it leads to a situation of a worldwide oligopoly. Following Knickerbocker's theory of *oligopolistic reactions* (Knickerbocker 1973), it is argued that the interdependency of different countries is high in this case and a tight coordination of the foreign subsidiaries is necessary to react flexibly to a competitor's actions. In this perspective, direct investment in a foreign country can also be seen as an "exchange of threats" between competitors.

Conclusion and Outlook

The choice of a foreign operation mode is considered one of the most important internationalisation strategy decisions and in this Chapter, the basic types have been presented. For each of the three options – market, cooperation and hierarchy – the following Chapters will provide a more detailed discussion.

It has to be pointed out, however, that the decision on foreign operation mode has to be made for each value-chain activity. Thus, a MNC might – for a specific foreign country – decide to outsource its R&D, internalise the sales and marketing activities, offer its after-sales service in a joint venture with a local partner and have major production steps carried out by a contract manufacturer. In addition, the interdependence between these activities has to be considered, since the inter-functional coordination is also affected by the chosen operation modes. Also, the choice of a foreign operation mode is usually not stable but changes over time, thus, mode switches are very common.

Considering the theoretical explanations and the complex influences on the choice of operation mode, most recent texts argue that the different theories should be seen as complementary. Thus, instead of a single theoretical approach, a multi-theoretical framework is often better suited to explain – and to support the – choice of foreign operation mode.

Further Reading

WELCH, L.; BENITO, G.; PETERSEN, B. (2007): Foreign Operation Methods – Theory, Analysis, Strategy, Glos, UK, Edward Elgar Publishing.

ANDERSEN, O. (1997): Internationalization and Market Entry Mode: A Review of Theories and Conceptual Framework, in: Management International Review, Vol. 27, No. 2, pp. 27-42.

Case Study: Accor[1]

Profile, History and Status Quo

In the 1960s, travel was booming in France, but the French hotel industry had not met the rising demand. The visionary entrepreneur P. Dubrule and his business partner, G. Pélisson, foresaw the upcoming need and market potential and hence founded the *Société d'Investissement et d'Exploitation Hôteliers* (*SIEH*) in 1967. Shortly afterwards, they followed this with the opening of an American-style hotel, an innovative concept to the unexploited French and later European market within the medium price range. Actually, Dubrule used the US chain *Holiday Inn* as source for his business inspirations. As an outsider to the hotel business, the management of Holiday Inn group did not take Dubrule seriously. Thus, he decided to launch his own hotel chain and drew up a plan by adopting the concept of the US chain.

Foundation of Accor

The two founders launched their brand *Novotel* in Lille-Lesquin in 1967. Only five years later, two hotels were opened abroad, in Neufchâtel (Switzerland) and Brussels. In 1974, the holding company *Sphere S.A.* was founded to roll out the new *Ibis* chain with its first two-star classified hotel located in Bordeaux. The year after, the *Société* acquired the *Mercure* hotel chain, a traditional three-star arrangement. In 1980, a further transaction took place – the acquisition of the upscale brand *Sofitel* which owned 43 hotels. Afterwards, the *Novotel SIEH Group* sought a major diversified extension through a merger with *Jacques Borel International* – a leader in managed food service and concession restaurants in Europe and world market leader in issuing about 165 million meal vouchers per year within eight countries. The newly emerged company was called *Accor*.

Diversification & Internationalisation

The *Accor Group* kept its tremendous growth and diversified expansion pace over the years by creating the no-star *Formule 1* chain. Furthermore, the company pursued its US market entry through the acquisition of the *Motel 6* chain in 1990. Additionally, in 1999 its overall hotel network grew by 22 % particularly based on the acquisition of *Red Roof Inn* in America. Hence, *Accor* became a leading hotel group globally in the early 1990s. Consequently, the company went public in 1997 and became *Accor S.A.* In 2001, the company further internationalised, including into the Chinese hotel market. *Accor*'s latest strategic decision was to increase its stake in the largest hotel and tourist group in Poland and Central Europe, the *Orbis Group*, to 50 % in 2008.

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1 Sources used for this case study include various annual reports, press releases, the web site http://www.accor.com as well as explicitly cited sources.

Being an innovative hotel group, business concepts are constantly revised or launched. For example, the new brand *Suitehotel* for medium-stay customers started in Europe in 2001. In addition, the new upscale brand *Pullman* was relaunched in 2007 and in 2008 *MGallery* was created. Otherwise, *Accor* kept its dynamic expansion growing through investments, such as the investment in 1985 in *Lenôtre* which owned gourmet restaurants, luxury caterer boutiques and a cooking school, and through the acquisition of the majority stake in *SPIC* to form subsequently *Accor Casinos* in 1997.

Actual Business and Figures

Today, *Accor* is Europe's leading hospitality group and focuses on two core businesses: *Hotel* and *Services*. In 2010, the company decided to demerge these two businesses and to become a pure player in the hotel sector. The case study will focus on the hotel business and describe the company's multiple strategic entry modes. Figure 12.4 highlights the group's brands. In 2009, the group comprised about 4,100 hotels with 500,000 rooms in total in about 90 countries.

In summary, for over 40 years *Accor* has been developing its expertise and skills across management, marketing & sales, purchasing, human resources, assets, finance, construction, technological support and online booking as a leader within the hospitality industry. In doing so, the company is high-performing with a strong growth potential in both global core businesses.

Accor's Hotel Business Development

Outlook of Hotel Industry

As the history of *Accor* has already shown, its worldwide expansion is due to a successful organic development within the company. Furthermore, ongoing acquisitions, mergers and consolidations are very important management business tools for the sustainable growth of the group. It is estimated that the number of hotel nights will increase globally by 3.7 % per year until 2012, whereas just in China an outstanding rise of 12 % p.a. is anticipated. For hotel chains a rise by 5.7 % is expected. Thus, *Accor* had to respond by redefining its positioning of the brand portfolio to benefit from the overall trend in both mature and emerging markets and from changes within the hotel industry itself, too. In doing so, the company first of all initiated in 2007 a more profitable hotel business model. Thereby, *Accor*'s strategic outlook will be implemented in a second step through revised operating and ownership structures of its hotel division. The reorganisation will then disclose the group's decision on the different market entry modes.

Strategic Vision of the Hotel Division

As the *first* objective within its new business model, *Accor* pursues an increase of the market share in the European midscale and economy segment by offering a more segmented hotel network. The group's brands *Suitehotel*, *Novotel*, *Adagio* and *Mercure* are within the midscale range, *All Seasons* represent the economy range, and new-builds *Etap* the budget segment. *Second*, the US hotel division should be strengthened through a special focus on *Motel 6*. *Accor* sees in its *third* strategic orientation a huge potential in emerging countries and is about to concentrate there on *Novotel* for the midscale and *Ibis* for the economy segment. *Fourth*, to respond to a more and more fragmented demand for its products, *Accor* will redefine its brands to become more specified and thus, expand the portfolio with innovative brands to cover all segments, for example with the creation of *Sofitel* and *Pullman*.

All in all, *Accor*'s focus is very global and consequently, a continuing strong internationalisation of its hotel chains needs to take place. Hereby, the crucial question arises how the hospitality group will be able to keep pace with the changing customer, client and market demands throughout the world.

Implementation of the Reorganisation: The Asset-Right Strategy

To meet the new challenges *Accor*'s major step was the reorganisation of its business base. Thus, the company had to evaluate its whole hotel network and brand portfolio to match a rising fragmented demand as follows:

- *First*, the decision has to be made whether each individual hotel should be maintained, sold or restructured.
- *Second*, the management has to determine how each hotel should be managed and owned.

All in all around *1,400 hotels had a change in their operating structure* between 2005 and 2010. To implement the profound business model, the company created the *asset-right strategy* with the following three dimensions:

First Dimension Disposals

- First of all, *Accor*'s management uses the disposal of underperforming property assets as a tool for a restructured network. With this divestment strategy the group releases hotels which do not fit its overall strategic orientation. For example in 2007, *Accor* sold 30 hotels in the UK to *Land Securities* for 683 million EUR; 67 hotels in Germany and 19 hotels in the Netherlands to *Moor Park Real Estate* for 747 million EUR. Here it can be seen that the *Accor* management formed close alliances with major real estate companies to push its refocusing on hotel operations and thus, improved margins. Moreover, the group gave up its side branches (*Go*

Voyages, Club Med, etc.) to focus even more on its core business. Further, the *Accor* group sold whole fully-owned chains for its reorganisation. For example, the American chain *Red Roof Inn* with 341 hotels was sold for about 1.3 billion USD in 2007.

Restructuring and Rebranding

- *Accor*'s second measure is the partial restructuring of its hotel business. A classical way of the group has been selling assets and simultaneously negotiating management-back agreements. *Sofitel The Grand* in Amsterdam is an example of implementing the *asset-right strategy* in May 2008. This management strategy reduces capital intensity and earnings volatility and enables *Accor* to focus primary on hotel management – its actual core competency. Additionally, variable lease backs and franchise-back arrangements following disposals are other ways to restructure. Hotel rebranding again is another management tool for restructuring brands. By using a "new" name for a brand, *Accor* has a good opportunity to achieve a momentous impact on its business within a short time. Quite an eventful history happened to the brand *Pullman* whose hotels were acquired in 1991. *Accor* began rebranding in 1993 to eliminate the *Pullman Hotels International* chain, then, years later in 2007, the old brand *Pullman* with its prestigious past was reborn.

Repositioning of Brands

- Finally, *repositioning* is a further management tool in conjunction with reorganisation. For instance, this occurred when *Accor* relaunched *Pullman* and upgraded it to a four-star deluxe hotel chain for business customers in 2007. Another example of repositioning is the upgrading of *Sofitel* hotels within the network. The brand thus upgraded to five stars with "French Touch" elegance in the luxury segment in the world's most beautiful destinations. *Accor* intends to be a major competitor in this segment with about 250 luxury hotels worldwide by 2010. Therefore, renovations and new product designs within all of *Accor*'s reorganised brands are also crucial, particularly within the last two presented dimensions, to maintain and even extend the group's competitive advantage.

Global Launch of 200,000 Rooms

The *asset-right strategy* is accompanied by *Accor*'s ambitious development project of launching 200,000 new rooms within the five years from 2005 until 2010 and another 200,000 new rooms until 2015. The planned openings cover all market segments and continents, but 60 % of the openings from 2010 until 2015 will be in the economy (36 %) and budget (23 %) segment. In this process, 40 % of the rooms will be opened in Europe and about one third in Asia-Pacific.

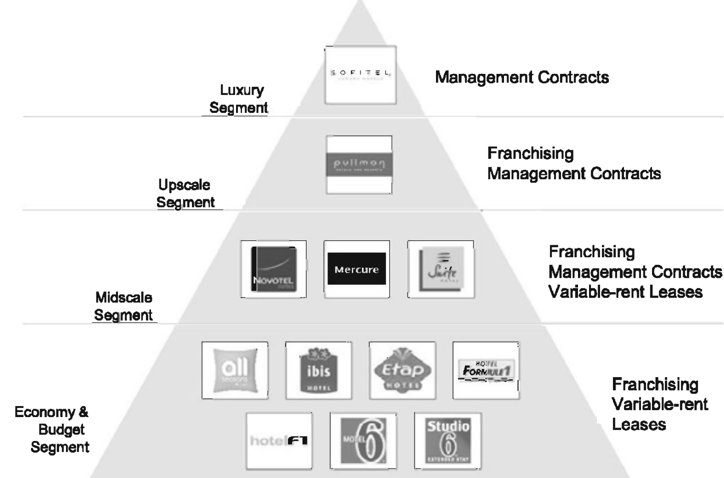
Altogether, the network of about 4,100 hotels is being optimised since 2007 and the reorganisation is embedded into the *asset-right strategy*. This includes divestments, restructurings, renovations and an expansion to a total of 5,000 highly customised hotels by 2010. In this way, the company wants to open

new rooms at the best rates in global growth territories. Therefore, *Accor* expects to justify rising prices for its noticeable value-added offerings and thus, a higher revenue growth.

Implementation of the Market (Entry) Penetration

Simultaneously to the reorganisation of its network, *Accor* brings a second step into focus: a new *real estate management strategy* within the *asset-right strategy*. This strategy complements the new business model which ought to foster the hotel portfolio and thus, *Accor*'s business development and expansion. Hereby, the hotel division shifts its hotel operating structure from *ownership* and (fixed) *leases* to prevalent *management contracts*, *franchise agreements* and (variable-rent) *leases* due to the evaluation of each individual hotel's engagement according to location, market segment and margin. Hence, it can be seen in Figure 12.5 how *Accor* concentrates increasingly on managing instead of owning hotels, which perceptibly changes the culture within the group. Thus, *Accor*'s adaption of its new oriented hotel operating and owning structure unveils its *strategic market entry modes*.

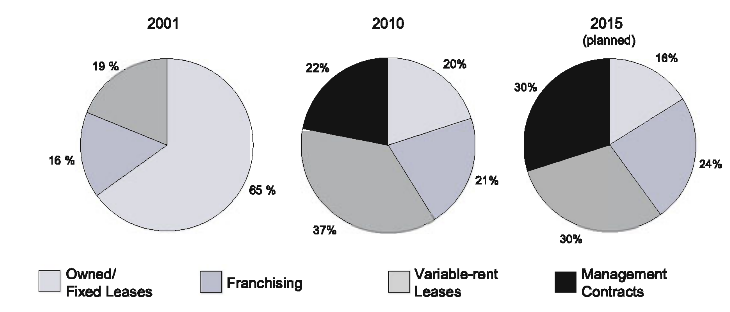
The Asset-Right Strategy: Trends by Market Segment — *Figure 12.4*



Source: Adapted from Accor 2010, p. 28, p. 47.

In particular, Figure 12.5 discloses the drastic change in the ownership structure of the whole group that has already been achieved from 2001, when about two thirds of the hotels of the group were owned by Accor or in fixed leases, until 2010, when only 20 % of the group's hotels were still owned. Furthermore, the chart on the right shows the intended move in ownership structure in the coming years which clearly demonstrates that the trend towards less capital-intensive operating structure will continue.

Figure 12.5 *Hotel Portfolio by Ownership Structure*



Source: Accor 2010, p. 29; www.accor.com.

Management Contracts

At the outset, *Accor* used to be primarily a builder, owner and operator, which possessed full control over its hotels in France. Abroad, the company had to develop a management style similar to the other large hotel chains. So next to owning property, as early as the 1970s, the group negotiated management contracts or signed franchise agreements for a certain period with either hotel owners or investors. Hence, according to a management contract, *Accor* manages the hotel under one of its banners for the hotel's owner in exchange for a management fee – in general, approximately 5 to 7 % of the revenues gained by the hotel (see Schuette/Jurgens 1997, pp. 3-4). Usually, the management staff is brought in by the group and the non-managerial staff is recruited in the local area. Employees working under a hotel management contract will then apply *Accor*'s methods, capabilities and training to provide high value-added services on behalf of the investor or the owner of the hotel. The owner or investor retains the right to participate in decision making with regard to investments for its property. Due to increased use of this entry mode, *Accor* anticipated an internal need for about 1,000 additional hotel general managers by 2010 and thus it intensified recruitment initiatives.

Franchising

Franchise agreements are the reverse of a management contract.The franchised hotel is operated by its owner. The group temporarily transfers the right to adopt its brand name and concept to a hotel owner or operator in exchange for about 2 to 3 % of the revenues (see Schuette/Jurgens 1997, p. 4). *Accor* commenced its first franchise activities already as early as 1970 in Reims and Nancy, in France. Lately, *All Seasons*, a network of quite independent hotels were mainly franchised. The first hotel of this two-star non-standardised economy hotel chain was opened in France in 2007. Many US companies already have a profound knowledge and management capabilities concerning franchising concepts, thus, local franchisees have the know-how to run hotels, accept the brands, the reservation system, etc. Hence, *Accor* seeks another major *franchise* programme to accelerate the development of its leadership in the economy segment there, the *Motel 6*. In 2007, *Accor* introduced the *Partnership Charter* where all partners declared they would pursue the fundamentals of the business, like customer satisfaction, brand development, corporate culture, etc. Therewith, the company wanted to increase what was already a balanced and strong relationship.

Variable and Fixed Leases

Once again, by carrying out the *asset management strategy*, *Accor* pursued the reorganisation of its hotel portfolio first. Thereby, the company executes restructuring, repositioning and also outright sales of non-strategic properties. Thus, the *Accor* group conducted several sales between 2005 and 2007 but continued to manage these hotels either by management contracts (17 hotels), franchise-back arrangements (86 hotels) or variable lease-backs (317 hotels) with an overall cash impact of 1,288 million EUR. In variable-rent leases, Accor leases the hotel from an investor but instead of paying a fixed rent, it pays a rent that varies according to the hotel revenue. This solution is used extensively in the Midscale and Economy segments. In detail, variable leases were created for many *Novotel*, *Mercure* and *Ibis* hotels in France when they were sold to *Foncière des Murs*. After that transaction the hotels were leased back at a variable rent of 15.5 % of the revenue. Those 12-year leases can be extended up to four times. Besides variable leases the group also still manages hotels where it pays fixed leases to the owner or investor.

All the examples show that the *Accor* group welcomes partnerships when they are arranged by mutual agreements. Thus, Figure 12.5 highlights the company's priority to implement a less capital-intensive and cyclical ownership structure with the *asset-right* strategy. Though, it is impossible to generalise a specific entry mode according to a segment, brand or location because the *Accor* management determines each kind of market entry from case to case. Hence, for example, *Pullman* is planned to be reorganised through rebranding and repositioning and will be operated by management contracts or franchise agreements with the objective of 300 operating hotels by 2015.

Summary and Outlook

Summing up, with the new business model for its hotel division, *Accor* targets more profitable and customised investments, less cyclical operations and thus reduced earnings volatility to satisfy not only its customers but investors as well. In doing so, *the company continuously transforms itself from a hotel owner to a hotel operator* which uses its skills and expertise to serve clients. Thus, to leverage a competitive and more effective hotel business model with a low capital-intensive operating structure, the group has been pursuing major property disposals and intensive reorganisations – including the ideal strategic entry mode – of its existing hotel portfolio. Furthermore, the group is about to open around 200,000 additional rooms between 2010 and 2015, in countries and segments with strong growth potential. The demerger of its service business will help to concentrate management capacity on the hotel business. As the Annual Report 2009 argues: "By becoming a pure player in the hotel sector, the Group will be more agile and more efficient in its operations, management of capital employed and customer relations" (Accor 2010, p. 84).

Questions

1. Explain the basic types of strategic market operation modes a hotel company can pursue when it is considering an international expansion of its business operations.
2. To implement optimal strategic market entries *Accor* formulated a new business model for its hotel division whereby the *asset-right strategy* was the cornerstone. Describe the objectives of the new model and pinpoint that strategy in its two main implementing steps.
3. Provide an overview of the tremendous expansion of the *Accor* business. Furthermore, pay special attention to the accompanying market entry strategies and modes.

Hints

1. The first part of this Chapter describes the basic operation modes.
2. See www.accor.com and Luc 1998 for an overview on *Accor's* history.

Chapter 13

Buying, Outsourcing and Offshoring

A key strategic decision is the choice between internalisation and externalisation with regard to all activities of the value chain. This strategic choice implies the question of the appropriate value chain architecture of a firm. In the context of internationalisation or even globalisation new options emerge such as offshoring. The purpose of this Chapter is to highlight the importance of externalisation and to describe the variety of alternatives.

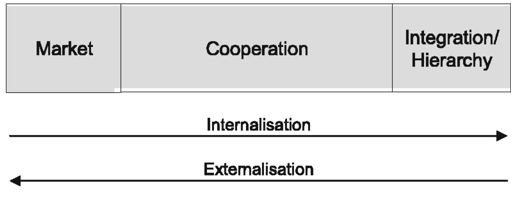
Internalisation vs. Externalisation

Market vs. Hierarchy

With regard to *new institutional economics* (for theoretical explanations, see Chapter 12) two polar options exist in order to realise activities: A value chain activity can be done internally, i.e., controlled or coordinated by hierarchy/integration, or externally, i.e., by other firms. Externalisation always means *buying* goods or services. In this case, the *market mechanism* is taking up the role or task of coordination (see Figure 13.1). These two basic alternatives are also called in a more practitioner-oriented terminology: *make or buy* (see Zentes/Swoboda/Morschett 2004, pp. 243-250).

If an activity that is currently being realised internally is transferred to an external firm, this process is called *outsourcing*, i.e., outside resource using. In contrast, if an activity is integrated in the internal value chain (intra-firm transaction), this process is called *insourcing*.

Transaction Modes — *Figure 13.1*



D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_14,
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Between these two polar alternatives a wide range of *cooperative agreements* exists (see Chapter 14) with fuzzy delimitations between externalisation and internalisation, such as *contract buying* or *contract manufacturing*, discussed later in this Chapter.

Advantages and Disadvantages of Outsourcing

The strategic choice of internalisation (insourcing) or externalisation (outsourcing) refers to all activities of the value chain of a firm (Porter 1985, p. 37).

Motives

Matiaske and Mellewigt (2002, pp. 646-647) identified in a *meta-study* of the scientific literature essentially four *motives* of outsourcing:

- *Cost advantages:* A central motive of outsourcing is cost reduction. The logic behind this argument is, that an external firm can realise the function in question more efficient than the outsourcing firm, because the firm is specialised in this field, i.e., the activity belongs to its core competences. A premise in this content is that this external firm is willing to transfer this cost advantage completely or partly to the outsourcing firm.
- *Concentration on core business*: Besides cost advantages, from a strategic point of view a tendency towards strong concentration on core business is another important motive of outsourcing. By outsourcing of minor/peripheral or supporting activities, a firm can focus its resources on the core activities of the value chain.
- *Improvement of efficiency and performance*: In addition to this, the bringing in of external service providers can lead to improvements of performance. Specialists have greater or better know-how, better qualified personnel and are more up-to-date with regard to technology than the outsourcing firm.
- *Advantages in financing and risk transfer*: Outsourcing of activities related to high financial investment, reduces the tied up capital and the funding requirement of the firm. At the same time, the financing of reserve capacities in order to serve to peaks in demand can be dropped. Finally, fixed costs are "converted" to variable costs.

Risks

The following *risks* of outsourcing have been identified by Matiaske and Mellewigt (2002, p. 651):

- higher total costs compared with the alternative "make" because of transaction costs (costs of negotiating, control, etc.)

- opportunistic behaviour of the firm (supplier) to which an activity has been transferred
- loss of know-how
- transfer of core competences.

The last mentioned risk means that core competences are not recognised as such and are transferred externally.

Strategic Relevance/ Competence-Matrix

Outsourcing can also be positioned in the so-called *"strategic relevance/competence-matrix"*, developed by Krüger and Homp (1997) (see Figure 13.2). Following this model, outsourcing is useful if the strategic relevance or importance as well as the strength of competence with regard to an activity or process are low. This situation is typical for support activities, such as facility management. If the strategic relevance is high but the strength of competence of a firm in this field is low, the firm has to invest in order to narrow the gap. The competence can be transferred, i.e., sold, to other companies even competitors, if the firm's capabilities are high and this asset is not crucial to market success. The combination of high competence and high strategic relevance forms the basis of *competitive advantages*: Activities or processes being positioned in this field are realised internally, neither outsourced nor transferred.

Strategic Relevance/Competence-Matrix — *Figure 13.2*

Strategic Relevance	Strength of Competence: low	Strength of Competence: high
high	Develop	Use
low	Outsource	Transfer

Source: Adapted from Krüger/Homp 1997, p. 105.

New Forms of Value Chain Architecture by Outsourcing

Decisions in the field of internalisation vs. externalisation lead to fundamental changes in the *value chain architecture* of a firm. With regard to the core processes, typical architecture types can be found:

- traditional architecture type
- architecture type "assembler"
- architecture type "coordinator".

Traditional Architecture

The traditional model, characterised by the fact that the supply-chain processes and the market-oriented processes are realised internally, to a large extent still exists in specific industries, such as the chemical and pharmaceutical industries. At first glance, in most industries this type is operating, but the degree of *vertical integration* has been dramatically reduced.

Architecture Type "Assembler"

In the automobile industry, the average degree of vertical integration lies between 20 and 30 %. The production of parts or components has been transferred or outsourced to suppliers. For example, in the automobile industry a typical car contains more than 10,000 components. In this industry manufacturers constantly face make-or-buy decisions: "*Toyota* produces less than 30 percent of the value of cars that roll off its assembly lines. The remaining 70 percent, mainly accounted for by component parts and complex subassemblies, comes from independent suppliers" (Hill 2008, p. 460).

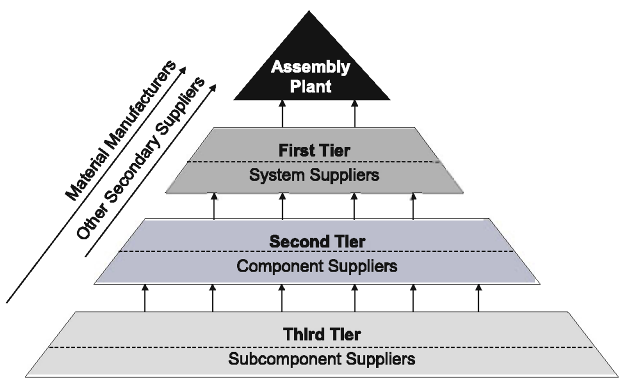
Reducing the degree of vertical integration leads to the "assembler" type. This type is characterised by a high extent of outsourcing, but the assembler is controlling the *total value chain*, i.e., its own value chain as well as the basic parts of the value chain of its suppliers. The assembler is coordinating R&D activities, sourcing activities and production activities. With regard to R&D the firm is responsible for *innovation management* and with regard to sourcing and production for *quality management*.

Supplier Pyramid

Due to the division of labour between a manufacturer and its suppliers, "*supplier pyramids*" are characterised by several layers of contractors or subcontractors. The *tier structure* of this supplier network is illustrated in Figure 13.3.

Supplier Pyramid

Figure 13.3



The "assembler" type of value chain architecture shows the fuzzy delimitation of externalisation and cooperative agreements. Two sub-types can be distinguished:

- contract buying
- contract manufacturing.

Contract buying is characterised by suppliers offering products and/or services developed and designed by their own and delivering these goods on the basis of mid-term or even long-term cooperative agreements *(contracts)*. Sourcing of raw materials and energy is typical for this type of agreement. Contract manufacturers are producing parts or components which are developed and designed by the outsourcing firm (see Morschett 2005; see also Chapter 14). In some cases, they have no R&D activities of their own.

Architecture Type "Coordinator"

Manufacturers without Production

The farthest-reaching type of outsourcing is typical for the value chain architecture of a "coordinator". This architecture is characterised by the fact that a manufacturer has no production activities at all: It is a "manufacturer without production": all production has been outsourced. This type of "coordinator" can be found increasingly especially in the consumer goods industries. Companies such as *Ralph Lauren, Nike, Adidas* and *Puma* are concentrating on product development, design and the control of the supply-chain. Their production activities are totally transferred to suppliers operating on a *contractual basis*.

Coordinating Store Brands

The value chain architecture of a "coordinator" is not only relevant with regard to manufacturers. To a growing extent retail and wholesale companies are adopting this form, migrating from the traditional architecture to that of a "coordinator". The development and design of *store brands* produced by contract manufacturers is an example (see e.g. Zentes/Morschett/Schramm-Klein 2007, pp. 167-170).

Insourcing by Verticalisation

Secured and Controlled Distribution

With regard to marketing, especially selling/distribution, quite another tendency can be found. Manufacturers are increasingly integrating direct sales activities in their value chain by establishing their own outlets (equity stores) or retail chains or by selling directly to consumers via Internet *(E-Commerce)* (Zentes/Swoboda/Morschett 2005; Zentes/Neidhart/Scheer 2006). Besides this form of *secured distribution*, there is a wide range of *contractual agreements* with legally independent retailers or dealers *(controlled distribution)*, for example, franchise agreements or shop-in-shop agreements (see Zentes/Morschett/Schramm-Klein 2007, pp. 53-62).

Insourcing market-oriented activities, such as selling to final consumers (*B2C-distribution*) is frequently combined with the supply-chain oriented architecture of a "coordinator". The already mentioned companies, such as *Ralph Lauren, Nike* and so on, are pioneers in this field. In the extreme case, a manufacturer has no production of its own and a pure controlled distribution network: It is "only" coordinating the supply-chain process as well as the market-oriented process.

Offshoring

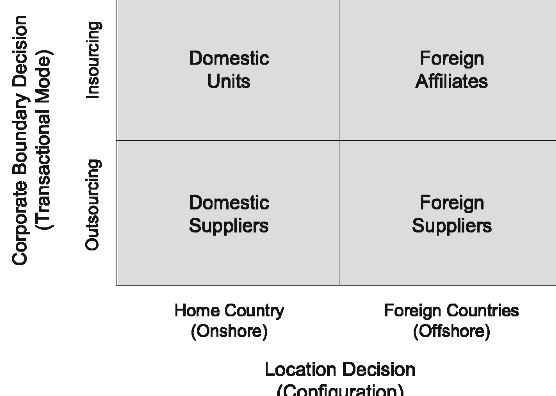
Corporate Boundary and Location Decision

While outsourcing concerns the decision to make or buy (*corporate boundary decision*), neglecting cooperative transactional modes, regardless of where the activity takes place, the location decision (*configuration decision*) refers to where the activity takes place regardless of whether it is within the corporate boundary or outside it (see Figure 13.4).

Offshoring refers to re-locating activities to foreign countries, mostly low-cost countries, e.g. *newly industrialised countries* (NICs), that are emerging as sourcing markets and/or production sites. This offers the opportunity for international sourcing and international production to make use of comparative advantages, such as low wages (see Chapter 16).

Transactional Modes and Configuration

Figure 13.4



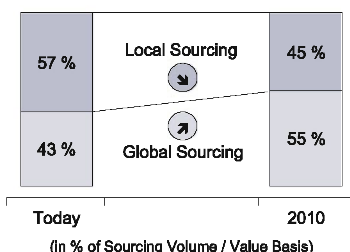
Source: Adapted from Abramovsky/Griffith 2006, p. 595.

Emerging countries are mostly interested in attracting foreign capital and know-how by establishing plants or R&D units in order to accelerate the economic transformation and development process or to produce and deliver to foreign countries in order to create values and to reinforce its home labour markets. They support or even sponsor therefore such activities or processes by tax reductions or temporary tax concessions which increase the *comparative advantages* of these countries. Sometimes they establish special *tax free areas*, territories with exemption from duties, often in geographical connection with ports, to attract foreign production sites.

Sourcing in Emerging Markets

With regard to *global sourcing*, the importance of emerging countries is growing. According to study conducted for the German Logistics Association (see Straube et al. 2007), the share of worldwide procurement will increase to over 50 % by the year 2010 (see Figure 13.5): "The worldwide procurement volume is growing all the time and today accounts for around 43 percent of total procurement. Experts forecast that 55 percent of goods and preliminary products will be procured worldwide by 2010, resulting in a corresponding decline in local and national procurement" (Straube et al. 2007, p. 4).

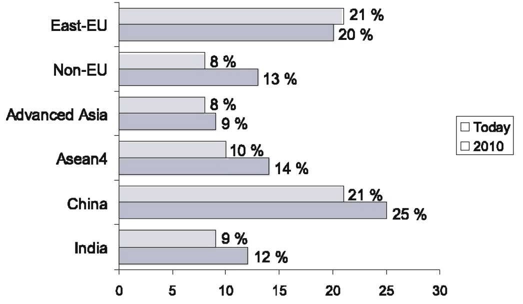
Figure 13.5 *Development of Sourcing Strategies*



Source: Straube et al. 2007, p. 5.

Emerging market sourcing is growing the fastest. It is one of the core areas of purchasing activities of firms. In terms of the overall purchasing volume, China is the most attractive procurement market because of relatively favourable wage levels (see Figure 13.6) (see also Zentes/Hilt/Domma 2007, p. 78).

Figure 13.6 *Development of Total Purchasing Volume in Selected Emerging Markets*



Source: Straube et al. 2007, p. 7.

Outsourcing/Offshoring of Management and Support Activities

In recent years, the outsourcing decision has gone beyond the production of physical products. Outsourcing also refers to support activities as well as to activities of the management processes, such as human resource manage-

ment, information management, etc. ("moving *white collar jobs* offshore"). In this field of *management and support activities*, too, the corporate boundary decision to outsource is combined with the location decision of offshoring, e.g. to prefer suppliers of low-cost countries. "For example, many U.S.-based companies from credit card issuers to computer companies, have outsourced their call centres to India. They are 'buying' the customer call center function, while making other parts of the product in house. Similarly, many information technology companies have been outsourcing some parts of the software development process, such as testing computer code written in the USA, to independent providers based in India. Such companies are 'making' (writing) most of the code in-house but 'buying', or outsourcing, part of the production process (testing) to independent companies. India is often the focus of such outsourcing because English is widely spoken there, the nation has a well-educated workforce, particularly in engineering fields, and the pay is much lower than in the USA (a call center worker in India earns about $200 to $300 a month, about one-tenth of the comparable U.S. wage" (Hill 2008, p. 460).

Conclusion and Outlook

Outsourcing and Insourcing

With regard to value chain architecture, an asymmetrical tendency can be seen: On the one hand, outsourcing or externalisation is the strategic mainstream with regard to the supply-chain process, which results in new value chain models, such as "assembler" or "coordinator". On the other hand, the companies are interested to control or even to secure the distribution in order to have *direct relations* with private and/or commercial customers. This strategic approach leads to new structures with regard to marketing & sales – insourcing or internalisation is the consequence.

The political and legal developments in the context of globalisation reinforce the tendency of offshoring, i.e., shifting sourcing and/or production to foreign countries. Companies in high-cost countries are increasingly concentrating on *intellectual value creation*, i.e., innovation management, quality management and brand management, which includes increasingly *channel management*.

Outsourcing Dilemma

Offshore production or *offshore sourcing* sometimes results in one of the biggest challenges facing international business or managers of international companies today: defining ethical standards and operating in a socially and ecologically responsible manner (see Griffin/Pustay 2010, pp. 144-151) (see Chapter 11). Companies often confront real *ethical dilemmas* where the appropriate way of action is not clear: "There are situations in which none of the available alternatives seems ethically acceptable" (Hill 2008, p. 134). "For

example, many people from developed countries would agree that it is unethical for a business to outsource production to an offshore factory that relies on child labour and/or that maintains unsafe working conditions. But people in that country might argue that as unattractive as they might seem to outsiders, those jobs are superior to the ones that would otherwise be available" (Griffin/Pustay 2010, p. 144-146).

Further Reading

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Case Study: Wipro[1]

Profile, History and Status Quo

India is the top business location worldwide for remote functions, including IT services and support contact centres and back-office support (A.T. Kearney 2007, p. 2). India "offers an unbeatable mix of low costs, deep technical and language skills, mature vendors and supportive government policies" (A.T. Kearney 2007, p. 5). Consequently, Indian IT service companies have been major beneficiaries of the increasing amount of technology outsourcing by Western firms. With sales of roughly 5 billion USD, profits of more than 750 million USD and more than 100,000 employees in 2009, *Wipro Limited* (*Wipro*) is one of the big players in the Indian IT service industry.

Wipro's Origins

Wipro was founded in 1946 by Mohamed Hussain Hasham Premji as *Western India Vegetable Products Limited*. Originally, *Wipro* was engaged in the manufacturing of hydrogenated vegetable oil and firstly diversified into consumer care products. In 1975, the company diversified into hydraulic engineering

[1] Sources used for this case study include the web site www.wipro.com, www.nasscom.in, various annual and company reports as well as explicitly cited sources.

and entered the IT business in 1980. Nowadays the company operates with four business segments.

IT Services

The IT services segment provides IT services to customers in the Americas, Europe and Japan. The range of the services includes IT consulting, custom application design, development, re-engineering and maintenance, systems integration, package implementation, technology infrastructure outsourcing, business process outsourcing (BPO) services and R&D services in the areas of hardware and software design. The segment makes up about 75 % of *Wipro's* revenues and generates more than 90% of *Wipro's* EBIT.

IT Products

The IT products segment focuses is a leader in the Indian IT market and focuses primarily on meetingrequirements for IT products of companies in India and the Middle East. The segment realises about 14 % of *Wipro's* revenues even though the contribution to profits is still much lower. Overall, *Wipro* is in a leading position in the domestic Indian IT market.

Consumer Care and Lighting

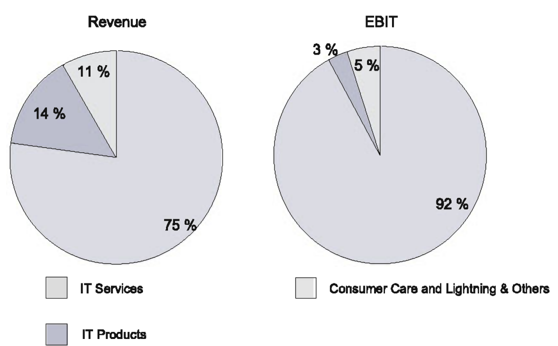
Wipro leverages its brand name and distribution strengths to sustain a profitable presence in personal care products, soaps, toiletries, infant care products, modular switch lights, and modular office furniture.

Others

The key business in the "Others" segment is entitled "*Wipro Infrastructure Engineering*" (WIN). The company sells hydraulic cylinders and truck tipping systems that are used in a variety of earthmoving, material handling, mining and construction equipments.

Figure 13.7 summarises the contributions of each segment to the financial performance of the company. Considering the importance of the segment and the outsourcing and offshoring context of this case study, the following will exclusively cover the IT Services segment.

Figure 13.7 *Segment-wise Contribution to Revenue and EBIT 2009*



Source: Wipro 2009, p. 9.

The Development of the Indian IT Industry

Evolvement of the Indian IT Industry

When the Indian IT industry originated in the 1960s, hardware was provided by multinational firms and as a consequence, the only opportunity for Indian firms was to specialise in the area of IT services. As the domestic market was small, Indian IT service companies relied heavily on export markets. By 1980/1981, while software exports hit the 13 million USD mark and many of today's major companies were founded, large companies in other sectors of the economy diversified into the IT sector (Ainavolu 2007, p. 252).

Importance of Body Shopping

At that time, the Indian software industry heavily relied on *"body shopping"* – that is, flying professional staff to the sites of overseas clients in order to work on software assignments before returning home. This was mainly due to the large talent pool of English-speaking computer scientists and engineers willing to work overseas for a fraction of US wages as well as the lack of appropriate hardware in India, caused by the limited availability of foreign exchange to purchase computers (Henley 2007, p. 119). "Body shopping" was an important building block for the future development of the outsourcing industry. The kind of software that was being developed in the 1990s was still mostly firm-specific, customised software and much of the work involved maintenance or the integration of legacy software systems. It has been argued by some observers that over two-thirds of all software development efforts are spent in maintaining and enhancing existing software codes, rather than producing new software (Arora/Athreye 2002, p. 255). Such work necessitates in-depth understanding of the software functions

through face-to-face contact. The building of trust between client and software provider that was possible as a result of face-to-face interaction on site, was critical for the development of the software industry. For the business relationship to develop, the client has to share confidential information with the software provider. "If the Indian software companies had established brand names and reputations, as many have today, this might not have been important, but the software houses were new entrants from a developing country not famous for the reliability of its infrastructure" (Henley 2007, pp. 119-120).

The Y2K Problem

Another software service that boosted the IT service sector in India was the urgent need to fix the *Y2K problem* for many customers. That included (re)programming electronic equipment to switch internal electronic clocks to the new millennium. By 2000 offshore software exports revenues had risen from 5 % of total Indian exports in 1991-92 to 58 %.

Indian software companies have achieved an almost iconic status in India with no important business conference in India being complete without a speech from representatives of companies such as of *Infosys, Satyam, HCL, TCS* or *Wipro* (Henley 2007, p. 120). Table 13.1 displays the outstanding development of the industry in recent years.

Table 13.1

Development of Revenues within the Indian IT Software and Service Industry

USD billion	2004	2005	2006	2007	2008	2009
IT Services	10.4	13.5	17.8	23.3	31.0	35.2
- Exports	7.3	10.0	13.3	17.8	23.1	26.9
- Domestic	3.1	3.5	4.5	5.5	7.9	8.3
ITES-BPO	3.4	5.2	7.2	9.5	12.5	14.8
- Exports	3.1	4.6	6.3	8.4	10.9	12.8
- Domestic	0.3	0.6	0.9	1.1	1.6	1.9
Engineering Services and R&D, Software products	2.9	3.8	5.3	6.5	8.6	9.5
- Exports	2.5	3.1	4.0	4.9	6.4	7.3
- Domestic	0.4	0.7	1.3	1.6	2.2	2.3
Total Software and Services Revenues	16.7	22.5	30.3	39.3	52.0	59.6
- Exports	12.9	17.7	23.6	31.1	40.4	47.0

Source: NASSCOM 2009.

Nowadays, the Indian IT industry consists of thousands of firms of which 1,200 are members of NASSCOM, the National Association of Software and

Service Companies. However, many of these firms are small and the industry is dominated by few large firms. In 2005, 25 firms accounted for about 60 % of export revenues of the industry (Ethiraj et al. 2005, p. 26).

Commonly Shared Features of Indian IT firms

Indian IT firms share some common features. Quality and security have been one of their strong points and also have been used to counter the image of a low-cost destination. Hence, in the extremely competitive international software market, Indian firms emphasise the quality of their procedures and human resources to gain a competitive advantage (Arora/Athreye 2002, p. 271). On the less positive side, the Indian IT industry is characterised by relatively low productivity and global firms are way ahead of their Indian counterparts (Ambastha/Momaya 2004, p. 69). For instance, annual revenue per employee for the top three Indian software exporters (*TCS, Infosys* and *Wipro*) ranges between 50,000 and 55,000 USD. Companies like *IBM* and *Accenture* earn 100,000-plus USD revenue per employee (Pankaj 2009).

Wipro's Approach towards Global IT Services and Products

In the fiscal year 2009, *Wipro* realised 53.1 % of its revenues within the Global IT Services and Products segment from work done in locations outside India, with the remaining 46.9 % of revenues realised from the work performed by development centres in India. Consequently it can be argued that two sets of capabilities[1] are important to prevail in the software services industry: client-specific capabilities and project management capabilities (Ethiraj et al. 2005, p. 26). Client-specific capabilities largely reflect tacit knowledge of the client's business domain and operating routines acquired through repeated interaction with the client.

Client Specific Capabilities at Wipro

International Scope

As of March 2009, *Wipro* had 863 active global clients. In order to serve its increasing number of global clients and to build trust by enhancing global visibility, in recent years *Wipro* decided to expand its global operations substantially by forming strategic alliances and performing numerous acquisitions. As a result, *Wipro* nowadays operates offices in more than 35 countries (Wipro 2009).

[1] The authors clearly distinguish between capabilities and resources. Resources consist of know how that can be traded, financial or physical assets, human capital, whereas capabilities refer to a firm's capacity to deploy resources (Amit/Schoemaker 1993, p. 35).

Service Offerings

The range of IT services offered by *Wipro* is extensive. *Wipro* optionally takes charge of the IT needs of an entire corporation as its services extend from enterprise application services like e-procurement and customer relationship management (CRM) to e-business solutions. The wide range of services puts *Wipro* in a superior position to deliver tailored solutions and to respond to a variety of client needs. The building of a web-based community portal, as an exemplary e-business project, delivers some insights into *Wipro's* services

Exemplarily Project

A leading internet service provider in Portugal decided to launch a community portal for women between 18 to 40 years of age including chats, forums, web-mail, and a search engine. Moreover the portal was required to provide a back office for content uploading and approval process. While most parts of the project were commenced onsite at the client's premises in Portugal, with *Wipro* being involved from requirement analysis until the start of the portal, back-office functionality was developed offshore. Thus, *Wipro* on the one hand offered consulting services regarding the design and structure of the portal, and, on the other hand, simultaneously ensured a cost-efficient development process of basic functions.

Project Management Capabilities at Wipro

Project management capabilities are acquired through deliberate and persistent investments in infrastructure (systems and processes) and training to improve the firms' software development processes. By forming strategic alliances and undertaking acquisitions, *Wipro* also seeks to build trust and enhance global visibility and to gain access to niche skill sets. Consequently, *Wipro's* acquisition strategy focuses on specialised players to supplement its service offerings, or as *Wipro* Chairman Azim Premji expresses it: "If the same competence is available externally, in likeminded companies, we have found it prudent to buy the 'wheel' rather than reinvent it. Our experience over the last two years has reinforced our faith that buying a 'wheel' is more economical than reinventing it."

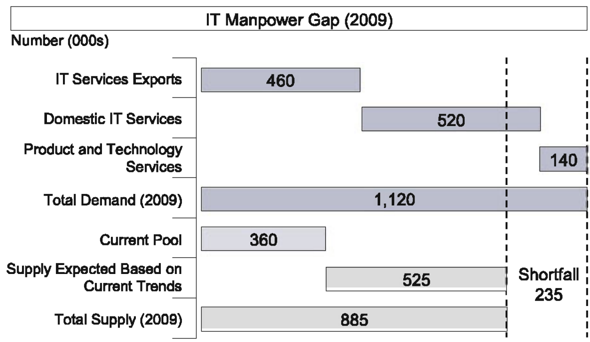
Apart from "buying" new capabilities through acquisitions, *Wipro* also seeks to improve the quality of Indian graduates. Hence, the company also tries to boost "inhouse" project management capabilities. The company therefore rolled out the so called "*Mission 10x*" programme whose major objective is to improve the quality of education for engineering graduates. Today, the programme reaches more than 1,000 schools and *Wipro* intends to address 10,000 faculty members from around 1,500 engineering colleges in the next couple of years.

Future Challenges for Wipro and the Indian IT Industry

Lack of Skilled Manpower

Currently, India is attracting companies like *General Electric, Microsoft, Oracle* and *Cisco* to set up research facilities, and the Indian research departments of these companies sometimes even exceed their US counterparts in terms of patents filed (KMPG 2008, p. 5). As a result, the "war for talent" will increase, as Indian educational institutions cannot provide multinational and Indian companies with a sufficient number of industry-ready graduates. Hence, a shortfall of 235,000 IT specialists has been identified in 2009 (see Figure 13.8). The shortfall of sufficiently qualified high skills in India has also been recently addressed by the World Economic Forum (World Economic Forum 2010, p. 22).

Figure 13.8 *IT Manpower Gap for 2009*



Source: KPMG 2008, p. 10.

Higher Value-Added Activities

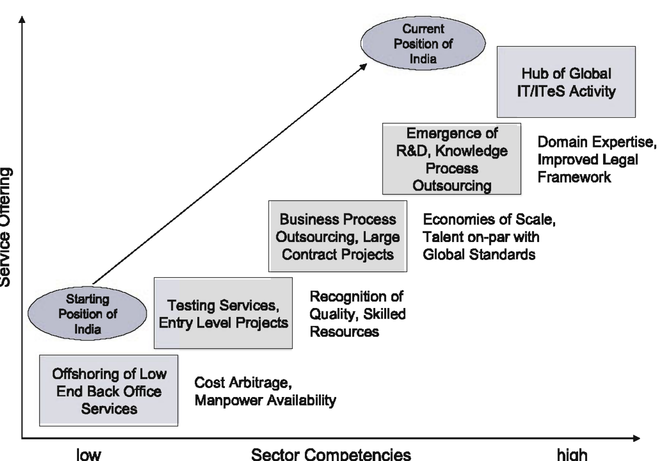
The Indian IT industry is currently evolving to an *innovation and research hub* for the global IT/ITeS industry (see Figure 13.9).

As low-cost operations and effective delivery mechanisms have become commodities, they cannot provide long term sustained competitive advantage (Ambastha/Momaya 2004, p. 76). The inherent marketing challenge is to deal with the client's perception of risk that grows with complexity, knowledge intensity, and depth of engagement. Thus, as "most Indian firms are

simply not trusted enough to be given important contracts" (Banerjee/Duflo 2000, p. 1014), the main constraint on growth is not price or technical sophistication, but credibility (Henley 2007, p. 125).

IT Value Chain

Figure 13.9



Source: Adapted from IBEF 2009.

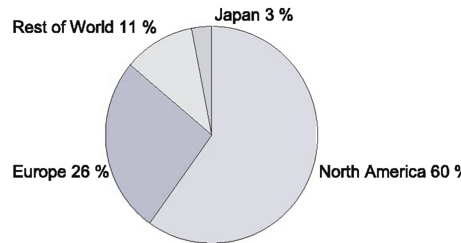
Dependency Reduction: Industry-wise

The Indian software and service sector is heavily dependent on the financial service industry (Henley 2007, p. 119). For instance, *Wipro* derives about 26% of its revenues in IT the services segment from clients in the financial service industry (Wipro 2009, p. 11). A reduction or postponement of IT spendings in this industry would seriously affect Indian IT services provider. Hence, a broader diversification is recommended.

Dependency Reduction: Geographically

The USA has always been by far the most important market for the Indian IT service industry. Figure 13.10 illustrates the geographical distribution of revenues of the Global IT Business and Products segment of *Wipro*.

Figure 13.10 *Wipro: Geographical Revenue Distribution as of 2009*



Source: Wipro 2009, p. 27.

In order to reduce the dependency on the economic development of the USA, especially considering the growing dissent towards outsourcing in the USA, a broader diversification across various country markets is to be recommended.

Questions

1. Apart from the cost advantage, what makes Indian IT companies, and *Wipro* in particular, so attractive as an outsourcing partner for IT services?
2. Imagine you work for an American insurance company that plans to outsource its IT operations. Think of potential problems/challenges that are associated with this decision.
3. How can *Wipro* best respond to the four major challenges mentioned in the case study?

Hints

1. See, for instance, Kapur and Ramamurti 2001, p. 24.
2. See Power, Bonifai and Desouza 2004.
3. See Arora and Athreye 2002.

Chapter 14

International Alliances

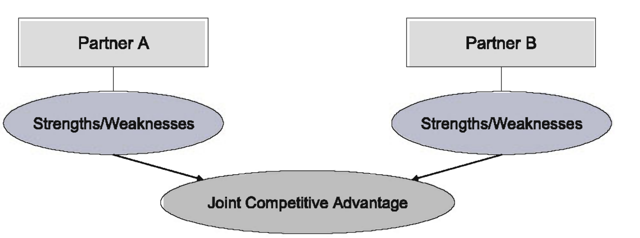
International alliances using cooperative relationships come in all shapes and sizes often under the rubric of strategic alliances. In this Chapter the types of international alliances, the motives and the logic behind such alliances are discussed.

Basic Types of International Alliances

Joint Competitive Advantage

In general, *strategic alliances* or *strategic partnerships* can be defined as "a coalition of two or more organizations to achieve strategically significant goals that are mutually beneficial" (Kotabe/Helsen 2008, p. 305). International alliances or *cross-border alliances* are partnerships of organisations/companies from different countries. By setting up a partnership the companies strive for a *joint competitive advantage*. This joint competitive advantage is based on joining strengths or compensating weaknesses (see Figure 14.1). From the point of view of *new institutional economics*, strategic alliances are positioned between the transactional options market and integration/hierarchy (see Chapter 12 and Chapter 13), or on a scale between externalisation and internalisation.

Strategic Advantages of Alliances — *Figure 14.1*



Strategic alliances lead to a new economic phenomenon: *co-opetition*. Cooperation and competition are no longer considered to be direct opposites. Rivalry, a basic feature of dynamic competition, is considered to be compatible with cooperation in order to achieve a common aim. This tendency also leads to a new perspective or even a new *paradigm* in competition theory and competition strategy. From the perspective of legislation, strategic alliances

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are not only being more tolerated than before but are even actively being encouraged. However, any cooperation that could lead to *collusion*, such as price fixing, is still considered to be a highly sensitive subject.

Critical Mass Alliances and Closing Gap Alliances

Y-Alliances

Critical mass alliances or *Y-Alliances* (Porter/Fuller 1986) achieve a joint competitive advantage by compensating individual weaknesses. The critical mass can be achieved, for example, by bundling the purchasing volume of the partners in a *buying group* or by joint R&D in creating an important innovation, such as in the field of semi-conductors or biotechnology or gene technology. The logic of this type of alliance centres around *economies of scale*.

X-Alliances

Closing gap alliances or *X-Alliances* (Porter/Fuller 1986) are based on combining complementary strengths. They are based on the mutual access to resources and potentials, such as local resources and capital, know-how, technologies, image, etc. To enter a foreign market by establishing a firm (equity joint venture) together with a domestic partner in the target country can be used as an example. The domestic partner knows the local market and has access to distribution channels, while the "entering" partner has, for example, a strong brand and marketing know-how.

Non-contractual Alliances, Contractual Alliances and Equity Alliances

A further distinction involves the formal structure of *cooperative arrangements:*

- non-contractual alliances
- contractual alliances
- equity alliances.

Non-contractual Alliances

Non-contractual alliances are usually formed ad hoc, even if they are planned to continue in the long term. This informal cooperative relationship is used, for example, in joint buying activities, such as in electronic *reverse auctions* on internet platforms (see e.g. Zentes/Morschett/Schramm-Klein 2007, p. 261).

Contractual Alliances

There are numerous forms of contractual alliances, also labeled as *contractual joint ventures*. The most well known, described in this Chapter, are:

- licensing
- franchising
- management contracting.

Equity Alliances

Equity alliances are characterised by the capital investment made by the alliance partners or parental partners. This can be structured in a number of ways. The first is a form of *cross shareholding*, an instrument which is predominantly chosen to stabilise an alliance. In *equity joint ventures* the alliance is institutionalised in a new legally independent unit, in which the alliance partners hold an interest, jointly assuming the risk as well as the responsibility for the management. Equity joint ventures are not necessarily characterised by *equal ownership* (50-50 ownerships). Equity joint ventures will also be described in this Chapter.

Comprehensive and Functional Alliances

Scope of Strategic Alliances

According to the *scope* of strategic alliances comprehensive alliances and functional alliances can be distinguished. Functional alliances are narrow in scope: Only a single function of the business area is involved. This type includes procurement alliances, R&D alliances, production alliances, marketing alliances or financial alliances.

Comprehensive alliances are characterised by a high degree of collaboration. The participating firms perform together all or at least the main activities of the value chain. The alliance *"oneworld"*, described as case study in this Chapter, is an example of this type.

Selected Forms of International Alliances

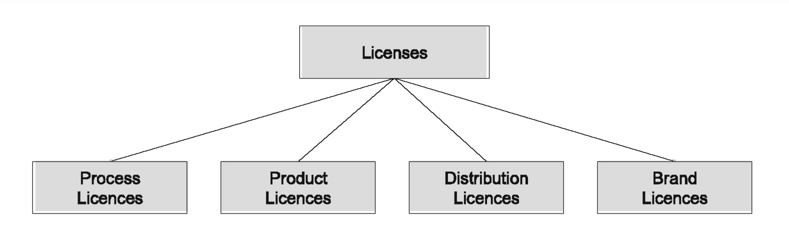
International Licensing

Licensing Agreement

In licensing agreements the *licensor* grants the rights to intellectual property to the *licensee* for a defined period, which pays *royalty fees* in return. The nature of licensing agreements varies depending on the activity of the value chain, e.g. production or distribution/marketing (see e.g. Burr 2005; Hill 2008, pp. 407-408) (see Figure 14.2).

Types of License Agreements

Figure 14.2



In *process licences* the licensor grants the licensee the right to use a specific production technology, often based on a patent, , e.g. in the chemical or pharmaceutical industry. In the case of a *product licence*, the licensor grants the right to manufacture a product or certain products in accordance with specific procedures, processes or formulas. *Contract manufacturing*, a contractual agreement between a company and a foreign producer under which the foreign producer manufactures the company's product (see e.g. Morschett 2005; Phatak/Bhagat/Kashlak 2009, p. 210), is often combined with this type of licensing. In this case the licensee is producing on behalf of the licensor and selling the products to him; the licensee has no *distribution licence*.

Contract Manufacturing

If a *distribution licence* has been granted, the licensee has the right to market the products in a specific territory. In the case of a "simple" distribution licence or a "pure" distribution licence, the licensor remains the manufacturer and therefore the supplier. These kinds of licensing represent a *foreign entry choice*.

Brand Licenses

Brand licences are very important with regard to marketing as they entitle a licensee to use a brand name. A specific shaping of brand licensing is to grant a licensee the right to use a *trademark* for products other than those the licensor is producing. An example of this kind of licensing intellectual property rights is the *American Coty Group*, which sells world-famous perfume brands like *Calvin Klein, Cerruti, Vera Wang, Chloé* and *Lagerfeld* on the basis of brand licences. *Coty* bought the division of luxury perfumes from the Dutch-British *Unilever Group*.

Advantages and disadvantages of licensing in international markets are listed in Table 14.1.

Table 14.1 *Advantages and Disadvantages of Licensing*

Advantages	Disadvantages
• access to difficult markets • low capital risk and low commitment of resources • information on product performance and competitor activities in different markets at little cost • improved delivery and service levels in local markets	• disclosure of accumulated competitive knowledge and experience • creates possible future competitors • lack of control over licensee operations • passive interaction with the market • exclusion of some export markets • organising licensing operations: cost of adaptation, transfer and controlling

Source: Bradley 2005, p. 244.

International Franchising

Franchise Agreements

Franchising is defined as a contractual agreement between two legally and financially separate companies, the franchisor and the franchisee. By franchise agreements the *franchisor* not only grants intangible properties, e.g. a trademark, to the *franchisee*, but it also includes counselling and help in the management of their business. In addition, the franchisees can profit from the experience of all other franchise partners. (see e.g. Zentes/Morschett/Schramm-Klein 2007, pp. 82-84).

Direct Franchising

With regard to international franchising, different options exist (see Zentes/Swoboda/Schramm-Klein 2010, pp. 236-238) (see Figure 14.3). In *direct foreign franchising* the franchisor signs individual contracts with partners in the different countries. In the case of *master franchising* the franchisor signs a *single contract* with the *master* or *general franchisee* in a country-market or in a region, who is allowed to grant franchises (sub-franchise relationships) in that market.

Indirect Franchising

An *indirect franchise structure* is characterised by a wholly-owned subsidiary or an equity joint venture created in a foreign country-market, which operates as a franchisor in this market. In this case, franchising is a mixture of a contractual alliance and an equity alliance or ownership strategy in the foreign market.

Franchisor´s Perspective

From the franchisor's perspective the advantages of franchising in international markets are (Bradley 2005, p. 247):

- rapid expansion over a wider area may be achieved relatively quickly
- low overhead costs
- avoidance of day-to-day business details
- uses the skills of people with local knowledge.

The disadvantages of franchising are from this perspective (Bradley 2005, p. 247):

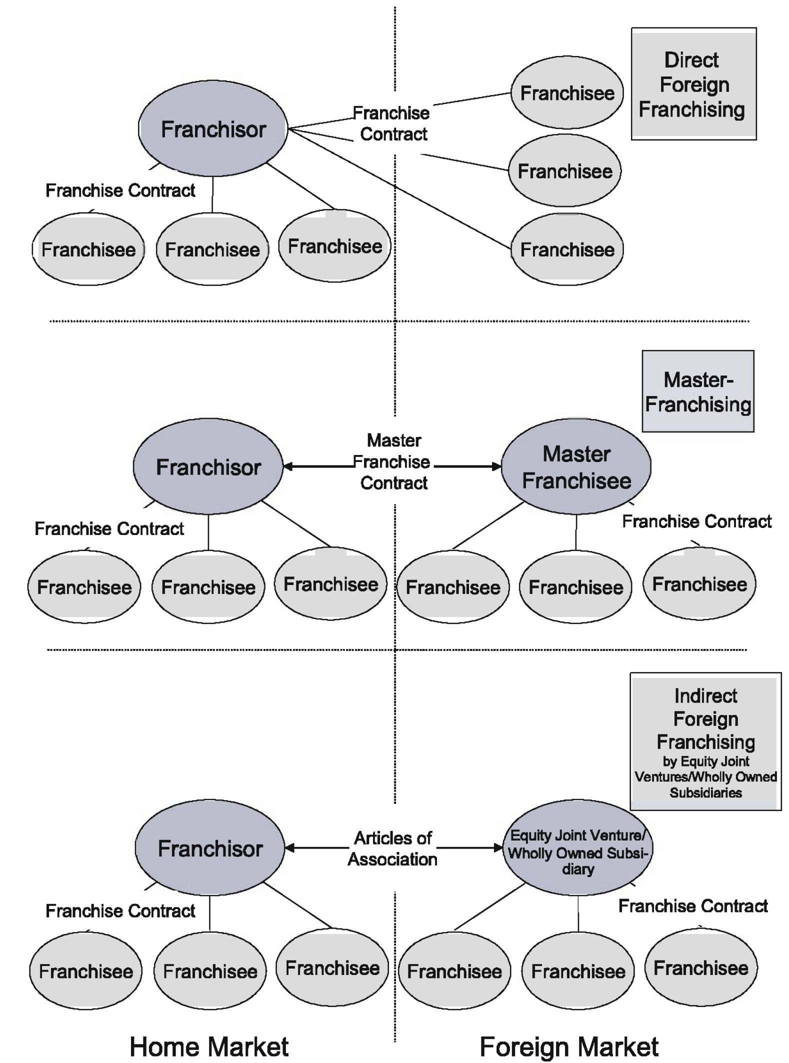
- risk of lowering the quality of a brand name
- absence of direct control over a franchisee's operations
- passive interaction with the market.

Franchisee's Perspective

Advantages from the franchisee's perspective are remaining entrepreneurial independence due to the relation based on *partnership*, the great variety of support activities and frequently the guarantee of *"territorial sovereignty"* with regard to the local market. Therefore, franchising is very attractive for SMEs.

Figure 14.3

Types of International Franchise Agreements



Source: Adapted from Zentes/Swoboda/Schramm-Klein 2010, p. 237.

International Management Contracting

Management Service Contracts

By international management contracts or *management service contracts* a company is allowed to be involved in the management of a firm in a foreign market of which the managing company has no shares (see e.g. Foscht/Podmenik 2005). By such agreements a firm provides managerial expertise and operates the daily business of the second firm for a specified period in return for monetary compensation. The managing firm gets a commission based on the revenues or profits of the managed firm and/or yearly (minimum) lump-sum payments.

In the case of international management contracts there is a clear distinction between the investors or shareholders and the company which is managing the operations, sometimes simultaneously training national managers until they are able to take over. Recent examples of management contracts can be found in industries like hotels (see the case study *"Accor"* in Chapter 12), hospitals, airports, seaports, and public utilities.

Managed Firm's and Managing Firm's Perspectives

International management contracts are a way to attain know-how and/or experience in a new field (Macharzina/Wolf 2008, p. 969) from the point of view of the managed firm. For the managing firm, such a contract serves as a *source of income* on the one hand and as a possibility to scout a new market and to establish the company or its brand in this market on the other hand. This is the case, if the managed firms appear externally as part of the *global chain*, usually under an internationally recognised name.

Figure 14.4 illustrates the structure of the management contract system of the German Fraport AG managing the Cairo International Airport.

Structure of a Management Contract System in the Airport Industry

Figure 14.4

Source: Fraport AG.

International Equity Joint Ventures

The reasons for establishing an equity joint venture with foreign partners, i.e., a firm that is jointly owned by two or more otherwise independent firms, are legislation or the need for the other partner's skills, competences or assets. Governments in some countries, mainly less developed countries, insist on joint ventures with local partners. This policy restricts the *ownership strategy alternatives*. The access to assets, such as capital, of the local partner is another reason for entering into an equity partnership (see, e.g., Voeth/Rabe 2005).

Access to Complementary Resources

"The financial advantages of joint ventures may permit an international enterprise to enter into more foreign projects when its financial resources are limited. In some cases, local partners will accept the technological know-how, patent rights, or even the trade name of the international enterprise as a substitute for capital in payment for a share of the subsidiary's equity. Joint ventures also lessen the risk of foreign exchange losses by reducing the amount of investment at stake" (Robock/Simmonds 1989, p. 216). The main disadvantages of equity joint ventures are potential conflicts in managing the business and transaction costs in coordinating the foreign operations. This situation is typical for equal ownership in contrast to acquiring a majority stake. In summary, the advantages and disadvantages of international equity joint ventures are listed in Table 14.2.

Table 14.2 *Advantages and Disadvantages of Equity Joint Ventures*

Advantages	Disadvantages
◆ reduced investment and reduced risk compared to a solo effort ◆ circumvention of local-content rules and other barriers ◆ access to regional resources ◆ circumvention of rules prohibiting the acquisition of existing companies or the establishment of a new firm in host countries ◆ establishment or modification of market barriers ◆ appearance as a local company ◆ use of aid programmes or subsidies in host countries	◆ high controlling costs ◆ conflicts with regard to marketing strategies or expenditure of profits ◆ cultural differences ◆ loss of influence ◆ slow adaptation of the joint venture to changes in the market, political and legal environment

Source: Adapted from Belew 2000, pp. 256-260; Scherm/Süß 2001, pp. 139-140.

Organisational Structure of Strategic Alliances

A fundamentally different distinction can be made as to how the strategic alliance is organised. Looking at *network management*, one can differentiate between the following organisational models (see Figure 14.5; see also Chapter 1):

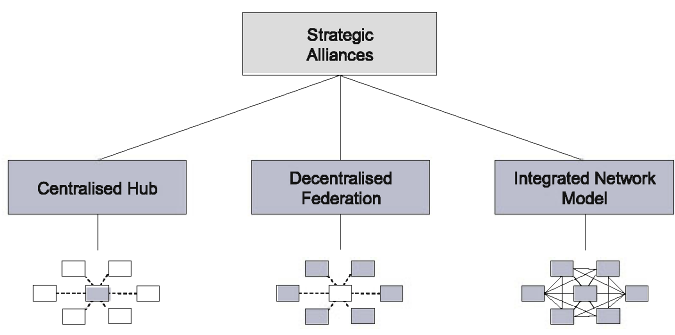
- centralised hub
- decentralised federation
- integrated network model.

Network Topology

The *centralised hub* is characterised by a star formation, with the centre as the hub. This is the case in traditional franchising systems: The franchisor operates as the centralised hub. The *federation* is characterised by a decentralised structure. The federation of largely independent players is coordinated by one organisational unit, which possesses only limited decision-making power. This is the case, for example, in buying and marketing alliances (functional alliances) of just a few, but very large retail companies. The *integrated network model* is characterised by a marked organisational and performance-oriented interdependence (see the case study in this Chapter).

Figure 14.5

Organisational Modes of Alliances



Source: Adapted from Bartlett/Ghoshal/Beamish 2008, pp. 338, 342.

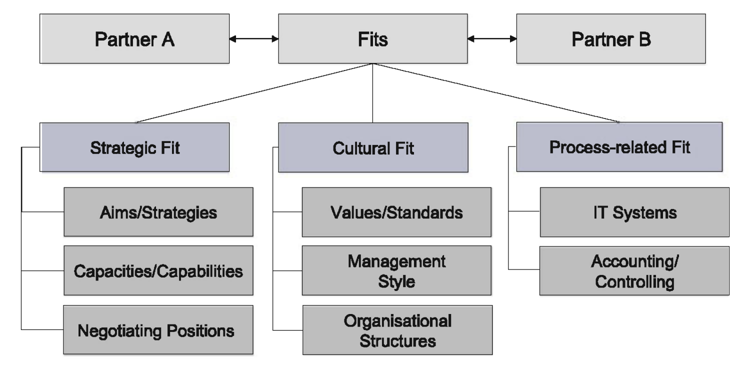
Stability of Strategic Alliances

Fits and Stability

The chances of the establishment of a strategic alliance and the stability of alliances are dependent to a great extent on the *fits* between the partners

(Zentes/Swoboda/Schramm-Klein 2010, pp. 242-243) (see Figure 14.6). These fits can also be used as *guidelines in assessing* potential partners.

Figure 14.6 *Fits in Cooperative Aggreements*



Relational Risks

The *strategic fit* refers to the aims and strategies, capacities/capabilities and negotiating positions of the partners. For example, if a partner does not fully commit himself to the alliance, because the partners do not have similar strategic goals, this lack of commitment may affect the attainment of the objectives of the alliance. Another *relational risk* or reason for the failure of partnerships is cultural divergence. This means that the values and standards, the management styles and the organisational structures must be compatible (*cultural fit* or *cultural proximity*). The process/infrastructure fit *(process-related fit)* refers to correspondence, or at least compatibility, of the technical systems of the organisation, such as of the IT systems, of the accounting/controlling system, etc.

Conclusion and Outlook

Networks of Value Creation

In the national as well as the international context, *networks of value creation* emerge. They represent a new organisational model for complex processes of value creation. A broad and growing variety of forms can be distinguished. Important manifestations of alliances have been discussed in this Chapter.

Besides the multitude of variants that are frequently implemented in a combined manner in companies, another phenomenon can be seen: Strategic alliances are spread to all industries and even to other social sectors. As seen,

management contract systems, which are of great importance in the hotel industry, are transferred in a growing extent to other industries, such as airports, seaports and other infrastructure entities or public utilities.

Social Franchising

Another example is *social franchising*. Social franchising can be defined as the "adapted usage of techniques from commercial franchising for projects which benefit the social aims of the non-profit sector" (German Foundation of World Population 2001, p. 3). The rise in the number of non-profit initiatives using franchising can be attributed "to the increased openness of the third sector to using commercial tools and to acting more entrepreneurially in order to become more effective" (Bundesverband Deutscher Stiftungen 2008, p. 25).

Further Reading

HAMEL, G.; DOZ, Y.; PRAHALAD, C. (2008): Collaborate with Your Competitors – and Win, in: BARTLETT, C.; GHOSHAL, S.; BEAMISH, P. (Eds.): Transnational Management, 5th ed., Boston, MA, McGraw-Hill; pp. 640-647.

OHMAE, K. (1993): The Global Logic and Strategic Alliances, in: Harvard Business Review, Vol. 67, No. 2, pp. 143-154.

SCHULER, R.S.; JACKSON, S.E. (2002): Strategic Human Resource Issues in International Joint Ventures, in: SCHOLZ, C.; ZENTES, J. (Eds.): Strategic Management – A European Approach, Wiesbaden, Gabler, pp. 243-262.

Case Study: oneworld[1]

Profile, History, and Status Quo

oneworld, formed in 1999, is the world's third largest airline alliance, after the *Lufthansa*-dominated *Star Alliance*, and *SkyTeam*, which is centred around *KLM* and *Delta Airlines*. In 2008, about eight million passengers were transferred between *oneworld* member flights, generating about 2,400 million USD in revenues for the member airlines. Of these revenues, 850 million USD were generated by alliance fares and sales (oneworld 2010). Almost two-thirds of the 850 million USD are classified as incremental by the alliance, i.e. revenues its members would not have earned if they were not members of

1 Information used for this case study includes various annual reports, press releases, the web site http//www.oneworld.com as well as explicitly cited sources.

the alliance, thus proving the enormous importance of the membership for the individual carriers.

Formed in February 1999, almost two years after the world's first and largest airline alliance, the *Star Alliance*, the five founding members – *American Airlines*, *British Airways*, *Cathay Pacific*, *Canadian Airlines*, and *Qantas* – started offering *oneworld* services and benefits. Today, there are eleven member airlines as well as roughly 20 affiliated airlines which provide regional services in association with the alliance's members.

The *oneworld* alliance is sometimes described as "two clusters of airlines" (Kleymann/Seristö 2004, p. 24), with one centring around *American Airlines* and the other evolving around *British Airways*. Initially, a very close cooperation on the Northern Atlantic routes between these two carriers had been planned. However, opposition from regulatory authorities, fearing that a monopolistic situation in the large US-UK market might ensue, placed severe limitations on the degree to which the two airlines can cooperate. The latest recruitment of *oneworld* is *Mexicana*, the leading airline in Mexico and Central America, that joined in November 2009. Russia's leading domestic carrier *S7 Airlines* and Indian based *Kingfisher Airlines* are about to further strenghten the alliance in the near future.

oneworld enables its members to offer their customers more services and benefits than any single airline can provide on its own. These include a broader route network, opportunities to earn and redeem frequent flyer miles and points across the combined *oneworld* network and more airport lounges. It is the only airline alliance whose members collectively achieved a profit in their latest full financial years.

In November 2009, *oneworld* was named the world's leading airline alliance for the seventh year running in the *World Travel Awards*, the travel industry's equivalent to the *Academy Awards*. The *World Travel Awards* are based on votes cast by roughly 170,000 travel professionals and agents in 200 countries. *oneworld* has retained the award for leading airline alliance every year since this category was introduced in 2003.

oneworld's Vision

The alliance's vision is to "generate more value for customers, shareholders and employees than any airline can achieve by itself". A specific set of guidelines has been set up by *oneworld* in order to achieve and fulfil this specific vision:

- making travelling smoother and easier and creating better value for customers
- going beyond and offering customers travel solutions that other individual airline networks cannot match

- establishing a mutual commitment that will reassure that high quality standards, service and safety are attained
- making customers feel comfortable while travelling, by creating a home-like environment
- delivering savings and benefits greater than non-allied airline carriers.

The Global Airline Industry

The global airline industry is regarded as being different to other industries in many ways. Over the course of the twentieth century, the airline industry has developed into one of the world's largest industries. While the airline industry in the broader sense consists of two segments, the passenger and the cargo segment, the focus of this case study is solely on passenger transportation. Since the start of commercial aviation, airlines have been a symbol of national pride for countries all over the world, as the fact of having a so-called "flag carrier" which travelled the globe in order to transport its citizens to new countries as well as to bring foreigners into the home country, was seen as a sign of power and economic prosperity. Thus, government-owned or government-controlled corporations usually operated these national carriers.

Deregulation and Liberalisation in the USA and Europe

As a result, the airline industry has traditionally been heavily regulated and government controlled since its beginnings at the start of the twentieth century. In Europe, the governance has been especially evident as the political agenda of the governments controlling or partially owning the airlines has affected the profitability of the industry (Vaara/Kleymann/Seristö 2004). In 1978, the US air traffic was deregulated and liberalised. In Europe, the European Union was the force that deregulated the airline industry in 1993 through the so-called third air traffic package, which aimed to create a market with free competition, free market entry and free pricing. The free market entry together with free pricing meant that the airlines only had themselves to answer to for making their companies profitable (Gustaffson 2005). These new terms of competition were very different and the companies that earlier had strategies focusing on building up national infrastructure and safety had to compete on the same terms as other industries. When the airline business was liberalised in the European Union, no-frills carriers *Ryanair* and *easyJet* quickly became the pioneers for low-cost operations in Europe. They adapted the same system that was already used in the American market by such budget airlines as *Southwest* and *ValuJet*. The business model of these low-cost or no-frills carriers basically consists in offering low travelling fares in exchange for eliminating many passenger services, based on the lowest possible costs.

Rise of No-frills Carriers

Possible Outcome of Greater Liberalisation

Air transport is governed by a 60-year-old system of bilateral air services agreements that limit access to markets and constrain consolidation. Governments determine markets instead of permitting passenger demand to do so, and airlines are not allowed the basic commercial freedoms that other businesses enjoy. It is estimated by many that greater liberalisation would improve industry profitability and bring significant social and economic benefits. For example, in 2006, liberalisation between India and the United Kingdom resulted in weekly flights doubling to 200. All airlines in that market today share the benefits of the newly created opportunities while customers benefit from increased competition and greater choice of flights. The International Air Transport Association (IATA) estimates that the full liberalisation of the airline industry by Chile, Singapore, and the United Arab Emirates (UAE) would result in the addition of approximately 20 million passengers, 200,000 jobs, and 3,600 million USD in GDP growth (IATA 2010, p. 24).

Effects of 9/11 and Rising Oil Prices

Over the last ten years, the industry has changed significantly and beyond the cyclical nature of the air transportation business. Not only did the tragic events of 11 September 2001 result in immediate layoffs and cutbacks of roughly 20 % in total system capacity, but the entire industry is suffering an economic crisis for a number of reasons. Over the past 25 years, for example, the industry has witnessed a reduction of more than 50 % in ticket prices while, at the same time, the airlines' labour costs and fuel prices have increased as kerosene prices, driven by the crude oil costs, have climbed to unseen heights. Today, the airline industry is one of the most competitive industries worldwide. In its long history, the industry has shown proof of the importance of collaboration with different competitors to remain competitive – or simply to avoid elimination (Holmgren/Platt/Svennerholm 2008, p. 9).

Airline Alliances and Networks

History of Airline Alliances

There is a long tradition of cooperation in the airline business. Despite some dispute in the relevant literature, most authors agree that the first step towards alliance in the airline business dates back to the 1930s when *Pan-Am* purchased *Peruvian Airlines* in order to expand its services into Latin America. Ever since the 1960s, airlines have cooperated in order to overcome capital-driven growth obstacles and to realise operative synergies. Another big milestone in terms of airline alliances was reached in 1992 when *Northwest Airlines* and *KLM* jointly launched the world's first open-skies agreement between the USA and the Netherlands. During the 1990s, a number of external factors pressured the airline industry to develop better solutions in order to meet higher demands and expenses, especially from business travellers.

The increased availability and usage of the internet as well as the strong trend towards globalisation also had a large impact on the overall airline industry environment. Under these circumstances, *Air Canada, Lufthansa, SAS, Thai Airways* and *United Airlines* joined forces and created the *Star Alliance* in 1997, which was a revolutionary change for the entire industry. Overall, it can be observed that while cooperation is by no means a new phenomenon, it has in the more recent past changed its focus from being mostly technically oriented (e.g. with maintenance pools between individual airlines) to customer-oriented marketing activities (Kleymann 1999, p. 131).

Driving Forces for Alliance Formation

Four main reasons and strategic factors can be cited which drive alliance formation:

- Need to *gain entry to international markets* which are restricted by bilateral agreements: an alliance allows carriers to serve international markets without actually obtaining the right to do so through country-negotiated bilateral agreements. Accordingly, global airline service networks are likely to be formed by alliance groups of airlines residing in different continents in order to benefit most from the enlarged route network served by becoming an alliance member.
- Wish to *build a global seamless network:* customers prefer airlines with a larger network since they can minimise their travel time, increase the number of online connections, and participate in better frequent flyer programmes.
- *Cost reduction*: joint activities, e.g. in parts pooling or ground handling, help reduce costs or create economies of scale.
- Desire to *maintain market presence* in areas where the specific characteristics and growth potential renders single activities unprofitable (Gudmundsson/Rhoades 2001, p. 210).

Importance of Airline Alliances

Today the economic importance of the alliances is enormous. Members of the three major airline alliances account for roughly 76 % of the global revenue passenger kilometres (RPK), a measure of the volume of passengers carried by an airline. A revenue-passenger kilometre is flown when a revenue passenger is carried one kilometre: revenue passengers include all passengers for whose transportation an airline receives commercial remuneration, i.e., excluding babies and children, as well as passengers travelling under fares available only to airline employees. All 15 of the world's biggest airlines are members of one of the three alliances, proof of the importance of these alliances. Table 14.3 compares the three largest alliances on the basis of some key indicators: *Star Alliance* clearly leads the field by a distinct span, followed by *SkyTeam* and *oneworld*.

Table 14.3 *Overview of Three Major Airline Alliances 2010*

Characteristics	Star Alliance	SkyTeam	oneworld
Number of Member Airlines	27	9	11
Most Important Members	Lufthansa, Air Canada United, ANA, US Airways, Continental, Air China, Singapore Airlines	Air France, Delta, KLM, Alitalia, Korean Air	British Airways, American Airlines, Iberia, Quantas, Finair
Founded	1997	2000	1999
Number of Passengers per Year	624 Mio.	384 Mio.	328 Mio.
Daily Departures	21,050	13,133	8,387
Countries Served	181	169	142
Destinations	1,167	856	727
Employees	404,000	316,445	295,164
Fleet	4,022	1,941	2,280

Source: www.staralliance.com; www.skyteam.com; www.oneworld.com.

Since airlines have traditionally, generated poor financial performance, not least due to government protection and ownership, it has been said that the airline business is not cyclical business, but bad business altogether. In the long run, an average airline loses money. Between 1982 and 2002, airlines belonging to the IATA organisation, representing some 230 airlines and carrying over 90 % of worldwide passenger traffic, generated revenues of two trillion USD and cumulative losses of five billion USD. As a result, airline alliances can also be seen as a response to the risks and uncertainty associated with industry turbulence. That is to say, airline alliances are seen as a means of improving financial performance in times of stiff and hardening competition. Given the downfall in air travel after 11 September 2001, the deregulation of many markets in Asia, Europe and North America, as well as the rapid rise of low-cost carriers, membership in an airline alliance has come to be regarded as a necessity for most well-established airlines (He/Balmer 2006, p. 243).

Strategic Benefits of Alliance Membership

One of the main strategic objectives in joining an airline alliance is achieving cost advantages. Contrary to the manufacturing industry, where cost advantages can be generated via economies of scale, cost potential in the case of the airline industry can be reaped from alliancing in terms of synergies, e.g. through joint fuel procurement or facility sharing. Airline alliances belong to the type of Y-Alliances, or critical mass alliances, where the corporations

engage in similar activities and are therefore potential rivals, as opposed to vertical relationships, or X-Alliances, among complementary buyers and suppliers.

Thus, *oneworld* members experience a typical situation of coopetition within their alliance. On the one hand, they profit from the alliance's advantageous terms with regard to the purchase of aircraft and fuel. On the other hand, they operate in the same business segment of air travel and are therefore rivals. However, compared to the bigger *Star Alliance* and *SkyTeam* (see Table 14.3), *oneworld* is characterised by a limited number of routes operating in direct competition by all its carriers which has lead to a comparatively mild increase in competition (Commerce Germany 2005, p. 10).

Table 14.4 shows the different possible types of joint activities for members of airline alliances. The most common types of activities include code sharing, blockspace and/or feeding agreements, whereas adoption of IT reservation systems and management contracts are used rather infrequently (Gudmundsson/Rhoades 2001, p. 210).

Types of Joint Activities of Airline Alliances

Table 14.4

Type of Activity	Description
Codeshare	one carrier offers service under another carriers' flight designator
Blockspace	one carrier allocates seats on its flights to another carrier to sell
Revenue Sharing	two or more carriers share revenues generated by joint activity
Wet Lease	one carrier rents the aircraft/personnel of another
Computer Reservation System	one carrier shares and/or adopts the internal reservation system of another
Insurance/Parts Pooling	two or more carriers agree to joint purchase
Management Contract	two or more carriers offer combined flight service
Baggage Handling/Maintenance/ Facilities Sharing	one carrier contracts with another to provide services/ personnel/facilities at specified sites
Franchising	one carrier "rents" the brand name of another for the purpose of offering flight service but supplies its own aircraft/staff
Joint Marketing/Common Branding	two or more carriers combine efforts to market joint services/ activities
Equity Swap/Governance	two or more carriers swap stock and/or create joint governance structures

Source: Gudmundsson/Rhoades 2001, p. 210.

oneworld Membership Market Advantages

When *oneworld* was founded, one of the main aims was to profit from different geographical areas in order to better serve the customer. The members wanted to expand and strengthen their international presence in ways that

would be impossible without an alliance. Each company thus compensates for the other's weaknesses in a given territory with the strength of its partners (Czipura/Jolly 2007, p. 61). Apart from this foremost important benefit of expanding seamless service networks, a number of other benefits were realised when the *oneworld* alliance was formed: Service quality could be improved due to an increased flight frequency, more convenient flight schedules and an augmented number of on-line connections could be offered. Also, waiting time for passengers on connecting flights could be minimised due to the higher number of flights offered (Oum/Park/Zhang 2000, p. 14).

Cost Advantages

As for cost sharing ventures, *oneworld* members could realise cost advantages from jointly purchasing equipment and fuel, leading to bulk discounts. Also, the airlines started operating joint transfer centres and help desks as well as maintenance centres which also helped cut costs (Commerce Germany 2005, p. 8).

Marketing Benefits

There are also a number of possible marketing advantages to be gained from membership in an alliance, such as enlarged frequent flyer programmes, where alliance partners cooperate to allow passengers to accrue miles on their home carrier's programmes even though they use a partner's flight and also permit them to use rewards on each other's flights. Although the *oneworld* alliance does not offer its own frequent flyer programme, customers who are members of schemes such as *American Airlines AAdvantage Program, British Airways Executive Club, Cathay Pacific Marco Polo Club, Finnair Plus, JAL Mileage Bank, Iberia Plus, LANPASS, Malév Duna Club, MexicanaGO, Qantas Frequent Flyer* or *Royal Jordanian Royal Plus*, can obtain their miles, rewards and privileges throughout the entire alliance.

Another marketing advantage stems from the multiple display of the same flight on computer reservation systems (CRS) in travel agencies or online booking tools: a codeshared flight is listed twice on the CRS screen since both partners list the same flight as their own. This leads to augmented display of the same offer, increasing the possibility of the flight being booked. In addition to these cost and marketing advantages, benefits result from increased market share and market power, which is why airline alliances such as *oneworld* constantly remain under strict anti-trust observation aimed at preventing cooperative pricing which might lead to disadvantages for the customers (Oum/Park/Zhang 2000, p. 14).

oneworld's Organisational and Management Structure

In order to succeed and be stable over time, a number of requirements and premises have to be met, such as an appropriate organisational structure.

oneworld alliance has opted for the following option: It is completely owned by its member airlines. It was the first of the globally operating airline alliances to establish a central unit responsible for the current and future management of the alliance. Only 15 months after its foundation, the *oneworld Management Company* (oMC) started to work in the newly-established headquarters in Vancouver, Canada, presided over by the Managing Partner. The company is governed by a board comprising the CEOs of each of the *oneworld* member airlines, who meet regularly in order to set strategic direction and goals and to review the achieved progress (oneworld 2010, p. 7). The location of Vancouver was selected because it is convenient to do business with all *oneworld* members during the same working day. Vancouver is convenient as far as the individual *oneworld* carriers are concerned since it is a handy crossover point between North America, Europe, and Asia (oneworld 2010, p. 7).

The alliance members are not as strictly bound by exclusivity stipulations as are members of the *Star Alliance*, for instance. *oneworld's* governance structure can be described as rather democratic and consensus-seeking. Consequently, the role of the central management company in Vancouver is that of a forum for communication and a coordinator for cross-airline working groups which are drawn from executives across all member airlines (Kleymann/Seristö 2004, p. 24). In order to assist the working groups in working across their many different countries and time zones, wide usage is made of technology, e.g. emails, eRooms, or dedicated intranet. For this purpose, the compatibility and correspondence of IT systems between the different airlines is necessary.

Branding and Identity

In international alliances, the question of an adequate brand management is crucial to the alliance's success. In the case of the *oneworld* alliance, ownership of the alliance brand resides with the member airlines themselves rather than with the management company. The size of equity in the brand mirrors the relative size of each carrier. Currently, brand-building activities focus mainly on vision, brand promise, corporate visual identity and corporate advertising. In terms of vision and brand promise, the creation of a clear statement of vision was a key element in the brand-building activities of the brand, addressing the two key stakeholder groups, the customers and member airlines and encapsulating the brand promise in the brand's strapline ("The airline that revolves around you"). *oneworld* has realised the importance of congruency so that service delivery, communications and reputation support and reflect the brand promise. For instance, *Finnair* is seen to contribute to the vision in terms of its Nordic route coverage and good reputa-

tion. On the other hand, *oneworld* has also recognised diversity and the particular strengths of individual airlines in that each member disposes of its own vision contributing to the alliance's vision; in the case of *Finnair,* it is: "Value creation and competitive advantage by being the champion of oneworld's Nordic dimension". As for the corporate visual identity, the creation of a distinctive identity is a prerequisite for a strong corporate brand.

Summary and Outlook

"In no other industry have formal, multilateral alliances been built to such an extent, and with such speed, as in the airline industry" (Kleymann/Seristö 2004, p. 75). During the last two decades, airline alliances have become truly prevalent since they are an attractive substitute for a formal merger or acquisition (He/Balmer 2006, p. 242). It is often estimated that the growth of airline alliances will persist since the "mega carriers" will continue to face severe difficulty in establishing either their own, independent global networks or successful merger and acquisitions (M&As) for a number of reasons. For example, tremendous financial means are required which normally exceed the carrier's means. Also, despite current liberalisation steps, a number of legal, political and institutional constraints on M&As between airlines of different national origin will remain, not least due to pride in national carriers, rendering M&As much more difficult or even impossible. It is probable that the new open skies deals between the European Union and the USA might also affect airline alliances. True open skies could obliterate any remaining protectionist rules altogether and thus render alliances superfluous. However, these changes cannot be expected to take place any time soon due to the extremely high investments which have been made by the airlines. Also, even without any flight restrictions, it is still a lot less expensive to sell tickets on a partner's plane than to operate one's own. Thus, any changes will be of a very slow pace and airline alliances will remain stable at least in the middle or even long term.

oneworld as the smallest of today's three strategic airline alliances has successfully established itself in this very dynamic, ever-changing industry still facing many regulations. In this competitive and changing environment, it is crucial for the alliance to constantly review its partners and carefully check if a joining member fits with the global strategy and network. *oneworld* currently strives to strengthen its network with Shanghai-based carrier *China Eastern* and also discusses membership with *Hainan Airlines*, another important Chinese carrier.

Questions

1. When the first airline alliance, *Star Alliance*, commenced in May 1997, scepticism was high. How do you evaluate the overall success of alliances in the airline industry? What are the main internal and external factors for successfully establishing an airline alliance?

2. Airline alliances can be systemised in terms of their degree of integration. Compare the three major airline alliances by pointing out their regional strengths and weaknesses and also by ranking them according to their degree of integration.

3. Compare strategic alliances in the airline industry to mergers and acquisitions. What are the different types of M&As and how probable do you estimate the emergence of airline M&As in the future?

Hints

1. See e.g. Gudmundsson and Rhoades 2001 for success factors for alliance duration and survival.

2. See the websites of the three major airline alliances to gain an overview of the alliances' respective status quo.

3. See e.g. Kleymann and Seristö 2004, pp. 1-26, for a discussion of M&As in the airline industry.

Chapter 15

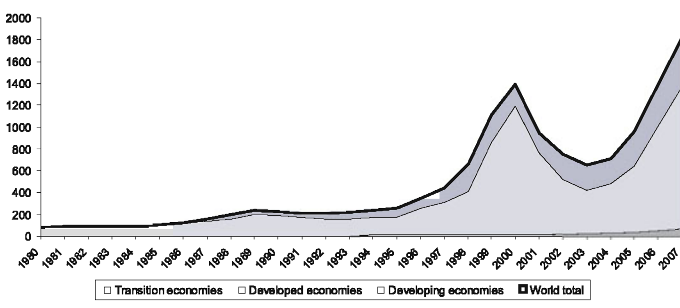
Wholly-owned Subsidiaries, Greenfield Investments, Mergers & Acquisitions

Wholly-owned subsidiaries afford the MNC increased control over its international business operations. The advantages and disadvantages of the main methods for wholly-owned subsidiaries, building new facilities (greenfield investments) and buying existing assets (acquisitions), will be discussed in this Chapter.

Foreign Direct Investment and Wholly-owned Subsidiaries

FDI is an internationalisation strategy that involves the transfer of equity funds to other nations to gain (whole or partial) ownership and control of foreign assets. *Partial ownership* relates to international collaborative ventures, i.e., international joint ventures or international strategic alliances (see Chapter 14). *Wholly-owned subsidiaries*, in contrast, represent full ownership (100 %) and full control over foreign business entities.

Global FDI Inflows (in billion USD) — *Figure 15.1*



Source: UNCTAD 2008.

D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_16,
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International Portfolio Investment

In contrast to FDI, *international portfolio investment* refers to passive ownership of foreign securities such as bonds or stocks. The main purpose of portfolio investment is to generate *financial returns*. In contrast, foreign direct investment seeks control of business units abroad and represents a long-term commitment (Cavusgil/Knight/Riesenberger 2008, p. 424). In order to qualify as FDI, thus, the investment must afford the parent enterprise control over its foreign affiliate. To define *control*, the United Nations uses a benchmark of 10 % or more of the ordinary shares or voting power of an incorporated firm or its equivalent for an unincorporated firm to be defined as FDI (UNCTAD 2008).

Foreign direct investment inflows are very important for the world economy. During recent years, they have continued to rise (see Figure 15.1), thus highlighting the importance of this internationalisation strategy.

Characteristics of Wholly Owned Subsidiaries

This Chapter focuses on wholly-owned subsidiaries as a specific form of FDI. They can be characterised by several key features (Cavusgil/Knight/Riesenberger 2008, pp. 424-425):

- *Greater resource commitment*: Establishing wholly-owned subsidiaries involves the highest commitment in terms of the firm's resources and capabilities.
- *Local presence and operations*: By establishing subsidiaries in the host countries, the MNC chooses to have a local presence and to establish direct contact with local actors such as customers, intermediaries, suppliers, or governmental institutions.
- *Global scale efficiencies*: By launching wholly-owned subsidiaries in different countries, MNCs can enhance their global performance if each location is chosen on the basis of competitive advantages. For example, R&D activities can be located in the most knowledge-intensive countries, or production facilities can be built at locations that provide the best ratio of productivity to labour cost.
- *Substantial risk and uncertainty*: Wholly-owned subsidiaries represent the highest level of risk because this strategy involves substantial local investment in the form of a permanent and fixed presence in the host country and thus exposes the MNC to local risk such as government inventions or inflation. Additionally, it reduces the company's flexibility.
- *Greater importance of cultural or social variables of the host markets*: Because of the high commitment to the host country markets, MNCs must deal more intensively with particular social and cultural variables in order to minimise potential problems.

The main advantages and disadvantages of *wholly-owned subsidiaries* are presented in Table 15.1.

Advantages and Disadvantages of Wholly-owned Subsidiaries

Table 15.1

Advantages	Disadvantages
◆ direct and independent presence ◆ independent marketing activities ◆ pushing of own strategies, easy alignment of own structures ◆ uniformity of market appearance ◆ influence- and supervision options ◆ bundling and deployment of company know-how (supervision of inflow and outflow) ◆ increasing market power towards buyers, suppliers and competitors ◆ frequent settlement sponsorships by host countries	◆ investment requirements and barriers ◆ high risks especially in insecure countries ◆ build up of considerably resources ◆ cost intensive acquisitions and time consuming start up ◆ decision for investment much less reversible than other transaction forms ▪ disadvantages in terms of flexibility because of capital commitment but advantages through decision superiority

Source: Adapted from Kutschker/Schmid 2008, pp. 906-907.

Types of Wholly-owned Subsidiaries

Establishing wholly-owned subsidiaries can be done in several ways. The main modes are *greenfield ventures* and *M&As*. *Greenfield investments* involve the establishment of new facilities in foreign markets, as opposed to *acquisition strategies*, i.e., purchasing existing facilities or existing companies in the host country.

Greenfield Investment

The *greenfield strategy* involves starting operations in the host country "from scratch" (Griffin/Pustay 2010, p. 381). As the word "greenfield" implies, companies typically invest in empty plots of land and *build new facilities* such as production plants, logistics subsidiaries, or other facilities for their own use.

This strategy gives the firm a much greater ability to build the kind of subsidiary company that it needs to pursue its *international strategy* efficiently. Firms can, for example, select the site that best meets their needs and they can construct modern or contemporary facilities (Griffin/Pustay 2010, p. 381). Unlike acquisitions, firms that follow the *greenfield strategy* start their activities in the host country with a clean record and do not need to deal

with existing debts or problems resulting from the past activities of existing firms.

Government Incentives

Often, host countries prefer MNCs to undertake greenfield investments because in many cases they create new jobs, new production capacity, and contribute to enhanced transfer know-how to locals. Many *governments*, therefore, offer *incentives* such as flat tax or construction subsidies to encourage greenfield investments (Cavusgil/Knight/Riesenberger 2008, p. 429).

Tacit Knowledge

Greenfield investments may be also favoured by companies that operate in businesses where transferring competencies, skills, and know-how is difficult and often *tacit knowledge* plays an important role. By establishing new ventures, companies can build an organisation culture from scratch, which is much easier than changing an existing culture of an acquired unit. Also, it is easier to establish processes and procedural methods in a new venture than to convert existing operating routines of acquired units (Hill 2009, p. 505).

However, greenfield ventures are slower to establish. Often, they are more risky because of a higher degree of uncertainty, in terms of future revenue and profit prospects (Hill 2009, p. 506). Other *drawbacks* can be associated with specific types of subsidiaries. For example, when firms establish new production plants, it is important that land in the desired location is available. Additionally, firms must comply with various local regulations, recruit staff from the local workforce and train them to meet the MNCs performance standards (Griffin/Pustay 2010, p. 381). This can be a very *time consuming* process.

Mergers & Acquisitions

Brownfield Strategy

The second strategy to establish wholly-owned subsidiaries is the acquisition of existing facilities or existing firms in the host country. This strategy is also called the "*brownfield strategy*" of international expansion.

Merger

In a *merger*, two (or more) firms join to form a new, larger entity. The corporations combine and share their resources and often the shareholders of the combining firms remain as joint owners of the combined company. In an *acquisition*, the acquired firm becomes a part of the acquirer, in a merger the new entity is formed subsuming the merging firms (Sudarsanam 2003, pp. 2-3).

Horizontal Vertical and Conglomerate M&As

Cross-border M&As can be accomplished relating to different types of industries. In *horizontal M&As*, firms that operate in the same business, firms selling the same products or a similar range of products, are acquired or come together in a merger. These firms share certain commonalities such as inputs, technology, knowledge base, marketing, or sales and distribution. In

a horizontal M&A, the firms operate on the same level of the value chain. In contrast, a *vertical M&A* refers to a combination of firms that produce goods or services that represent the output of successive stages of the same vertical chain, i.e., downstream or upstream activities in the flow of the production and distribution process. These forms of M&As represent a specific type of vertical integration (Sudarsanam 2003, pp. 139-140). In horizontal and vertical M&As, firms are combined that operate in the same industry. *Conglomerate M&As* differ, because the firms that come together operate in unrelated businesses. Conglomerate M&As thus represent the diversification of business activities of the acquiring firm or the merging firms.

M&As may take many forms. Table 15.2 gives an overview of a selection of M&A strategies.

Types of M&A Strategies

Table 15.2

Strategy	Method
Merger of Equals	Companies of equal size come together. Often, one of the merging companies is considered the "primus inter pares" once the merger has taken place.
Friendly Takeover	The management of the takeover target has a positive attitude towards the takeover.
Tender Offer	Public, open offer by an acquirer to all shareholders. The bidder contacts the shareholders directly, inviting them to sell their shares to the offer price.
Unfriendly/Hostile Takeover	The takeover target is unwilling to be acquired or the target's management has no prior knowledge of the offer.
Proxy Contest	Specific type of a hostile takeover in which the acquiring company attempts to convince the existing shareholders to use their proxy votes to install a new management that is open for the takeover.
Builder Acquisition	The objective of the acquisition is to integrate the takeover target into the network of the MNC, e.g. to realise synergies, economies of scale, etc.
Raider Acquisition	Acquisitions that are conducted with the purpose of post-acquisition asset stripping.
Leveraged Buyout (LBO)	Acquisition of a company with cash that is raised with a preponderance of debt raised by the acquirer. Several different types of LBO exist, depending on the acquiring party, for example investor buyout, management buyout, or employee buyout can be distinguished.

Empirically, cross-border M&As can be regarded as the most relevant strategy. The growth in *FDI flows* is strongly driven by cross-border M&As. In 2007, 89.3 % of the world's FDI inflows constituted of cross-border M&As, accounting for a transaction value of 1.6 trillion USD (UNCTAD 2008).

While only a small percentage of the number of M&A deals were so-called *mega-deals*, with a transaction value of more than one billion USD, this small number of mega-deals accounted for 70.9 % of the overall value of M&As that were accomplished as the worldwide total in 2007 (see Table 15.3).

Table 15.3 *Cross-border M&As Valued at over 1 Billion USD*

Year	Number of Deals	Percentage of Total	Value (in billion USD)	Percentage of Total
1987	19	1.6	39.1	40.1
1988	24	1.3	53.2	38.7
1989	31	1.1	68.2	40.8
1990	48	1.4	83.7	41.7
1991	13	0.3	31.5	27.0
1992	12	0.3	23.8	21.0
1993	18	0.5	37.7	30.5
1994	36	0.8	72.6	42.5
1995	44	0.8	97.1	41.9
1996	48	0.8	100.2	37.9
1997	73	1.1	146.2	39.4
1998	111	1.4	408.8	59.0
1999	137	1.5	578.4	64.0
2000	207	2.1	999.0	74.0
2001	137	1.7	451.0	61.7
2002	105	1.6	265.7	55.0
2003	78	1.2	184.2	44.8
2004	111	1.5	291.3	51.5
2005	182	2.1	569.4	61.3
2006	215	2.4	711.2	63.6
2007	300	3.0	1,161	70.9

Source: UNCTAD 2008.

Motives and Barriers of Cross-border M&A

M&As often take place in industries that are in the mature or declining stages of the product life cycle. These industries are characterised by low overall growth, excess capacity and a small number of large competitors. The main *motives* for cross-border M&As are revenue enhancement and cost savings (Sudarsanam 2003, pp. 100-112):

- *Revenue enhancement*: (Horizontal) M&As lead to an increase in market share of the merging firms, conferring enhanced market power. Additionally, the merging firms may be able to exploit each other's marketing resources such as brands or general marketing expertise. The distribution channels established by each firm in the diverse countries may be used to sell the joint firm's products and thus, global presence of the new entity can be created expeditiously.
- *Cost savings*: A consolidating M&A is associated with opportunities for scale, scope and learning economies in various functional activities such as production, marketing, distribution, logistics, or R&D. However, the merging firms or the acquirer also may rationalise production and take

out excess capacity of the new entity or in the network of the MNC. Additionally, redundancies in other functions such as marketing or distribution may be reduced and by this, fixed costs of the joint entity can be reduced.

Nevertheless, cross-border M&As face a variety of *obstacles*. In the diverse economic and legal frameworks of countries, many barriers exist that may complicate M&A and hinder the attainment of the objectives. The main *barriers* to M&A in different countries are described in Table 15.4.

Barriers to Cross-border M&A — *Table 15.4*

Structural Barriers	
Statutory	• strong powers for supervisory boards to block mergers; unions and workers' councils have say on takeovers and strong redundancy rights • issue of bearer shares, double voting or non-voting shares; absence of one share, one vote (OSOV) principle • discriminatory tax laws against foreign acquirers, e.g. withholding taxes on dividends
Regulatory	• antitrust regulation, foreign investment review, rules of stock exchange and professional self-regulatory bodies • absence of statutory or voluntary bodies to regulate takeovers
Infrastructure	• absence of M&A services, e.g. legal, accounting, investment banking services
Technical Barriers	
Management	• two-tier boards which cannot be removed or changed quickly • families dominate shareholding • powers to issue shares with differential voting rights or to friendly persons • powers to limit maximum voting rights; powers to override shareholders in company's interest
Information Barriers	
Accounting	• accounting statements not available, quality of information poor • low compliance with international generally accepted accounting principles; accounting practice biased to avoid tax liability, or conservative, hence accounting statements opaque
Shareholders	• due to issue of bearer shares, shareholding structure not known
Regulation	• regulatory procedures not known or unpredictable
Culture and Tradition	
Attitude	• 'to sell is to admit failure' syndrome; dislike of hostile bids; dislike of institutional constraints on dividends or short-term profits • unwillingness to disclose information
Value system	• high premium on trust and confidence in negotiations rather than formal contracts

Source: Adapted from Sudarsanam 2003, p. 205.

Advantages and Disadvantages of Mergers & Acquisitions

The high relevance of cross-border M&As is a result of the main advantages that are associated with this strategy. By acquiring existing ventures or merging with partner firms, the company can obtain *quick access* to new markets and rapidly build their presence in the host country. In acquisitions, for example, the acquiring firm can use this strategy to build a sizable presence in the target market rapidly because it gains control over the acquired

firm's facilities, its employees, technology, brands, or distribution networks. In this connection, it is important to notice that M&As add no new capacity to the industry. This is an obvious benefit in mature markets or if markets are characterised by *overcapacity* (Griffin/Pustay 2010, p. 381).

Entering foreign markets via M&A also can be a strategy to *pre-empt* a MNC's *competitors*. This is of major importance in highly globalised industries with intense competition (Cavusgil/Knight/Riesenberger 2008, p. 429). Cross-border M&As in this context can be used to obtain global scale rapidly and to improve *competitive strength* compared with the MNC's global competitors (Hill 2009, p. 503).

Even though *acquisition strategies* are associated with high sums that have to be paid to acquire the takeover candidate usually shortly after the deal is closed, acquisition strategies are often regarded as less risky than *greenfield investments*. The main argument is that the acquisition provides the MNC with an immediate stream of revenue and profits. Additionally, the firm acquires a set of tangible assets (e.g. factories, logistics systems) and intangible assets (e.g. local brands, local management know-how) that can reduce the risk of *mistakes or failure* in foreign markets (Hill 2009, pp. 503-504). In *mergers*, the companies pool tangible and intangible resources and capabilities of the partner firms in the new entity. This is associated with scale and scope economies and particularly if these resources are complementary, the competitive advantage of the new venture may be enhanced.

Hidden Liabilities

However, cross-border M&As are associated with several disadvantages and often produce disappointing results. One of the main reasons for failures or problems in international acquisitions results from the fact that the acquiring firm purchases not only all valuable assets of the acquisition candidate, but it is also confronted with all the *liabilities* (e.g. managerial or financial liabilities) of the acquired firm. Often, the MNC cannot assume all the liabilities and buys "a pig in a poke". The acquired firm may, for example, reveal *hidden liabilities* such as poor labour relations or unfunded financial obligations once the acquisition process is finished (Griffin/Pustay 2010, p. 382). In this connection, another problem in acquisition strategies relates to the calculation of an adequate price for the takeover candidate. For the acquiring firms it is difficult to estimate the appropriate takeover sum and often, acquiring firms *overpay* for the assets of the firm acquired. This is often the case if more than one firm bids for the target firm (Hill 2009, p. 504).

Table 15.5

Advantages and Disadvantages of Cross-border M&As

Advantages	Disadvantages
◆ access to customers, distribution channels, materials, HR ◆ rapid market development ▪ time savings/synergy effects ▪ if applicable fast market entry in numerous geographic regions ▪ positive cash-flow ◆ scale effects ◆ gain of know-how ▪ complementary effects ◆ gain of market position/image ◆ fastest mode of diversification ◆ no increasing competition intensity in host ◆ country ▪ little danger of overcapacity	◆ massive risk ◆ huge capital availability as requirement ▪ best case scenario: financial markets as balancing instrument ▪ in reality: limited range of alternatives for SME ◆ high information and search costs ▪ adequate target company as basic requirement ▪ negotiation problem (Information asymmetries) ◆ necessity of coordination and integration of heterogeneous structures, systems, cultures ◆ adaptation of market appearance required ◆ provisos/resistances of local management ▪ possibly brain drain ◆ provisos/resistances of host country government (foreign infiltration) ◆ growing management complexity

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 658.

The main general advantages and disadvantages that are associated with cross-border M&As are summarised in Table 15.5. The disadvantages of M&As frequently lead to *integration failures*. Especially in cross-border M&As, empirical evidence shows that in many M&A transactions the companies are not able to achieve the expected outcomes, e.g. in terms of scale economies, market performance or synergy effects (see Table 15.6).

Table 15.6

Causes of Failure and Success in Cross-border M&As

Cause of Failure	Cause of Success
◆ target management attitudes	◆ detailed post-acquisition integration plans
◆ cultural differences	◆ speed of implementation
◆ no post-acquisition integration planning	◆ clarity of acquisition purpose
◆ lack of knowledge of industry or target	◆ good cultural fit
◆ poor management of target	◆ high degree of target management cooperation
◆ no prior acquisition experience	◆ knowledge of target and its industry

Source: Adapted from Sudarsanam 2003, p. 545.

Conclusion and Outlook

Foreign direct investment can be regarded as a hierarchical mode of international market entry. The establishment of wholly-owned subsidiaries, either by greenfield operations or by cross-border M&As, represents an *internalisation* strategy.

Despite high investment cost and a time-consuming process of entry into new markets, the main advantage of *greenfield investments* is that companies are able to establish *"optimal" facilities* that fit with the interests of the firm. Greenfield strategies offer the possibility to integrate *state-of-the art* technology (e.g. production facilities) and thus can result in increased operation efficiency.

Post-merger Integration

Cross-border M&As also represent entry strategies that are usually associated with high investment cost. Additionally, they are characterised by high *cost of integration* of the diverse companies with diverse organisational (and national) cultures. While M&As provide opportunities for *rapid entry* into new markets and quick access to distribution channels, existing management experience, local knowledge, contacts with local markets, suppliers and governments and established brand names or company reputation, there also are high risks. For example, taking over companies that are regarded as a *country's heritage* can raise national resentments in the host country. Also, a lack of integration with existing operations of the acquiring company or between the merging firms as well as *communication* problems between the companies can produce unfavourable outcomes (Hollensen 2007, p. 368).

Further Reading

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Case Study: Nestlé[1]

Profile

Nestlé, the world's leading nutrition, health and wellness company (see key figures in Table 15.7), was founded in 1866 by Henri Nestlé, a trained pharmacist. The headquarters are located in Vevey, Switzerland. Today *Nestlé* employs approximately 278,000 people and runs 449 factories or operations in 83 countries with about 8,000 brands worldwide. It is often referred to as "the most multinational of the multinationals".

Key Figures of Nestlé in 2009

Table 15.7

	2009 (in CHF)
Sales	107,618 million
Earnings Before Interest, Taxes, Restructuring and Impairments (EBIT)	15,699 million
Net Profit	10,428 million
Capital Expenditure	4,641 million
Market Capitalisation, end December	174,294 million
Basic Earnings per Share	2.92

Source: Adapted from Nestlé 2010, p. 17.

Nestlé's product and brand portfolio is characterised by strong market positions, often leadership. It can be considered focused as well as diverse. Focused in that 75 % of sales are accounted for by about 30 brands, diverse in that the company covers a good spread of categories. .Major brands that recorded especially strong increases in 2009 were *Nespresso, Nestlé Pure Life, Galderama and DogChow.*

Major Markets

Although most of the factories of *Nestlé* are located in Europe, the American market is the key market concerning employees and sales. Sales, even in 2009, haven been increasing in most major markets, with the strongest boosts having been achieved in Brazil and in China (see Table 15.8). Nevertheless, the USA is still by far the biggest sales market for *Nestlé* among the principal markets.

[1] Sources used for this case study include the web sites www.nestle.com, www.emaxhealth.com, www.nestlenutrition.com, www.alacrastore.com, www.ny times.com as well as explicitly cited sources.

Table 15.8 *Sales of Nestlé in 2009*

By Principal Market	Differences 2008/2009 in % (in local currency)	2009 (in million CHF)
United States	+2.7%	30,698
France	-1.1%	8,055
Germany	-6.4%	5,805
Brazil	+10.5%	5,787
Italy	-8.1%	3,886
United Kingdom	+6.0%	3,730
Mexico	+6.2%	3,121
Spain	-3.6%	2,789
Greater China Region	+10.7%	2,514
Japan	0.0%	2,465
Switzerland	-1.0%	2,046
Other Markets		36,722

Source: Nestlé 2010.

Table 15.9 *Major Brands of Nestlé in 2010*

	Main Brands
Coffee	Nescafé, Nespresso, Taster´s Choice, Ricoré, Ricoffy, Bonka, Zoégas, Loumidis
Water	Poland Spring, Nestlé Pure Life, Arrowhead, Vittel, Deer Park, Levissima, Perrier, S. Pellegrino, Ozarka, Contrex, Ice Mountain, Zephyrhills, Nestlé Aquarel, Hépar, Acqua Panna
Other Beverages	Nestea, Nesquik, Nescau, Milo, Carnation, Libby´s, Caro, Nestomalt, Nestlé
Dairy – Shelf Stable	Nestlé, Nido, Nespray, Ninho, Carnation, Milkmaid, La Lechera, Moça, Klim, Gloria, Svelty, Molico, Nestlé Omega Plus, Bear Brand, Coffee-Mate
Dairy – Chilled	Nestlé, Sveltesse, La Laitière, La Lechera, Ski, Yoco, Svelty, Molico, LC1, Chiquitin
Ice Cream	Nestlé, Antica Gelateria del Corso, Dreyer's/Edy's, Drumstick/Extrême, Maxibon/Tandem, Mega, Mövenpick, Sin Parar/Sem Parar/Non Stop, Delta
Infant Nutrition	Nestlé, Nan, Lactogen, Beba, Nestogen, Cerelac, Nestum, Neslac, Guigoz, Good Start
Performance Nutrition	PowerBar, Pria, Musashi
Healthcare Nutrition	Nutren, Clinutren, Peptamen, Modulen
Bouillons, Soups, Seasonings, Pasta, Sauces	Maggi, Buitoni, Thomy, Winiary,Torchin, Osem, Totole, Haoji
Frozen Foods	Stouffer's, Lean Cuisine, Hot Pockets, Buitoni, Maggi, Wagner, La Cocinera
Refrigated Foods	Nestlé, Buitoni, Herta, Toll House, Sabra
Chocolate, Confectionery and Biscuits	Nestlé, Crunch, Cailler, Galak/Milkybar, Kit Kat, Smarties, Butterfinger, Aero, Polo
Nestlé Professional	Chef, Davigel, Minor's
Petcare	Purina, Friskies, Fancy Feast, Alpo, Gourmet, Mon Petit, Felix, Dog Chow, Cat Chow, Pro Plan, Purina ONE, Beneful, Tidy Cats

Source: www.nestle.com.

Fundamental Principles of Nestlé's Strategy

Nestlé's strategy is guided by several fundamental principles. The existing products shall grow through innovation und renovation while a balance in geographic activities and product lines is maintained. Its concept is clear:

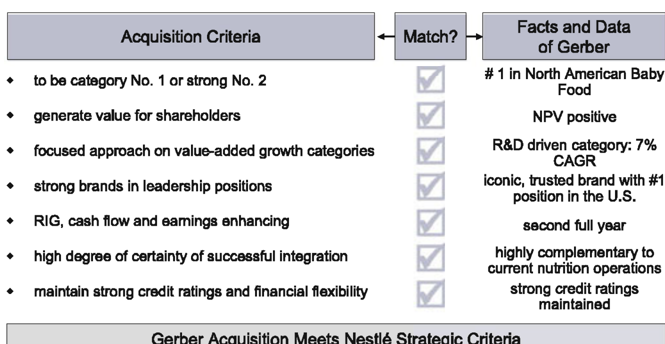
Nestlé uses acquisitions as a form of external growth to strengthen its organic growth. Due to these activities *Nestlé* has acquired multiple companies, merged with others and made several greenfield investments since its foundation, which have led to its wide diversity of brands (see Table 15.9). As a result, *Nestlé* has many subsidiaries and joint ventures all over the world. Interestingly, *Nestlé* kept the brand names of the acquired companies. Thus, the customers still affiliate the name with the original product and quality.

Pillars of Nestlé's Acquisition Strategy

Regarding *Nestlé's* acquisition strategy, it follows seven criteria. The acquisition must allow *Nestlé* to create the No. 1, or a strong No. 2, position in a given category. It has to generate value for the shareholders by quantifiable and measurable synergies and must focus on value-added categories. The existing brands have to be in leadership positions. In addition, the organic growth, cash flow and earnings must increase or at least have potential for improvement. *Nestlé* insists on a high degree of certainty of successful integration, which includes business fit, management commitment, existing know-how and organisation culture. The last criterion is that the acquired company has to maintain credit ratings and financial flexibility. *Nestlé* consequently walks away from a takeover if any of these criteria is not fulfilled. Figure 15.2 presents an example of a completed criteria list, using the acquisition of *Gerber*.

Exemplary Application of Nestlé Acquisition Criteria

Figure 15.2



Source: Nestlé 2007.

History of the Expansion

Origin

The success of the *Nestlé Company* began in 1867 when the pharmacist Henri Nestlé developed the world's first infant food, the so-called *Farine Lactée Henri Nestlé* which had great success. In the following years, *Nestlé* remained a fierce competitor of the *Anglo-Swiss Condensed Milk-Company* in the infant food sector. The two companies merged in 1905 to form *Nestlé and Anglo-Swiss Milk Company* and *Nestlé* also merged with the *Swiss General Chocolate Company* (1904), which implied a diversification of the assortment by adding chocolate to the product portfolio.

Internationalisation

Nestlé started its international activities by M&As in its early years. As a result, it was running companies in the USA, the United Kingdom, Germany, Spain and Canada by the beginning of the twentieth century. In 1907, the company began to manufacture intensively in Australia. Additionally, it invested in warehouses in Singapore, Hong Kong and Bombay to supply the growing Asian markets.

Although World War I brought grievous disruptions, *Nestlé* used the new demand for dairy products and purchased about 40 existing factories in the USA. In addition, the company bought its first Canadian milk plant in Chesterville, Ontario, where it began to operate in 1918 as *The Maple Leaf Condensed Milk Company*. In the 1920s, the production of chocolate became the company's second most important activity and *Peter-Cailler-Kohler*, the world's leading chocolate company, merged with the expanding *Nestlé Company*. With the invention of the coffee powder *Nescafé* (1938), *Nestlé* reacted to the request of the *Brazilian Coffee Institute* to develop new products to reduce Brazil's large surplus of coffee beans. Ten years later it was followed by *Nestea* and *Nesquick*.

World War II led to sharply decreasing profits and to organisational as well as logistical problems. As a result, factories were established in developing countries, particularly in Latin America. On the other hand, the success of Nescafé as a favourite beverage of American servicemen caused *Nestlé's* total sales jump to 225 million USD in 1945, which made *Nestlé* a worldwide coffee concern.

Diversification of Assortment

The period from 1944 to 1975 was characterised by the diversification of the *Nestlé* assortment. It was the most dynamic phase in *Nestlé's* history. In 1947 it merged with the Swiss manufacturer of *Maggi seasonings and soups*, *Alimentana S.A.*, becoming *Nestlé Alimentana Company*. Three years later, *Nestlé* acquired *Crosse & Blackwell*, the British manufacturer of preserves and canned foods. Additionally, it purchased *Findus Frozen Foods* (United Kingdom) in 1963, 30% of *Vittel* (France) in 1969 (*Nestlé* took nearly full control in 1992), *Libby's Fruit Juices* (USA) in 1971 and *Stouffer's Frozen Foods* (USA) in 1973. Furthermore, *Nestlé* merged with *Ursina-Franck* (Germany, in 1971) and

diversified its assortment finally by becoming a major shareholder of one of the world's leading producers of cosmetics, *L'Oréal* (France, in 1974).

From 1975 to 1977 the price of coffee beans quadrupled and the price of cocoa tripled. These new circumstances caused *Nestlé* to respond to the radically changed marketplace. Therefore, *Nestlé* again leapt into unknown waters by acquiring *Alcon Laboratories, Inc.*, a US producer of pharmaceutical and ophthalmic products. In addition, due to its product enlargement, *Nestlé* came up with a new company name, *Nestlé*, in 1977.

Strategic Refocusing

In order to improve its financial situation, *Nestlé* divested a number of non-strategic or unprofitable businesses between 1980 and 1984, while, on the other hand, the company tried to continue its policy of strategic acquisitions. In this context, the takeover of the American food giant *Carnation*, one of the largest takeovers in the history of the food industry, and the acquisition of *Hills Brothers Inc.*, the third largest US coffee firm, were sealed in 1985. In 1988 *Nestlé* also acquired *Rowntree Mackintosh PLC* (United Kingdom), *Sunmark* (USA) and the *Buitoni-Perugina Company* (Italy).

Ongoing Acquisitions

The 1990s were successful years for *Nestlé*, acquiring numerous companies and creating *Nestlé Sources International* in 1993 (2002: *Nestlé Waters*) as well as the *Nutrition Strategic Business Division* in 1997 (2006: *Nestlé Nutrition*). *Nestlé* acquired *Alco Drumstick* (USA, 1991), *Perrier* (France, 1992), *Alpo pet food* (USA, 1994), *San Pellegrino* (Italy, 1997) and *Spillers Pet Foods Company* (UK, 1998) which enabled *Nestlé* to expand its position in Northern Europe and the UK, amongst others (Pfiffner/Renk 2005). Especially in the ice cream sector, *Nestlé* purchased the market leaders, for instance, in Egypt and Spain, as well as brands in Italy, the Philippines, Australia and South Africa. In 1997 *Nestlé* entered the Canadian ice cream market with the purchase of *Ault* and *Dairy World*, giving the company a 40% market share. Additionally, *Nestlé* entered joint ventures with *General Mills* (USA) and *Coca-Cola* (USA). The 1990s saw the divestment of the Swedish *Findus* brand (1999) as well as the purchase of 97% of *Intercsokolàdé*, a Hungarian chocolate maker, which marked *Nestlé's* first venture into the newly opened markets in Eastern Europe.

GLOBE Initiative

In July 2000, *Nestlé* set up a group-wide initiative called *GLOBE (Global Business Excellence)*, aimed at harmonising and simplifying business process architecture. It enabled *Nestlé* to realise the advantages of being a global leader. In the same year, *Nestlé* acquired *PowerBar, Inc.*, the leading US manufacturer of energy and nutrition bars, followed by the takeover of *Ralston Purina* (USA: today *Nestlé Purina Pet Care*) in 2001 as well as the *Schöller Holding Group* (Germany) and *Chef America, Inc.* in 2002. The *Schöller* acquisition enabled *Nestlé* to strengthen its position in the German market (strong No.2) and to obtain access to the Northern and Central European market.

Chef America in contrast was the instigator in the new frozen sandwiches category, securing *Nestlé* the first mover advantage in a growing, on-trend market (Pfiffner/Renk 2005). Besides, *Nestlé* entered into a long-term trademark/technology licensing agreement with the *Pillsbury Group* for the use of the *Haagen-Dazs* brand in North America and started joint ventures with *Fonterra* (*Dairy Partners Americas*) and *L´Oréal* (*Laboratoires innéov*).

Between 2000 and 2003, *Nestlé* once again divested several companies because they were unprofitable or did not form part of the company's core business. Nevertheless, the year 2003 started with the acquisition of *Mövenpick Ice Cream* (Switzerland) and *Dreyer's Grand Ice Cream, Inc.* (USA), enhancing *Nestlé's* position as one of the world market leaders in this product category. *Valio*, a Finish ice cream company was purchased one year later. In 2005 it acquired the German frozen food company *Wagner* as well as the nutrition companies *Protéika* (France) and *Musashi* (Australia).

Jenny Craig, the USA weight management company, and *Uncle Toby's* (Australia) as well as *Delta Ice Cream* (USA) were acquired in 2006. With the first two acquisitions, *Nestlé* created a *FoodServices Strategic Business Division*. The year 2007 was also characterised by three significant acquisitions. The first milestone in 2007 was the acquisition of *Novartis Medical Nutrition* (Switzerland) which guaranteed *Nestlé* a No. 2 position globally for healthcare nutrition. *Gerber*, the iconic US baby food brand which secured *Nestlé* the No. 1 position in the largest single baby food market worldwide (USA), was the second while the Swiss water company, *Sources Minérales Henniez S.A.*, was the third. The end of 2007 was marked by a strategic partnership with the Brussels-based luxury chocolate maker *Pierre Marcolini*. The move underlines *Nestlé's* promise to outclass the competition in the premium and luxury chocolate market.

Recent Acquisitions

Since 2000, *Nestlé* has become the leader of the food industry globally, with sales of more than 107 billion CHF in 2009. In 2009, 10 factories were acquired or opened and 16 were closed or divested, whereas one factory was converted into a distribution centre. In total, *Nestlé* has made 185 acquisitions and 211 divestures since 1985. Furthermore, it has bouth stakes in 83 companies (see Table 15.10 for a summary of M&As by *Nestlé*).

Two exemplary acquisitions are described in detail in the following section. Out of the numerous acquisitions made by *Nestlé,* the acquisition of *Ault Foods Ltd.* and *Wagner Tiefkühlprodukte GmbH* are presented because they illustrate the characteristic strategy of *Nestlé* to move into new markets. The aim of the acquisition of *Ault Foods* was to enter the Canadian ice cream and frozen novelty sector, while the partial takeover of *Wagner* was aimed at entering the German frozen products market.

Summary of Nestlé's M&A's from 1985 until 2009

Table 15.9

Year	Acquisitions	Stakes	Divestitures	Year	Acquisitions	Stakes	Divestitures
2009	9	3	6	1996	4	8	13
2008	4	0	11	1995	12	7	6
2007	8	0	10	1994	5	9	9
2006	2	1	6	1993	11	4	12
2005	5	1	5	1992	14	6	11
2004	5	1	7	1991	8	2	7
2003	12	3	18	1990	6	0	6
2002	9	5	14	1989	4	3	4
2001	8	10	12	1988	6	2	6
2000	13	7	12	1987	4	0	4
1999	4	3	9	1986	6	2	3
1998	12	3	9	1985	5	0	5
1997	9	3	6	Total	185	83	211

Source: www.alacra.com.

Acquisition of Ault Foods Ltd. in 1997

Ault Foods Limited ("*Ault*") which markets an extensive range of dairy products and operates plants in Ontario and Quebec is a leading Canadian food processing company. It is one of the few dairy processors in the world with a major R&D capability. Its product innovations include a dairy-fat replacement system, Olivina margarine, Cheestrings and Lactantia PurFiltre milk.

In addition to producing its own brands, *Ault* also manufactures *Laura Secord Ice Cream* and has licence agreements with *Nestlé Drumstick, Haagen-Dazs* and *Sealtest Parlour*.

On 2 January 1997, the sale of the Frozen Products Division of *Ault* to *Nestlé* for 221 million USD came into effect. The acquisition demonstrates *Nestlé's* strategy of purchasing companies to gain entry to new international markets. On the one hand, *Nestlé* uses takeovers to broaden its product portfolio, but on the other hand it is trying to buy market leaders or strong brands to push into international markets and maintain itself as a global player.

Ault stated that the acquired division represented less than 15% of the company's sales and profit. With this transaction, *Nestlé* acquired *Ault's* ice cream and frozen novelty plant in London, Ontario, as well as important frozen product trademarks, several warehouses and distribution centres. In addition, this transaction included long-term supply and co-pack agreements. Effective with the completion of this agreement, *Ault's* employees in the Frozen Products Division became employees of *Nestlé*.

Win-Win Situation

The deal delivered benefits for both sides. Graham Freeman, President and CEO of *Ault*, stated that the Frozen Products Division had more value to *Nestlé* because of its worldwide leadership in ice cream and frozen novelties. Additionally, the sale allowed *Ault* to focus all its attention to its ongoing core businesses. *Nestlé* in contrast established its market entry in the Canadian ice cream and frozen novelty sector by this purchase, hence becoming the market leader. According to Frank Cella, former Chairman and CEO of *Nestlé Canada*, this operation was therefore consistent with *Nestlé's* worldwide strategy of increasing its global ice cream business.

Acquisition of Wagner Tiefkühlprodukte GmbH in 2005

Major Player in Frozen Food

Wagner Tiefkühlprodukte GmbH, based in Braunshausen, Germany, is one of the biggest frozen foods companies in Europe. The assortment of this family-owned company comprises the well-known "Stone Oven Pizza", premium products such as "La Pizza Rusticale", a range of organic pizzas called "Unsere Natur" and "NaturLust" and deep-frozen snack products, "Piccolinis" for instance, which is the second best-selling frozen food product in Germany. With a market share of approximately 33 % and a turnover of around 200 million EUR, *Wagner* is a strong No. 2 in the growing German frozen pizza market (with average growth rates of about 8 %).

Wagner's innovations, consistent quality and brand strategy gained high market acceptance, not only in Germany but in several Western European countries such as Austria (with a market share of approximately 25 %).

*Nestlé*acquired 49 % of *Wagner* in 2005. The acquisition once again shows *Nestlé's* internalisation strategy. By purchasing 49 % of *Wagner*, *Nestlé* made inroads into the German frozen products market, especially for pizza products. *Nestlé* did not only gain entry to the market, however, it took care to acquire a strong brand as well. Therefore, *Wagner*, as a strong No. 2 with a market share of approximately 33 % and being one of the biggest frozen foods companies in Europe, represented exactly what *Nestlé* was looking for.

Combined Strenghts

While *Wagner's* managing directors continue to manage the business, a proportionate membership board of directors under the chairmanship of *Nestlé Deutschland AG's* chairman controls the strategic direction. By this solution, the contract partners can combine the *Wagner* management strengths, its strong brand equity, capacity of innovation and product quality with *Nestlé's* global sales reach, marketing know-how, and R&D competences. Hence, *Nestlé* was the ideal partner for *Wagner* to develop its business further in Europe and in new markets, as well as to secure jobs by its forward-looking

and forward-thinking strategies. Additionally, *Nestlé* could tap into the lucrative German frozen pizza market by this acquisition.

Since *Nestlé* bought the stake in *Wagner* in 2005, *Wagner's* revenues have grown by about 20 % and the share of international sales increased from 13 % to 30 %. To further intensify the partnership between the two companies, *Nestlé* increased its stake in *Wagner* from 49 % to 74 % on 1 January 2010. Gottfried Hares, spokesman for *Wagner* management, states: "Nestlé has proven to be the ideal partner for the further development of our business in Europe and for succeeding in new markets."

Summary and Outlook

Nestlé, a company founded in 1866 by the Swiss pharmacist Henri Nestlé who became famous with the world's first infant food, *Farine Lactée Henri Nestlé,* within about 100 years grew to be the world's leading nutrition, health and wellness company. It is one of the fastest growing companies worldwide due to its acquisitions and mergers, and is still enlarging the gap from its competitors.

Nestlé's ability to capitalise on a wide variety of market conditions across the world remains one of its decisive competitive advantages. Time will tell, if it will continue its strategy under the new CEO Paul Bulcke.

Questions

1. Differentiate mergers and acquisitions from wholly-owned subsidiaries and illustrate the advantages and disadvantages of these growth strategies.
2 Analyse the ice cream market in Canada and illustrate what kind of synergy effects the acquisition of Ault had for *Nestlé*.
3. Compare the expansion strategies of *Nestlé* and *Danone* and point out which processes and organisational structures are important to create new subsidiaries in foreign countries.

Hints

1. See Gaughan 2002.
2. See Datamonitor 2008e.
3. See Danone 2009.

Part V

Selected Value Chain Activities

Chapter 16

International Production & Sourcing

MNCs are complex phenomena but their ultimate objective is to sell their products to customers, and while other value-chain activities (like R&D and marketing) are certainly highly relevant, the MNC has to provide the goods and services it wants to offer. Sourcing the necessary inputs and producing the right outputs is a complex task that is at the core of a MNC's strategy. In this Chapter, the basic decision between sourcing and production is shortly explained, the configuration of production and sourcing activities is discussed and basic production processes are highlighted. In addition, different types of foreign production plants are described and the main developments in international sourcing explained.

Introduction

The term "production" refers to the value-generating activities that transform inputs into outputs and eventually create products. While this term includes manufacturing and service activities, this Chapter will focus mainly on manufacturing activities, i.e., the production of physical products. *"Sourcing"* includes all activities that organise the supply of the company with input goods and services that are needed but not produced within the company itself. It usually involves the identification of the required goods and services, supplier selection, price negotiations, etc. Generally, ensuring security of supply of products of an adequate quality and at an adequate price is the main objective of the sourcing managers.

Relationship between Production and Sourcing

Given that in some industries more than 50 % of the value of the final product stems from externally procured inputs, the relevance of sourcing for the MNC's success is enormous. However, both types of activities, production and sourcing, can be understood to be just *different operation modes* for the same activity. A first, basic decision of a company refers to the "make-or-buy" question (see Chapter 13). For example, for a car company that needs a lighting component as an input for its final product, the company has to decide on whether it wants to manufacture this component by itself or wants to procure the component from an external supplier. From the perspective of transaction cost theory, this decision merely fixes the level of vertical integration in a "given" production chain, i.e., it just answers the "who" is carrying out a certain activity. In particular with regard to international production strategies, many authors also use the term "sourcing" when referring to *"internal suppliers"*, i.e. other production units of the same MNC. In this

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Chapter, however, the term "sourcing" is used for procurement from external suppliers.

Logistics as Linking Pin

Furthermore, it has to be noted that production, sourcing and *logistics* are three closely interrelated parts of a production system. Parts and components have to be transported from a supplier to the focal company (*procurement logistics*), they might have to be stored in a warehouse, they are transported to the first stage of the company's production process and subsequently through the company's production chain (which might be geographically dispersed) (*production logistics or intra-logistics*) and finally, products have to be delivered to customers (*distribution logistics*). Logistics will not be discussed in the Chapter but it has to be considered in the configurational decisions for production as well as in the selection of suppliers.

Configuration of Production Activities

Concentration vs. Decentralisation of Production Sites

A MNC has to decide whether it wants to carry out production activities in one factory in a centralised location or whether it prefers to decentralise the activities across different countries. For example, Swiss manufacturers of luxury watches, like *IWC*, often locate all their production activities in Switzerland and serve the world market from there. On the contrary, Japanese car manufacturers started to relocate their production facilities to their target markets in the 1980s and often serve regional markets from regional production sites (see the case study on *Nissan* in Chapter 5).

Advantages of Production Decentralisation

Advantages of decentralising production activities into different countries include:

- *Circumvention of trade barriers*: MNCs can save custom tariffs and overcome non-tariff barriers by locating production in the target market.
- *Acceptance by local governments*: Host country governments prefer local production which has benefits for their labour market, trade balance, etc. Often, they are willing to give incentives for locating production in their countries.
- *Easier adaptation to local markets*: Locating production facilities in the target market leads to increased sensitivity for local market needs.
- *Advantages in distribution logistics*: By locating production closer to the markets, MNCs reduce delivery costs to their foreign customers and shorten delivery times. This shortens their *time-to-market* (which is important, e.g., for clothing companies like *Zara*, or consumer electronics

like the *Sony Playstation*) and to deliver to their commercial customers *just-in-time*.

- *Increased flexibility*: By having production capacity in different countries rather than one single location, MNCs can reduce their risk exposure and they can shift production more flexibly, e.g. in the case of changes in the cost structure or in the foreign currency exchange rates. In addition, they can exploit arbitrage advantages and market imperfections, e.g. by using cheap labour in one country, better resource access in another country, differences in tax systems or interest rates, etc.
- *Better access to local inputs and better relations with local suppliers*: Local production not only facilitates access to customers but also to local inputs. This can be natural resources (like oil, ores, etc.) or agricultural products (like coffee, rubber, etc.) or other input goods. Relations with suppliers in a foreign market are also improved by locating facilities in their proximity.
- *Potentially lower production costs*: In particular for MNCs from high-income countries, relocating production to different foreign countries gives them access to lower input prices, in particular, a labour force with a lower wage-level.

Advantages of Production Concentration

On the other hand, decentralising production is not the only advantageous arrangement. Concentrating production in one location (in this case, still very often the home country of the MNC) also has some major benefits. Among them are:

- *Economies of scale and experience curve effects*: Having one large production plant instead of several smaller ones enhances the output volume of the factory, which results in economies of scale and in positive effects on the unit costs by the experience gained in the production process.
- *Ease of coordination*: While the dispersion of production processes might reduce production costs, it usually drastically increases coordination costs (e.g. between factories in different countries that work in the same production chain). Concentrating production activities in one location reduces the challenge of coordinating dispersed production processes.
- *Better bundling of procurement volume*: Similarly, a concentrated production usually leads to a better integration of the necessary inputs. Prices for input goods that are centrally negotiated for a large volume delivered to one location are often substantially lower. The coordination effort to bundle procurement of factories in different countries is high (even with common IT systems for enterprise resource planning (ERP)) and even in

the case of a perfect coordination, suppliers still demand higher prices in the case of decentralised deliveries.

- *Better availability of capabilities in some home countries*: From the perspective of MNCs in industrialised countries like Germany, the availability of skilled labour offers quality advantages that are often not given in foreign host countries.
- *"Country-of-origin" effect*: For many MNCs, the home country is still a major source of its image advantage. Thus, e.g., producing Swiss watches in Switzerland or a *Porsche* car in Germany provides the companies with a competitive advantage.

In some cases, concentration in the home country is a consequence of *path dependency and inertia*. If the existing production facilities are concentrated in the home country, the *cost of relocation* is substantial. *Sunk costs* in existing facilities, existing labour contracts and supplier relations may make a switch to a foreign location – which might be better in a static comparison – too expensive. Bending to the interests of the home-country government and local trade unions, as well as negative image effects in the case of a plant closure, also lead to inertia.

Fragmentation and Regional Concentration as Trends

As a general trend of the last decades, one can observe that production processes are becoming increasingly fragmented (i.e., split into different production stages which are located in different countries, an issue that will be discussed later in this Chapter) but at the same time, each stage in the production process becomes relatively more concentrated, to avoid inefficient duplication. *Lower logistics costs* (in the last few decades) and *reduced trade barriers* have caused this trend. For instance, in areas of regional integration like the European Union, many companies do not have dedicated factories for each country anymore but centralise production to one or a few factories that deliver throughout the region. This trend can be observed clearly in the consumer goods industry (e.g. companies like *Unilever* or *Procter & Gamble*) where in the preceding decades national factories were created, but which are now increasingly concentrating their production. Considering of logistics costs, rising prices for oil and climate control regulation might, however, change this trend in the future.

Influence Factors on the Configuration Decision

Given the opposing forces towards concentration and towards decentralisation, particular influence factors on this decision have to be regarded (Zentes/Swoboda/Morschett 2004, pp. 390-402; Hill 2009, pp. 567-574). Eventually, these influence factors help the MNC manager to decide on the opti-

mal production configuration for his MNC and explain why the optimal decision differs strongly among MNCs.

Product- and Production Technology-related Issues

A first set of influence factors is given by product- and production technology-related factors. These include:

- *Product-specific trade barriers*: While some products are not confronted with major trade barriers anymore, encouraging centralisation, others are still are exposed to high custom tariffs, pulling production to the target markets.
- *International standardisation of product*: If there are few national differences in consumer taste and preference for products, the need for local responsiveness is reduced, facilitating centralised manufacturing.
- *Value-to-weight ratio*: Logistics costs are strongly driven by the weight (and the volume) of products. If value-to-weight is low (as in the case of soft drinks, for example), there is greater pressure to manufacture the product in multiple locations; if it is high (as in the case of luxury goods), logistics costs do not pose a barrier to produce the product in a single location and export it to other parts of the world.
- *Product-specific country image*: Country-of-origin image advantages are usually only present for certain industries, like high-tech products from Japan or the USA, highly reliable products from Germany or Switzerland, or design-oriented products from Italy.
- *Characteristics of the manufacturing technology:* In some industries, *fixed costs* (e.g. for setting up a manufacturing plant) are very high and *minimum efficient scale* (at which most economies of scale are exploited) is high as well. In these cases, a company is more likely to centralise its production in one or a few plants (and vice versa). As another characteristic of the manufacturing technology, it has to be regarded whether the production process can be separated into different stages or not. If yes, this may influence the location choice for each stage separately, while one continuous and inseparable process often leads to a concentrated production in the home country.

Country-related Issues

In addition, country-related issues have to be regarded: Obviously, the *home country* of the MNCs plays a major role for location decisions, since in most cases *relative* advantages are considered. MNCs from industrialised countries already have access to a skilled but rather expensive labour force. Depending on their needs, this promotes relocation or home-country production. MNCs from developing countries might have to relocate to more expensive regions to enjoy country-of-origin advantages. The percentage of foreign sales of the MNC (or, inversely, the relevance of the home market) influences its willingness to relocate. In addition, the home country's inclu-

sion in regional trade agreements (like the NAFTA or the EU) or free-trade agreements influences the relevance of trade barriers. Besides the home-country factors, a universe of characteristics of the potential *host countries* plays a role for location decisions. These include competitiveness, country risk, host government influences, corruption, trade barriers, regional integration agreements, national culture and many more.

MNC-related Issues

In addition, configurational decisions depend on the MNC, its characteristics and its *strategy*. For example, the competitive strategy (cost leadership vs. quality leadership), the production and inventory strategy (e.g. just-in-time), the international orientation (e.g. global strategy vs. multinational strategy), the configuration of the other value-added activities (like marketing, R&D, etc.) will all have an impact on the configuration of production facilities.

Customer- and Marketing-related Issues

Additionally, customer- and marketing-oriented factors will influence the optimal configuration decision. For example, if the company is attempting to *standardise* its products worldwide, the centralisation option is more viable than in the case of multinational marketing with adaptation of the products to each country. The necessity of flexibility in the production and the importance of *delivery times* (like in the high-fashion industry) will shift production closer to the target markets, and the exploitation of the country-of-origin image differs with the marketing strategy. Also, customers' production strategies (in the case of business-to-business transactions) will influence the necessity to locate the MNC's production facility close to the customer.

Location Choice

Countries differ and so does their attractiveness as potential locations for foreign production. The many characteristics of the different countries (and, linked to this, also the customer-related factors) have been discussed above.

Scoring Model

The selection of a certain location is – as becomes evident when looking at the different reasons for concentration vs. decentralisation – important because it influences production costs, logistics costs (procurement logistics, production logistics and distribution logistics), access to resources and customers but also the development of capabilities – e.g. the capability to adapt products to a certain market. Given the various reasons for establishing international production sites, the weight that companies attach to the differing aspects naturally differs. Thus, a *scoring model* is usually a pragmatic instrument to select a location for a production facility since it integrates location characteristics and accepts the differing requirements of a company. An example is given in Table 16.1. Here, a single location is evaluated. The overall score of different locations has to be compared for the final selection.

Table 16.1

Example of a Scoring Model for the Selection of a Production Location

Location Characteristic	Importance of Criterion in Percent (w_i)	Evaluation of Country (e_i) (from 1 - very bad to 10 - excellent)	Combined Score (w_i x e_i)
Attractiveness of Local Market	20 %	8	1.6
Logistic Costs	5 %	4	0.2
Wage Level	15 %	2	0.3
Availability of Skilled Labour	15 %	9	1.35
Innovativeness of Country	10 %	8	0.8
Availability of Suppliers	20 %	8	1.6
Stability of Local Currency	5 %	9	0.45
Political Risk	10%	4	0.4
SUM (Overall Score)	**100 %**	**-**	**6.7**

Given the effort to evaluate many locations with this procedure and in particular to gather the necessary data, *multi-stage selection procedures* are applied. Here, in a first step many countries are screened based on very few, often macroeconomic criteria, as a first step. This greatly reduces the set of feasible alternatives. In a second stage, more criteria are regarded for the reduced country set and all countries below a certain threshold are eliminated. In the third stage, specific locations within countries are compared on a more detailed set of criteria that are customised to the specific objectives of the MNC.

Re-Relocation

Divestment

The last few decades have seen major shifts in global production. Often, companies have relocated their production to foreign countries. However, many studies also reveal that relocation is not a one-way street. Instead, *divestment* from foreign countries is also a very common phenomenon, where companies close down (or sell) foreign production plants and relocate their production back to their home countries. The most frequently mentioned reasons for "re-relocation" are the low flexibility of foreign production sites (in particular with regard to the integration of foreign production processes into production chains with home-country factories), logistics costs, transport times, lower delivery reliability, product quality problems in many low-wage countries, and the increased cost of coordination. Specifically, foreign production sites require intensive travelling by production managers, frequent meetings, etc. which are too expensive for many SMEs.

Split Production Processes

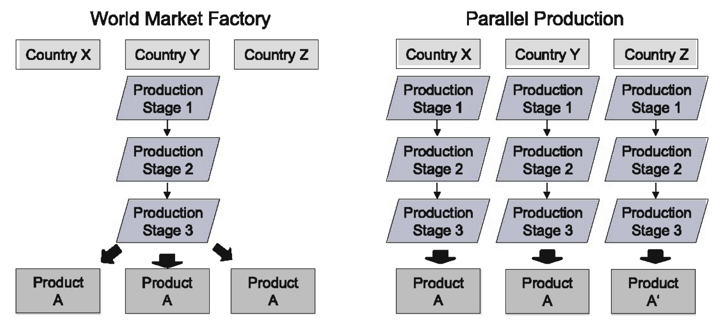
The case that has been implicitly considered in the preceding sections is a rather simple one: Production has been looked upon from the perspective of a one-stage production process and a company that only produces one product. Reality, however, is much more complex. Here, production processes are usually fragmented into *multi-stage production processes* whereby the different stages have to be linked to form complex production chains.

Multi-stage Production Processes

As a typical example of such multi-stage production processes, a process from the clothing and textiles industry can be illustrated: the manufacture of a pair of jeans. For a pair of jeans that is eventually sold in France, the cotton is grown and picked in Uzbekistan, then spun into thread and woven into cloth in India. From there, the parts are transported to Bangladesh. Buttons that have been produced in South Korea and labels that are manufactured in Mexico also arrive in Bangladesh where the cloth is cut and made into a pair of jeans. From Bangladesh, the finished jeans are transported via ship to the destination port in Le Havre (for a negligible transport cost of approximately 0.20 EUR per garment).

To give an overview of the basic options for a company in such a case, a (still simple) three-stage process will be investigated in the subsequent part of the text: A company that produces some parts from input goods and raw materials in stage 1, then manufactures components out of those parts in stage 2 and finally assembles finished products in stage 3.

Figure 16.1 *World Market Factory versus Parallel Production*



Source: Adapted from Knüppel 1997, pp. 139-142.

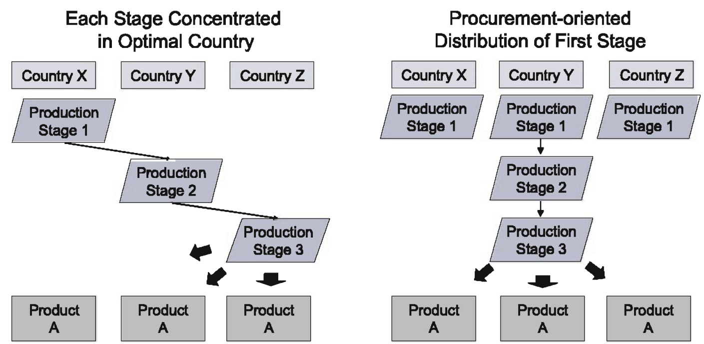
World Market Factories and Parallel Production

Figure 16.1 illustrates two solutions for the configuration of such multi-stage processes. In the case of a *world market factory*, a product is completely produced in one factory and transported from there to the different international markets. This is the highest possible level of concentration and it realises all concentration benefits. It also suffers from all the disadvantages of concentration. In the case of *parallel production*, full production chains are replicated in different country markets and each factory serves its local market. Frequently, high trade barriers are the motivation for this production strategy. Also, this strategy is used in cases where different or highly adapted products are produced for the different markets.

Very frequently today, multi-stage production processes are designed as *cross-border production processes*. These are characterised by geographically dispersed production stages that are in a vertical flow relationship and by the international flow of goods between different production units of the MNC (given the interrelatedness of production and sourcing, some of those production units might not even belong to the MNC but to suppliers, outsourcing partners, etc.).

Figure 16.2

Selected Types of Cross-border Production Processes



Source: Adapted from Knüppel 1997, pp. 139-142.

Fragmentation of Processes

This fragmentation and separate configuration of the production process has major advantages. In the case of a non-separated production chain, all production stages are exposed to the same country conditions. However, different production stages might have different requirements (e.g. different intensity of capital or labour) which logically results in suboptimal locations for most of the stages in the case of a combined location. This disadvantage can be overcome by splitting production stages and selecting optimal loca-

tions for each specific production stage. For instance, labour intensive manufacturing steps can be located in low-wage countries while knowledge and capital intensive stages can be located in countries where skilled labour and the necessary infrastructure are available. However, even in the case of fragmentation, the interrelatedness of the production stages has to be considered, i.e. the coordination effort and the logistics costs that result from the overall production chain.

Two examples of such processes are shown in Figure 16.2. In the first case, each production stage is concentrated in one country and the three stages placed in three different locations. In the second example, the first production stage is decentralised and, for example, each part is produced in that country that is closest to the necessary input sources (e.g. suppliers or natural resources). Stages 2 and 3 are concentrated in this example. Similarly, it would be possible to concentrate production stages 1 and 2 in the home country and to decentralise the last production stage sales-oriented to the different target markets.

Product Split

As a further consideration, it has to be noted that the majority of MNCs are *multi-product companies*. Thus, in addition to the split into different production stages, the production may or may not be split by product type. The specialisation of factories to single products (or product groups) has advantages but reduces economies of scope that might emerge from efficiency advantages when several products are produced jointly.

In practice, companies do both simultaneously. For example, *Mercedes-Benz* produces only engines and other components at its factories in Berlin, Hamburg and Stuttgart-Untertürkheim (thus, single production stages), while it undertakes many production stages for its A-class and B-class vehicles in Rastatt, for its M-class in Tuscaloosa (USA) and the S-class in Sindelfingen (thus, a type of world market factories, for one or several products). Regarding the C-class, the company will from 2014 produce it in Germany, South Africa, China and the USA, thus, in a type of parallel production.

Types of International Production Plants

To categorise foreign production plants in order to understand better their location choice as well as other management characteristics, a model that has been developed by Ferdows is frequently used (Ferdows 1989; Ferdows 1997; Zentes/Swoboda/Morschett 2004, pp. 440-444). On the one hand, it is accepted that foreign production plants are often established with one dominant motive: This can be either the *access to low cost production factors*, the *proximity to attractive sales markets* or the use of superior *local technological resources*. But the competence of the site, or, more concretely, the *extent of*

technical activities that are carried out at foreign production plants also strongly differs. Six groups of foreign production plants can be identified based on those two dimensions (see Figure 16.3).

Figure 16.3

Types of Foreign Production Plants

Extent of Technical Activities at the Site				
	high	Source	Lead	Contributor
	low	Offshore	Outpost	Server
		access to low cost production input factors	use of local technological resources	proximity to market

Strategic Reason for Establishing the Plant

Source: Ferdows 1989, p. 8; Ferdows 1997, p. 77.

For example, an *offshore factory* is mainly established to exploit low labour costs in a foreign country and certain simple parts or components are produced there and usually delivered to the main production site of the MNC in the home country or a third country. *Job processing*, where only certain labour-intensive production stages are carried out in a nearby foreign country, is a typical example of this factory type (here, the *maquiladoras* at the Mexican-US border are an extreme example). Technical competence at the site can be very limited and it is merely implementing production processes that are decided on centrally at the HQ or in other factories. A *server factory* often assembles final products from components that are delivered from the home country. An example would be *Volkswagen*'s factory in Aurangabad in India where the company assembles *CKD*-kits (complete knock-down) of parts that are produced abroad. Server factories are established to circumvent trade barriers or to adapt the last production stages to the local market needs. With a similar objective but a more complete value-added chain, a *contributor factory* serves local markets (often in the form of parallel production). As a last example, the *lead factories* really strategically contribute to the success of the MNC by realising full value-chains and developing products and production processes based on the local technical competence. They are competence centres for a certain product (see Chapter 2 for the explanations of the transnational organisation in which those factories are frequently found).

International Sourcing

Production involves the transformation of inputs into outputs. It is a question of vertical integration whether the company produces necessary inputs by itself or sources them from external suppliers. The reasons to decide for *buying* (i.e. sourcing) instead of *making* include costs which might be lower for a specialised supplier than in the case of vertical integration or the access to foreign production locations of the supplier without the investment to establish those by itself. A detailed discussion of this decision was presented in the Chapters of Part IV ("Foreign Operation Modes").

From Traditional to Modular Sourcing

Generally, a *trend towards a reduction of companies' own value-adding* and a replacement of companies' own production activities by those of external suppliers can be observed for several decades now. The global car industry, with the Japanese manufacturers leading this trend, has demonstrated the benefits of this strategy. As has been pointed out in Chapter 13, this reduction in own value-added was combined with a development from traditional sourcing to modular sourcing. In the *traditional sourcing*, a "one-tier" model was used where numerous suppliers delivered single parts or raw materials to a company. This company then carried out the complex assembly and production task. In *modular sourcing*, a few module suppliers deliver a few complex and pre-assembled modules to a company that only does the final assembly and few of its own production steps. Close relations are established with these few vertical cooperation partners, also called "first-tier suppliers", including joint development, open information and knowledge exchange. This leads to a tight coordination of a few business relationships and a reduction of coordination efforts for other suppliers. Instead, the first-tier suppliers coordinate their own supplier network which leads to a *pyramidal structure* of the supplying companies (see Figure 13.3).

Single Sourcing and Multiple Sourcing

However, these advantages of single sourcing for strategic components and systems must be balanced with the disadvantages. For certain goods, supply might be better not focused on one supplier but on a few, e.g. in the case of so-called *dual sourcing* on two suppliers. While the procurement volume from each supplier is lower in this case, with the obvious disadvantages for the negotiation of procurement prices, dual (or, more general, multiple) sourcing enhances the *security of supply*. If one supplier cannot deliver, e.g. due to a strike or a political problem in his country, the other supplier can often replace this volume. The company avoids dependency from one supplier and improves its negotiation power. The negative impact on procurement prices that results from smaller volumes for each supplier can often be offset by the *competition between the suppliers*.

Configuration of Sourcing Activities

Global Sourcing

Considering sourcing, the optimal configuration of these activities also has to be decided on. Given the similarity of production and sourcing, many of the arguments mentioned above for or against concentration and decentralisation and for and against activities in foreign countries also hold true for sourcing. The trend towards global sourcing is based on a number of reasons (Zentes/Swoboda/Morschett 2004, pp. 313-315):

- cost reduction by using international sourcing markets, e.g. due to lower wages, prices for raw materials, taxes, etc.
- improving the quality of inputs due to wider selection of suppliers
- improving the innovativeness by monitoring different procurement markets
- securing and stabilising supply by spreading the procurement volume across different countries
- unavailability of certain products in the home market
- stabilising procurement prices by avoiding sudden volatility in specific regions (e.g. with regard to foreign currencies)
- exploitation of arbitrage advantages that stem from market imperfections.

Furthermore, the opening of procurement markets in Eastern Europe and China, which were very difficult to access in the past, drastically increased international procurement. The increasing competition and the strong cost pressure on MNCs resulted in efforts to reduce input prices and, in the last few decades, global sourcing (with a strong and rising market share of China as a sourcing market) has often been seen as the response to this pressure.

Outsourcing and International Sourcing

Considering the operation mode of sourcing activities, outsourcing is also a feasible option. Foreign trade companies in the home country, procurement agencies in foreign markets and trading houses with a global scale, such as the Japanese *sogo shosha*, make it possible to enter international sourcing markets without having to develop all the necessary skills and knowledge internally.

Counter-trend towards Regional Sourcing

However, the trend towards international or even global sourcing is confronted with a counter-trend towards national or even regional procurement. The reasons for re-concentrating sourcing in the home country are manifold. First, the trend towards reduction of inventories and *just-in-time production* as well as towards close supplier relationships promotes local relationships and suppliers in the proximity than can reliably deliver goods on time. Tight

business relationships in *regional clusters* (see Chapter 6) are based on similar arguments. In the motor vehicle industry, *supplier parks* have been developed that gather all relevant suppliers in a geographic location near the manufacturing plant to be able to realise those strategies. *Security of supply* has also been demonstrated to be higher in the case of domestic sourcing than in the case of sourcing from China, India or Russia. Furthermore, consumers more and more often also value *regional products* in a globalised world, a trend which has been strengthened in recent years by the concern about environmental problems that results from global transport chains. In the near future, the *climate problems* and the scarcity of oil is likely to result in rising logistics costs that may make regional sourcing more efficient.

Sourcing for Foreign Production Plants

Another facet of international sourcing configuration is linked to international production. MNCs also have to source inputs for their foreign production plants. This is linked to the configuration of international production (where, for example, a foreign factory might be receiving goods mainly from the HQ) and the strategic objectives for this plant but also to the local conditions. For instance, *Volkswagen* sources only about 45 % of the supply for its Chinese production plants in China but intends to source about 75 % of the inputs for its new Indian production plant in Pune locally, mainly due to the availability of highly qualified suppliers in the area.

Objectives and Trade-offs for International Sourcing

To summarise, international sourcing has to follow four main objectives simultaneously:

- reduction of *costs* of input goods
- *security* of supply
- improvement of *quality* of input goods
- *speed* of delivery.

Those four objectives have to be balanced in the international sourcing strategy since they are partly complementary but partly also conflicting. For example, sourcing from China is usually substantially cheaper than sourcing from Western Europe, but products take several weeks to transport by container ship or are very costly to transport by plane. The quality level is – as some recent cases have highlighted – not always guaranteed and given the long transport routes, the security of supply is put at risk throughout the logistics chain. On the other hand, from the perspective of a Western European MNC, sourcing in the home country might secure supply and guarantee the quality with very short delivery times, but the cost level might be

prohibitive. In this case, Eastern Europe might be a good sourcing location when considering the four objectives simultaneously.

In all, it is important to note that sourcing decisions should not be solely based on cost considerations but on a bundle of objectives. Also, cost considerations have to include not only the purchasing price of the goods but also logistics costs, risk premiums, etc. which often makes more proximate solutions optimal. Studies have shown that of the total costs of procurement in China (in the case of German companies), approximately 15 % are logistics costs.

Conclusion and Outlook

Production and sourcing are core activities of a MNC and internationalisation of these activities started long ago. Italian trading houses imported silk and other goods from China in medieval times. The East India Company sourced and sold cotton, silk, saltpetre and other products (including opium) from Asia for centuries as one of the largest companies of its time. However, recent decades have seen a dramatic increase of this phenomenon. New locations like Eastern Europe (and, again, China and India) have emerged as potential locations for production and sourcing. Cost pressure in the industrialised countries forces companies to internationalise production and to reduce sourcing costs and new technologies (in information technology and logistics) act as enablers, reducing transaction costs for cross-border transactions.

Cross-border production processes are the rule, not the exception, and about one-third of world trade today occurs as intra-company trade, confirming that statement. However, decentralisation and cross-border production as well as international sourcing is not only beneficial. It bears risks and costs for companies as well as externalities, and it is by no means clear whether this trend will remain or might even be reversed in the coming decades. In any case, an optimal management of the operations is necessary to achieve the MNC's objectives efficiently and effectively.

Further Reading

FERDOWS, K. (1997): Making the Most of Foreign Factories, in: Harvard Business Review, Vol. 75, No. 2, pp. 73-88.

UNCTAD (1993): World Investment Report 1993 – Transnational Corporations and Integrated International Production, Geneva, United Nations Publications, pp. 111-178.

Case Study: Electrolux[1]

Profile, History and Status Quo

Foundation and Product Range

Electrolux is a Swedish MNC, founded in 1910 in Stockholm as *Elektromekaniska AB*, and changing its company name to *AB Electrolux* in 1919. Concentrating in the beginning mainly on the production of vacuum cleaners and later also on refrigerators, *Electrolux* is today a leading MNC in appliances for home and professional use. *Electrolux's product range* consists of two product categories: consumer durables and professional products. Consumer durables include appliances for the kitchen (e.g. refrigerators, freezers, cookers, dishwashers and toasters), laundry products (washing machines and tumble dryers) and cleaning products (e.g. vacuum cleaners and air cleaners). *Electrolux* provides restaurants and industrial kitchens with professional products such as ovens, dishwashers, refrigerators, cookers, hoods and laundry equipment (e.g. washing machines, tumble dryers, utensils for finishing and ironing). In 2009, the share of sales of consumer durables was 93 % and of the professional products 7 %.

Market Position and Brand Portfolio

Over the years, *Electrolux* has steadily grown to the world's second-ranked manufacturer of home appliances, after *Whirlpool Corporation*. In 2009, *Electrolux* sold its products in more than 150 countries. In total, the company sold more than 40 million products in 2009, of which about half of the appliances were sold under the global *Electrolux brand*. In 2010, *Electrolux's brand portfolio* can be divided into three groups (see Table 16.2).

Table 16.2 *Selected Brands of Electrolux (2010)*

Scope of Brands	Brands
Electrolux Master Brand	Electrolux, Electrolux-Arthur Martin, Rex-Electrolux, Juno-Electrolux, AEG-Electrolux
National Consumer Brands	BEAM, Chef, dishlex, Elektro Helios, Eureka, Fridgidaire, Faure, Gibson, Husqvarna, Kelvinator, Marijnen, Progress, Rosenlew, Simpson, Tornado, Tricity Bendix, Volta, Westinghouse, Zanker, Zanussi, Zoppas
Special Brands	Electrolux Professional, Dito Electrolux, Molteni, Zanussi Professional

Source: www.electrolux.com.

1 Information used for this case study includes various annual reports, press releases, the web site http://www.electrolux.com/ as well as explicitly cited sources.

Electrolux's Recent Configuration Decisions

Location, Net Sales and Employees in 2003 and 2004

In 2003, *Electrolux* had 95 production facilities located all over the world, with a large focus on Western Europe (50) and North America (21). In 2004, *Electrolux's main sales markets* in terms of total net sales were likewise Western Europe (40.9 %) and North America (39.1 %), whereas Eastern Europe (6.6 %), Oceania (4.7 %), Latin America (4.1 %) and Asia (3.6 %) constituted only a minor part of the company's net sales. Similarly, Western Europe and North America showed the highest number of employees (see Table 16.6 for more detailed information). However, comparing the relative net sales per region with the relative number of employees per region, it becomes evident that the low-cost locations in Eastern Europe, Asia and Latin America are more important for the company in terms of employees than in terms of total sales. This observation shows that not only net sales in a specific region are an influence factor on the configuration decision of the company, but also other factors such as lower labour costs. Nevertheless, it has to be noted that the number of employees does not perfectly reflect the volume of production taking place in these locations.

Challenges for Electrolux in the Beginning of the Twenty-first Century

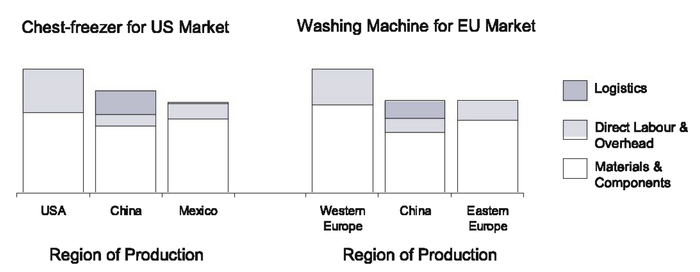
In the beginning of the twenty-first century, *Electrolux* was confronted with different challenges. Firstly, the company was faced with margins below the industry average. Moreover, most markets of the company were saturated and competition from Asian and Eastern European manufacturers was increasing because of cost advantages due to lower wages in these countries. Likewise, some of *Electrolux's* traditional competitors decided to relocate their production to low-cost countries and to purchase more and more materials and components from low-cost countries which made them more competitive. Besides, the company had to manage increasing production costs, including due to rising prices for materials and components.

Comparison of Total Production Costs in High and Low-Cost Countries

A comparison of production costs for selected appliances showed that the total production costs of washing machines intended to sell in the EU are the highest when produced directly within the EU and are nearly equal when produced in Eastern Europe or in China. When produced within the EU, costs for materials and components alone are nearly equal with total production costs in China and Eastern Europe. Moreover, even if costs for materials and labour are lower in China than in Eastern Europe, high logistic costs from China to the EU outweigh the lower costs for materials and labour. Conversely, transport costs from Eastern Europe to the EU market are insignificantly low. Nearly the same result appeared for the production of chest-freezers manufactured in China or in Mexico and intended to be sold in the US market. Thereby, total production costs are even lower in Mexico than in China, again due to lower transport costs from Mexico to the USA than from China to the USA (see Figure 16.4).

These examples show that higher freight costs due to long geographic distances may outweigh cost benefits based on lower material and labour costs. Here, it has to be noted that freight costs not only increase with longer geographic distance, but also with heavier products. As *Electrolux's* product portfolio mainly consists of large and heavy products such as refrigerators, chest-freezers or washing machines, the company usually faces high transport costs.

Figure 16.4 *Schematic Representation of Regional Production Costs*



Source: Electrolux 2005, p. 4.

Electrolux has already implemented *several restructuring programmes*, e.g., in 1998 and 2002. In 2002, the president and CEO of *Electrolux*, Hans Stråberg, stated that "the Group's performance has improved substantially over the past few years, mainly through cost cutting and restructuring. There is still room for reducing costs and improving the performance of our operations" (Electrolux 2003, p. 1).

Objectives of the Restructuring Programme 2004

In 2003 and 2004, *Electrolux* announced new restructuring programmes in order to react to the market challenges at that time. The company constituted the objective of the restructuring programme in 2004 as follows: "We are continuing our efforts to reduce costs, particularly in production and purchasing. We are also improving the efficiency of our marketing organisations in a number of countries. In terms of production, we are reducing the number of plants, product platforms and product variants, and we are increasing the share of production in low-cost countries" (Electrolux 2005, p. 18). The specific target that is almost reached in 2010 is that 60 % of the production should be located in low-cost countries. All of the vacuum-cleaners of the group (a product group with particularly low transportation costs) are now produced in low-cost countries.

Even though *Electrolux* had already started before *to consolidate and to relocate its production*, as well as to purchase raw materials, etc. more and more from low-cost countries, these activities were intensified after implementing the new restructuring programme in 2004. On the one hand, consolidating and relocating production was estimated to cause *total costs* of almost 8,000–10,000 million SEK until 2010, but on the other hand, *Electrolux* expected *annual savings* of about 2,500–3,500 million SEK.

Global Product Platforms

Moreover, at that time, many companies decided to decrease the number of product platforms in order to build *global platforms*. *Electrolux* also followed this trend and stated that "reducing the number of product platforms generates benefits that include enabling greater standardisation of components, fewer product variants and simpler production. It also gives the Group a more powerful negotiating position for large-scale purchasing, and reduces the number of spare parts in inventories" (Electrolux 2006, p. 14).

Closure and Relocation of Production Plants

In addition to the plant closures listed below, *Electrolux* implemented further plant closures also in the low-cost Asian countries of China and India. Moreover, the company closed cookers plants in Denmark and in the UK in 2007 and 2008. In 2009, some plants in China, Russia, the USA and Spain were closed.

Plant Closure Decisions in 2004 and 2005

Table 16.3

<table>
<tr><th>Location of Closed Plant</th><th>Product Area(s) of Closed Plant</th><th>Shut-down Date</th><th>Cost (million SEK)</th><th>No. of Employees</th></tr>
<tr><td>Greenville, MI (USA)</td><td>refrigerators</td><td>2005</td><td>1,100</td><td>2,700</td></tr>
<tr><td>Reims (France)</td><td>cookers</td><td>2005</td><td>289</td><td>240</td></tr>
<tr><td>Adelaide (Australia)*</td><td>hoods</td><td>2005</td><td rowspan="4">205</td><td rowspan="4">550</td></tr>
<tr><td>Orange (Australia)*</td><td>refrigerators, freezers</td><td>2005</td></tr>
<tr><td>Adelaide (Australia)</td><td>motor plant</td><td>2005</td></tr>
<tr><td>Christchurch (New Zealand)</td><td>cookers</td><td>2005</td></tr>
<tr><td>Västervik (Sweden)</td><td>vacuum-cleaners</td><td>2005</td><td>220</td><td>500</td></tr>
<tr><td>El Paso, TX (USA)</td><td>vacuum-cleaners</td><td>2004</td><td>153</td><td></td></tr>
<tr><td>El Paso, TX (USA)</td><td>outsourcing of components</td><td>2005</td><td></td><td>850</td></tr>
<tr><td>Tommerup (Denmark)</td><td>tumble dryers</td><td>2006</td><td>49</td><td>180</td></tr>
<tr><td>Nuremberg (Germany)</td><td>washing machines, dishwashers, tumble-dryers</td><td>2007</td><td>2,300</td><td>1,750</td></tr>
<tr><td>Fuenmayor (Spain)</td><td>refrigerators</td><td>2006</td><td rowspan="4">535</td><td>450</td></tr>
<tr><td>Mariestad (Sweden)</td><td>refrigerators</td><td>2005/2006**</td><td>150</td></tr>
<tr><td>Florence (Italy)</td><td>refrigerators</td><td>2005/2006**</td><td>200</td></tr>
<tr><td>Parabiago (Italy)</td><td>lawn mowers</td><td>2005</td><td>100</td></tr>
</table>

* Part of production
** Capacity of out-back

Source: Electrolux 2005, p. 19; Electrolux 2006, p. 15.

Increased Investments in Low-Cost Countries

Simultaneously with the plant closures, especially in Western Europe, North America and Australia, *Electrolux* intensively increased its *investments in new plants in low-cost markets* in Eastern Europe (e.g. Hungary and Poland), Asia (Thailand) and Latin America (e.g. Mexico) (see Table 16.4).

Table 16.4 *Investments in Low-cost Countries in 2003-2005*

Country	Product Area(s)	Investment (in million SEK)	Production Start
Mexico	refrigerators	1,200	2005
Hungary	refrigerators, freezers	600	2005
Russia	washing machines	80	2004/2005
Poland*	tumble-dryers	270	2005
Poland	washing machines	500	2006
Poland	dishwashers	275	2005
Poland	cookers	380	2006
Thailand	professional washing machines	90	2005/2006
Thailand	washing machines	80	2003
China	hobs, hoods	55	2005

* Increase in plant capacity

Source: Electrolux 2006, p. 15.

Locations in 2007

In 2010, *Electrolux* announced that almost 60 % of its production has already been located in low-cost countries. Before, the company managed to reduce the total number of plants from 95 in 2003 to 54 in 2006. At the same time, the number of plants in high-cost countries decreased from 35 in 2004 to 22 in 2008. Thereby, e.g., in Western Europe and North America, the number of plants has decreased by (more than) 50 % (see Table 16.5).

Table 16.5 *Number of Production Plants in 2003 and 2006*

Region	2003		2006
Western Europe	50	↘	24
Eastern Europe	4	↗	7
North America	21	↘	8
Latin America	6	→	7
Asia	5	→	4
Oceania	8	↘	4
Africa	1	→	0
Total	95	↘	54

Source: Electrolux 2004b, p. 2 and Electrolux 2007, p. 19.

After *Electrolux* has located 60 % of its production to low-cost countries in 2010, it will nevertheless keep 40 % of its production in high-cost countries. The company justifies this fact by citing three reasons: First, net-present value may be negative for implementing the production to low-cost countries (20 %). Second, production plants in high-cost countries may be efficient and profitable (10 %). And third, decreasing demand for the goods produced would make the relocation useless (10 %).

Net Sales and Employees in 2009

In 2009, *Electrolux* reached sales of 109,132 million SEK. The company's *largest market* is Western Europe (36.7 %), followed by North America (33.1 %). However, whereas net sales, especially in North America but also in Western Europe, had largely fallen, net sales in Latin America have strongly increased. Regarding *Electrolux's* employees, the Group's allocation of employees is still concentrated in Western Europe (31.8 %). However, compared with the figures of 2004, the number of employees has decreased in total from 72,382 to 50,633, in particular in Western Europe and in North America, and even in Asia. In Latin America and Eastern Europe, the number of employees has nearly doubled (see Table 16.6).

Table 16.6

Net Sales and Employees by Region in 2009

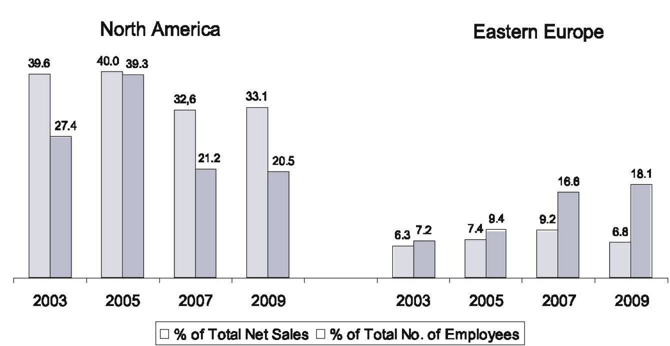
Region	Total Net Sales (in million SEK)		% of Total Net Sales		No. of Employees		% of Total No. of Employees	
	2009	2004	2009	2004	2009	2004	2009	2004
Western Europe	40,024	49,315	36.7 %	40.9 %	16,116	29,975	31.8%	41.4 %
Eastern Europe	7,454	7,911	6.8 %	6.6 %	9,177	5,648	18.1%	7.8 %
North America	36,104	47,289	33.1 %	39.2 %	10,384	21,547	20.5%	29.8 %
Latin America	14,747	4,967	13.5 %	4.1 %	10,921	6,132	21.6%	8.5 %
Asia	4,022	4,358	3.7 %	3.6 %	2,282	4,143	4.5%	7.1 %
Oceania	5,725	5,617	5.2 %	4.7 %	1,659	3,755	3.3%	5.2 %
Total	109,132	120,651	100 %	100 %	50,633	72,382	100 %	100 %

Source: Electrolux 2010b.

As illustrated in Table 16.6, whereas total sales and the number of employees have decreased for most regions between 2004 and 2009, the numbers have increased in some regions, e.g. in Latin America. However, looking at the data for Eastern Europe more carefully, it becomes obvious that the number of employees increased much more strongly than the net sales in this region (see Figure 16.5) even though the strong impact of the financial crisis on this region in 2009 must be considered as well. This development may be justified by the fact that many goods produced in Eastern Europe are exported to other countries, in this case especially to Western Europe where many plants have been closed in the last few years. On the other hand, net sales and the

number of employees decreased in North America whereby the number of employees decreased due to plant closures in this region and relocation to Latin America. As the look into transportation costs in Figure 16.4 shows, it is beneficial for Electrolux to locate its production in low-cost countries close to its primary markets and Asia is not a primary location for Electrolux in this regard.

Figure 16.5 *Development of Net Sales and Employees in North America and Eastern Europe*



Source: Electrolux 2010b.

Electrolux's Sourcing Development

Purchasing Challenges and Objectives

One challenge of *Electrolux* in the beginning of the twenty-first century was increasing production costs as, on the one hand, prices for materials were rising, and on the other hand, consumers demanded more sophisticated products, e.g., better convenience and higher reliability, which required higher R&D efforts. In 2004, the company's expenditures for direct materials, including components, made up about two-thirds of the company's total purchases. In order to reduce these costs, with its restructuring programmes, besides plant closures and relocation, *Electrolux* also aimed at *more efficient purchasing*.

Purchasing Costs and Savings

In spite of *Electrolux's* high purchasing expenditures, the company announced in 2004: "We were able to offset about half of the increase in material prices through more efficient purchasing. Over the next few years we expect to achieve more savings in purchasing. This will be based on increased internal coordination for better utilisation of the Group's size, a reduction in the number of suppliers, a higher share of purchases from Eastern Europe and Asia, and standardisation of components and products"

(Electrolux 2005, p. 18). In the following years, *Electrolux* managed to increase its purchases from low-cost countries from 20 % in 2003 to 48 % in 2007. In 2007, the company reported *purchasing savings* of about 1,700 million SEK thanks to these activities. In a few years from 2010, the objective is to source 70 % of its purchases from low-cost countries (Electrolux 2010a, p. 42). Moreover, the company attached high priority to combined purchasing with product development. However, costs for raw materials and components were still rising even though savings could be made due to relocated purchasing activities. In 2006, the composition of raw material costs was as follows: the largest cost part was carbon steel (42 %), followed by plastics (23 %), copper and aluminium (11 %), stainless steel (8 %) and others (16 %). Anyway, achieved savings as well as higher sales prices made it possible to balance these costs.

Electrolux's Spin Offs, Outsourcing and Divestment Activities

Spin Offs and Outsourcing

In 2004, *Electrolux's outdoor products segment* was characterised by substantial growth and profitability. It generated sales of about 27,000 million SEK and had 11,500 employees. In 2005, *Electrolux's* board decided to *spin off* this segment as it was considered to be "large enough to comprise a separate company" (Electrolux 2005, p. 20) and expected to generate a better long-lasting profitability when managed as a separate unit. The new parent company which includes *Electrolux's* outdoor product division is called *Husqvarna* and has its headquarter in Stockholm. Further, in 2005, *Electrolux* decided to *outsource* components in El Paso (USA) – 850 employees of the group were affected by this company decision.

Acquisitions and Divestments

Recent restructuring programmes which aimed, among other things, at consolidating and closing production plants or at reducing the complexity of *Electrolux's* operations, also influenced the company's acquisition and divestment activities. Whereas until the year 2000, *acquisitions* played an important role for *Electrolux*, the company only implemented a few acquisitions thereafter, but increased its *divestment activities* at the same time. For instance, in 2002 and 2003, *Electrolux* decided to divest its motor and compressor operations.

Summary and Outlook

In recent years, *Electrolux* implemented several restructuring programmes aiming primarily at reducing costs. *Electrolux's* objective was to decrease its production plants as well as to relocate its production from high-cost coun-

tries, e.g. Western Europe and North America, to low-cost countries, especially in Eastern Europe and Latin America, which are close to the main sales markets of the company, namely Western Europe and North America. For the near future, ongoing relocations of production plants as well as of *Electrolux's* purchasing activities are already announced.

Questions

1. One objective of *Electrolux's* recent restructuring programmes was to decrease the number of plants and to follow the trend to global platforms. Moreover, *Electrolux* wanted to focus on the production of standardised products. What are the advantages and disadvantages of product concentration to global platforms and/or to a few production plants? What are the advantages and disadvantages of product standardisation? For your answer, discuss the advantages and disadvantages for companies in general, and for *Electrolux* in particular.
2. By relocating production to low-cost countries as well as by reducing the number of plants, the company expects to save production costs, among other advantages. What (short-term and long-term) side effects and disadvantages of these activities do you see for different shareholders and stakeholders?
3. Describe, compare and try to explain the development patterns of net sales and employees (in % of the total net sales and the total number of employees) in the last decade in the following regions: Western Europe, Eastern Europe, North America and Asia. How do you explain the facts of plant closures in Asia (China and India) and respectively the decreasing relative share of employees in Asia, even if it is generally known that labour costs in Asia are very low compared with other regions? Also describe and try to explain the developments in net sales and employees of Brazil compared with those of Mexico.

Hints

1. See, e.g. www.bloomberg.com and *Electrolux's* annual reports.
2. See www.electrolux.com for figures of net sales and employees. For your answers, you may, obviously, also use the Figures and Tables displayed in the case study.

Chapter 17

International Research & Development

International R&D becomes ever more important. But besides the many advantages of R&D internationalisation for MNCs, it also poses a major challenge. In this Chapter, benefits and caveats of international R&D are discussed. Different roles of foreign R&D units are highlighted, the coordination of international R&D investigated and different organisational models for MNC's international R&D described.

Introduction

Given the high relevance of innovation for the sustainable competitiveness of MNCs, R&D is a core value-chain activity. The internationalisation of R&D is not a new phenomenon. A certain level of international R&D to adapt products and technologies to local markets has always been necessary. However, basic and applied research was traditionally reserved for the home countries of MNCs. In the last two decades, though, some new trends have emerged (UNCTAD 2005, pp. xxiv-xxvi; Luo/Shenkar 2008, p. 356) in that the R&D of MNCs is increasingly undertaken abroad. For example, German MNCs set up more foreign R&D units in the 1990s than they had done in the preceding 50 years. The percentage of foreign R&D of Swedish MNCs doubled from 22% in 1995 to 43% in 2003. In recent years, for the first time, MNCs are setting up R&D facilities outside developed countries that go beyond adaptation for local markets. Increasingly, in some developing countries, MNCs' R&D is targeting global markets and is integrated into the core innovation efforts of the companies. *IBM's* R&D centre in Beijing or the *Daimler* R&D facilities in Bangalore are just two examples. In addition, MNCs from the newly industrialised nations like Singapore, South Korea or Taiwan have begun to relocate R&D activities to other countries as well.

R&D Intensity

However, the magnitude of foreign R&D differs substantially between industries, with the chemical and the pharmaceutical industry reaching levels of about 50 % of R&D undertaken abroad and other industries still being substantially lower. Partly, this differing degree of R&D internationalisation can be explained with the different levels of R&D intensity in those industries and it seems that in particular those industries with a very high R&D intensity display above average levels of R&D internationalisation. A common classification of industries by R&D intensity, i.e. R&D expenditure as percentage of sales, is provided by the OECD (see Table 17.1).

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Table 17.1 *Classification of Manufacturing Industries by R&D Intensity*

Industry Category	R&D Intensity	Examples of Industries
High Technology	>5 %	aircraft, space craft; pharmaceuticals; computing equipment; television, radio and communication equipment; medical, precision and optical instruments
Medium-high Technology	1.5-5 %	electrical machinery and apparatus; motor vehicles; chemicals (excl. pharmaceuticals); machinery and equipment; railroad and transport equipment
Medium-low Technology	0.7-1.5 %	refined petroleum products; rubber and plastic products; basic metals; fabricated metal products (excl. machinery)
Low Technology	<0.7 %	textiles, textile products, leather and footwear; food products, beverages and tobacco; wood, paper, paper products; printing and publishing

Source: OECD, cited from UNCTAD 2005, p. 108.

Types of R&D

While R&D is often considered a homogeneous task, it is important to distinguish different types (UNCTAD 2005, p. 103): The objective of *basic research* is to gain a more comprehensive knowledge or understanding of the subject under study without targeting specific applications. In industry, basic research refers to research that advances scientific knowledge but does not have specific immediate commercial objectives. The objective of *applied research* is to gain the knowledge or understanding to meet a specific, recognised *need*. In industry, applied research includes investigations to discover new scientific knowledge that has specific commercial objectives, e.g. with respect to products. Finally, *development* is the systematic use of the *knowledge or understanding* gained from research directed towards the production of useful materials, devices, systems or methods, including the design and development of prototypes and processes.

Configuration of R&D

As for all value-chain activities, a first basic decision focuses on the choice of location(s). Before concrete location(s) are selected, a decision has to be made whether R&D should be concentrated in one country (commonly the MNC's home country) or geographically dispersed in a number of R&D units.

Centrifugal-Centripetal Forces Model

The forces models of R&D internationalisation emphasise that positive and negative influence factors on the internationalisation of R&D exist and act as *opposing forces*. *Centrifugal forces* pull R&D away from the centre, i.e., the home country of the MNC, while *centripetal forces* act to keep R&D in the centre (Pearce 1989; Fisch 2001, p. 20). This existence of opposing forces explains a tension concerning the degree of internationalisation; the degree at which the forces are in equilibrium is considered to be optimal.

Motives for the Internationalisation of R&D

The general trend towards internationalisation of R&D is based on a number of different motives (Schmid 2000, pp. 5-6; Zentes/Swoboda/Morschett 2004, pp. 537-540; Luo/Shenkar 2008, pp. 356-360):

- *access to scarce production factors*, in particular qualified research personnel
- exploitation of *cost advantages* in the host country, e.g. lower wages
- enhanced *speed* of R&D, e.g. through international division of labour
- *tapping local knowledge* in host countries and establishing links to local information and communication networks, e.g. by establishing "listening posts" in lead markets or in regional innovation clusters (see Chapter 6), and *proximity to scientific institutions*, e.g. universities or private research institutes, to gather knowledge and capabilities
- enhanced *innovation power* by creating competition between R&D units
- development and exploitation of *complementary resources* and competences in different locations
- *circumvention of legal restrictions* in the home country or better acceptance of certain technologies in different host countries
- securing *market access* and fulfilling *legal requirements* (e.g. local content)
- better *identification of local market needs* and easy *adaptation* of technologies to local markets by presence of R&D in the host country
- *avoidance of the not-invented-here syndrome* at the foreign subsidiaries
- *enhancing the innovation capacity* of the MNC by leveraging the knowledge of different R&D units with the possibility to identify a diversity of ideas and local needs and developing a truly transnational R&D process in which these diverse stimuli are systematically combined.

R&D Internationalisation often as a By-product

Frequently, R&D internationalisation is a by-product and not the result of planned internationalisation. In the case of M&As, which usually are not principally targeted at the R&D units of the acquired companies, the dispersion of R&D may be the result of "administrative heritage" and it is often retained to avoid a brain drain (Schmid 2000, pp. 6-7).

Motives for a Regional Concentration of R&D

On the other hand, a number of arguments against the internationalisation of R&D are brought forward. These *centripetal forces* are mainly based on the dispersion of R&D activities and not necessarily against internationalisation.

Given the fact that concentrated R&D activities are usually located in the home country of the MNC, i.e., in the headquarters, the effect is the same. Advantages of R&D concentration include (Schmid 2000; Zentes/Swoboda/Morschett 2004, pp. 541-542; Shenkar/Luo 2008, p. 359):

- achieving *economies of scale* and reaching a *critical mass* for R&D activities
- *economies of scope*, since by carrying out various R&D projects at one location, spill-over effects of knowledge creation occur
- easier *coordination and control* of the activities which might help to avoid dissipation of efforts and to reach a better alignment of the R&D activities with the corporate goals
- *better communication* due to the presence of all researchers at one location and a personal *face-to-face contact* which is particularly important in the case of tacit knowledge (since R&D requires dense knowledge exchange)
- establishment of *informal networks* among the different researchers
- *simplified organisation*, since complex cross-border structures and processes can be avoided
- *avoidance of unintended duplication* of research work, since local researchers are usually better informed about the projects of their colleagues
- *avoidance of conflicts* between researchers at different locations
- relevance of *country-of-origin effects* that are usually rooted in the home country of the MNC
- higher likelihood to establish a *uniform R&D culture*
- better *avoidance of a leakage* of proprietary knowledge when research results and innovations only have to be communicated within one R&D centre.

Overall, these aspects cause R&D traditionally to be highly concentrated in the home country of the MNC and to be the least fragmented of economic activities of a MNC (UNCTAD 2005, p. xxiv).

Internationalisation of Different Types of R&D

With regard to the various advantages and disadvantages of R&D internationalisation, it becomes obvious that the mentioned forces influence different types with different strength. Thus, research and development are often not undertaken in the same location (Kuemmerle 1997; Boutellier/Gassmann/Zedtwitz 2008, p. 189). Development is often collocated with manufacturing while basic research frequently either remains at the corporate head-

quarters or is located in regional innovation clusters. Development as well as applied research serves to support local marketing while basic research origins in scanning and evaluating external sources, e.g. by establishing listening posts or tapping the knowledge of university spin-offs. Finally, development and applied research are pulled towards attractive markets since their purpose is adaptation of technology to particular market needs, while basic research is pulled towards the quality of scientific input.

Roles of International R&D Units

UNCTAD Typology

As for subsidiaries in general (see Chapter 3), international R&D units can be categorised into different roles. Based on the type of R&D undertaken and the primary motives for the establishment of the R&D unit, the UNCTAD (2005, pp. 138-139) suggests the following typology (see also Pearce 1989; Nobel/Birkinshaw 1998; Zedtwitz 2005; Luo/Shenkar 2008, p. 361):

- Local adapters are "*market-seeking*" R&D units. Their purpose is to facilitate exploiting HQ technologies by adapting it to the local context.
- Locally integrated laboratories (also called "indigenous technology units" or "international independent laboratories") are more advanced than local adapters and are capable of *independent innovation* aimed primarily at local (and perhaps regional) markets. The units remain linked to local production and are usually a natural evolution from local adapters.
- The most advanced type of innovative activity by foreign affiliates is the international technology creator (also labelled "internationally interdependent laboratory" or "global technology unit"). This unit serves the same purpose as core innovating centres in the home country. These facilities can do both research and development, and their *output is typically aimed at global exploitation* by the parent company.
- The fourth role for a R&D unit is the technology scanning or monitoring unit. This is typically a "business intelligence" function undertaken to identify and generate new ideas. With the same purpose, but in the absence of a separate R&D facility, scanning can also be done by another department of the MNC.

As becomes evident, these four roles are closely linked to the necessary *communication flows* in the R&D network. More explicitly, a model that is proposed by Bartlett/Ghoshal/Beamish (2008, pp. 456-457) describes different innovation models that explain the direction of knowledge flows (see also Gassmann/Zedtwitz 1996, p. 10). In the "*centre-for-global*" innovation model, R&D is carried out in one concentrated location and the new tech-

nology is then exploited globally. This follows the traditional "*centralised hub*" model of MNCs (see Chapter 1). "*Local-for-local*" R&D is undertaken in the different country subsidiaries and it relies on subsidiary-based knowledge that is used to identify local market needs and to create innovations which target the local market. Cross-border communication is low in this case. In "*local-for-global*" processes, a foreign R&D unit takes a leading role as a *international technology creator* and creates innovations that are subsequently used by the whole MNC. This case of a specialised task is a clear expression of a *transnational organisation*. Another *transnational* innovation model leads to "*global-for-global*" processes where R&D units work together to create an innovation. Globally linked but widely dispersed capabilities and resources are used to enhance the R&D capacity of the MNC and the results are exploited by all organisational units of the MNC.

International R&D Alliances

Besides configuration and role of international R&D, the operation mode (see Chapter 12 for the basic options) has to be considered by the MNC. MNCs not only have the option to undertake R&D on their own, in wholly-owned R&D units, but also to choose cooperative operation modes for their R&D activities, e.g. by establishing a joint venture or by a contractual arrangement like (active or passive) licensing. In addition, like for other value-added activities, the market option is available, i.e. purchasing new technologies from independent external sources.

Benefits of R&D Alliances

R&D alliances have a number of benefits (Dunning/Lundan 2008, p. 379; Rotering 1990, pp. 80-81; Zentes/Swoboda/Morschett 2004, pp. 552-553):

- *synergy effects* through the exploitation of complementary technological knowledge
- *expansion of own know-how* by tapping the partner's tacit and explicit knowledge
- *sharing of costs* of R&D projects
- the *enhanced flexibility* to react to changes in the technological environment, e.g. by enabling a higher number of simultaneous research projects
- *reduced risk* by spreading technological and financial risk, given the high uncertainty in the field of R&D
- *shorter innovation cycles*
- concentration of own resources on *core competences*
- joint *establishment of norms and standards* for new technologies

- *better exploitation of research findings*, e.g. due to complementary marketing potentials (e.g. sales regions or products).

Disadvantages of R&D Alliances

Unfortunately, R&D alliances are also characterised by a great number of substantial disadvantages. Theoretically, these can often be explained with the transaction cost approach (with the low efficiency of inter-company knowledge transfer) or the knowledge-based view (with the better effectiveness of intra-company knowledge transfer). Caveats include (see, e.g., Rotering 1990, p. 85; Zentes/Swoboda/Morschett 2004, pp. 553-554; Oesterle 2005):

- *technological dependence* from external partners and potential *erosion of core competences*
- *problems* in the course of the *knowledge transfer between partners* due to low absorptive capacity for proprietary knowledge and a lack of effective knowledge transfer mechanisms in alliances
- *danger* of *knowledge dissemination to the partner or others*
- risk of losing a competitive advantage (alliances as *learning races*)
- high *coordination effort* and high negotiation costs
- *narrowing of own decision power* and company-individual flexibility
- *difficulties in assigning the profits* from an innovation to each partner
- *potentially enhanced time requirements* due to coordination and communication efforts.

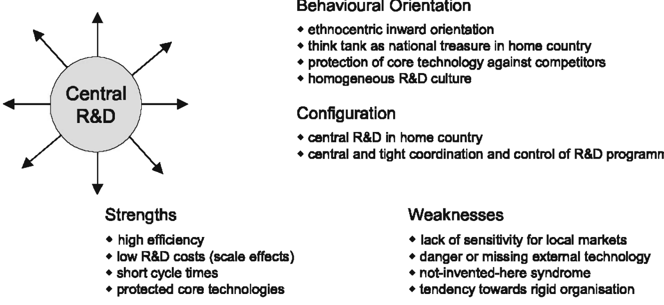
Strong Growth in R&D Alliances

Overall, as a basic trend, strategic R&D alliances are found to be strongly on the increase. The relevance of cooperative R&D has been increasing for the last 50 years (UNCTAD 2005, p. 126). Growth was steady in the early years of this period and accelerated from the 1980s onwards. Although collaborative activity in R&D is not new it has evolved towards direct strategic uses (Narula 2003, p. 110). The relative share of non-equity (contractual) partnerships in the total number of strategic alliances increased considerably over the same period (Hagedoorn 2002). In addition, it is found that the industry composition of R&D alliances shifted strongly from information technologies (whose share dropped from 54% to 28%) to pharmaceuticals and biotechnology (whose share increased from 11% to 58%). In the latter, there is a strong incentive for MNCs to form strategic alliances with other companies in the industry as well as with academic institutions, as no single company could develop excellence in all the areas of research that may be required to develop a new drug. Moreover, there are strong pressures on pharmaceutical companies to reduce drug development costs and to share the risks involved (UNCTAD 2005, p. 126).

Organisational Model for International R&D

Boutellier, Gassmann and Zedtwitz (2008, pp. 77-95) have proposed an organisational model for international R&D that is frequently applied in literature. This model which is based on the *concepts of Bartlett/Ghoshal and Perlmutter* (see Chapter 2) includes the configuration and the coordination of international R&D simultaneously. It distinguishes R&D concepts based on the *geographical dispersion* of internal competencies and knowledge bases and the *degree of cooperation* between R&D sites which reflects the level of global integration concerning the R&D activities.

Figure 17.1 *Ethnocentric Centralised R&D*



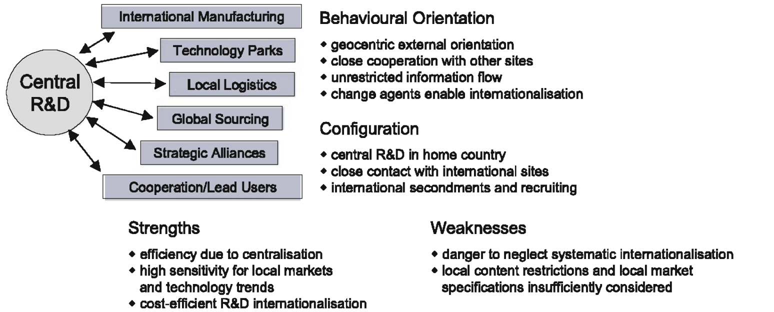
Source: Boutellier/Gassmann/Zedtwitz 2008, p. 80.

In the *ethnocentric centralised R&D organisation*, all R&D is concentrated in the home country. Examples are *Microsoft* or *Volvo*. The MNC assumes that the HQ is technologically superior to its subsidiaries. Central R&D creates new products and technologies which are then distributed worldwide. Physical collocation of R&D employees and a common understanding of the R&D strategy facilitate the control of R&D activities and enhance efficiency. Other advantages and disadvantages are shown in Figure 17.1.

The more dependent the company becomes on foreign markets, the more inappropriate becomes the ethnocentric approach. In the *geocentric centralised* model (Figure 17.2), a multicultural and multinational work force is hired but the efficiency of centralisation maintained by concentrating the activities at a central R&D site. Examples are *Nissan* in the early 1990s or *Hilti*. Geocentric centralised R&D combines the advantages of internationalisation with the advantages of a physically centralised R&D.

Geocentric Centralised R&D

Figure 17.2

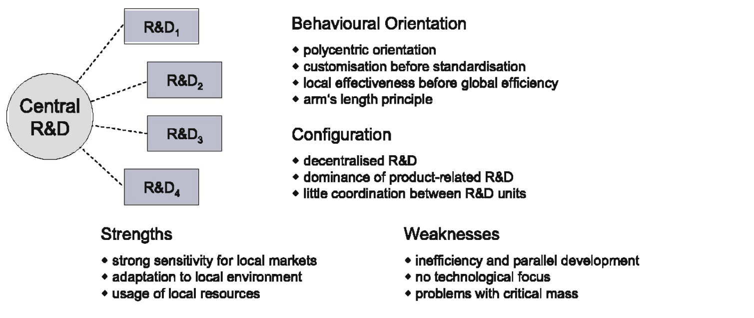


Source: Boutellier/Gassmann/Zedtwitz 2008, p. 82.

Centralisation often limits the potential adaptation to local markets. In the *polycentric decentralised R&D model* (Figure 17.3), differences between markets are emphasised by giving autonomy to dispersed R&D units who have the task to develop technologies and products that fulfil the requirements of their host country. The units in the different countries are *independent* from each other and no strong corporate R&D centre exists that would supervise the dispersed activities. This model was frequently used by European MNCs in the 1970s and 1980s.

Polycentric Decentralised R&D

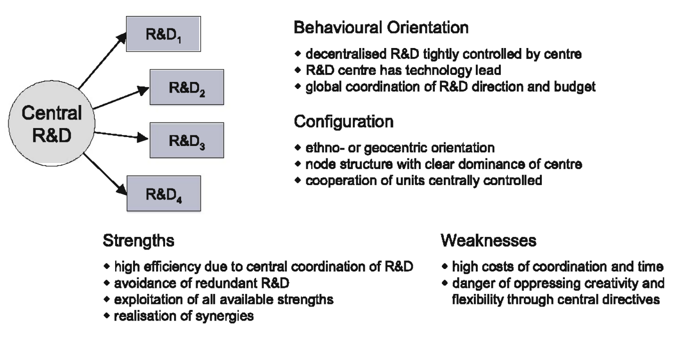
Figure 17.3



Source: Boutellier/Gassmann/Zedtwitz 2008, p. 84

Figure 17.4

R&D Hub Model

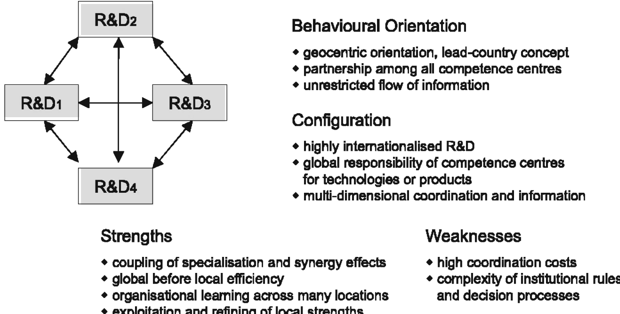


Source: Boutellier/Gassmann/Zedtwitz 2008, p. 86.

In the *R&D hub model* (Figure 17.4), strategic R&D is concentrated in the home country where the main research centre is located which is responsible for all basic research activities and takes a global lead in most technologies. Frequently, the foreign units start as listening posts to tap into local knowledge which they transfer to the HQ. The common R&D strategy is developed in the HQ and duplication of work avoided by a tight control. An example of a hub model is *Daimler* with its corporate research centre in Stuttgart but listening posts in Japan and China, a research and technology centre in Palo Alto and another research centre in Bangalore.

Figure 17.5

Integrated R&D Network



Source: Boutellier/Gassmann/Zedtwitz 2008, p. 88.

Finally, in an integrated R&D network (Figure 17.5), there exist a number of interdependent R&D units in which specialisation is common and units take over the role of a centre of excellence in close interaction with their peer units. As described in the role typologies (see Chapter 3), units hold a "world product mandate" which is often achieved via their own initiative.

Trends within the Organisational Model

Starting from ethnocentric models, most MNCs have understood that this is not adequate to fulfil the heterogeneous market needs and to exploit the diverse competencies in the MNC's units around the world. This leads to the establishment of listening posts (thus, increased dispersion of R&D units) and to an increasing geocentric orientation which results in the requirement to coordinate the R&D activities. Given the complexity of R&D, the time lag between effort and result and the required creativity, foreign R&D units are increasingly empowered and gain a certain level of autonomy to increase their own initiative. If MNCs have developed polycentric R&D models in the past, they increasingly realise that excessive levels of autonomy lead to inefficiency, redundant work, under-exploitation of synergy effects and insufficient exchange of knowledge which limits the innovation capacity of the MNC. Thus, the result of current trends is *some form of integrated R&D network*. Once MNCs have established those, however, they start to observe that the complexity in a very dispersed network is high and that lateral coordination between R&D units is expensive and sometimes slow. As a consequence, the number of main research centres in a MNC is reduced and decisions recentralised in a smaller number of research centres that take a leading role as competence centres for a certain technology, product or process. This consolidation process is attempted to achieve economies of scale and improve coordination while maintaining the advantages of internationalisation (Boutellier/Gassmann/Zedwitz 2008, pp. 92-93).

Conclusion and Outlook

Effective and efficient international R&D is a prerequisite for the maintenance of a sustainable competitive advantage of a MNC. The diverse market needs and growing competences all around the world make the advantages of R&D internationalisation increasingly overweigh the disadvantages. Therefore, empirical studies – like a study by UNCTAD (2005) – clearly reveal increasing levels of internationalisation. This is particularly true for development, but increasingly also for basic and applied research. Linked to this internationalisation is the trend to R&D alliances where complementary skills are exploited by joining forces with another company.

Integration of Dispersed R&D Networks

However, a network of foreign R&D subsidiaries poses the challenge to coordinate these activities in order to align all units to the corporate goals and to reach a level of integration that optimises the opposing needs of efficiency and effectiveness. Different organisational concepts for R&D can be observed in practice and the integrated R&D network currently seems to offer the optimal trade-off between dispersion, autonomy and integration.

Cross-functional Integration

The alignment of R&D with the other activities of a company which might also be dispersed worldwide poses an additional challenge. International marketing has the task of identifying current and future customer needs. This is one root of successful R&D, besides basic research. R&D has to find solutions to customer needs which then have to be marketed by the marketing & sales department. Thus, a *close link between R&D and marketing* is necessary because both activities are aimed at *creating customer demand*. Furthermore, newly developed products have to be manufactured cost-efficiently and time to market has to be minimised. This requires close collaboration between *R&D and manufacturing* to acknowledge the necessities of manufacturing already in the R&D stage. Vice versa, manufacturing can also provide input for R&D since it experiences suboptimal design for production or unnecessary components in its daily work. Thus, tight cross-functional integration between R&D, manufacturing and marketing is necessary for long-term success but it increases the complexity of finding the optimal configuration and coordination for the three activities simultaneously (Zentes/Swoboda/Morschett 2004, pp. 532, 701-705; Hill 2009, pp. 614-615).

Further Reading

UNCTAD (2005): World Investment Report 2005 – Transnational Corporations and the Internationalization of R&D, Geneva.

BOUTELLIER, R.; GASSMANN, O.; ZEDTWITZ, M. von (2008): Managing Global Innovation – Uncovering the Secrets of Future Competitiveness, 3rd ed., Berlin, Springer.

Case Study: Danone[1]

Profile, History, and Status Quo

The origins of *Danone* date back to 1919 when the Greek doctor Isaac Carasso established the company in Barcelona, Spain. With the intention of curing patients suffering from a digestive disorder, Carasso adopted old and proven Balkan traditions that treated such disorders with yoghurt, which was a largely unknown product in this area at the beginning of the twentieth century. Over a period of time it was defined as a medical formulation and was exclusively distributed via pharmacies. Later on Carasso opened a small yoghurt business named "*Danone*", after his first son Daniel ("*Danone*" is the Catalan diminutive for Daniel: "Little Daniel" as minimisation). In the late 1920s Daniel Carasso emigrated to France in order to expand his father's business idea in another country. At the dawn of World War II he handed over *Danone* to friends for a certain time and flew to the USA where he established the first American yoghurt factory, in New York, supported by his Swiss friend Joe Metzger. According to the original "*Danone*" he named the business "*Dannon*" to make it sound more American. As soon as the war had come to an end he returned to France where he took up the family business again. The American *Dannon* was left in the hands of Joe Metzger.

BSN Gervais Danone

In Europe, *Danone* merged with *Gervais*, the leading fresh cheese producer in France in 1967, becoming *Danone Gervais*. Furthermore, with a view to diversification and world expansion, *Danone* merged with the leading French glass container and beverage company *Boussois-Souchon-Neuvesel* (*BSN*), lead-managed by Antoine Riboud in 1973. Henceforth it operated under the name *BSN Gervais Danone*. Based on this innovative and powerful formation, the merger became the biggest food company in France. During the 1970s and 1980s, *BSN Gervais Danone* established a strong base in Europe with a few acquisitions of Italian and Spanish food companies before it finally changed its name in *Danone* in 1994.

Group Danone

Two years later, Franck Riboud became chairman and chief executive officer of *Danone*. It was his idea to reorganise the company into three product divisions "fresh dairy products", "beverages" and "biscuits", and to place innovation, health and nutrition at the heart of the company's strategy. Thereby he pushed *Danone* on the road to success. With the successful acquisition of *Numico, Danone* added a new pillar to its strategy. *Numico* rounds out *Danone`s* brand portfolio and is completely attuned to the company's

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[1] Sources used for this case study include the web sites http://www.danone.com and http://www.danone.de, and various annual and interim reports, investor-relations presentations as well as explicitly cited sources.

mission of bringing health through food. *Numico* consists of two businesses, Baby Nutrition and Medical Nutrition, which are both characterised by a very high R&D intensity. On the one hand, this makes the R&D activities of *Danone* more complex. On the other hand, innovation in health and nutrition constitutes the major key to growth and success for Danone.

Danone generated revenues of 14,982 million EUR in 2009, making *Danone* one of the largest and most successful food companies in the world. About 47 % of its revenues were realised in Western Europe, with France being the dominant market followed by Spain and the United Kingdom. The USA constitutes the single most important market outside Western Europe. Presently the company operates with approximately 81,000 employees in five continents.

The company has four business lines. They all have an excellent market position in Western Europe and currently strive to boost sales in emerging markets like China and Indonesia. Table 17.2 shows some key facts regarding the business lines of *Danone*.

Table 17.2 *Business Lines of Danone*

	Fresh Diary Products	Waters	Baby Nutrition	Medical Nutrition
Worldwide Market Position	1	2	2	1 (EU)
Revenues (in million EUR)	8,555	2,578	2,924	925
Percentage of Group Revenues	57.1	17.2	19.5	6.2
Trading Operating Margin	14.5	12.6	18.3	20.5
Flagship Brands	Activia, Actimel Danonino	Aqua, Evian, Volvic	Blédina ,Nutricia, Cow & Gate, Bebiko ,Mellin	Nutricia, Fortimel, Neocate, Nutrini

Source: Adapted from Danone 2010a, p. 100.

International Research & Development

A commitment to health and well-being has always been at the heart of *Danone*. Since its establishment the company has stood for products with the highest standards and the maxim to develop healthy commodities. In order to realise its mission, bringing health through tasty, nutritious and affordable food and beverages to as many people as possible, intensive research is one

of the most important factors. On this account the company gives high priority to science and research. Danone's research thereby focuses on three top priorities (Danone 2010a, p. 89):.

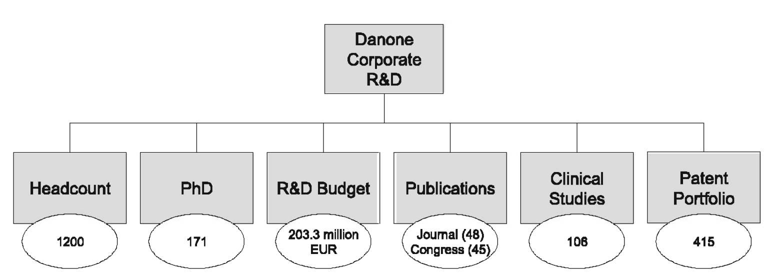
- Reinforcing the existing benefits of existing products for digestive and cardiovascular health, the immune system, bone formation and weight management while at the same time exploring new benefits to underpin future innovation.
- Developing affordable solutions to open access to healthy food for low-income groups.
- Building recognition for the place of nutrition as a component of treatment for certain illnesses.

In order to achieve these goals, *Danone's* research strategy basically rests on three pillars: Corporate, *Danone Institutes* and research partnerships with external partners.

Corporate Research

As one of the few global players in its field, *Danone's* worldwide R&D activities are rather concentrated at two locations. The *Daniel Carasso Centre* in Palaiseau (France) is the company's principal research center. The centre acts as a strong catalyst for innovation for all the group's *Fresh Dairy Products* and *Waters* brands worldwide, in relation with local R&D teams to better understand and take into account the geographical specificities. The second research centre is located in Wageningen (the Netherlands). The centre specialises in life sciences focusing on the development of baby and medical nutrition product concepts. *Danone* recently announced to invest significantly in its R&D facilities and to integrate its Dutch-based R&D activities in a new innovation centre in Utrecht. The opening is planned for 2012.

Corporate R&D at Danone — *Figure 17.6*



Source: Adapted from www.danone.com.

In summary, *Danone's* corporate research employs a total workforce of about 1,200 scientists and is equipped was a total R&D budget of more than 200 million EUR. Further facts about Danones corporate research are displayed in Figure 17.6

Danone Institutes

Parallel to its own research facilities, *Danone* has been supporting so called *Danone Institutes* since 1991. *Danone Institutes* are independent non-profit organisations, with the aim of contributing to the development of knowledge on the links between diet, nutrition and health. Based in 18 countries, their activities and programmes range from supporting scientific research, to disseminating information, public education and providing training to health professionals and practioners. The network of 18 *Danone Institutes* today involves more than 250 highly reputed independent experts (researchers, physicians, dietcians) covering all aspects of food and nutriation. Each year, all of the *Danone Institutes* grant roughly sixty scholarships and prizes to support research in nutrition, for a total of one million EUR. They also organise around a dozen scientific and practice related conferences and publish numerous books and newsletters in order to keep practitioners, journalists, educators, etc. informed of recent scientific advances in nutrition (Danone 2010b, p. 86).

Research Partnerschips

To complement the findings of the own research centres and the Danone Institutes, the company maintains numerous partnership agreements with prestigious research institutions like, for instance, the *Pasteur Institute* and *the Massachusetts Institute of Technology (MIT)*. The structure of *Danone's* research ensures a great flexibility, enables the teams to work with the top experts all over the world and assists in keeping up to date with local consumer needs. This "approach enables the group to develop an intimate knowledge of the local context in each country or region, and instead of merely offering a standardised range, it is able to provide specific products that reflect the needs, cultures, tastes, environment, socio-economic and public health climate in each country".

Overall, *Danone's* R&D approach can be described as a geocentric centralised system. This strategy "offers a simple way to somehow internationalize R&D without giving up the advantage of physically centralized R&D".

Heart of Strategy

Danone has placed innovation at the heart of its strategy. In order to maintain the company's competitive advantage in the long term, *Danone*'s research is challenged to offer products with meaningful differentiation in terms of health and nutritional benefits, taste, etc. The products always promise an add-on-effect. They offer, for instance, help for a better digestion, strengthen the body's defensive forces or care for the skin. This strategy is effective and makes the company unique and successful. During the last few years *Danone's* brands often advanced to be market leaders in the respective seg-

ments, for instance, *Actimel*. It is remarkable that, in recent years, *Danone* has grown faster than the consumer goods giants *Nestlé* or *Unilever* despite spending way less on R&D and Marketing. Its formula for success is imagination, rapidity and its concentration on only a few categories and brands. Excellent market research and close collaboration between marketing and R&D departments supports *Danone* in satisfying its consumers' actual needs, e.g. by giving a fast response to increased health awareness. Being up to date and staying in touch with the consumers is a challenge for all companies. In order to perform this task, marketing managers and developers collaborate with consumers to identify their needs.

Twice a week, experts guide a mixed group of entirely different consumers through *Danone* market research to identify their needs and to achieve a harmonisation between supply and actual demand.

Collaboration in Different Stages

Figure 17.7

Marketing + R&D Lead with Consumers + External Experts
R&D LEAD
Marketing Lead R&D Support

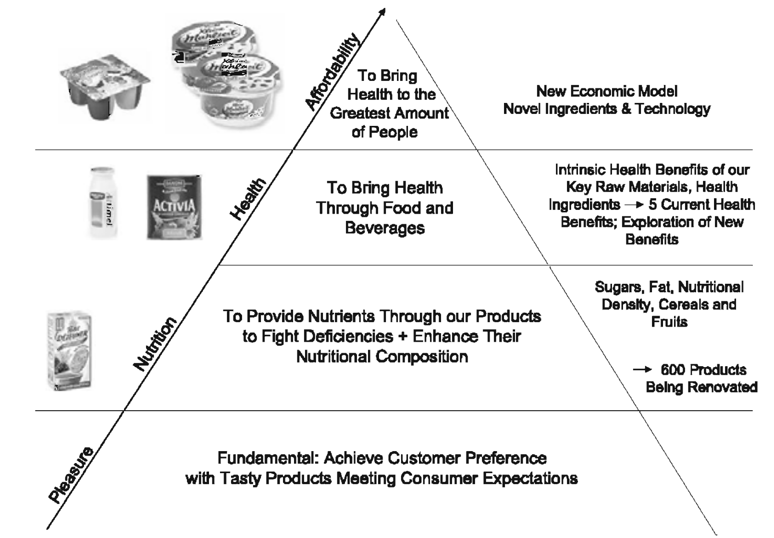
Definition of Consumer Benefits
Scientific Trans-lation
Active Ingre-dients
Formu-lation, Techno-logy, Packaging
Carrying out Scientific Research into the Functio-nality of Various Ingredients
Building up Scientific Evidence to Support the Claimed Benefits
Consumer Commu-nication

Source: Adapted from Danone 2007.

Another special feature of *Danone* is its "souchothèque" ("bacterial bank"). Since its creation, *Danone* has been building a collection of lactic bacteria strains sampled directly from bio-diversity. Nowadays its bacterial bank contains approximately 3,500 different strains of those bacteria. Only a hundred of them have been properly studied to date, hence there is a huge potential of undiscovered innovations yet to be found. That is the reason for making this field a key research area by *Danone*. It invests approximately 1 % of the yearly net sales in R&D activities which meant an investment of 140 million EUR in 2006. In order to attend its mission, 80 % of *Danone*'s research projects focus strictly on health and nutrition and 50 % of the research budget is devoted to probiotics.

In conclusion, note that *Danone* employs 110 health and nutrition professionals all over the world and currently has 200 scientific collaborations. 994 product launches and updates were made in 2006.

Figure 17.8 *R&D's Four Strategic Focusing Points*



Source: Danone 2006.

Questions

1. Have a look at the R&D strategy of *Nestlé*. Are there differences to *Danone*? How does *Nestlé* organise its R&D?
2. Could *Danone* organise its R&D activities in a different way? Use the five concepts of international R&D organisation and discuss the advantages and disadvantages of *Danone's* current research & development organisation in comparison.
3. What are the steps taken by *Danone* to promote innovation?
4. Why has *Danone* been so successful in recent years even if it invests only a small percentage of its turnover in R&D activities?

Chapter 18

International Marketing

This Chapter discusses the diverse options of standardisation versus adaptation of the marketing strategy in the context of the international marketing mix. International marketing mix strategies are presented in relation to the component strategies, i.e. international product strategy, international pricing strategy, international communication strategy, and international distribution strategy.

International Marketing Strategy

One of the most frequent motives of internationalisation is seeking new markets (see Chapter 4). The international marketing strategy brings the *customer focus* to the firm's international strategy. International marketing, generally, is concerned with identifying, measuring, and pursuing *market opportunities* abroad. It implies "the application of marketing orientation and marketing techniques to international business" (Mühlbacher/Leihs/Dahringer 2006, p. 38) and alludes to the *positioning* of the MNC itself and its products and services in foreign markets (Cavusgil/Knight/Riesenberger 2008, p. 516).

Basic Strategy Types

The basic types of international marketing strategies can be classified following the Integration/Responsiveness-Framework (see Chapter 2) into:

- *International marketing strategy*: This type of marketing strategy can be considered an *ethnocentric* marketing strategy which is characterised by the application of the marketing strategy of the home country to all foreign markets without adaptation to the local environment. This strategy represents a standardised approach to marketing that is referred to as "*transference*", i.e., the marketing strategy that has been developed for the home market is transferred to (all) other markets (Shoham/Rose/Albaum 1995, p. 15).

- *Global marketing strategy*: The global marketing strategy is associated with the firm's commitment to coordinate its marketing activities across national boundaries in order to satisfy global customer needs (Hollensen 2007, p. 7). Global marketing is associated with a *standardised* approach, i.e., a marketing strategy being applied in multiple markets at one time (Shoham/Rose/Albaum 1995, p. 15) with the objective to achieve global efficiency and economies of scale.

D. Morschett et al., *Strategic International Management*,
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- *Multinational marketing strategy*: Multinational marketing strategies focus on the diversity of international marketing and imply a strong adaptation to the needs of each single market. Thus, *individual marketing programmes* are developed for each single market, with a multitude of diverse marketing programmes being applied simultaneously.
- *Transnational marketing strategy*: The transnational marketing strategy implies the combination of global efficiency and multinational diversity with a strategy that strives to achieve the slogan "think globally, act locally". This strategy is sometimes also referred to as "*glocalisation*" (Hollensen 2007, p. 8).

This classification of marketing strategies centres on the basic decision between standardisation and adaptation of the marketing strategy, marketing processes or the marketing programme to local needs.

Standardisation versus Differentiation

The two sides of the debate on the globalisation of markets induced by *Levitt* (1983; see Chapter 2) represent local marketing versus global marketing and focus on the central question of whether a *standardised* (global) or a *differentiated*, country-specific marketing approach has the most merits. The main factors that favour standardisation versus local adaptation (differentiation, customisation) of the marketing strategies are summarised in Table 18.1.

Table 18.1 *Selected Factors favouring Standardisation versus Differentiation*

Factors Favouring Standardisation	Factors Favouring Differentiation
◆ economies of scale, e.g. in R&D, production and marketing (experience curve effects) ◆ global competition ◆ convergence of tastes and consumer needs (consumer preferences are homogeneous) ◆ centralised management of international operation (possible to transfer experience across borders) ◆ a standardised concept is used by competitors ◆ easier communication, planning and control (e.g. through Internet and mobile technology) ◆ stock cost reduction	◆ local environment-induced adaptation, e.g. government and regulatory influences, legal issues, differences in technical standards (no experience curve effects) ◆ local competition ◆ variation in consumer needs (consumer needs are heterogeneous, e.g. because of cultural differences) ◆ fragmented and decentralised management with independent country subsidiaries ◆ an adapted concept is used by competitors

Source: Adapted from Hollensen 2007, p. 419.

Standardisation or adaptation of the marketing strategy are two extremes of a continuum, that is, as adaptation increases standardisation decreases, conversely, as adaptation decreases standardisation increases. The discussion of standardisation versus local adaptation on a strategic level can relate to diverse aspects of the marketing strategy (Hollensen 2007, pp. 417-418):

Perspectives on Standardisation/ Differentiation

- *Regional perspective*: Full standardisation in this context relates to a *global* marketing strategy in which the same marketing strategy is applied to all markets which are served by the company. In contrast, in a *multinational* marketing strategy, individual marketing strategies are developed for each local market, thus, each country market is considered specifically. A mixture of standardisation and adaptation is represented by the *multi-regional* marketing strategy. This strategy distinguishes several rather homogeneous regions and develops specific marketing strategies on this regional level (e.g. European Marketing, North American Marketing).
- *Marketing process perspective*: A standardisation of marketing processes relates to standardised *decision-making processes* for cross-country or multi-regional marketing planning. Standardisation in this context relates to, for example, the standardised launch of new products or standardised marketing controlling activities, and seeks to rationalise the general marketing process.
- *Marketing components/marketing mix perspective*: In terms of the marketing components perspective, standardisation or differentiation relate to the degree to which the individual elements of the *marketing mix* are unified into a common approach. A fully standardised approach consists of standardisation regarding all marketing components. On the other hand, a fully differentiated approach implies the adaptation of all marketing mix elements to local requirements. A mixed strategy implies that some components are standardised or adapted to some degree, others are differentiated to some degree.

The International Marketing Mix

"4P" of International Marketing

The key elements of the *international marketing programme* that constitute the international marketing mix are the international product strategy, the international pricing strategy, the international marketing communication and the international distribution strategy. These elements are also referred to as the *"4P"* (product, price, placement and promotion) (Kotler/Armstrong 2004).

International Product Strategies

Core of International Marketing Mix

The international product strategy refers to all decisions that relate to the firm's product and services offerings in the international marketplace. It comprises decisions on which products (or product lines) shall be offered in each country market, decisions on product (and product line) standardisation or customisation, or new product development. The *international product strategy* is often regarded as the core of the international marketing mix strategy. The product with its core benefits must fulfil the customers' desires and the other elements of the marketing mix usually cannot compensate for product insufficiencies (Mühlbacher/Leihs/Dahringer 2006, p. 453). Often, the product strategy is the starting point for further marketing mix decisions. For example, decisions on standardisation or customisation of the communication strategy often depend on whether the *product* is standardised or locally adapted.

Product Elements

Products are complex combinations of tangible and intangible elements. They not only consist of the *core physical properties* but comprise additional elements such as packaging, branding or other *augmented features,* e.g. support services (Czinkota/Ronkainen 2007, pp. 327-328).

Product Strategy Alternatives

Several strategies of the international product strategy can be distinguished. Depending on their general marketing strategy, companies basically have *four alternatives* in approaching international markets (Czinkota/Ronkainen 2007, pp. 328-329; Kotabe/Helsen 2008, pp. 351-352):

- *extension* of the home-grown product strategy to foreign markets and selling the same product abroad
- *modification* of the products for each local market according to the local requirements
- *invention strategy* that consists of designing new products for the global market
- incorporating all differences into one flexible product design and introducing a *global product*.

In this context, the main question relates to which *product features* should be tailored to market conditions. The possibilities but also the need to standardise product elements in the international context differ, with adaptation being most necessary referring to the *augmented product features* and standardisation of the *core product* (i.e., functional features, performance) being the easiest (Doole/Lowe 2008, p. 269; see Figure 18.2).

Customisation Strategies

To minimise the *cost of customisation*, companies can use product design policies that allow them to modify the products to meet local requirements with few operating expense. For example, *modular design* approaches allow

the firm to assemble individual products for each country market using a selection from a range of standardised product components that can be used worldwide. *Common platform approaches* start with the design of a mostly uniform core-product or platform to which for each local market, customised attachments can be added (Kotabe/Helsen 2008, pp. 355-356). A specific strategy that allows selling a standardised product on each country market even though there are specific local requirements is a strategy referred to as *"built-in-flexibility"*. The products incorporate all local differences in one product and adapt flexibly to the local requirements (e.g. mobile phones that adapt to differences in voltage or different network frequencies).

International Product Range Strategy

As most MNCs offer not a single product but a range of products, companies also need to specify the *international product range strategy*. For each country market, it is necessary to decide on the *breadth* of the product range, i.e., the number of product lines to be offered, and on the *depth* of the product range, i.e., the number of products or product variants to be offered per product line. In this context, decisions have to be taken on standardisation versus adaptation of the product range to local requirements.

International Pricing Strategies

International pricing often is considered the most critical and complex issue in international marketing. When talking about the price of a product, it is important to notice that it is a sum of all monetary and non-monetary assets the customer has to spend in order to obtain the benefits provided by the product. The main *pricing decisions* in international marketing comprise the following (Mühlbacher/Leihs/Dahringer 2006, pp. 661-662):

International Pricing Decisions

- The *overall international pricing strategy* determines general rules for setting (basic) prices and using price reductions, the selection of terms of payment, and the potential use of countertrade.
- The *price setting strategy* relates the determination of the basic price of a product, the price structure of the product line, and the system of rebates, discounts, or refunds the firm offers.
- The *terms of payment* are contractual statements fixing, for example, the point in time and the circumstances of payment for the products to be delivered.

A company's *pricing strategy* is a highly cross-functional process that is based on inputs from finance, accounting, manufacturing, tax, and legal issues (Kotabe/Helsen 2008, p. 407) which can be diverse in the international context.

It thus is not sufficient to place sole emphasis on ensuring that *sales revenue* at least covers the *cost* incurred (e.g. cost of production, marketing or distribution), it is important to take many other factors into consideration that may differ internationally (Doole/Lowe 2008, p. 382). The most important factors that *influence* the international pricing strategy are summarised in Table 18.2.

Table 18.2 *Factors Influencing the International Pricing Strategy*

Company and Product-specific Factors	Market Factors	Environmental Factors
• corporate and marketing objectives • firm and product positioning • degree of international product standardisation or adaptation • product range, cross subsidisation, life cycle, substitutes, product differentiation and unique selling proposition • cost structures, manufacturing, experience effects, economies of scale • marketing, product development • available resources • inventory • shipping cost	• consumers' perceptions, expectations and ability to pay • need for product and promotional adaptation, market servicing, extra packaging requirements • market structure, distribution channels, discounting pressures • market growth, demand elasticities • need for credit • competition objectives, strategies and strength	• government influences and constraints • tax, tariffs • currency fluctuations • business cycle stage, level of inflation • use of non-money payment and leasing

Source: Adapted from Doole/Lowe 2008, p. 383.

There are several options to select from in terms of the general rules for price determination. They represent different levels of adaptation to local requirements.

Standard Price

A *standard pricing strategy* is based on setting a uniform price for a product, irrespective of the country where it is sold. This strategy is very simple and guarantees a fixed return. However, no response is made to local conditions (Doole/Lowe 2008, pp. 392-393).

Standard Formula Pricing

With a *standard formula pricing*, the company standardises by using the same formula to calculate prices for the product in all country markets. There are different ways to establish such a formula. For example, *full-cost pricing* consists of taking all cost elements (e.g. production plus marketing, etc.) in the domestic market and adding additional costs from international trans-

portation, taxes, tariffs, etc. A *direct cost plus contribution margin formula* implies that additional costs due to the non-domestic marketing process and a desired profit margin are added to the basic production cost. The most useful approach in standard formula pricing is the *differential formula*. It includes all incremental cost resulting from a non-domestic business opportunity that would not be incurred otherwise and adds these costs to the production cost (Mühlbacher/Leihs/Dahringer 2006, p. 664).

Price Adaptation

While these strategies accentuate elements of international standardisation in pricing, in *price adaptation strategies* prices typically are set in a decentralised way (e.g. by the local subsidiary or local partner). Prices can be established to be the most appropriate for local conditions. While this ability to comply with *local requirements* constitutes a clear advantage, the main disadvantages result from difficulties in developing a global strategic position.

Parallel Markets/ Grey Markets

Additionally, the potential for price adaptation is limited by interconnections between the diverse international markets. Therefore it is necessary to coordinate the pricing strategy across different countries because otherwise re-imports, *parallel market* or *grey market* situations can emerge. In these situations, products are sold outside of their authorised channels of distribution. As a specific form of arbitrage, grey markets develop in the case of price differences between the different markets in which the products are sold. If they emerge, products are shipped from low-price to high-price markets with the price differences between these markets allowing the goods to be resold in the high-price market with a profit. Parallel markets, while legal, are unofficial and unauthorised by the companies and can result in the cannibalisation of sales in countries with relatively high prices and damaging relationships with authorised distributors.

Geocentric Pricing

To avoid these drawbacks both from totally standardised or differentiated approaches, *geocentric pricing approaches* can be chosen. Neither a single price is fixed, nor are local subsidiaries allowed total freedom for setting prices. For example, firms can set *price lines* that set the company's prices relative to competitors' prices (i.e. standardised price positioning) or they can centrally coordinate pricing decisions in the MNC (Doole/Lowe 2008, p. 393; Mühlbacher/Leihs/Dahringer 2006, pp. 666-667).

In this context, it is important to notice that international pricing decisions also depend on the globalism of the industry. *Global industries* are dominated by a few, large competitors that dominate the world markets (Solberg/Stöttinger/Yaprak 2006). It depends on the firm's ability to respond to the diverse external, market-related complexities on international markets which international pricing strategy is appropriate (see Figure 18.1).

Figure 18.1 Taxonomy of International Pricing Practices

Source: Adapted from Solberg/Stöttinger/Yaprak 2006, p. 31.

International Marketing Communication

International marketing communication includes all methods the companies use to provide information to and communicate with existing and potential customers and other stakeholders of the firm. The *international communication process* is affected by many factors that complicate communication in an international (cross-country or cross-cultural) setting (see Chapter 7). In this context, aspects such as language difference, economic differences, socio-cultural differences, legal and regulatory differences, or competitive differences are of high relevance.

The *international communication mix* consists of a diverse set of communication tools such as advertising, personal selling, sales promotions, public relations or direct marketing (see Table 18.3).

The most viable form of communication is *advertising* which often constitutes the most important part of the communication mix in the consumer goods industry. However, in business-to-business markets advertising is less important than it is in personal selling (Hollensen 2007, p. 545).

Communication Tools in International Marketing

Table 18.3

Advertising	Public Relations	Sales Promotion	Direct Marketing	Personal Selling
◆ newspapers ◆ magazines ◆ journals ◆ television ◆ radio ◆ cinema ◆ outdoor ◆ internet	◆ annual reports ◆ house magazines ◆ press relations ◆ events ◆ lobbying ◆ sponsorships	◆ rebates and price discounts ◆ catalogues and brochures ◆ samples, coupons, gifts ◆ competitions	◆ direct mail ◆ database marketing ◆ internet marketing ◆ mobile marketing (SMS, MMS) ◆ viral marketing ◆ advertising games	◆ sales presentations ◆ sales force management ◆ trade fairs ◆ exhibitions

Source: Adapted from Zentes/Swoboda/Schramm-Klein 2010, p. 350; Hollensen 2007, p. 545.

The main decisions in the context of the international communication strategy relate to the *choice of communication modes* for each country market and to the *choice of communication themes* in the international context. Both aspects can be standardised or differentiated internationally.

Communication Mode

Similarly to price strategies, *standardisation* of *communication tools* or communication *media selection* can be performed either in terms of a totally standardised approach that implies the use of the same tools (or same media) in all countries, or in terms of setting uniform selection methods (e.g. relating to media reach, contact situation or modality) for communication tools and media that are employed in all markets. Usually, a more *differentiated approach* is necessary because of international differences in culture, media use or media availability (Mühlbacher/Leihs/Dahringer 2006, pp. 627-628)

Communication Themes

Regarding *communication themes* or the content of communication *messages*, the optimal degree of standardisation depends on the intended positioning on each country market. The main options for companies are internationally standardised campaigns, locally adapted (differentiated) campaigns or mixed campaigns that use the same communication theme (*"umbrella campaign"*), but adapt the execution to local requirements, for example by adapting media, language, tonality or colours or by adapting testimonials. This strategy is also referred to as *"pattern standardisation"* (Kotabe/Helsen 2008, pp. 451-452).

Standardised Campaigns

There are several advantages of *standardised campaigns*. For example, scale economies are also relevant in marketing communication. They can result from reduced planning and development costs of marketing campaigns. Additionally, standardised campaigns can help to establish a *uniform* prod-

uct and company *image* in all markets. This is particular important with international customers, cross-national segments or if media overlaps between country markets (or globally). Standardised campaigns can be coordinated internationally more easily and offer the opportunity to use good ideas and creative talents better. By running global campaigns, it also becomes possible to benefit from high-quality, creative campaigns for small markets or countries with low subsidiary resources (Kotabe/Helsen 2008, pp. 446-447).

Nevertheless, it is not possible or beneficial to use standardised campaigns in all cases. For example, often *cultural*, especially language, barriers are stronger than expected. Customers do not always understand foreign languages well and problems such as mistakes, misinterpretations or changed meanings can arise when translating standardised messages. Other problems might result if products or the use of products are *culture-bound* (e.g. in the case of food), if the communication topic is culture-bound (e.g. hygiene products), if the communication design is culture-bound (e.g. the use of colours or background music) or if the communication content is culture-bound (e.g. gender issues, eroticism). Additional difficulties might emerge if products are in *different stages of their product lifecycle* in different countries, because different life cycle stages imply different communication content (Hollensen 2007, pp. 429-430). Also *legal differences* might restrict certain types of communication or certain communication messages in the diverse countries. For example, relating to the advertising of pharmaceuticals or "vice products" such as alcohol or cigarettes, the application of comparative advertising or advertising targeting children (Kotabe/Helsen 2008, pp. 457-460).

International Branding Strategies

Closely linked to product positioning and communication issues in international marketing are decisions on *international branding strategies*. The main purpose of branding is to differentiate the company's offerings and to create brand identification and awareness. Branding strategies can be distinguished according to the *brand architecture* into single brand strategies or family (or umbrella) brand strategies (for a number of products). Companies may also choose to market several brands in a single market.

Geographic Branding Strategies

The company needs to make the decision which general branding strategy, in terms of the brand architecture, is to be applied for each country market. The main problem in international branding strategies is whether to choose an integrated, *global branding* approach, which consists of the use of a uniform branding approach for all markets, or to use differentiated, regional or

local branding strategies. In this connection, decisions on the geographic extension of the brands are necessary.

The basic strategies are *global brands*, i.e. establishing one single brand for all markets (*"universal brand"*), and *local brands*, implying the use of individual brands on each country market. Also, mixed strategies are possible, for example by establishing several *regional brands* with a focus on several country-markets.

Advantages of Global Brands

Many companies strive for *global brands* because of the advantages associated with this strategy. Global brands offer the highest possibility of achieving a *consistent image* across the world and also are necessary requirement for global advertising campaigns. Global brands have much more *visibility* than local brands and often the fact of being global adds to the image of a brand, and global brands reach the highest (overall) *brand equity* (Kotabe/Helsen 2008, p. 375). Also, *scale economies* are associated with global branding. For example, the cost of creating and strengthening the brand can be spread over large sales volumes.

Advantages of Local Brands

However, there are limitations to global branding. For example, if companies offer a diverse product range in international markets, the product offer in the host country does not always fit the global brand's image, thus limiting its applicability. *Local brand names* also might be easier to understand and not all *global brand names* are adequate for internationalisation. Also, if other elements of the international marketing mix are *adapted* to local conditions, local branding might be more appropriate. For example, if advertising messages are adapted to each market or if products are changed by customising, for example, product design or recipes to local requirements, these strategies are easier to implement under different *local brand names*. This also applies to price differentiation which is easier with different brand names. Thus, brand differentiation can be used as a strategy to limit parallel or grey markets. In this context, companies can also implement *mixed strategies*, in which a global corporate brand is used in all markets but product brand names are adapted to the local requirements.

International Distribution Strategies

The international distribution strategy is closely connected with the foreign operation modes the MNC applies in the diverse markets. It mainly relates to decisions on the structure of the marketing channels and to marketing logistics (Hollensen 2007, p. 507):

- *International channel structure and channel design*: e.g. types of intermediaries (alternative distribution channels), coverage (intensive, selective, ex-

clusive), length (number of levels), control resources, and degree of integration

- *International marketing logistics*: physical movement of goods through the international channel systems, e.g. order handling, transportation, inventory, storage, warehousing.

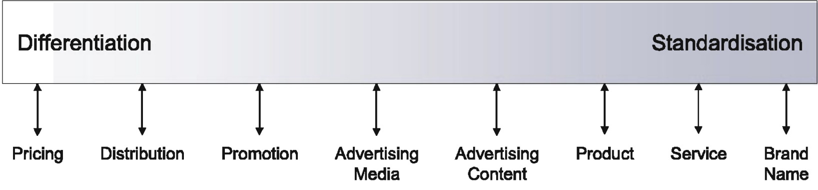
International Channel Configuration

International *channel configuration* is highly dependent on the availability of marketing channels on each country market, on customer characteristics and culture that determine channel use. Additionally, aspects relating to channel costs, channel control or continuity of channel relationships are important. Channels can vary from direct channels to multilevel channels, employing many types of intermediaries that each serve a particular purpose (Doole/Lowe 2008, p. 415). *International channel relationships* are complicated by many factors such as those relating to product ownership, geographic, cultural and economic distance and different rules of law.

Conclusion and Outlook

The *key decisions* in the international marketing strategy relate to the standardisation or the adaptation of the marketing mix to local conditions. In practice, few marketing mixes are totally standardised or totally differentiated and usually mixed strategies are applied. Also, the degree of standardisation and adaptation differs between the diverse instruments of the marketing mix. Figure 18.2 shows the *general standardisation level* for different elements of the international marketing mix.

Figure 18.2 *General Standardisation Level for Different Elements of the Marketing Mix*



Source: Adapted from Zentes/Swoboda/Schramm-Klein 2010, p. 408.

Interrelatedness in the Marketing Mix

In this connection, it is important to notice that the decisions relating to each element of the international marketing mix cannot be taken separately. Efficiency and effectiveness of the sub-strategies such as the international prod-

uct strategy, the international pricing strategy or branding decisions, depend on the fit of all marketing mix elements. Thus, it is important to take into account the *interrelationship* between all elements in the marketing mix. Additionally, the *coordination* between the diverse country markets in which the company is present is important.

Further Reading

CZINKOTA, M.; RONKAINEN, I. (2003): An International Marketing Manifesto, in: Journal of International Marketing, Vol. 11, No. 1, pp. 13-27.

SOLBERG, C.A. (2002): The Perennial Issue of Adaptation or Standardization of International Marketing Communication: Organizational Contingencies and Performance, in: Journal of International Marketing, Vol. 10, No. 3, pp. 1-21.

Case Study: Richemont[1]

Profile, History, and Status Quo

Formation of the Richemont Group

In 1988 the luxury goods group *Richemont* was established through a spin-off of the international assets of the *Rembrandt Group Limited* of South Africa and the company was listed on the Swiss Exchange. At the time of its formation, *Richemont* already owned a stake in the jeweller *Cartier Monde S.A.* and in *Rothmans International* which also held a stake in *Cartier* and, moreover, in the British brand *Alfred Dunhill*. Via *Dunhill*, stakes in *Montblanc* and *Chloé* were acquired. The year after, the luxury group additionally acquired *Philip Morris'* 30 % interest in *Rothmans International.*

Strong External Growth 1990-2000

In the following decade, *Richemont* bought watchmakers *Vacheron Constantin* (1996), *Officine Panerai* (1997), *Jaeger-LeCoultre*, *IWC* and *A. Lange & Söhne* (all in 2000). In 1999, *Richemont* acquired a 60 % stake in the very renowned jewellery brand *Van Cleef & Arpels*. At the same time, *Rothmans International* merged with the world's second largest cigarette producer *British American Tobacco Plc* (*BAT*) whereby *Richemont* held a 23.3 % interest. At the end of 2008, *Richemont* announced the creation of *Reinet Investments S.C.A.* mainly for holding the tobacco businesses formerly held by *Richemont*. Eventually, *Richemont* turned into a pure luxury goods company.

1 Sources used for this case study include various annual reports, press releases, the web site http://www.richemont.com as well as explicitly cited sources.

Five Luxury Goods Business Segments

Thus, over the years, *Richemont* developed into a leading holding company among the largest luxury goods groups in the world today with the purpose of increasing value for shareholders. Hereby, with its fully owned prestigious subsidiaries or "Maisons" as the company calls its brand companies (e.g. Cartier, Montblanc, IWC), the group covers five key business areas: jewellery, watches, writing instruments, leather & accessories, and others (see Figure 18.3). In 2009, *Richemont* increased its turnover by 2 % to 5,418 million EUR.

Figure 18.3 *Richemont's Sales 2008 and Maisons by Business Area*

Source: Richemont 2010.

Group Level Responsibilities

Group Level Support for Independent Maisons

The group assigns high levels of autonomy to the different Maisons and this is seen as a crucial success factor for the company. As *Richemont* expresses this: "Each Maison within the group's portfolio is run as an independent entity. This safeguards each Maison's heritage and allows individual creativity to flourish, ensuring that each Maison remains distinctive and unique" (Richemont 2008, p. 7). At the group level, *Richemont*'s group management formulates corporate strategies and is mainly responsible for the definition of business fields in which the company operates. Recent decisions on this level involve, for example, separating the luxury goods business from *Richemont*'s other interests, acquiring the component manufacturing activities of *Roger Dubuis S.A.*, creating a joint venture with *Ralph Lauren or acquiring the luxury shopping website Net-a-porter.*. In addition, the group management provides central functions to support the subsidiary's management in different fields such as human resources, logistics, finance, etc.

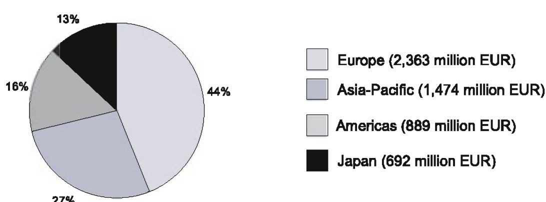
Considering marketing, the group management's activities are limited, given that most marketing activities are planned and executed on the level of the Maisons. However, there is a *Strategic Product & Communication Committee* which supports the high degree of autonomy of each Maison by ensuring that their products and communication comply with each individual Maison's strategy and are distinct from each other.

International Marketing

Sales of the *Richemont group* are largely distributed over the world (Figure 18.4). While the largest share of sales is still in Europe (44 % of sales, reaching about 2.4 billion EUR), Asian markets have consistently grown in importance. This is a general trend in the luxury goods industry. But due to the wide diversity of *Richemont*'s geographical operations the holding company does not depend on any specific market and can flexibly respond to shifts in demand.

Richemont's Sales 2009 by Region

Figure 18.4



Source: Richemont 2010.

In spite of the widespread markets, the international marketing strategy of *Richemont*, respectively of the different Maisons of *Richemont*, can be characterised overall as "global"[1]. As has been shown in the first part of this Chapter, such a strategy aims at satisfying global customer needs and it is linked to a rather standardised marketing approach across the different regional markets. The underlying assumption in this approach is that global cus-

1 It has to be noted that the high level of independence of the different Maisons might lead to different international marketing strategies. Hence, the case study illustrates general strategies and approaches by using specific examples from different *Richemont* companies but exceptions might exist.

tomer needs are rather homogeneous. An assumption that is often brought forward regarding the specific segment of customers of luxury goods.

The international organisation structure (see also Chapter 9) of *Richemont* which is organised around the Maisons is well aligned to this approach. This global product structure clearly indicates that the company considers the differentiation between its brands more relevant than the heterogeneity between different country markets.

To consider the international marketing strategy in more detail, the subsequent part of the text will describe the "four Ps" (product, price, promotion, place).

Product

The core of the international marketing mix of *Richemont*'s Maisons is certainly given by the various very exclusive products. Being manufactured from highly valuable raw materials and often richly bejewelled, the goods have a very prestigious and highly sophisticated reputation and they carry well-established and mostly highly traditional brands – important intangible product attributes. Therefore, highest quality is of paramount importance.

Global Brands

Most of the company's brands have a long-range history. The oldest Maison, *Vacheron Constantin*, was founded in 1755 and is one of the group's several brands for innovative and high-end watchmaking. First of all, considering the branding strategy, it can be noted that all of *Richemont*'s brands are global. For instance, group companies like *Cartier*, *Jaeger-Le Coultre*, *IWC*, *Montblanc*, etc. use a single brand worldwide. While this seems quite natural in the luxury goods industry, a look at consumer goods manufacturers in other fields (e.g. appliances) reveals that besides global branding, other options would be readily available.

Standardised Product Offer

Regarding the different Maisons listed in Figure 18.3, the jeweller *Cartier* is by far the largest, followed by *Montblanc* (writing instruments and increasingly also other products, like watches). The last two segments comprise among others luxury menswear, *Dunhill*, and for the very fashion-conscious and sophisticated women, *Chloé* products. Innovation and frequent introductions of new products are important for all the Maisons and the product range of the each Maison is broadly uniform worldwide. Thus, the product strategy is highly globalised, products and product ranges are the same around the world and each Maison attempts to follow its distinct style worldwide and to adapt to the global customer taste. This becomes evident when comparing the product offer of brands like *Cartier* or *IWC* in catalogues or on the specific regional websites for Europe, Asia or the Americas. Appealing to a global taste also means following shifts in regional relevance.

For instance, at the beginning of 2009, the specialised media claimed that new collections of different *Richemont* brands have been designed with a focus on Asian design tastes which clearly reflects the increasing relevance of these markets.

Cooperation with Suppliers

As another aspect of the product strategy, the high quality standard and the intangible product attributes, *Richemont* ascertains the compliance of its *Supplier Code of Conduct* – a subset of the *Corporate Social Responsibility Guidelines* – to pursue good practice in terms of conflict-free diamonds, preservation of protected species, etc. Another major threat is counterfeiting, as the group works hard to minimise the impacts of unauthorised copying of its products on its business. Lately, *Richemont* executed further acquisitions to improve particularly its manufacturing activities, when the group bought the component production of *Roger Dubuis S.A.* but also the watch-case manufacturer *Donzé-Baume S.A.*

Customer Service

As a part of the international product strategy, expensive and prestigious watches and jewellery also require an outstanding service, e.g. broad warranties and, more importantly, an excellent repair service. To avoid long waiting times, these activities are dispersed to the different regions. For example, for the Chinese market, *Richemont* maintains two main workshops for customer service functions in Shanghai and Beijing, which closely follow group standards and procedures. For the Americas, *Richemont* opened a Technical Centre in Dallas, Texas, in 2008. The new state-of-the-art facility serves as the primary technical centre for the region's watch repair operations, encompassing all of the group's Maisons.

Extending the Brand Portfolio

With regard to international product and brand strategy, the growth policy of *Richemont* in the 1990s demonstrates that growth does not only occur within each brand but that growth can be enhanced by enlarging the product and brand portfolio. Recently, the group announced a planned joint venture with the internationally renowned brand *Polo Ralph Lauren Inc.* which will use this brand for watches and jewellery.

Price

Almost all of the group's products are positioned as *high-end luxury products* in the corresponding price range. Around the world, a *cross-national and cross-cultural customer segment* is able to afford these luxury products. As a consequence, the Maisons' pricing systems and policies are similar around the world and they are integral to the overall positioning strategy.

Arbitrage

In particular for luxury goods with very high prices and rather low logistics and arbitrage costs, a rather standardised strategy is also required to restrict the emergence of *grey markets* or *parallel imports* in markets with higher pur-

chasing power. Arbitrage strongly limits potential price differences. Furthermore, the internet reduces the ability to differentiate prices between different regions of the world. In this product sector, consumers will compare prices and the price transparency that the internet creates is an important influence factor on pricing policy of luxury good manufacturers.

On the other hand, keeping prices in a narrow range is not always easy considering dynamic environments. The global financial crisis influences the economic power around the world – with different impact in different parts of the world. In particular fluctuating currency exchange rates. make balancing the dual requirements of adapting to local conditions and of avoiding grey markets an ongoing challenge.

Promotion

Promotion policy includes the different ways in which a company communicates with its target audience, in particular with its different markets. In its promotional strategy *Richemont* uses the typical elements of the promotion mix: advertising, public relations, personal selling, and sales promotion.

Rather Standardised Advertising

To develop effective advertising, the Maisons create independent strategies and usually apply international campaigns with unified themes, slogans and designs. The underlying reason is the necessity for a globally uniform image in this industry. For instance, the customer segment tends to travel extensively. Frequently, purchases of *Richemont* products are not carried out in the customers' home countries but also abroad (e.g. during a vacation or business trip) and the typical customer is exposed to *Richemont* advertising (which is frequently not only in national magazines but also in international media) in different locations. As a consequence, different marketing messages in different countries would irritate the customer and harm the clear image of *Richemont*'s brands. In addition, standardised advertising leads to the best exploitation of international creativity.

Standardised Advertising Messages

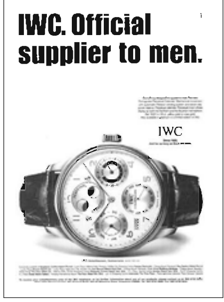
Cartier, for example, launched a new campaign "How far would you go for LOVE" that received a lot of attention worldwide. This elaborate, multi-tiered campaign involved works from different contemporary artists from different parts of the world with short films, photographs, videos and music. All these art pieces are available from one global website (www.love.cartier.com) which only adapts to the different regions and countries by adapting the language. On the other hand, global advertising campaigns are not easy to develop since they need to consider cultural and other national differences in the perception of colours, slogans, testimonials, etc.

Another example are the campaigns of the watch maker *IWC* which pursues an international standardised positioning and hence advertising over the

years. The Maison positions its watches as very masculine and its provocative and ironic headlines differentiate the brand clearly from other companies (within the *Richemont group* but in particular to external competitors). Figure 18.5 displays advertisements of *IWC* in three different countries. It is very evident that the design (considering the layout, the fonts, the general design) is highly standardised and, more importantly, the advertising message ("IWC manufactures sophisticated watches for masculine men") is uniform worldwide.

Figure 18.5

Typical Ads of IWC from Different Countries



Translation: The German advertising states: "Almost as complicated as a woman. But on time." The Italian Advertising says: "IWC. Official sponsor of men."

International Celebrities

The Maisons try to convey their messages very often with the help of celebrities to foster its branding – not only in their advertisements but more broadly. Here, celebrities with an international profile and international appeal are used. For example, *Montblanc* published international advertisements with Nicolas Cage and Johnny Depp who are prominent worldwide. Similarly, Jude Law participated in the grand opening of *Dunhill*'s Tokyo store. Under the header "friends of the brand", *IWC* has a number of celebrities who act as brand ambassadors, mainly at events. Internationally well-known people, such as artists (like James Turrell), singers and actors (like Ronan Keating or John Malkovich) as well as athletes (like Boris Becker) participate in this group.

Public Relations

Another important method to promote products or brands is public relations (*PR*). PR refers to communication to the public which is not paid for by the company but rather stimulated by working with the media and offering them interesting news. For *Richemont*, most of the Maisons are heavily in-

volved in different activities that result in press coverage. *Cartier* for example is associated with the prestigious Sankt Moritz and Windsor polo tournaments. Furthermore, the Maison awards the *Cartier Women's Initiative Awards* for promising female entrepreneurs, sponsors the annual American Film Festival and conducts social marketing as well. As part of its "How far would you go for love?" campaign, *Cartier* announced a specific day (19 June 2008) as "Love Day". On this designated Cartier Love Day, *Cartier* pledged to donate a percentage of sales on all Love collection creations sold in its boutiques during a period of three days. In this synchronised global action all *Cartier* subsidiaries around the world contributed towards chosen humanitarian causes focusing on children, e.g. *Action against Hunger*.

In addition, *Cartier* is also involved with the world of contemporary art by sponsoring exhibitions and important museums. Through its foundation (Fondation Cartier pour l'art contemporain), the company has been supporting art since 1984. Consequently, the Maison has a strong visibility to generate favourable *publicity*.

Place

Considering that the point of sale is the final touch-point with the consumer, stores have to represent the image of each Maison and create a luxurious atmosphere. The two major channels to distribute the Maisons' products are *retail*, which refers to the company's own retail outlets, and *wholesale*, which primarily covers sales to independent retailers.

Boutiques

In 2009, retail sales grew by 4 % to 2,304 million EUR and the total retail network encompassed 1,370 boutiques, e.g. *Montblanc* 358 and Cartier 279. Of the outlet network, the group now owns about 60 % (797 boutiques) and the rest were franchised to partners or owned by third parties.. For further growth *Richemont* gives priority to organic growth of its retail network but may also pursue acquisitions. Moreover, the Maisons use other types of *POS* like *shop-in-shop* (210 by 2008 from 66 in 2004) or *online channels* (www.bluenile.com).

Boutiques at Cosmopolitan Locations

Like the other elements of the marketing mix, a highly standardised approach becomes evident and is logical for *Richemont*. Boutiques, like those of *Montblanc* or *Cartier*, can be found around the world and they all follow a global design. For example, in 2009, the worldwide network of Cartier boutiques and authorised retailers was further enhanced through major openings and renovations, especially in emerging markets. 25 new boutiques were opened, of which five were in China. Other openings included New Delhi in India and the Dubai Mall and Qatar Villagio in the MiddleEast. At the same time, 25 major boutique renovations were undertaken around the

world. These boutique enhancements were complemented by the launch of a pilot e-business website in Japan. Major boutique openings of Montblanc during 2009 took place in Beijing, São Paulo, Dubai, Moscow, and Geneva. These openings contributed to the overall growth of the boutique network of Montblanc to 358 (of which 91 are now in China). Guidelines for the design and layout of the boutiques are developed centrally, at the respective Maison's headquarters. Considering *Montblanc* outlets at the Champs-Élysées in Paris, Bond Street in London, Madison Avenue in New York or the Bahnhofstrasse in Zurich, these stores are obviously not only visited by domestic customers in the host country but they welcome a highly international clientele. The nationality mix of customers is even stronger at the many airport outlets. As a further example, *IWC* developed a new boutique concept in 2004. The first outlets were opened in Las Vegas and in Singapore, Hong Kong, Zurich, Bangkok and Seoul followed. This again shows that these concepts are not local but developed with a global perspective. These customers might visit a store on a trip to New York, then again in Paris and finally buy the product in Zurich. Considering the location of boutiques, a uniform appearance is necessary and logical. As Johann Rupert, Executive Chairman of the group, points out in the Annual Report: "It has been important to realise that consumers in new markets expect to see the same breadth of product offering as they see when travelling abroad and, to this end, we are taking care to ensure that our boutiques are both opened in the most prestigious locations and offer the full range of products."

A further element of the distribution strategy is a strong trade marketing which involves marketing activities of the Maisons that are targeted toward their retail partners. Dedicated magazines (like *Watch International*), events that also contribute to the success of local retailers, the provision of decoration material and intensive support with displays and other material, in particular for new product launches, are a key element. These activities also contribute to a uniform image around the world since they allow the Maisons further to influence the presentation of their products at the POS.

IT and Logistics as Background Function

The boutiques of each Maison, e.g. *Montblanc*, are linked to the same retail information system (in this case, *SAP Retail*) worldwide, so that not only the appearance but also the coordination of the distribution network is tightly integrated. As a part of distribution, the group also optimises its channels through the roll-out of an enterprise resource planning system to achieve *a single global IT solution* for all of the company's operations without future supply chain constraints. In 2007, this implementation took place at the group's principal distribution facility in Fribourg/Switzerland which ships to retail partners and worldwide regional distribution centres. Furthermore, direct shipments from the central platform in Fribourg to all points of sale in Benelux, Scandinavia and in the UK minimise handling time and delays,

especially in the after-sales service, e.g. the distribution of spare parts. It has to be noted that this is one of the activities where a strongly unified solution for all Maisons is aimed at.

Summary and Outlook

Richemont has shown an impressive growth over the two decades since its formation. This has occurred both, organically within each of the group's companies and by acquiring additional brands. The growth has been consolidated by some major restructuring activities, the latest with regard to separating the non-luxury goods businesses from the core of the luxury activities.

As has been shown, *Richemont's* different Maisons are highly independent and it is their task to maintain and strengthen their uniqueness – by differentiating themselves from external and internal competitors. Considering the international marketing activities of each brand, all marketing mix elements are globally integrated, following a global marketing strategy. For example, *Cartier* offers the same products with similar prices and the identical marketing message around the globe – more and more often via dedicated boutiques which are largely owned by the company. These boutiques are the final touch-point to the customer and they also follow a uniform layout and design since the cosmopolitan luxury goods customer will frequently visit different stores in different countries. To avoid a blurred image, a uniform marketing approach is a crucial success factor for these companies.

Both considerations – *differentiation between the brands but global standardisation within each brand* – are accompanied by the company structure. The group management provides support for highly autonomous Maisons. However, background processes like IT or logistics which can benefit from global economies of scale are coordinated rather centrally to exploit the synergy effects.

While in 2009, the financial crisis had finally reached the luxury goods industry which used to be less affected by previous downturns, the group was already back to a good growth rate by the middle of 2010. Considering the consistent growth of *Richemont* over the past decades and the assets of the company that lie primarily in some of the world's most prestigious brands, maintaining the growth path in the long run seems certain.

Questions

1. Considering the product and pricing strategy, investigate two of *Richemont*'s Maisons in detail. Discuss critically whether a local adaptation of products might be a good strategy for the future.
2. Considering the promotional strategy, investigate one of *Richemont's* Maisons in detail. Discuss critically whether a local adaptation of advertisements – e.g. considering colours, fonts, testimonials, etc. – could enhance sales. Also consider the potential long-term effects of local adaptation of the promotional strategy.
3. A major pillar of a luxury goods manufacturer is the distribution of its products. Study *Montblanc's* strategy and discuss benefits and caveats.

Part VI

Selected International Business Functions

Chapter 19

International Human Resource Management

Human resources are among the most critical success factors of international management. Human resource management (HRM) in a MNC faces challenges that are far beyond those of purely domestic operations. For example, it needs to manage expatriate assignments and is confronted with intercultural issues. This Chapter explains the basic activities, models and particularities of international HRM.

Introduction

Human resource management (HRM) generally refers to those activities undertaken by a company to effectively acquire and utilise its personnel. More particularly, it encompasses the process of recruiting, selecting, allocating, training, appraising, and compensating employees (Dessler 2008, p. 2; Dowling/Festing/Engle 2008, p. 2).

While in principle, the tasks of international HRM (IHRM) are the same as in purely domestic companies, managing human resources in MNCs is confronted with a much *higher complexity*. For instance, different cultural environments influence the effectiveness of management techniques in different countries. As another task, employees from one country, e.g. the home country of the MNC, might be allocated to operations in another country, or vice versa. To analyse the complexity of IHRM, a model that is illustrated in Figure 19.1 considers three dimensions (Morgan 1986; Zentes/Swoboda/Morschett 2004, p. 857):

Dimensions of IHRM

- The first dimension refers to the *different activities* of HRM.
- The second dimension considers the *regional aspect*, i.e. the different countries in which the company is active. The usual distinction is between the home country, the host country and other countries. In this case, the host country refers to the location of the specific foreign subsidiary that is focused on in a specific analysis (e.g. Spain, if the recruitment of employees for a Spanish subsidiary is discussed).
- The third dimension regards different *employee groups*. Here, the usual categorisation distinguishes employees from the home country (often called "parent-country nationals"), employees from the host country and employees from other countries (third-country nationals).

D. Morschett et al., *Strategic International Management*,
DOI 10.1007/978-3-8349-6331-4_20,
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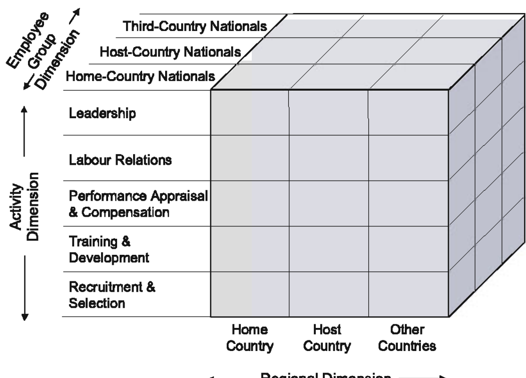
Figure 19.1 Dimensions of International Human Resource Management



Source: Adapted from Morgan 1986, p. 44.

Increased Complexity of IHRM

The main difference between HRM for purely domestic companies and IHRM stems from the enhanced complexity (Dowling 1999, pp. 30-35; Zentes/Swoboda/Morschett 2004, p. 854):

Reasons for Increased Complexity of IHRM

- The *extent of the activities* of IHRM is broader. For instance, relocating employees to a foreign country has to be prepared and organised. Questions of international taxation have to be considered for compensation issues. MNCs have to provide certain administrative services to their employees abroad. Given the geographical dispersion of activities in a MNC, the deployment, i.e., getting employees with the right qualifications to the geographic location where the company needs them, is a key challenge.
- IHRM focuses on different and *heterogeneous groups of employees* with a different cultural background. Different national cultures affect expectations and values of employees and the effectiveness of different leadership styles.
- *Norms and laws* strongly influence HRM in different countries. Regulations concerning labour rights, wages, participation of employees in company decisions, or terminating a labour contract, are strongly heterogeneous between different countries. Other external factors exert a strong influence as well.

- Central decisions on HRM have an impact for employees from different nations. *Perceived fairness* and *equal treatment* of employees in different locations require an international perspective of HRM.
- IHRM is more *strongely involved in the private sphere* of employees. For example, the families of employees are an important factor in the case of expatriates. They have to be considered in the selection process as well as in the administrative work in the host country.
- *Risks and costs* of IHRM are usually higher than in the case of purely domestic countries. If candidates for international assignments are not optimally chosen, the financial and personal consequences are commonly more severe than in a purely domestic setting.

Activities of IHRM

Recruitment and Selection

Recruitment refers to searching for and obtaining potential job candidates. *Selection* is the process of evaluating the candidates and deciding who should be employed for a particular job (Dowling/Festing/Engle 2008, p. 109). A first decision for IHRM is where employees for the various positions should come from. Taking the example of a French MNC with the need to fill an executive position in a subsidiary in Romania, it is evident that three options are available: a French national, a Romanian national or a manager from a third country. The general *staffing options*, thus, are:

Parent-country Nationals

- *Parent-country nationals* (or home-country nationals), in this case French employees, frequently have the advantage of knowing the MNC and the headquarters' strategies, values and procedures very well. They share a common national culture with the staff at the corporate headquarters and have been socialised into the corporate culture. They often have technical competence and experience in the specific function for which they are send abroad. They facilitate communication between the foreign subsidiary and the corporate headquarters. They support the implementation of the corporate strategy in the host country. On the other hand, they usually do not know the host country very well and might have difficulties in adapting to the new environment. The procedures learned in the home country might not be efficient in the host country and the cultural adjustment not easy. Furthermore, home-country nationals are a very expensive option since in addition to their usual salaries they receive substantial additional payments during their assignment abroad.

Parent-country nationals are the typical case of *expatriates* who are discussed in more detail later in this Chapter.

Host-country Nationals

- A second option is to employ a *host-country national*. In this case, a Romanian manager would be used to staff the position in the Romanian subsidiary. While this staffing option is commonly used to fill middle-level and lower-level jobs, it is often also appropriate for top-level positions in the subsidiary. Host-country nationals have detailed market knowledge as well as local relations. They understand the culture of employees and of customers better and are capable of adapting the company's strategy to the specific requirements of a local market. However, candidates with adequate qualifications and experience might not easily be found, depending on the host-country. Also the reduced cultural conflicts in the host-country might be offset by an enhanced number of cultural conflicts between the subsidiary and the HQ.

Third-country Nationals

- As a third option, a MNC may also hire *third-country nationals*. In the example, this could be a Hungarian manager who would be selected to work for the French MNC in the Romanian subsidiary. Reasons for this might be that the third-country national is expected to adapt faster to the new environment than a home-country national or that he has gathered experience in a certain function that is needed in the host-country. The MNC might have a pool of internationally experienced managers from different countries that is used to fill positions in its different subsidiaries regardless of nationality. Third-country nationals might also be a compromise considering the costs of the assignment since they receive foreign service premiums and other additional payments but might have a lower base salary than a home-country national. The third-country national is also a specific type of *expatriate*.

Staffing Philosophies (EPRG Concept)

The use of the three different staffing options is related to the different *staffing philosophies* of a MNC (Hill 2009, pp. 628-631; see Chapter 2). Concerning HRM, an *ethnocentric staffing model* considers parent-country nationals as the most adequate for higher-level positions in foreign countries, based on the assumption that home-country nationals are most effective in implementing corporate strategies in foreign locations and are better educated, trained and more competent. The *polycentric staffing model* emphasises the heterogeneity between different locations and, thus, prefers the use of host-country nationals. As a disadvantage of this model, i.e. staffing each country with managers from this country, employees in general only have limited opportunities to gain international experience. In a *geocentric staffing model*, MNCs select the best person available, regardless of his/her nationality. However, even in this model, cultural aspects regarding adaptability should be considered when evaluating candidates.

Internal and External Recruiting

In addition to the geographic aspect of recruitment, MNCs have to decide on the *source of candidates*: internal or external to the company. Covering the need to fill a position with an internal candidate is linked to promoting or relocating employees. Internal recruitment has several benefits which include relatively low cost and effort to introduce the candidate into the new position, existing general knowledge about the company and its strategy and pre-socialisation into the corporate culture. The MNC can evaluate the abilities and personality of the candidate very well. In addition, the selection of an internal candidate is often part of a long-term career planning and personnel development strategy. It usually increases motivation and employee loyalty if promotions and international assignments are used as rewards for high performance (Dessler 2008, p. 176). But the internal pool of candidates is limited and sometimes MNCs do not find the employees with the needed qualification from their current staff. In this and other cases, external sources are used. Job postings in newspapers, head-hunters, etc. are frequently applied to fill management positions in foreign subsidiaries but – compared with internal candidates – the identification of suitable candidates and the evaluation is a challenge. Studies show that *expatriates* are usually recruited from internal sources (Zentes/Swoboda/Morschett 2004, p. 858-859). The main reason to select expatriates from within the MNC stems from the fact that the main benefits of home-country nationals (e.g. knowledge of the company culture and strategy) are mainly guaranteed if internal candidates are chosen.

Selection Criteria

As *selection criteria* for a position in a MNC, in particular in a foreign subsidiary, it has to be noted that a candidate must have two sets of competences (Griffin/Pustay 2010, p. 581; Rugman/Collinson 2009, pp. 356-357): The skills and abilities necessary *to do the job* (i.e. functional, technical and managerial skills) and the skills and abilities necessary *to work in a foreign location* and/or with employees from different countries. This includes adaptability to new situations, location-specific skills (like the language of the host-country) and personal characteristics such as cultural sensitivity, self-reliance, motivation to work abroad, stable family situation, etc.

Training and Development

For all of its employees, a MNC must provide *training*, i.e., instruction directed at enhancing specific job-related skills and abilities, and *development*, as a rather general education concerned with preparing employees for new assignments and/or higher-level positions. More general, when considering employees and their capabilities as a critical part of the resources of a company, training and development is part of the way in which MNCs enhance

its stock of human capital (Griffin/Pustay 2010, p. 586; Dowling/Festing/Engle 2008, p. 138).

Approaches to Intercultural Training

In MNCs, employees must learn more than purely technical or managerial skills. In addition, employees must be accompanied and prepared for the particularities of an international assignment or for working with colleagues with different nationalities. Given the high cost and risk of an international assignment, sufficient pre-departure *intercultural training* is crucial for success. This aims at ensuring that the manager understands the host-country culture and can behave accordingly. The applied *training methods* depend, among other factors, on the duration of the foreign assignment (Dowling/Festing/Engle 2008, pp. 141-143; Mendenhall/Dunbar/Oddou 1987, p. 340; Zentes/Swoboda/Morschett 2004, pp. 871-875):

Information-giving Approach

- For short-term stays abroad (i.e., a month or less), short trainings (of less than a week) are sufficient. *Providing information* to the manager is the priority and *area briefings* and *cultural briefings*, via lectures, videos, books or interactive media, are the appropriate measure.

Affective Approach

- For longer assignments that are still less than one year, interaction with the foreign culture will be common. Thus, in addition to information-giving, the *affective approach* focuses on transmitting the necessary sensitivity to the foreign culture. *Culture-assimilation training* in which the participants are exposed to the kind of intercultural interactions that they are likely to encounter in the host country may be required. The training might take between one and four weeks.

Immersion Approach

- If the employee is to stay for more than one year in the foreign country and the host-country culture is strongly different from the home-country culture, the level of cross-cultural training should be even higher and the training period could ideally extend one month. Systematic *sensitivity training*, *field experiences* and intercultural experiential workshops might in this case be appropriate in a type of *immersion approach*. Also, *preliminary visits* to the host-country (including the spouse) can help to facilitate the adjustment to the new environment.

Considering the paramount relevance of intercultural training, it is surprising to see that so few companies actually provide such training (Dessler 2008, p. 709).

Management Development

Another aspect of training and development is that the international assignment also serves the purpose of developing the international skills of specific managers. As part of management development, individuals gain international experience, establish a better cultural awareness and get better connected to the diverse organisational units of the MNC (Dowling/Festing/Engle 2008, p. 150). With increasing globalisation of companies, and in par-

ticular in the transnational organisation, this type of management development is not only offered to home-country nationals, but increasingly also to managers from other locations. *Inpatriates*, i.e., employees from other countries that work for some time in the corporate headquarters to develop their skills, to be socialised into the corporate culture and to develop informal relationships within the organisation, are a phenomenon that is observed more and more often. Eventually, these managers are relocated to the host-country and combine some of the advantages of expatriates (in particular the close knowledge of the corporate strategy and culture) with the advantages of host-country nationals (in particular the close knowledge of the host-country including cultural awareness).

Performance Appraisal and Compensation

Another activity of IHRM involves the evaluation of the performance of employees as well as determining their compensation. The main *purposes of performance measurement* are coordination (since linking incentives to certain performance measures will lead the manager to put more effort in the improvement of these performance measures), feedback on performance and rewarding for a certain performance.

Global or Multinational Model

A first decision refers to the level of uniformity in the MNC's performance appraisal systems in the different countries (Zentes/Swoboda/Morschett 2004, p. 885). Should the performance appraisal follow a *global model*, with a rather standardised approach worldwide, or a *multinational model*, with performance measurement and appraisal being tailored to the country-specific context? As will be discussed in more detail in Chapter 20 ("International Control"), it might be difficult to compare the performance of managers across countries. External factors (e.g. different market growth) or the specific situation of a subsidiary (e.g. age or size) influence a subsidiary's results and render attributing certain outcome measures, like sales growth, to the manager's performance difficult. Thus, setting the same objectives for a certain performance indicator for each manager might not adequately evaluate his performance.

In addition, on a strategic level, different subsidiaries have different tasks to fulfil (see Chapter 3). Thus, using the same performance indicators for each subsidiary might not be beneficial for supporting the specific objectives. On the other hand, incentive systems are an important component in developing a strong corporate culture. If the same performance indicators are measured worldwide, the coherence within the MNC will improve. Different motivational structures in different countries that might otherwise lead to divergence in the MNC can be partially overcome by common incentive systems. Furthermore, breaking down overall objectives of the corporation

into individual performance goals is also more consistent with a rather standardised approach. Eventually, the complexity of customised performance appraisal systems might exceed its benefits.

Elements of Expatriate Compensation

A second aspect of compensation in MNCs is the compensation of expatriates. Here, the typical compensation scheme consists of several elements (Rugman/Collinson 2009, pp. 362-364; Dessler 2008, pp. 710-712):

- *Base salary*
- *Cost-of-living allowance* which is intended to compensate for differences in the cost of living between the home country and the foreign location. International organisations, statistical offices and consulting companies provide information on the cost of living in different locations. Usually to maintain the manager's standard of living, the MNC will adjust the base salary to offset this difference. In addition, relocation costs, enhanced rental expenses, medical care, private schools for the manager's children, additional costs to travel to the home country, the membership in a country club or a golf club, etc. may be compensated.
- A *foreign service premium* to induce the manager to accept the international assignment. In particular in the case of rather unattractive assignments, this payment which is also called a *hardship premium* is necessary. For instance, accepting a position in Mozambique, Bangladesh, or the rural areas of India or China may often rewarded with up to an additional 40 % of the base salary.
- Finally, different tax regimes and the non-existence of tax agreements that might avoid double taxation of the manager's income might make *tax equalisation* necessary. Here, the objective is to ensure that the expatriate's *after-tax income* allows a similar standard of living as in the home country.

In sum, costs for an expatriate are often twice as high as for a local manager. Expatriates often earn substantially more than their local colleagues. This may lead to perceived unfairness. Given the fact that expatriates often origin from the home country of the MNC, host-country nationals might see this as an expression of an ethnocentric attitude of the MNC.

Labour Relations

As a part of IHRM but sometimes in a separate department, relations with workers, in particular with organised labour, have to be managed. Different countries have highly diverse legislation concerning employees' rights. For instance, in many European countries, workers play an active role in companies' decisions. As part of *industrial democracy*, employees have the right to

influence the management of a company. In particular in Germany, firms above a certain size have to establish a supervisory board (similar to the board of directors of a US company) and half of the members are appointed by labour, known as *codetermination*. While this model represents the most extreme in industrial democracy, other countries like the Scandinavian states, the Netherlands or Austria, use similar models (Rugman/Collinson 2009, pp. 366-371; Griffin/Pustay 2010, pp. 597-598). In many cases, trade unions have a tremendous influence in industrial democracy which is traditionally guaranteed by legislation.

Collective Bargaining

Another aspect of labour relations includes *collective bargaining* where agreements between labour unions and the management are negotiated. Often, an umbrella agreement, e.g. on wages, for an entire industry is the result (Griffin/Pustay 2010, pp. 597-598). In addition, trade unions or other labour representatives might influence the strategic choices of MNCs by constraining their ability to vary employment levels in different countries and by imposing barriers to the integration of the operations of a MNC. For example, plant closures and production relocation are heavily influenced by trade unions – directly and indirectly via their influence on local governments (Dowling/Festing/Engle 2008, pp. 253-254). To manage labour relations, most MNCs follow a mixed approach with *some level of centralisation* and *some level of decentralised negotiations* by subsidiary managers.

Restrictions of Strategic Choices for MNCs

Leadership

Cultural Influence on Effectiveness of Leadership Styles

Leading employees is another facet of IHRM. Here, as has been discussed in Chapter 7, heterogeneity between different country cultures exerts a strong influence on effective and efficient management. For example, work ethics, job satisfaction, intrinsic motivation, etc., are all related to culture. Also, as the cultural models by *Hofstede* and *GLOBE* reveal, work-related cultural traits are widely divergent between countries. Research has consistently shown that no single leadership style works equally well in all situations, e.g. because the *motivation* in different cultures depends on different features. This *contingency perspective* leads to the recommendation to adapt the leadership style at least partially to the host-country. For instance, in countries with high individualism, employees are more strongly motivated by *individual incentives* than by incentives that are linked to the performance of a group. In countries with high acceptance of power distance, *clear hierarchical orders* are accepted and expected from a superior while the same behaviour might cause frustration in countries with low power distance. Conversely, employees in countries with low individualism might strongly favour *teamwork* and an atmosphere in which *interaction with their colleagues* is promoted. In countries with strong uncertainty avoidance, employees might be better

motivated by *secure jobs* and long-term employment than by *high salaries*. Overall, a participative leadership style is preferred in some countries (e.g. the USA, the Netherlands, or the UK) while a hierarchical leadership style is preferred by employees in others (e.g. Arab countries, Greece, Southern America). In general, the lower the perceived discrepancy between the expected leadership style and the actual leadership style, the higher are the motivation, performance and satisfaction of employees (see Zentes/Swoboda/Morschett 2004, p. 890). These few examples serve to illustrate that, from the perspective of the motivational power, tailoring the leadership style to the host country may be beneficial. But, as a counter-argument, the unity of the MNC has to be considered and a coherent leadership style across the MNC is one of the strongest determinants of a uniform corporate culture across all subsidiaries.

Expatriate Assignments

The reasons to deploy expatriates to a foreign subsidiary are various (Miller 1989; Zentes/Swoboda/Morschett 2004, pp. 877-878; Griffin/Pustay 2010, p. 578; Dessler 2008, p. 703; Dowling/Festing/Engle 2008, pp. 88-92):

Reasons to Deploy Expatriates

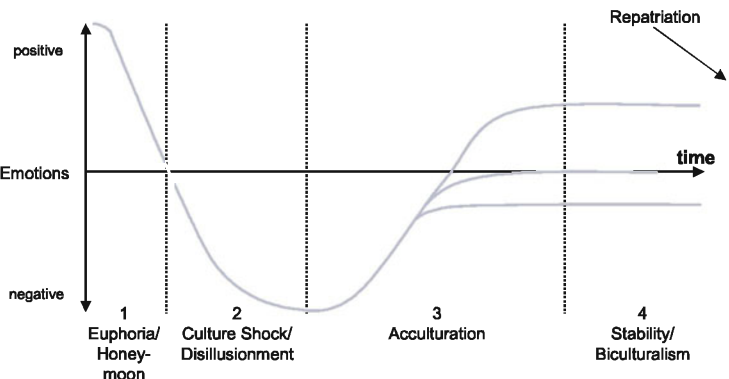
- Supporting the subsidiary operations by *filling a position* with a competent candidate that might not be available in the current host-country staff.
- *Coordinating* the MNC: Expatriates are often the *linking pins* between the headquarters and the subsidiary. They help to implement the corporate strategy in the host country. They are a means of *coordination by direct supervision* and help to transfer the corporate culture from the HQ to the subsidiary and, upon their return, vice versa. *Informal relations* are being established between the expatriate and host-country employees.
- *Knowledge transfer*: In particular for tacit knowledge, expatriates are a transfer mechanism. They give knowledge that they have gained via personal experience in the HQ to their colleagues and subordinates in the foreign subsidiary. When returning to the home country, they transfer knowledge that they have gathered in the subsidiary back to the HQ.
- Expatriate assignments can be an important *incentive* in the *career path* of executives. In this case expatriates are selected for *management development* and as a reward for high performance. The expatriate enhances his managerial skills, learns how to lead people from different cultural backgrounds, develops a tolerance for ambiguity and learns to accept different perspectives.

Phases in Expatriate Assignments

After the candidate has been selected for an international assignment and has been send abroad, the expatriate has to adjust to the new environment to work effectively. Research has shown that cultural adjustment of expatriates to the host country typically proceeds through four different phases (see Figure 19.2; Hofstede 2001; Zentes/Swoboda/Morschett 2004, pp. 882-884; Dowling/Festing/Engle 2008, pp. 117-118):

Phases in Cultural Adjustment

Figure 19.2



Source: Adapted from Hofstede 2001, p. 259; Griffin/Pustay 2010, p. 585.

- In the first stage, the *euphoria phase*, the excitement of working in the new environment is high. The manager sees the new culture as exotic and stimulating and underestimates the challenges of adjusting. This stage usually lasts a few weeks or months.
- In the second stage, many expatriates become disillusioned and the differences between the old and the new environment are perceived in a magnified perspective. The challenges of everyday living become apparent for the expatriate and his family. A *culture shock* occurs which may lead to feelings of disorientation, helplessness and self-doubt. Adequate pre-departure training and careful consideration of personal characteristics of potential expatriates improve this phase. However, expatriates may remain stuck in this phase and it is in this phase that a premature termination of the assignment is most likely.

- After a certain critical point, the expatriate often overcomes the problems and *acculturation* to the new environment can be observed. The employee begins to understand the patterns of the new culture, improves his language competence and adjusts to everyday living. However, this improvement might not be sufficient and various outcomes of this stage are possible (see Figure 19.2).
- In the fourth phase, the situation stabilises and the employee adapts to the new culture. Anxiety has ended and confidence in a successful assignments is gained. The expatriate might even develop a *bicultural perspective*. In this phase, he or she might even prefer some of the environmental influences of the host-country over the situation in the home country.

Repatriation

The average expatriate stays *three to five years* on an international assignment before returning to the home country. *Reasons for repatriation* can also be manifold. Ideally, an expatriate is repatriated after the predetermined time of the assignment is completed. Other reasons include the expatriates' dissatisfaction with the situation abroad, poor performance of the expatriate, a HQ decision that considers the expatriate too expensive for the specific position or an open position at the HQ or somewhere else that needs to be filled adequately (Rugman/Collinson 2009, p. 358). In addition, it has been shown that the inability of an expatriate's spouse to adapt to the foreign culture as well as other family-related aspects are among the major reasons for *expatriate failure*, indicating the high relevance of integrating the family in the considerations of the MNC (Hill 2008, p. 632).

Reverse Culture Shock

In any case, it is only a successful expatriate assignment if it ends with successful repatriation and MNCs should therefore pay as much attention to repatriation. If managers and their families have been successfully expatriated, they become comfortable with living and working in the foreign culture. Returning home can be almost as challenging as was the original relocation abroad. A *reverse culture shock* might occur for many reasons (Rugman/Collinson 2009, p. 358): The home office job lacks the high degree of authority and responsibility the expatriate enjoyed in the overseas job. Sometimes, the employee might feel that the company does not value international experience. Frequently, employees may no longer be well connected to people at the HQ and often, their old job may have been eliminated or drastically changed. Considering their career, an adequate position might not be available at time of re-entry and futhermore, the financial situation might worsen.

Given the high cost and relevance of expatriates, MNCs must attempt to minimise the potential effects of reverse culture shock because otherwise, the management development that is related to the expatriate assignment is

not successfully completed and in the long run few managers will be willing to take international assignments if it leads to career problems and dissatisfaction. In this regard, *adequate career planning* for the time after expatriation is a prerequisite for long-term success (Rugman/Collinson 2009, pp. 358-359).

Conclusion and Outlook

Considering the complex challenges of international management and the dual requirements of local responsiveness and global integration, the employees of the MNC – non-managers and managers – are crucial to develop and implement effective and efficient international strategies. Locally customised HRM practices and performance measures reflect the differentiated network, however, the increasing necessity of normative integration within the MNC results at the same time in unifying approaches.

As a basic trend, the number of ethnocentrically oriented companies is permanently decreasing and the enhanced relevance of foreign subsidiaries – considering the percentage of sales or the contribution to the MNC strategy – is accompanied by an enhanced relevance of managers from foreign countries. Thus, MNCs develop more competence in their subsidiaries. Management development is not only relevant for home-country nationals but increasingly for managers regardless of their nationality. *Expatriates and inpatriates* have, thus, become a common phenomenon.

Internationalisation of Top Management

Caused by the increased relevance of foreign markets for the sustainable competitiveness of MNCs, top management is more and more often composed of executives from different nations to incorporate multiple perspectives in strategic decisions. MNCs like *Nestlé, ABB* or *Unilever* have a top management in which home-country nationals are the clear minority. Even in the case of home-country nationals, the typical career path of top managers in MNCs includes long assignments abroad, usually in different foreign locations. This way, either as parent-country national or as third-country national, executives of MNCs are increasingly socialised and formed in different parts of the world and learn to accept, understand and exploit international diversity.

Further Reading

DOWLING, P.; FESTING, M.; ENGLE, A. (2008): International Human Resource Management, 5th ed., London, UK, Cengage Learning Services.

Case Study: Unilever[1]

Profile, History, and Status Quo

Unilever is a MNC, formed of Anglo-Dutch parentage, which gathers many of the world's consumer product brands in foods, cleaning agents, and personal care under one umbrella. Beyond that it is dual-listed, consisting of *Unilever N.V.*, based in The Netherlands, and *Unilever PLC.*, situated in United Kingdom. With a workforce of approximately 160,000 people in over 100 countries worldwide, *Unilever* is one of the largest consumer goods firms in the world. In 2009 the company generated a worldwide turnover of 40 billion EUR with hundreds of brands. *Unilever´s* strong portfolio of foods, home and personal care is trusted by consumers all over the world. Among them, the top 25 brands account for over 75 % of the company's total sales. Figure 19.3 presents some well-known *Unilever* brands.

Figure 19.3 *Selected Unilever Brands*

Source: Unilever 2010.

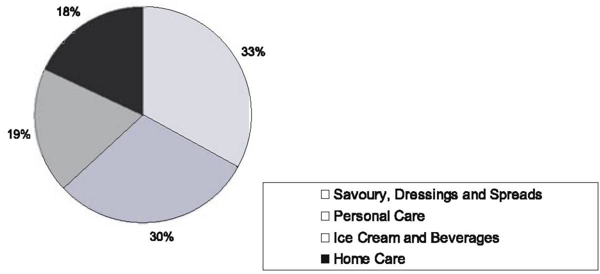
In order to achieve its innovative goals and the pursuit of staying successful, the company invests about 1 billion EUR every year in research and development activities. On this account *Unilever* runs five laboratories around the world and owns 317 manufacturing sites across six continents.

Figure 19.4 gives a brief overview of the percentage allocation of *Unilever´s* portfolio of categories.

1 Sources used for this case study include the web sites http://www.unilever.com and http://www.unilever.de, and various annual and interim reports, investor-relations presentations as well as explicitly cited sources.

Unilever's Sales Distribution in 2009

Figure 19.4



Source: Unilever 2010.

History

In 1888 Dutchman Simon van den Bergh started the industrial fabrication of margarine in Germany in order to avoid the extremely high protective duties. His compatriot Anton Jurgens, first acrimonious business rival then companion, followed his idea and started manufacturing margarine in the German market as well; not far from van den Bergh´s factory. Almost 40 years later, in 1927, the two rival family businesses joined together and created *Margarine Unie* in Rotterdam and *Margarine Union* in London.

Parallel to the events happening around van den Bergh and Jurgens, Englishman William Hesketh Lever started producing *Sunlight* soap within his company *Lever & Co* (later on the business operated under the name *Lever Brothers*) in Mannheim. Finally, in 1930 *Margarine Unie/Union* and *Lever Brothers* merged and became *Unilever* in Germany. It was the greatest merger in history at that time. During the same year *Procter & Gamble* entered the United Kingdom market with an acquisition and became (and still is) one of *Unilever´s* largest rivals.

With the advent of World War II, exchange controls and frozen currencies crippled the international trade and made it almost impossible to operate. *Unilever* in Germany was unable to move profits out of the country and invested alternatively in different enterprises. In *Unilever´s* history there is a long tradition of both buying and selling companies and brands. During the 1960s, for instance, it expanded and diversified through innovation and increasingly through acquisitions. Maljers (1992, p. 46) characterised *Unilever's* structure as follows: "The company has evolved mainly through a Darwinian system of retaining what was useful and rejecting what no longer worked". Dominant economic conditions led to flat sales during the follow-

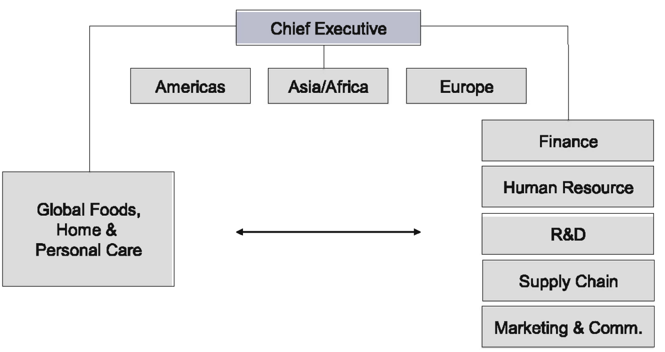
ing decade. Nevertheless *Unilever* established itself at the start of the 1980s as the world's 26th largest business.

Reorganisation

With the beginning of the 1990s the company started a radical reorganisation focusing on its core business lines: Foods (e.g. *Rama, Pfanni, Magnum*), Home Care (e.g. *Domestos, Viss*) and Personal Care (e.g. *Dove, Axe*). Over time, *Unilever* has cut its brands from 1,600 to 900 by 2001.

In order to cope with the requirements of increasing globalisation, the organisation had to become more flexible by minimising its management. Nowadays *Unilever* provides single point accountability and has fewer management layers to deliver faster decisions and faster execution. Figure 19.5 gives a brief overview of the company's international structure.

Figure 19.5 *Three Pillars: Categories, Regions and Functions*

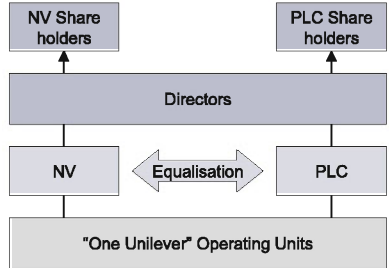


Source: Unilever 2010.

The chief executive is responsible for the results of the company and manages an executive team consisting of three regional presidents, one category officer and several functional managers, e.g. for finances and for R&D, among a multiplicity of individual managers around the world who nonetheless share a common vision and understanding of *Unilever* strategy.

As already mentioned, *Unilever* group consists of two companies: *Unilever NV* in the Netherlands and *Unilever PLC* in United Kingdom. Both have separate legal identities but ultimately they operate as a single entity (see, in this context, Figure 19.6).

Legal Structure — *Figure 19.6*



Source: Adapted from Unilever 2010.

Corporate Policy

Communication of trust through high quality brands is one of *Unilever´s* most important core competences. Today the company holds a strong portfolio of trustworthy brands resulting from a long lasting selection. During the last few years the company has expanded by tightening its brand portfolio, optimising its workflows and an increasing awareness for customer needs. The company grows through focusing on its key brands, simplifying its systems and continuing to develop a world-class supply chain.

Mission

Unilever´s mission is to add vitality to life. The intention of that strategy is focusing more intensively on customers needs which arise from current topics influenced by the environment (e.g. the increased awareness of health or quality of life). All actual requirements ask for qualified and innovative employees who reduce theory to practice.

Instruments for a Successful HRM

In former times human resource departments were simply instances for the production factor "human being". Nowadays human resource management plays a key role and is an active and integrated part of the entrepreneurial design process (Scholz 2000, p. 1) in almost every internationally active company. The following statements regarding *Unilever´s* human resource management policies are valid for national and international aspects. All human resource programs presented in the following sections can be found in every *Unilever* subsidiary all over the world. Thus there will be no explicit differentiation consecutively.

Unilever has recognised staff as one of its most important assets and supports them with different programs and training courses. Operating under

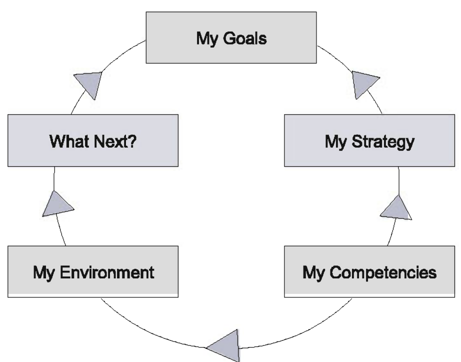
the condition that work has to be fun to be successful, Nick Kitchen (Global Human Resource Manager for IT) explains moreover that a business is only as good as the people in it. As a successful consumer goods giant, *Unilever* practices a comprehensive human resource management.

Individuality

Continued success depends on new ideas and innovations. *Unilever* recruits people from a diversity of background and cultures, and supports them all in realising their personal potential. It offers an environment in which employees can flourish, and it offers opportunities for the staff to pursue their goals, both professionally and personally. That is the reason for being one of the world's most admired employers. Regarding this fact *Unilever* offers on the one hand multiple steps in which the company can determine if a job applicant fits in with the company and on the other hand if the company and its policy is in line with the interested party's imagination. Among other things *Unilever* provides its so-called "personal evaluation toolkit". First of all this exercise shall support decision making and furthermore pointing out the right individual career path for the potential job applicant. Figure 19.7 gives a short overview of the process.

Personal Evaluation Toolkit

Figure 19.7 *Personal Evaluation Toolkit – Step-by-step*



Source: www.unilever.com.

Unilever offers job opportunities for experienced professionals, graduates and as well for students in line with an internship. The company's graduate program educates future business leaders and trains them according to the company-specific needs. The so-called *UniTrain programme* lasts two years and allows graduates a direct entry. "The programme develops professional skills through structured training and on-the-job learning, gained in real jobs

UniTrain

with real responsibility" (Unilever 2008). Students may apply for *UniTrain* within five different divisions: distribution management, financial management, supply chain management, information management & technology and human resource management. The selection, after the online application, results from a three-step procedure including online-tests, telephone interview and assessment centre. A special challenge offers the human resource management sector the new "recruitainment"-programme on which the applicants must solve real computer-animated problems at *Unilever*. The activity on the job will be supplemented by *UniTrain* workshops, e.g. through soft skill training, coaching calls or learning groups. Subsequent to *UniTrain*, *Unilever* confers the first management tasks upon the graduates and still gives helpful feedback. Moreover *Unilever* encourages the young professionals to complete an international assignment in their early years.

Unilever Academies

Working with *Unilever* symbolises a constant learning process. The companionship on the part of the company will not end with the successful conclusion of the access program. Even as adequate member of the group the learning goes on and on. *Unilever* attaches great importance to a constant development of its employees through national and international workshops guided by qualified training supervisors and institutes. With the help of interactive *Unilever Academies* the company has set up internal learning forums for staff from different departments and different countries. The intention is a continual exchange between colleagues all over the world. An example of the exclusiveness and the creativity of *Unilever´s* workshops is the *Unilever Manager Workshop*. For the past 50 years this event has taken place once a year. Selected young *Unilever* managers are trained in challenging tasks and braced for prospective managerial decisions. The development of visions and professional arrangements are in the centre of attention.

Self-Realisation

Besides the education workload given by *Unilever* at the beginning of individual careers, the company empowers its employees to achieve their own personal goals in combination with the group. From their first day, new trainees are given targets for their personal development. Those who show potential to move up will be promoted intensively by the direct bosses as well as by the managers up to three levels above.

Regarding the international context, *Unilever* prefers to have its foreign operations run by locals supported by experienced managers in the beginning and guided by the *Unilever* education programme on the job. *Unilever* prefers developing in-house talents and hot-housing future leaders in all markets. Resulting in the fact that 95 % of *Unilever´s* top managers are home-grown talents who were promoted by the company along their careers. Thereby it is irrelevant if they are educated to work in the headquarters or if they work in a subsidiary in a different countries.

Unilever pursues a polycentric staffing strategy, the company recruits basically host country nationals to head the subsidiaries in foreign countries. Indeed most of the subsidiaries are currently managed by local managers who were trained by experienced expatriates in the forefront. Only 10 % of the dispatched employees are sent to actually head a unit. That only happens if no qualified local manager is available or if a foreign assignment is important to a manager's career development. Most of the foreign assignments last three up to four years. *Unilever´s* philosophy provides that these employees who guide new local managers or who manage a foreign subsidiary for a period of time will be reintegrated in their former business environment.

Besides the commitment on the part of the company, *Unilever* employees offer help to their colleagues. UEN, which stands for *Unilever Expatriate Network*, is a platform for *Unilever* employees who are willing to make their own experiences available for workmates. The *Unilever* expatriate network is run by members of *Unilever* who voluntarily devote some of their time. Experienced expatriates share their collected experiences, practical local knowledge and give advices for the first steps of newcomers.

Questions

1. What kind of accompanying measures in the context of international resource management are often used in general by internationally-active companies and how can companies support expatriates in the forefront?
2. How could *Unilever* accompany its employees more intensively? Arrange a plan of the first steps for how you would prepare staff for a temporary employment assignment abroad.
3. Reintegration or re-entry describes the ending of a temporary assignment abroad e.g. the return of an expatriate. What kind of problems may appear and how can a company avoid or soften these difficulties?

Hints

1. Check the country specific websites of *Unilever*.
2. Consult the literature and in particular the theories of Heenan and Perlmutter 1979 to answer the questions.
3. See also Evans and Pucik 2002 and Dowling, Festing and Engle 2008.

Chapter 20

International Control

Control is a fundamental task of management and its main task is to provide adequate information to decision makers at different levels of the company. This Chapter introduces the functions of international control, discusses the particularities of control in a MNC and describes several control instruments.

Introduction

Control is a fundamental task of management. It involves developing plans for a company, including budgets, monitoring the actual results and deciding on corrective actions in case the actual results differ from the planned results (Rugman/Collinson 2009, p. 444; Mellahi/Frynas/Finlay 2005, p. 347).

Control Process

The typical *control process* for a MNC subsidiary consists of three steps: First, HQ and the subsidiary jointly plan the objectives for the subsidiary for the next year. The influence of the subsidiary management in this process differs strongly between different MNCs. Second, throughout the year, the HQ monitors the performance of the subsidiary against the set objectives. Third, if the subsidiary fails to achieve its objectives, the HQ intervenes to learn why the problems occurred and reacts accordingly when necessary (Hill 2009, p. 666). In addition, on the level of corporate controlling, the plans and budget proposals of the diverse subsidiaries or divisions have to be *consolidated* in an overall plan and budget.

Defining Performance Simensions

More concretely, the first stage of the control process involves defining the performance dimensions. "*What you measure is what you get*" and, thus, the selection of performance indicators and the specific targets give a *sense of direction* and clarity of purpose to managers and employees at the different levels of the MNC and it serves to *align their activities* with the corporate strategy. It also exerts a *motivational influence*. The objectives for the subsidiary should be challenging but realistic (Merchant/Stede 2007; Boddy 2008, p. 640).

Traditionally, the most important criterion for evaluating the performance of a foreign subsidiary is the subsidiary's actual *profits* compared with budgeted profits. Other commonly used criteria include the subsidiary's actual *sales* (compared with the objectives) and its *return on investment* (ROI) (Hill 2009, p. 666).

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Effectiveness and Efficiency

More generally, controls can take many forms. A major distinction is between measures for effectiveness and for efficiency:

- *Effectiveness* is a measure of how well the outcome of an activity relates to the objectives. For example, sales, profits, the number of customers or of produced units could be measures of the effectiveness of a subsidiary unit. Effectiveness reflects "*doing the right things*".
- *Efficiency* is a measure of output divided by the input needed to produce the output. For example, sales per salesperson or produced units per machine hour are efficiency measures. Efficiency means "*doing things right*".

Objective and Subjective Measures

Some aspects of performance can be measured *objectively* (e.g. sales or ROI) while other performance indicators which might be equally important are more depending on *subjective evaluation* (e.g. innovativeness, company reputation, service quality) (Boddy 2008, p. 601). However, some level of quantification is necessary to compare actual results with pre-set standards.

Principal-Agent Problem

If one considers the HQ-subsidiary relationship from a principal-agent perspective (see Chapter 8), with the subsidiary acting on behalf of the HQ, then a major problem lies in the *information asymmetry* since the subsidiary (the agent) usually knows substantially more about its activities and its external environment than the HQ (the principal). From this perspective, it is the task of controlling to reduce this information asymmetry without causing information overload at the HQ. Thus, providing the right amount of necessary information is crucial.

Controlling as Staff Function

It has to be noted that the controllership function usually is a staff function. Controlling assists management in making decisions by providing adequate information. Thus, the controller delivers information and monitors performance but the use of this information remains the responsibility of line management (Merchand/Stede 2007). As a consequence, establishing and running a system to collect and provide information regularly, i.e. an *information and control system*, is part of the controlling task (Boddy 2008, p. 22).

Particularities of International Control

Considering the requirements for controlling a MNC, a set of heterogeneous factors, with regard to the external environment as well as to the internal relationship between subsidiary and headquarters, enhances the quantitative and qualitative challenges. Some measures are *uniform* across the MNC while others are *unique* to a certain situation or country. A number of particularities of international control are given (Zentes/Swoboda/Morschett 2004, pp. 802-806).

In a MNC, usually a *greater number of "control objects"* (e.g. divisions, countries, subsidiaries) has to be considered. In addition, these are usually characterised by a greater degree of *heterogeneity* than in a purely domestic context. Furthermore, the separate organisational units are interdependent, e.g. due to intra-company product flows. Fluctuations in *currency exchange rates* may cause substantial distortions in the comparison between subsidiaries and in the performance measurement. For example, the US subsidiary of a French MNC may fail to achieve its profit goals in Euro, not because of performance problems but merely because of a decline in the value of the US Dollar against the Euro (Hill 2009, p. 666). Due to different currencies, the control of cross-border transactions (including internal product flows) is also more complex. The *comparability* of data is not guaranteed. Different subsidiaries operate in different external environments, thus, comparing profits or ROI may not be an adequate measure to compare the performance of the subsidiary's management (Hill 2009, p. 669).

Curreny Exchange Rates

Different *legal systems, taxation systems and accounting practices* have long required the compliance of MNCs with heterogeneous reporting standards for their external financial reporting. While external financial reporting and internal control are two separate systems with different objectives and purposes, they are usually based on the same databases. Since IFRS (International Financial Reporting Standards) are now introduced as a legal standard in many countries (Boddy 2008, p. 646), a convergence of internal control is likely. International control concerns people from different cultural backgrounds, and *cultural differences* will affect how people respond to control systems (Boddy 2008, p. 622). Problems and misunderstandings between the HQ in one country and a subsidiary in a foreign country are more likely. Cultural differences have an impact, e.g., on the expected and accepted time horizon for planning and reporting, on the use of quantitative or qualitative performance measures, or on the degree of precision and detail in planning and monitoring.

Different Accounting Practices

Gathering *information* in the international context is *more difficult and more costly*; in addition, the information is often *more uncertain*. External data for foreign markets, in particular in less developed countries, might not be easily available. The resulting information advantage of the local management might be exploited to manipulate information which obviously limits its reliability. It also increases the problems of performance measurement (which is a type of agency problem). Finally, as has been pointed out in Chapters 1–3 of this book, the tasks and roles of subsidiaries in different countries vary and also other characteristics like the age or the value-added activities (manufacturing plants, sales subsidiaries, etc.). This has to be considered when measuring its performance.

Gathering External Data

Currency Issues

MNCs have subsidiaries in different countries and usually do business in different currency areas. As a consequence, MNCs are usually exposed to three kinds of exchange risks (Rugman/Collinson 2009, pp. 433-435):

Transaction Risk

- When specific contracts are denominated in a foreign currency, the MNC is confronted with *transaction risk*. In this risk, a financial loss may occur due to an unanticipated exchange rate change which affects already fixed future cash flows when exchanged in the home country currency. For example, accounts receivable in US-Dollars from the sale of a machine today that is being paid by the foreign customer in one year might not result in the planned Euro-value then. Instruments to reduce this risk exist (e.g. *futures* or *options*) but are costly.

Translation Risk

- The *translation risk*, or *accounting risk*, is the risk of losses on the MNC's balance sheet by value changes in foreign-currency assets and liabilities. For example, the plant and equipment of a Japanese subsidiary that is consolidated in the British MNCs' financial statement is subject to devaluation if the Yen is loosing value versus the British Pound.

Economic Risk

- *Economic risk* is the risk of unexpected changes of potential future cash flows from foreign operations that result from exchange rate changes. This can, e.g., be caused by changes in sales, prices or costs. As a recent example, the strong rise of the Euro against the US Dollar in 2007/2008 caused *Airbus* to issue profit warnings. It assumed that its products, which are mainly produced in the Euro-zone, will be less competitive in the future against *Boeing* since most plane purchases are contracted in US Dollars. A strategy of so-called "*natural hedging*" tries to reduce this risk by spreading costs over different currency areas. For example, *Mercedes* and *BMW* have built factories in the USA that allow shifting production output to or from a country as a response to a shift in exchange rates.

To avoid costly and unnecessary risk reducing mechanisms by separate subsidiaries that do not oversee the *MNCs' overall risk exposure* and can usually not evaluate the *net effects*, a certain level of centralisation of financial management of MNCs is required. As a general trend, MNCs today are using a centralised structure to manage currency and financial issues (Shenkar/Luo 2008, p. 402).

Particularities of Control in Multi-Level Organisations

MNCs are not only international, they are typically also multi-level organisations, composed at least of a headquarters, divisions (regional, product, or functional) and usually also country subsidiaries (see Chapter 9).

Heterogeneous Information Needs

"Quite simply, [...] information is produced because people need it. The reasons why they need it vary from one group of people to another" (Gowthorpe 2005, p. 73). It is evident that, in particular in a MNC, the needs of the different groups of people differ strongly – when comparing the information needs of corporate management, subsidiary management, a production manager or the marketing manager of a subsidiary. Since setting performance standards, monitoring them and providing information to the decision-makers in the organisation is the main task of controlling, the different decisions made at the different levels in the organisation and the related information requirements have to be regarded.

Decision and Information Requirements at Different Levels in a MNC

Table 20.1

Decision Type	Decisions	Information Requirements	Information
Strategic	**Corporate Management**		External
	• basic long-term strategic decisions for company • resource allocation to divisions • coordination of divisions (incl. selecting and appraising division management)	• opportunities/threats and strengths/ weaknesses info on coporate level • info across divisions (and performance) • long-term developments (highly aggregated)	
	Division Management		
	• basic targets for subsidiaries • mid-term planning • resource allocation to subsidiaries • coordination of subsidiaries (incl. selecting and appraising subsidiary management)	• targets from HQ • long-term, mid-term, rather speculative data • specific product and/or region related coordination and evaluation data • quantitative monetary info on division results	
	Subsidiary Management		
Operational	• development of country-specific strategies • coordination of operational issues in subsidiary	• targets from division management • operative data from internal accounting • only immediate info on external environment • supportive data from division or HQ	Internal

Source: Adapted from Zentes/Swoboda/Morschett 2004, p. 806.

As the overview in Table 20.1 indicates, the proportion of *strategic decisions* increases with the hierarchy level in the organisation, usually requiring more aggregated information about the *external environment* and rather *long-term, future-oriented* information. An attempt to capture fully the heterogeneity and cross-relationships within the MNC may even lead to information overload at the HQ which would reduce decision effectiveness. On the other side, at the level of subsidiary management, the preoccupation with *operational decisions* requires more *internal information*.

Level of Detail for Performance Targets

As another consequence of the multi-level organisation, the corporate management and subsequently the division managers have to decide on the level of detail with regard to the performance objectives for the subordinate

unit. This decision is related to the basic attitude concerning *centralisation* or *decentralisation* (Merchant/Stede 2007; Boddy 2008, p. 187):

- The superior hierarchy level can decide to set performance targets only on the level of *bottom-line figures*, i.e. rough outcome figures as ROI, etc. In this case, the subsidiary manager has the autonomy to decide *how* to achieve the desired results. These outcome figures are like a "compass" and give loose guidance – leading managers in the right direction but not commanding specific actions. Thus, this system allows for the flexibility to adopt to the specific host country or to unexpected changes.
- On the other hand, top management can set *unambiguous targets* about a *comprehensive set of performance indicators* which guarantees a tight control over the operational behaviour of the subsidiary. This systems acts like a "roadmap" which provides clear guidance to subsidiary managers as exactly how to achieve the specified objectives. The caveat is that superiors in the HQ might not fully understand the specific situation of the subsidiary and, thus, might not really know which subsidiary decisions are best suited to reach the objectives. It also severely limits the flexibility of the subsidiary management to respond to unexpected situations. The advantage of this approach is coherence in the subsidiary behaviour.

Subsidiary Participation in the Process

Considering the planning and budgeting process, the multi-level organisation also has to decide on the *level of participation* of the subsidiaries in this process (Zentes/Swoboda/Morschett 2004, pp. 813-815):

- In a *top-down planning process*, top management starts the planning process and in a cascading procedure, each subsequent management level uses this plan as an obligatory input and merely concretises the objectives for its organisational unit. The objective of plans at lower hierarchy levels (e.g. the subsidiary) is only to fulfil the preset objectives of the superordinate plans. The main advantage of this procedure is the strong coherence of the plans of the organisation; the main disadvantage is a negative impact on the motivation of subsidiaries, in particular if the preset performance objectives are not considered adequate by the subsidiary management.
- Pure *bottom-up process*es hardly exist in reality. Here, subsidiary management (or division management) would set their own performance targets and take decisions for their own organisational units. At the top-management level, plans would be merely acknowledged and maybe consolidated. The advantages of this procedure would be that subsidiary managers are highly motivated to reach the self-set objectives and that the targets are fully aligned to each local context.

Most Common Participation Process

- By far the most common procedure is an integrated *top-down-bottom-up process* that attempts to combine the advantages of both processes. Here, top management issues *guidelines* and rough performance objectives for all divisions/subsidiaries. Then, each subsidiary develops concrete plans and performance targets for its organisational unit, e.g. budgets for the coming year. These plans and budgets are proposed to the HQ. After consolidation and analysis, the HQ might request modifications which then are carried out by the subsidiary in new proposals. These steps might be repeated several times and for an annual budgeting process, the whole procedure may last about three to four months. Despite the time and effort, the procedure has many advantages. Since the process starts with HQ guidelines, coherence is guaranteed and at the same time, corporate priorities are clearly communicated to the subsidiaries. Interdependencies among organisational units are considered by the top-down approach. But simultaneously, the subsidiary is involved in the process which leads to better acceptance of the targets and, thus, commitment to achieve them.

Consolidation on the Corporate Level

In addition, in a multi-level organisation, *consolidation* of reports, financial indicators, financial statements, etc. becomes important. While the typical MNC comprises a parent company and a number of subsidiaries located in different countries and often organised as separate legal entities, most of which are wholly owned by the parent, economically, all the companies in the MNC are interdependent. Thus, the purpose of consolidation is to provide information about the group of companies in the MNC by excluding the transactions among the members of this group (i.e. eliminating sales figures resulting from intra-company product flows or netting out the amount of money owed between MNC units) (Hill 2009, p. 662).

Organisational Issues

As another concern in multi-level organisations, the organisational relation within the controlling function (which is usually a staff function) exerts a strong influence on the role and the main tasks of the controller (Merchant/Stede 2007). This can be described by using the example of a corporate controller and a divisional controller. The organisational challenge arises from the two main responsibilities of a *divisional controller*: On the one hand, he has a certain *support function for the division management*. On the other hand, the divisional controller has a *responsibility towards the corporate controller* to ensure that the internal control practices in the division conform to the corporate objectives and standards and that the information provided by the division to the HQ is accurate. He acts, thus, partly as a corporate guardian over the division activities.

Solid- and Dotted-Line Relationships

In each case, the division controller has to serve two different organisational units. Which of the two functions is dominant is largely dependent on the organisational attachment of the controller (Merchand/Stede 2007). If the divisional controller has a *"solid line"* relationship with the division management, reflecting that the division management has functional and hierarchical authority and the division controller a direct reporting responsibility to the division management, and only a *"dotted line"* relationship with the corporate controller (i.e. an indirect reporting responsibility) then the division support task prevails. Controllership function is in this case rather decentralised and the divisional controller perceived to be a *"division ally"* and a trusted supporter. If, however, the solid line is between the divisional controller and the corporate controller and the dotted line between the divisional controller and the division management, the direct reporting responsibility is giving emphasis on the internal and financial control responsibility. In this case of a centralised controllership function, the division controller is often seen as a *"corporate spy"*, or at least more as a representative of HQ.

Performance Measurement

As has been shown before, profits, ROI, and other performance indicators of foreign subsidiaries are strongly influenced by the external environment in which they operate. Thus, using standardised quantitative criteria to assess the performance of subsidiary managers might not be adequate. However, this might make it necessary to separate the evaluation of the subsidiary itself from the evaluation of the subsidiary management (Hill 2009, pp. 668-669):

Evaluating Subsidiaries

- When *comparing subsidiaries*, it may be adequate to compare ROI, sales, profits, etc. Eventually, it is the task of the HQ to invest its resources in those countries that generate the highest returns. Whether the return of a foreign subsidiary is low due to strong competition, a negative exchange rate development or other influences are not of primary interest. Still, the MNC may want to reduce its investment in a low-performing country.

Evaluating Subsidiary Managers

- When evaluating the *performance of managers* of different subsidiaries, the economical, political, social conditions have to be considered. For example, the manager of a subsidiary that has grown by 3 % might have performed better than the manager of another subsidiary that has grown by 8 %, depending on the average market growth in two countries. Furthermore, it seems reasonable to evaluate the management on the basis of their results in local currency and after consideration of those financial effects which they cannot directly influence (e.g., interest rates, taxes, inflation, transfer prices, etc.).

Transfer Pricing

Intra-company Sales

One characteristic of most modern MNCs is substantial intra-company transactions, e.g. sales of components that are produced by one foreign subsidiary to a subsidiary in another country which uses those components to assemble a final product which might then be sold by another subsidiary in a third country. As already mentioned, about one third of world trade consists of those *intra-company sales.*

Influence of Transfer Prices

The price at which exchange of products or services or rights between different units in the MNC occurs is referred to as the *transfer price*. Obviously, the choice of the transfer price strongly affects the performance of the two subsidiaries that are engaged in the exchange. Using the *arm's length principle,* the price the buyer pays would be the market price under conditions of perfect competition. Thus, it would be openly negotiated between the foreign subsidiaries which would also require the free choice for the buyer to choose another, external supplier. This would also perfectly make use of market mechanisms as a coordination instrument for internal resource allocation. However, transfer prices are *not only a bilateral issue* between the subsidiaries, and *not a zero-sum game* since they also influence the overall profits of the MNC. For instance, raising the sales price of a certain component will raise the profit of the selling subsidiary on the expense of the buying subsidiary. If the selling subsidiary is located in a low-tax country, this will reduce the overall *worldwide tax liability* of the MNC. A similar influence is exerted by *custom tariffs*. Since these are often a percentage of the value of the goods, lowering transfer prices lowers the *import duties* to be paid. In addition, transfer prices might be set with regard to avoid *government restrictions on capital flows*. For example, transfer prices between a foreign subsidiary and the headquarters can be used as a hidden mechanism to repatriate profits from this subsidiary (Rugman/Collinson 2009, pp. 424-425; Hill 2009, pp. 685-686).

Restrictions on Fixing Transfer Prices

However, considering the strong impact of transfer prices, *government regulations* usually keep the range for manipulation in a rather tight frame. Also, the MNC's overall interest on setting certain transfer prices obviously has to be considered when *evaluating the subsidiary management* since this important profit determinant is in this case out of their direct responsibility. It also has to be noted that the flexibility is drastically reduced in the case of a *joint venture* (as buyer or seller) where each of the joint venture partners might have different strategic objectives linked to the transfer price.

Selected Control Instruments

On the strategic level, relatively broad and highly aggregated plans about missions, goals and general strategies are developed (Mellahi/Frynas/Finlay 2005, p. 347). On the operational level, short-term financial planning is the major concern of control, and operational optimisation, with a strong emphasis on quantitative data. The tactical level is the intermediate level between strategic and operational level. From strategic control to operational control, the level of detail and specificity increases while the planning and control period decreases. Control instruments can roughly be attributed to the three levels. *Operational control instruments* include short-term budgets, cost control, inventory control, break-even analysis, or contribution margin analysis and short-term budgets. *Tactical instruments* are, e.g., ABC analysis, industry analysis, benchmarking and financial ratio systems (like the Dupont pyramid). Typical examples of rather *strategic control instruments* are portfolio analysis, scenario planning, balanced scorecard and shareholder value.

Budget

A budget is a plan, expressed in financial terms (or, more generally, in quantitative terms) which extends for a certain period (often one year) into the future (Gowthorpe 2005, p. 378).

Usually, in particular in complex organisations, a number of budgets is prepared, e.g. for sales, production, labour, etc. A reasonable *starting point* is frequently given by the sales budget. With this as input, the production budget can be prepared. This again is usually directly linked to a materials budget, a labour budget, etc. The outcome of the budget process then is a *full set of interrelated budgets* (Gowthorpe 2005, p. 387). Part of international control involves ensuring the coherence of these budgets.

Portfolio Analysis

It is a principal task of the MNC top management to develop a corporate strategy that *defines the businesses* in which the company should be active and, thus, to *structure the portfolio* of businesses. Closely related to this task, the MNC management has to ensure an *effective resource allocation* across business fields, countries and value-added functions. Portfolio models offer a framework that allows an overall assessment of the given portfolio of business units and to determine the desired composition of the future portfolio (see Grünig/Kühn 2006, pp. 165-193, with a detailed overview of such models).

Most portfolio models have in common that they position objects (mostly business units) in a two-dimensional space, i.e. a *matrix* that is created from two criteria. Usually, they also suggest *norm strategies* for the overall portfolio as well as for business units in a specific position in that portfolio. The main differences between the portfolio models are the selected dimensions:

Investment Optimisation Models

- Traditionally, the term "portfolio" origins in the *investment optimisation models*. Here, the portfolio dimensions (which can also be applied to business units or country subsidiaries if they are seen as investment objects which have to yield a certain return on investment) are *risk* and *return*, with the implication that diversification helps to reduce *overall* risk and that the optimal diversification depends on the correlation of risks of the diverse business units.

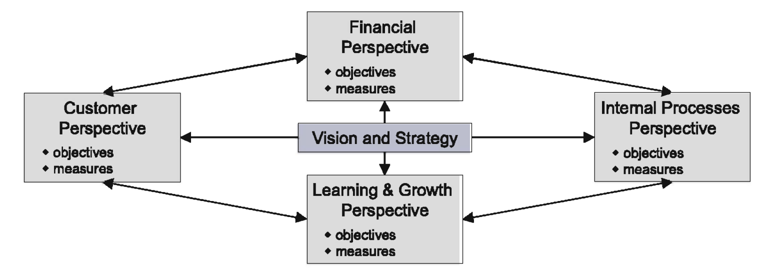
BCG Matrix

- In the well-known *Boston Consulting Group portfolio matrix*, the *relative market share* of the business unit and the *market growth rate* are used to group business units into categories such as *cash cows* (high market share but low growth) or *question marks* (low market share but high growth). It is assumed that, for example, the cash expenditure and the cash inflows depend on the two dimensions and, thus, a balance in the portfolio of cash-generating business units and cash-requiring (but high growth) business units should be given to ensure the long-term competitiveness of the company.
- Another often used portfolio matrix is the *General Electric matrix* which uses the *industry attractiveness* and the *competitive strength* of the business unit as dimensions.

Balanced Scorecard

The control instrument that has arguably attracted most attention in the last decade is the balanced scorecard (BSC) proposed by Kaplan and Norton in 1992. Basically, this is a specific, four-dimensional performance measurement system that comprises *financial objectives* as well as *non-financial measures* (see Figure 20.1). "The balanced scorecard translates an organization's mission and strategy into a comprehensive set of performance measures that provides the framework for a strategic measurement and management system […] The BSC enables companies to track financial results while simultaneously monitoring progress in building the capabilities and acquiring the intangible assets they need for future growth" (Kaplan/Norton 1996, p. 2). More specific, the BSC is build on the assumption of leading and lagging indicators with financial indicators considered to be "lagging" and other indicators (like learning & growth) seen as "leading" indicators that are closer to the root of the long-term company success.

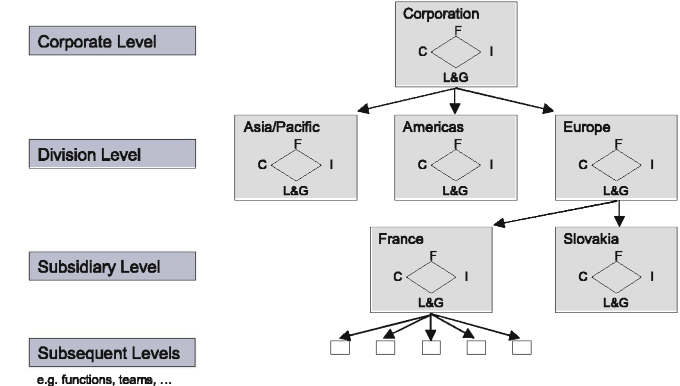
Figure 20.1 *The Balanced Scorecard*



Source: Kaplan/Norton 1996; Gowthorpe 2005, p. 542.

With regard to international control in a MNC, the BSC offers the opportunity to break down superordinate strategies and detailed performance measures on the corporate level into specific and clear objectives for subunits (see Figure 20.2).

Figure 20.2 *Implementing the Balanced Scorecard in Multi-Level Organisations*



Source: Adapted from Rieg/Gleich 2002, p. 697; Zentes/Swoboda/Morschett 2004, p. 830.

Thus, a rather detailed set of performance indicators which comprises financial and non-financial measures is targeted by each subunit, guaranteeing coherence in the organisation.

Shareholder Value

From the shareholder perspective, a major objective of management is to increase the value of the company for its owners. Thus, company decisions should be based on their expected influence on shareholder value. Translating this to MNC management, the performance of a subsidiary or investment project is measured in terms of its contribution to the value of the MNC (Zentes/Swoboda/Morschett 2004, pp. 839-844).

This dynamic investment perspective investigates expected future cash flows and is calculated, e.g., based on *discounted cash flow* (i.e., the net present value of future free cash flows). An example of value-based performance measurement is presented in the *Daimler* case study to this Chapter.

Economic Value Added (EVA)

One of the most frequently applied models of value management is the economic value added (EVA) developed by *Stern Stewart* (Stern/Shiely/Ross 2001). EVA is computed according to formula (1) (Dragun 2004, p. 162; Estrada 2005, p. 288):

(1) EVA = net operating profit (after taxes) - WACC x capital

Thus, the value added considers not only the profit of the company but also whether the profit is sufficient to compensate its capital providers appropriately. It is calculated as profit (using an adjusted profit measure) less the *cost of capital*, thus, as a kind of residual income over the required rate of return for the capital investment (which also considers the *opportunity costs* for the investor). A problem is to define the *weighted average cost of capital* (WACC) which is averaging across the costs of debt and the costs of equity capital. The costs of debt are simply the interest expenses required to serve the debt. But the cost of equity capital is more difficult to calculate because it depends on uncertain factors such as overall stock market risk, return expectations and the *risk-free rate of return* available to investors (Dragun 2004, p. 161). In particular in MNCs, the required rate of return that includes a *risk premium* can differ for investments in different countries or different investment projects that carry different risks. For each investment project in a subsidiary, if EVA is greater 0, this project creates shareholder value but if EVA is below 0, the project destroys shareholder value (Estrada 2005, p. 286). Across potential investment projects or subsidiaries, capital is to be invested in the one with the greatest expected EVA.

Risk Premium

EVA as Evaluation Criterion

Conclusion and Outlook

International control covers not only operational performance monitoring but in particular also strategic control which is mainly future oriented. In an international setting, the complexity of control enhances dramatically, due to, e.g., currency issues, different external environments and cross-border interdependencies. In the MNC, the multi-level structure adds to the complexity, resulting in highly heterogeneous information requirements at different organisational levels and units. A very comprehensive set of control instruments is available to handle this complexity. Their application depends not only on objective and rational decisions but also on subjective attitudes and corporate values.

Polycentric, Ethnocentric and Geocentric Orientation

The general "orientation" of the MNC will influence its response to the challenges for international control. With a *polycentric orientation*, the MNC will leave many decisions to the subsidiary, determine only rough objectives and merely control the output level, e.g. profits. With an *ethnocentric orientation*, the foreign operations are treated as extensions of domestic operations, leading to rather uniform planning and control systems and tight integration into the control system with rather detailed performance indicators and objectives which might neglect the particularities of each foreign country. The *geocentric solution* tries to handle control on a global basis with the adequate level of centralised decisions and uniform control instruments and performance objectives while regarding the heterogeneity of the subsidiaries (Rugman/Collinson 2009, pp. 422-423). This would include, for example, comparing performance of subsidiaries in a rather uniform way as an input for decisions on resource allocation but considering a more complex set of performance criteria for the evaluation of subsidiary managers.

As a general trend it can be observed that control is moving increasingly *from "looking back" to "looking forward"* to support management better (Nurdin 2009, p. 11). Related to this trend is the development that financial performance measures are increasingly supplemented with non-financial performance measures (like customer or employee satisfaction). The widespread application of the BSC clearly reflects this trend to monitor a comprehensive set of performance indicators.

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Case Study: Daimler[1]

Profile, History, and Status Quo

Daimler is a globally leading producer of premium passenger cars and the largest manufacturer of commercial vehicles in the world. Headquartered in Stuttgart, *Daimler* generated revenues of about 78.9 billion EUR in 2009 and thus is one of the largest companies in Germany.

Origins of Daimler

The origins of *Daimler* date back to 1886 when Gottlieb Daimler (*Daimler-Motoren-Gesellschaft*) and Karl Benz (*Benz & Cie. Rheinische Gasmotorenfabrik*) made history by, independently from each other, developing the first internal combustion engine. In consequence of the dramatic situation of the German economy after the First World War, *Daimler-Benz* was formed in 1926 as a result of a merger between the two pioneering automobile companies *Daimler-Motoren-Gesellschaft and Benz & Cie. Rheinische Gasmotorenfabrik*. After recovering from the Second World War, *Daimler-Benz* positioned itself as an innovative manufacturer of high quality automobiles and evolved to one of the most successful car manufacturers in the world.

From Daimler-Benz to DaimlerChrysler

In 1998, *Daimler-Benz* and the US automobile company *Chrysler* announced plans to merge, with *Daimler-Benz* acquiring *Chrysler* for more than 35 billion USD in a stock swap. Operating as *DaimlerChrysler*, the newly formed corporation was led by dual headquarters and chairmen and it was agreed that the respective product brand identities would be operated separately. Moreover, in order to further strengthen its position in the automobile industry, *DaimlerChrysler* acquired a 34 % stake in *Mitsubishi Motors* in 2000. This move made *DaimlerChrysler* the third largest automaker in the world.

From DaimlerChrysler to Daimler

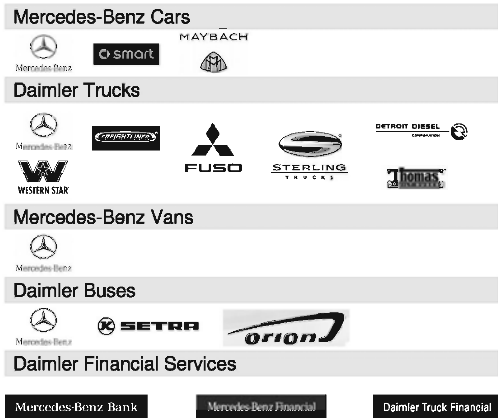
What started with the ambition to create the leading car manufacturer in the world, ended up in an economic disaster and one of the most prominent examples of value destruction in international management. Two vastly different corporate cultures, the lack of synergies, as well as performance and quality issues of *Chrysler*, forced *DaimlerChrysler* CEO Dieter Zetsche to terminate the collaboration between *Daimler* and *Chrysler*. With the transfer of a majority interest in *Chrysler* to *Cerberus*, a private equity company that specialises in restructuring heavily troubled companies, in 2007, a new chapter was opened in the company's history. The deal was accompanied by a change of name from *DaimlerChrysler* to *Daimler*.

1 Sources used for this case study include the web sites http://www.daimler.com, and various annual and interim reports, investor-relations presentations as well as sources explicitly cited sources.

Organisational Structure and Performance

Daimler operates a divisional structure that comprises five divisions. Figure 20.3 displays the divisions and the respective brands.

Figure 20.3 *Divisions and Brands of Daimler*



Source: Daimler 2010.

- The *Mercedes-Benz* Cars division comprises the brands Mercedes-*Benz, Maybach and smart. Mercedes Benz,* the most valuable premium car brand in the world, constitutes the core brand of the segment.
- The *Daimler Trucks* division develops and produces vehicles of the *Mercedes-Benz, Freightliner, Sterling, Western Star, Thomas Build Busses and Mitsubishi Fuso* brands in a global network. *Daimler Trucks* is the world's leading manufacturer of trucks.
- The product portfolio of the *Mercedes-Benz* Vans unit comprises the van model range of the *Mercedes-Benz* brand: *Vito and Viano, Sprinter, and Vario.*
- The *Daimler Buses* division supplies buses as well as bus chassis under different brands. *Daimler* is the market leader for buses above the eight tons mark and *Orion* is the world's leading producer of hybrid buses.
- *Daimler* Financial Services provides a range of leasing, financing, fleet management, and insurance products in close cooperation with the company's automotive brands. The *Mercedes Benz Bank* in Germany offers additional investment products and credit cards.

Table 20.2 reveals selected performance and financial key figures for the various divisions for the year 2007.

Selected Performance and Financial Key Figures for the Daimler Divisions 2009

Table 20.2

	Mercedes-Benz Cars	Daimler Trucks	Mercedes-Benz Vans	Daimler Buses	Daimler Financial Services
Revenues (in million EUR)	41,318	18,360	14,123	4,238	11,996
EBIT (in million EUR)	-500	-1,001	630	183	9
Unit Sales	1,093,905	259,328	165,576	32,482	-
Employees	93,572	70,699	15,226	17,188	6,800
Required Rate of Return on Net Assets (RONA)	12%	12%	12%	12%	13%
Net Assets (in million EUR)	11,373	6,720	1,728	1,221	4,671
Value Added (in million EUR)	-1,865	-1,808	-181	36	-599

Source: Daimler 2010, pp. 76-78.

International Controlling

Value Based Management

"The financial performance measures used at *Daimler* are oriented towards our investors' interest and expectations, and provide the basis for value based management"(Daimler 2010, p. 76). Key elements of value based management as performed by *Daimler* are (Malmi/Ikäheimo 2003, p. 251):

- aim to create shareholder value
- identify value drivers
- connect performance measurement, target setting and rewards to value creation or value drivers
- connect decision making and action planning, both strategic and operational, to value creation or value drivers.

Daimler's striving for value based management is in line with recent developments in controlling and accounting as value based management has attracted considerable interest among organisations across all industries (Malmi/Ikäheimo 2003, p. 235).

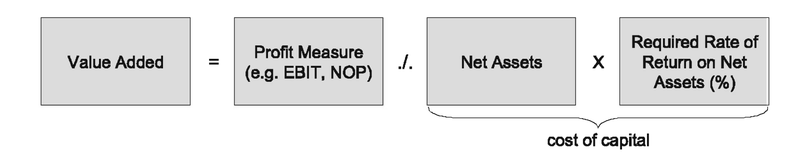
Value Based Performance Measurement at Daimler

Value Added

For purposes of performance measurement, *Daimler* differentiates between the group and the divisional level. The core performance measurement tool that is applied at both levels is *value added*. All management decisions at *Daimler*, like acquisitions or location decisions, are based upon this figure.

The value added indicates the extent to which the operational profit measure exceeds the cost of capital (see Figure 20.4). Hence, value added shows to what extent the group and/or its divisions achieve or exceed the minimum return requirements of the shareholders and creditors, thus creating additional value.

Figure 20.4 *Calculation of Value Added*



Source: Adapted from Daimler 2010, p. 76.

Elements of Value Added

The operational profit measure at divisional level of *Daimler* is EBIT (earnings before interest and taxes). EBIT is calculated before interest, income taxes and results from discontinued operations and thus reflects the profit and loss responsibility of the divisions. In contrast to the divisions, the operational profit measure at group level is net operating profit. Net operating profit includes the EBIT of the divisions as well as profit and loss effects the divisions are not considered responsible for, e.g., results from discontinued operations and income taxes. The cost of capital is comprised of two elements: net assets and the required return on net assets. Net assets represent the basis for the investors' required return. While performance measurement at the financial service segment is on an equity basis, the industrial divisions are in charge of all operational assets. Thus, all assets, liabilities, and provisions the industrial divisions are responsible for are allocated to them. Net assets at group level include the respective net assets of the industrial divisions and the equity of the financial service segment as well as net assets of discontinued operations, income taxes, and other reconciliation items the divisions are not responsible for. The required rate of return is derived from the minimum return that investors expect from their invested capital and comprises the cost of equity as well as the costs of debt and pension obligations of the industrial business. The cost of equity is calculated according to the capital asset pricing model (CAPM). Thus, the cost of equity is determined by the interest rate for long-term, risk-free securities (such as government bonds) plus a risk premium reflecting the specific risks of an investment in *Daimler* shares. The cost of debt is derived from the required rate of return for obligations entered into by the Group with external lenders. By

using the information provided in Table 20.2, Figure 20.5 illustrates the calculation of the value added for the *Mercedes-Benz* Cars division.

Figure 20.5

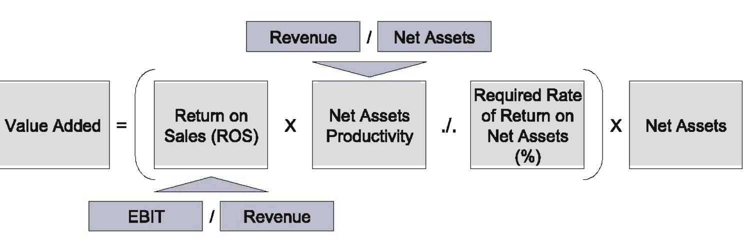
Value Added of the Mercedes-Benz Cars Division (in million EUR) in 2009

Value Added -1,865	=	EBIT -500	./.	Net Assets 11,373	X	Required Rate of Return on Net Assets 12 %

Alternatively the value added of the industrial divisions of *Daimler* can be calculated by using the *return on sales* (ROS) and *net assets productivity*. ROS is the ratio of EBIT and revenue while net assets productivity can be determined by dividing revenues with net assets (see Figure 20.6).

Figure 20.6

Determination of Value Added by using ROS and Net Asset Productivity

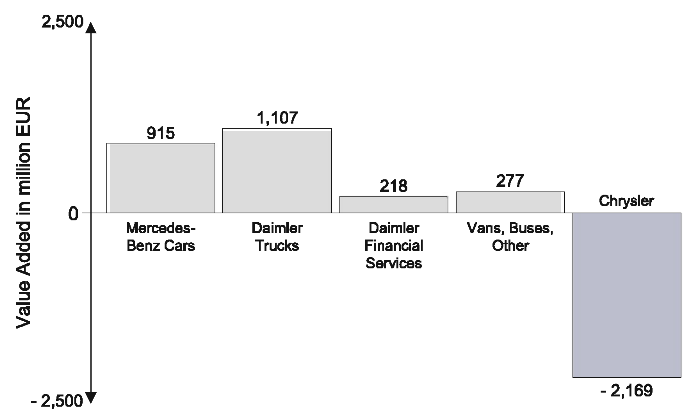


Source: Adapted from Daimler 2010, p. 76.

Value Based Decision Making at Daimler

The acquisition of *Chrysler* in 1998 and the disposal of *Chrysler* in 2007 were arguably two of the most important strategic moves in the history of the *Daimler* company. While the acquisition of *Chrysler* was based on a variety of reasons that range from synergy potentials to management compensation, the disposal of *Chrysler* was basically a value based decision. That becomes evident when comparing the value added of *Chrysler* in the fiscal year 2006 with the value added of the other divisions of the group. While all other divisions delivered a positive value added, *Chrysler* weakened the performance of the group with a value added of -2,169 million EUR (see Figure 20.7).

Figure 20.7 *Value Added of former DaimlerChrysler Divisions in 2006*



Chrysler more than offset the positive value added of the other divisions in 2006 and caused a negative value added for the whole group. The group's profit was therefore insufficient to cover the cost of capital employed. The reason for the poor performance of *Chrysler* was the difficult market and competitive situation in the USA. Hence, from a value based point of view, as *Chrysler* almost entirely absorbed the value contributions of the other divisions, selling *Chrysler* was doubtless a sound strategic move.

Reaction of Rating Agencies on Chrysler Deal

Immediately after the announcement that a majority interest in *Chrysler* would be transferred to *Cerberus* on 14 May 2007, Standard & Poor's upgraded its long term rating from BBB to BBB+ with a stable outlook. *Fitch* placed the BBB+ rating on a positive watch and upgraded *Daimler* from BBB+ to A- three days after the *Chrysler* transaction was closed. *Moody's* changed its outlook from negative to positive as well and finally upgraded the rating from BAA1 to A3 with a continuation of the positive outlook, providing *Daimler* with a higher flexibility in terms of financial management.

International Financial Management

The international financial management of *Daimler* is separated from other financial functions like reporting or accounting and rests on five pillars: capital structure management, cash management, liquidity management, management of market price risks, and the management of pension funds.

Capital Structure Management

Capital structure management is concerned with questions regarding the capitalisation of financial service, production, distribution, and regional holding companies. Apart from basic principles like cost-optimisation and

risk-optimisation, the equity levels of the group companies also depend on refinancing conditions in local banking markets as well as taxation legislation and restrictions on capital transactions in certain countries.

Cash Management

Cash management determines cash requirements and surpluses on a worldwide basis. *Daimler* undertakes remarkable efforts to limit the number of external bank transactions by internal assessment of cash requirements and surpluses. Subsequent cash concentration and cash-pooling procedures are performed accordingly.

Liquidity Management

Liquidity management is concerned with securing the company's ability to meet its payment obligations at any time. Therefore all cash flows from operating and financial activities are tracked in order to identify financial requirements. Besides operational liquidity, *Daimler* keeps additional liquidity through a pool of receivables from the financial service segment as well as a confirmed credit line. This additional liquidity is available on a short-term basis to settle urgent financial demands. Liquidity surpluses are invested in the money market to optimise returns.

Management of Pension Funds

The management of pension funds comprises the investment of pension assets to cover the corresponding obligations. Pension assets are held in separate pension funds and are therefore not deployable for general business purposes. Decisions on capital contributions worldwide are centralised in the pension committee. The funds are invested to different asset classes and constantly benchmarked to optimise fund allocation.

Management of Market Price Risks

As *Daimler* generates approximately 50 % of its revenues outside Western Europe, market price risks like fluctuations in interest rates and commodity prices and especially fluctuations in foreign exchange rates, constitute a remarkable threat for the financial performance and financial stability of the company.

Exchange Rate Risks

An exchange rate risk occurs when revenue is generated in a different currency than the related cost. For instance, the *Mercedes-Benz* Cars division is confronted with this situation. While huge parts of the revenues are generated in foreign currencies (especially USD), most of its production costs are incurred in EUR. The *Daimler Trucks* division, on the other hand, is exposed to this transaction risk as well, but to a lesser extent, because the division vastly benefits from a worldwide production network. Moreover, as many of *Daimler's* subsidiaries are located outside the EUR-zone, exchange rate risks also exist related to the net assets, revenues and expenses of these companies. Since the financial reporting currency of the company is EUR, the income and expenses of the subsidiaries have to be translated into EUR to fit into the financial reporting standards of the group.

Hedging Instruments

The company's overall exposure to exchange rate risks and other market price risks is determined on a continuous basis and hedging instruments are applied respectively. *Daimler* applies a total of four hedging instruments to minimise the impact of market price risks on the results of the group and the divisions: spot sales, outright forward, swaps and options. In contrast to the spot sale, that is a binding contract about the immediate purchase/sale of foreign currency to a fixed spot rate, the outright forward is a binding contract about the purchase/sale of foreign currency in the future at a fixed forward rate. A swap is a binding contract about the immediate and simultaneous exchange of foreign currency. An option grants the owner the right, not the duty, to purchase or sell currency at a specified exchange rate.

Summary and Outlook

The strategic goal of *Daimler* is to achieve sustainable profitable growth in all divisions and to increase the value of the group. However, realising profitable growth in a market that is characterised by overcapacities and thus extremely competitive necessitates a rigorous international controlling as well as a solid financial management. The disposal of *Chrysler* showed that, *Daimler* clearly connects decision making and action planning to value creation and has emphasised *Daimler's* aim to increase shareholder value as the most important factor of value based management.

Questions

1. The case study reveals the value added for the divisions. Calculate the value added for the whole group for 2009.
2. *Daimler* heavily emphasises the shareholder value concept. Compare and discuss the shareholder value approach with an alternative concept known as the "stakeholder approach".
3. In 2007, *Daimler* invested almost 3,500 million EUR to buy back its own shares. What was the rationale for this move?

Hints

1. See *Daimler's* annual report for 2009
2. See Argenti 1997 and Campbell 1997.
3. See Mitchell, Dharmawan and Clarke 2001 for a general discussion of buy-back programmes.

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