chapter 1

The Multinational Corporation

Purpose

The purpose of this chapter is to define the multinational corporation (MNC) and outline its major characteristics and challenges. Various strategies for entering the international arena are delineated. The focus of this book will be on equity modes of entry involving fully owned subsidiaries. First, we paint a broad picture of the globalization of business, the significance of the triad economies and the issue of national identity.

The Globalization of Business

The phenomenon of MNCs has been ascribed to a combination of two main factors: the uneven geographical distribution of factor endowments and market failure (Dunning, 1988). That is, because of their national origins, some firms have assets that are superior to those in many other countries. Moreover, a substantial proportion of these firms have concluded that they can only successfully exploit these assets by transferring them across national boundaries *within* their own organizations rather than by selling their right of use to foreign-based enterprises. More recently, nationally endowed assets have been supplemented by MNCs acquiring, developing and integrating strategically important assets located in other countries, thereby making their national origins somewhat less significant.

To date, this combination of unequally distributed factor endowments combined with difficulties in using market-based arrangements has yielded more than 60,000 MNCs with over 800,000 affiliates abroad. On a global basis, MNCs generate about half of the world's industrial output and account for about two-thirds of world trade. About one-third of total trade (or half of the MNC trade) is intra-firm. MNCs are particularly strong in motor vehicles, computers

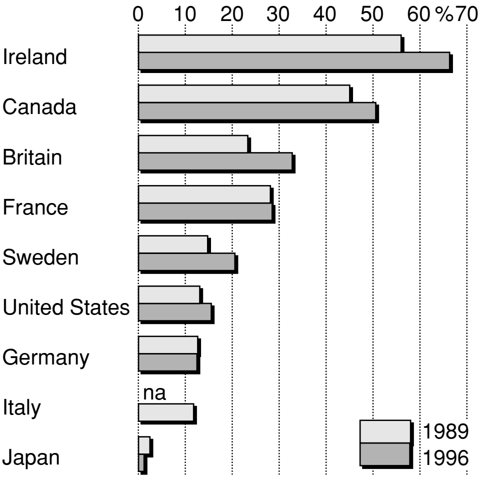

Figure 1.1 Share of foreign affiliates in manufacturing output
Source: OECD © The Economist Newspaper Ltd, London, 8 January, 2000

and soft drinks, having on a global basis 85 per cent, 70 per cent and 65 per cent of these markets, respectively. In some countries they are the dominant manufacturing presence. As figure 1.1 shows, in 1996, affiliates of MNCs accounted for nearly 70 per cent of Ireland's manufacturing output, and over 50 per cent of Canada's. A substantial proportion of manufacturing in Britain, France and Sweden is also accounted for by MNCs. All the indications are that the level of production undertaken by foreign-owned manufacturing will continue to rise. For example, by 1998 for the EU as a whole a quarter of total manufacturing production was controlled by a foreign subsidiary of an MNC compared to 17 per cent in 1990.

The advantages of becoming a global player in manufacturing are more obvious than for service-based firms. In the case of the former, the value chain can be divided across many locations. Parts of the manufacturing process can be located to low-cost countries, while R&D can be located in a region with specialized competencies with its costs spread across many markets. In the case of service firms, much of the value chain has to be generated locally: that is, there is little in the way of opportunity to centralize activities to low-cost locations. To a greater or larger degree, services have to be tailored for each client unlike, for example, pharmaceuticals, which can be mass-produced. Sharing advanced knowledge is also more problematic. In manufacturing companies it can be made available through patented technologies or unique products. In service companies it has to be transferred from country to country through learning processes. Nevertheless with the liberalization of recent years, the share of services in foreign direct investments (FDI) has risen significantly particularly within telecommunications, utilities, investment banking, business consulting, accountancy and legal services.

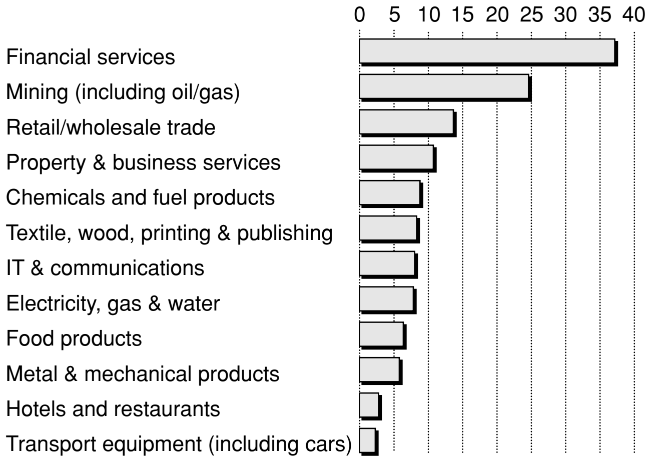

Figure 1.2 Stock of foreign direct investment in Britain, end of 1997, £bn
Source: ONS © The Economist Newspaper Ltd, London, 22 January, 2000

Accenture, the management consultancy, for example, has a staff of 75,000 in 47 countries and the accountancy PricewaterhouseCooper (PwC) has 160,000 in 150 countries. The emergence of new services, such as software, back-office services, call-centres and data entry, has also contributed to the relative growth of services in FDI. At the broad sectoral level, the share of services in FDI now accounts for about half of inward FDI stock in the world.[1] Although Britain is by no means representative of developed economies in terms of spread of foreign direct investment, figure 1.2 nevertheless provides a useful indicator of the diversity of sectors within which MNCs operate.

Despite setbacks such as the Asia crisis of the late 1990s, the long-term flow of foreign direct investment (FDI) is one of inexorable increase. The annual average FDI growth rate between 1986 and 2000 was 30 per cent or more for 65 countries including Denmark, Finland, China, Germany and Finland. Another 29 countries, including Austria, the Netherlands and Russia, had FDI growth rates of 20–29 per cent. For 1999 and 2000 over three-quarters of global FDI inflows went to the developed world partly because of intense cross-border mergers and acquisitions activity. The major recipients at the end of the 1990s were the USA and the European Union (EU), with Germany, the United Kingdom and the Benelux countries figuring particularly strongly. Among developing countries China (including Hong Kong) was by far the most important recipient: nearly 400 of the Fortune 500 firms have invested in China to date.[2]

Within these recipient countries subsidiaries tend to cluster geographically in and around areas with well-developed infrastructures including suppliers, skills and innovative capabilities. In the USA, California, New York, Texas, Illinois and New Jersey are the main magnets; in Japan it is Tokyo, and in China it is the coastal regions.

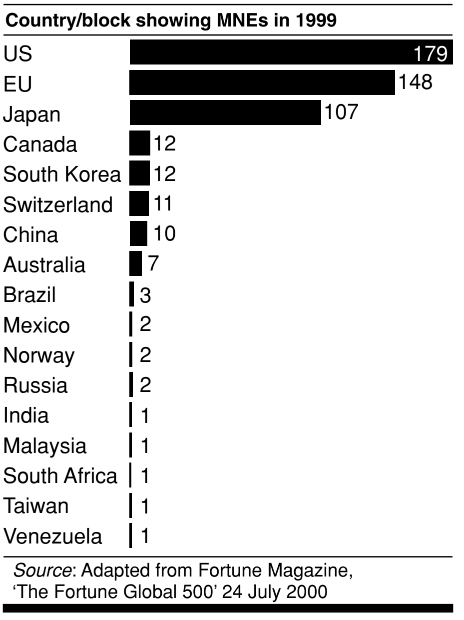

Figure 1.3 The world's 500 largest MNCs
Source: Rugman, 2001

Regional Boundaries

The 'triad' economies, the EU, the USA and Japan, have long accounted for the bulk of global FDI. As figure 1.3 indicates, most MNCs are therefore from the triad. Rugman's (2001) analysis indicates that of the world's largest 500 MNCs, a total of 434 are from the triad. This total has increased from 414 in 1990 indicating the permanency of the triad hegemony. Together, the 434 triad MNCs currently account for 90 per cent of the world's stock of FDI meaning that developed countries are the primary destinations for FDI. The 434 triad MNCs carry out half of all world trade, often in the form of intra-company sales between subsidiaries. However, it should be borne in mind that most of them first and foremost operate in a strong triad home base. In other words, much of the production, marketing and other business activities are organized by regional boundaries rather than being truly global so that the bulk of FDI is concentrated within regions and neighbouring regions. For North America there are strong FDI links with Latin America and the Caribbean, Japan with Asia, whereas for the EU links are strong within Western Europe with some recent strengthening with Central and Eastern Europe. Furthermore, MNCs generally have large portfolios of purely domestic assets. Even the largest MNCs have on average nearly half of their total assets in domestic assets whereas for many smaller MNCs the proportion is substantially larger. Rugman (2001: 10) may be overstating his case somewhat when he concludes that:

> There is no evidence for globalisation, that is, of a system of free trade with fully integrated world markets. Instead the evidence on the performance and activities of multinational enterprises demonstrates that international business is triad-based and triad-related . . . European, North American and Asian manufacturing and service companies compete viciously for market share, lobbying their governments for shelter and subsidies.

However, Rugman's perspective is a useful antidote to naïve notions of the geographical scope of most MNCs, particularly smaller MNCs.

National Identity

Despite the increase in globalization most MNCs have home bases that give them resolutely national identities. General Electric and Microsoft are clearly American just as Honda and Toyota are Japanese. Only one in five of the boards of ostensibly global US companies include a non-US national. Sixty per cent of Honda's sales are outside Japan, but only 10 per cent of its shares are held by non-Japanese. Toyota has 41 manufacturing subsidiaries in 24 countries but no foreign managers among its vice-presidents in Tokyo. Mergers and acquisitions have little impact. Daimler-Chrysler, hailed in 1998 as a merger of equals, soon became a German company with German executives taking control of the US operation while many of Chrysler's most senior executives either left or were forced out. Even within Europe with its single market and single currency, pan-European companies, free of national demarcations, remain elusive. One typical variant is that pan-European ventures end up being dominated by one nationality. Thus Alstom, the transport and power engineering group, started out as a British-French joint venture but is now dominated by French executives, with the UK managers playing a junior role. The other typical variant is that management structures are specifically designed to take into account constituent national sensitivities. For example, the European Aeronautic Defence and Space Company (EADS) formed in 2000 through a merger of Aerospatiale Matra of France and Daimler-Chrysler Aerospace of Germany with Casa of Spain as a junior partner, has two chairmen (one German and one French), two chief executives (ditto) and two headquarters (Munich and Paris).

There are exceptions such as Royal Dutch/Shell and Unilever, two long-standing Anglo-Dutch groups with bi-national identities. But there are few companies with genuinely multinational identities. The most obvious exceptions tend to be located within professional services. The Boston Consulting Group has now more partners outside the USA and also generates two-thirds of its revenues outside the USA. However, these are nationally owned partnerships that confer a degree of local independence. Outside professional services multinational identities are more elusive. However, because an increasing number of MNCs have more employees outside their home base country, creating some inclusive corporate identity is increasingly important in order to enhance knowledge flow from subsidiary to corporate headquarters. ABB, the Swedish-Swiss engineering conglomerate, from its launch in 1988, has always insisted that it has no national axe to grind. It has a tiny corporate headquarters of only 100 employees in Zurich, an executive board comprising a variety of nationalities, and English as its working language. Swedish Percy Barnevik, ABB's first chief executive, famously insisted on fellow Swedes writing to him in English. And yet it took 14 years from its inception and a substantial crisis before a non-Swede, Jürgen Dormann, became its chief executive.

The Focus

MNCs have a number of advantages over local companies. Their size provides them with the opportunity to achieve vast economies of scale in manufacturing and product development. Their global presence also exposes them to new ideas and opportunities regardless of where they occur. Moreover, their location in many countries can be used as a bargaining chip in obtaining favourable conditions from governments anxious to preserve inward investment and jobs. However, with all the advantages size confers, there are also the potential liabilities of slowness and bureaucracy. MNCs are not necessarily successful. Indeed, the Templeton Global Performance Index (2000, 2001) reveals that in 1998 while the foreign activities of the world's largest MNCs accounted on average for 36 per cent of their assets and 39 per cent of revenues, they only generated 27 per cent of their profits. Over 60 per cent of these companies achieved lower profitability abroad than at home. The report concludes that many MNCs are not particularly good at managing their foreign activities, particularly in regard to digesting acquisitions, and that strong core competencies do not guarantee international commercial success. Furthermore, the gap between the best- and worst-performing companies is growing.

Over 40 years ago Hymer raised the question of why MNCs existed at all given that they are 'playing away from home' both in national and cultural terms. Domestic companies have 'the general advantage of better information about their country: its economy, its language, its laws and its politics' (1960/1976: 34). Certainly the liability of foreignness is particularly severe in the initial entry phase. An MNC will often have to compete head on with domestic companies that have a number of natural advantages. First, domestic companies have a customer base they have cultivated and which is familiar with their brands. This loyalty to a local player has to be overcome in such a way that it does not evoke a nationalistic reaction. In the early 1990s, Norwegian ice cream manufacturers responded to Unilever's entry into the Norwegian market by playing the nationalistic card. In an aggressive advertising campaign that featured Norwegian national symbols, great emphasis was put on the intrinsic superiority of Norwegian ingredients. The public turned its back on Unilever's products and it withdrew from the Norwegian market.

Second, local firms will also have developed supply chain relations that may involve long-term contractual relationships that effectively preclude newcomers. This has been a formidable barrier for companies entering the Japanese market.

A third entry barrier is that national regulators will tend to discriminate against foreign subsidiaries. Except when they are so locally embedded that they are perceived as domestic, foreign firms will be significantly more investigated, audited, and prosecuted than their domestic counterparts (Vernon, 1998). Even in the United States, officially committed to applying the same 'national treatment' to the offspring of foreign companies that they give to their own companies, it has been empirically documented that 'foreign subsidiaries face more labour lawsuit judgements than their domestic counterparts' (Mezias, 2002: 239). As such foreign MNCs such as Honda, Unilever and Novartis, have recognized the need to form a body that monitors and responds to discrimination. The Organization for International Investment (Offi) has found it must remain alert. According to Nancy McLernon, Offi's deputy director, '[Discrimination] can come from any direction, any time.' For example, in 1998:

> someone at the US Interior Department had a bright idea – to conserve the increasingly tight supply of irrigation water in 16 states in the west of the country by forbidding its use to foreign companies . . . Bear Creek, a fruit and flower company belonging to Japan's Yamanouchi, lost its water rights for its roses. It was 10 months before Offi was able to get the Treasury and State Departments to convince the Interior Department to turn the taps back on. (*The Financial Times*, 5 May 2000)

Finally, a fourth entry barrier is the lack of institutional and cultural insight. When Wal-Mart moved into Germany it had little feel for German shoppers, who care more about price than having their bags packed, or German staff, who hid in the toilets to escape the morning Wal-Mart cheer. Added to that were two of factors mentioned above, the inflexibility of local suppliers and the entrenched position of local discounters such as Aldi, but also the strength of trade unions. In the wake of losses of $300m a year, John Menzer, head of Wal-Mart International, admitted, 'We screwed up in Germany.'

To overcome these disadvantages an MNC must possess some unique strategic capability whether it is advanced technological expertise, marketing competencies or scale economies. In addition, an MNC also has to have some form of organizational capability that enables it to leverage more from its assets via subsidiaries than it could through other entry strategies (see below). This capability and the costs associated with developing it must not be taken for granted. Increasingly, one of the most important aspects to this organizational capability involves the management of the knowledge base of the MNC. This comprises not only the transfer of knowledge between the various parts of the MNC, but also the creation of new forms of knowledge by combining knowledge located transnationally both within and beyond the MNC.

The focus of this book is on the managerial and learning challenges that MNCs have to confront in order to create the necessary organizational capabilities. Not only are these challenges substantial, they are also constantly evolving. Even Coca-Cola, one of the most profitable foreign operations in the Templeton Global Performance Index for 1998, acknowledges this. In an open-hearted essay published in the *The Financial Times* (2000), Coca-Cola's CEO Douglas Daft revealed that:

> Sometimes you have to stumble before you realise you have wandered off the right path. That is what happened to our company in 1999. After 15 years of consistent success, we endured a year of dramatic setbacks. Those events provided us with a clear wake-up call that told us we had to rethink our approach for the new century.

In essence the challenge for MNCs is to retain their size, which gives them economies of scale and scope, and their global reach which enables them to exploit new opportunities and ideas wherever they may occur. They also need to maintain their multiple country locations that not only grant them flexibility in deciding where they will source products, but which also enable them to bargain with local governments. However, it is these strengths that also represent their liabilities in that large, globally distributed companies can easily become bureaucratic and therefore non-entrepreneurial and insensitive to the many different environments in which they operate (Birkinshaw, 2000). Indeed, some researchers claim that there is a non-linear inverted U-shaped relationship between international diversification and performance.[3] Beyond a threshold of international expansion, returns diminish due to the limits of the firm and its management. That is, at some point the transaction costs involved in co-ordinating and controlling geographically dispersed units outweigh the benefits of international diversification.

Addressing these liabilities involves developing a corporate culture that stimulates commitment to the company, entrepreneurial attitudes and a non-parochial mindset. This must be supported by appropriate reward and career systems. Added to this is the need for structures that match the strategic thrust of the company by defining the basic lines of reporting and responsibility. However, unlike purely domestic companies, the context within which MNCs operate involves national cultural differences, distance and regulations that vary by national setting and which may be biased against foreign companies.

In short, MNCs must have the capacity to respond to local conditions as well as the ability to benefit from their size through the integration of their activities. How much local responsiveness and how much global integration are needed may vary but to a substantial extent they are the two most important issues MNCs with say 200,000 employees and locations in 30 countries must respond to.

Entry Strategy Alternatives

Once a firm has decided to enter the international arena it must make a choice regarding the appropriate mode for organizing its foreign business activities. There are a number of entry strategies available. These alternatives are not mutually exclusive, indeed, large companies may employ them simultaneously in different contexts. Choice of entry modes can be fruitfully divided into the following:

1. Non-equity modes:
   - exporting,
   - licensing,
   - franchising
   - contract manufacturing and service provision
2. Equity modes:
   - joint ventures
   - fully owned subsidiaries.

These modes vary in terms of the risk they involve. They also differ in terms of their organizational, management and resource demands as well as the amount of control that can be exercised over foreign operations.

Exporting

Exporting is a relatively low-risk entry strategy as it involves little investment and exit is unproblematic. As such, it is an obvious alternative for firms lacking in capital resources. An exporter is, however, entirely dependent on being able to identify efficient and reliable distribution channels. Changing a distributor with whom one is dissatisfied is often contractually difficult. Other critical factors are import tariffs and quotas as well as freight costs.

Licensing

Licensing is another low investment, low-risk alternative that is a particularly useful option in countries where regulations limit market entry or where tariffs and quotas make export a non-viable strategy. It is also a preferred strategy when the target country is culturally distant from the home country or there is little prior experience of the host country. A licensing agreement gives a firm in a host country the right to produce and sell a product for a specified period in return for a fee. The main weakness with licensing is the licensor's lack of control over the licensee. This applies to quality standards that, if disregarded, can be detrimental to the brand's image. It also applies to the monitoring of sales that form the basis for royalty payments. Another risk is that the licensee may appropriate the competence underlying the product, thereby becoming a direct competitor. That is why licensing is primarily suitable for the mature phase of a product's life cycle in which the technology that is transferred to the licensee is older and standardized. In other phases of a product's life cycle direct ownership is a more viable strategy.

Franchising

Franchising is similar to licensing but more comprehensive. For a fee and royalty payments the franchisee receives a complete package comprising the franchiser's trademark, products and services, and a complete set of operating principles thereby creating the illusion of a worldwide company. Holiday Inn and, not least, McDonald's with its 29,000 restaurants in 121 countries are two familiar examples. Both of these franchisers place great emphasis on ensuring that quality does not vary. However, beyond that, management control is so devolved that McDonald's chief executive Jack Greenberg characterized McDonald's as in reality being 'an amalgamation of local businesses run by local entrepreneurs from Indonesia to France.'[4]

Contract manufacturing and service provision

Nike distinguishes between design, product development and marketing, on the one hand, and shoe and clothing manufacturing, on the other. The latter is not integrated in Nike but is contracted out to independent plants in developing economies such as China, Indonesia, Thailand and Vietnam, primarily for reasons of cost. In Indonesia in 2001 its nine contractor factories paid base monthly salaries slightly above the official minimum wage of about $28. The main benefits to Nike are that it has none of the problems of local ownership, nor does it invest its own capital in manufacturing. Nonetheless, various pressure groups have ensured that Nike has become a focus for international scrutiny because of allegations of sexual harassment and physical and verbal abuse of workers at its contract factories. Increasingly it has recognized that it cannot relinquish moral responsibility for conditions at contractor manufacturers. It has even commissioned outside groups such as the Global Alliance for Workers and Communities to examine conditions in its contractor plants as a means of improving conditions.

Mobile phone vendors, including Ericsson, Philips and Motorola, have applied the same model to handset manufacturing. They outsource the production of handsets to Asian companies, such as the Singapore-based Flextronics, on a contractual basis while retaining control of research, design, branding and marketing. The key advantage to mobile phone vendors in not owning their own factories is that they have the flexibility to ramp production up or down in accordance with extreme fluctuations in demand without long-term capital investments or an increase in their labour forces. The disadvantage lies in that they are handing over control of a vital part of their supply chain. Not only is quality control more problematic, there is also a dependency on the contract equipment manufacturer (CEM) possessing or having access to the necessary parts. In 2000, Philips ran into difficulties when it emerged that its CEM was lacking in flash memory chips, thereby jeopardizing production of nearly 20 million handsets. It is these disadvantages that have caused Nokia to resist outsourcing beyond the manufacture of assemblies.

Basically the task of the CEM is to manufacture products according to well-specified designs provided by their clients. Their use is appropriate when technology is less important as a differentiator and value is derived from competing on brand, distribution and style. In the case of mobile handsets, Motorola has concluded that they are no longer complex products but merely commodities. Contracting out involves therefore no loss of critical learning opportunities. In the personal computer industry, the commodity model has been taken a step further. Vendors not only contract out manufacturing but also a large proportion of the work design is allocated to companies that offer original design manufacturing. Distribution may also be outsourced. Contracting taken to this extreme means that the MNC is not a firm in the traditional sense, that is a vertically integrated organization, so much as a network of contractually determined market based obligations that together constitute a complete supply chain. This emerging organizational form makes for a new set of managerial challenges – the management of contracts and relationships across borders. This is a theme we will return to in the final chapter of the book.

Finally, it should be noted that contract arrangements are by no means confined to manufacturing. Nearly half of the 500 largest MNCs regularly use Indian IT service providers on a contractual basis because of their combination of low costs and advanced processing skills. The contracts involve a spread of IT services from low value work, such as systems maintenance, to the more lucrative development of new applications such as Internet-based portals.

International Joint Ventures (IJVs)

The establishment of IJVs have been an increasing trend since the 1970s. By the 1990s IJVs were the mode of choice about 35 per cent of the time by US MNCs and in 40 to 45 per cent of international entries by Japanese multinationals (Beamish *et al.*, 2000). An IJV is an agreement by two or more companies to produce a product or service together. It involves a much higher level of investment and therefore of risk than the previous entry strategies. Generally, an IJV consists of an MNC and a local partner. Equity proportions vary but usually relative ownership approximates to 50–50, although there are many variations including IJVs with more than two partners including relatively passive partners with minority holdings. Control of the five to ten management positions that typically constitute the top management group of an IJV is a central issue in IJV negotiations, particularly in regard to the top position of general manager. This position usually goes to the partner that has the dominant equity position or some other basis of power such as critical technology. The partner that does not win the top position will argue strongly for other slots that guarantee the desired level of representation. Typically members of the management group of IJVs have two agendas: on the one hand they are expected to commit themselves to the success of the IJV, on the other they are 'delegates' of their respective parents. As legal entities, IJVs have boards of directors who set strategic priorities and make decisions regarding the use of profits and investment policy (Hambrick *et al.*, 2001).

Until recently, an IJV was the only means of entry in India because local participation was mandatory. In China, foreign retailers are barred from having full control of mainland operations thus compelling retailers such as Carréfour of France, Wal-Mart of the USA and Tesco of the UK to look for local partners. However, even when local participation is not obligatory, an IJV may be appropriate because a local partner can provide intermediate inputs, such as local market knowledge, access to distribution networks and natural resources, as well as making the MNC an insider in the host country. When Tesco entered the South Korean market in 1999, it chose to do so with Samsung, Koreas's biggest conglomerate and most powerful brand. By choosing to put Samsung's name in the joint-venture title first and by appointing a Samsung executive as chief executive, Tesco went a long way to diffuse potential criticism in a country dominated by small, traditional shops. In addition it was helped by Samsung to develop a hypermarket adapted to Korean tastes including assistants in traditional Korean dress who bow to each arriving customer, and octopus, squid and lobster that are plucked from tanks and chopped up alive, sushi-style.

The benefits of IJVs are that they provide a combination of rapid entry into new markets, risk-sharing and increased economies of scale. The problem they face relates to diverging expectations and objectives. Rarely are the two partners equally matched with the MNC usually the stronger partner in terms of technology and management skills. The result is that the local partner may come to view the MNC as overzealous in protecting its core technology and on imposing its control on the joint venture, while the MNC finds it difficult to trust its local partner. The friction that this generates is a major explanation of why many IJVs result in partner dissatisfaction or outright failure. Indeed, some surveys have suggested such outcomes for about half of MNCs with IJVs (Beamish *et al.*, 2000).

Fully owned subsidiaries

Disregarding local ownership restrictions imposed by host country governments, preferring fully owned subsidiaries to IJVs is largely a product of an assessment by the MNC of the transaction costs involved in obtaining intermediate inputs. Fully owned subsidiaries are preferred when these represent the most efficient solution, a calculation that may well stem from problems in locating a reliable partner. However, it is also to some extent a product of national culture. It has, for example, been shown that all things being equal, the propensity for US firms investing in Japan to choose joint ventures over wholly-owned subsidiaries is substantially higher than for Japanese firms investing in the USA (Makino and Neupert, 2001).

Fully owned subsidiaries can be divided into mergers and acquisitions (M&As), on the one hand, and start-ups, on the other. Although it is often difficult to distinguish between mergers and acquisitions in precise terms, mergers are usually the result of a friendly arrangement between companies of roughly equal size, whereas acquisitions are unequal partnerships, often the product of a hard-fought battle between acquiring and target companies. The scale of M&As as a vehicle for FDI has increased rapidly since the beginning of the 1990s. Most new FDI in 1998 was in the form of M&As. M&As have the advantage of providing rapid entry into a market and therefore economies of scale. Established product lines, distribution channels and insider status are all obtained. They can also be of great value as a means of capturing new expertise. On the other hand the difficulties encountered in integrating the acquisition into the culture and overall strategy of the MNC should not be underestimated, particularly in the case of acquisitions where there may be deep resentment amongst employees in the acquired unit. Frequently, despite due diligence, the acquirer also lacks a proper understanding of what has been acquired. A new identity for the acquired firm has to be developed and as acquired businesses often involve a seat on the parent board, there may be board-level disagreement as to precisely what that identity is. The difficulties are such that as many as 50 per cent of M&As fail.[5] However, as the World Investment Report 1999 comments, MNCs do 'not seem to be deterred by the relatively poor results that have been observed with respect to M&As' (UNCTAD, 1999: xxii).

Start-ups do not involve having to grapple with the problem of integrating cultures and creating a unified purpose. Nevertheless, as an entry strategy it is generally the strategy that carries the highest risk particularly in countries with nationalistic attitudes toward foreign ownership. Start-ups also require the longest time to establish, and require the greatest contribution of know-how.

The choice of start-up versus acquisition tends to be affected by the industry the MNC is operating in. MNCs operating in industries that are driven by unique or superior technical expertise are characterized by a preference for start-ups since they can build their operations in a way that minimizes the costs in transferring their knowledge. An acquisition will often involve dealing with incompatible methods for absorbing and processing knowledge and even a low motivation for new knowledge. For example, Nokia, since it began to focus on mobile phones, has expanded mainly through start-ups, whereas ABB, operating in established technology sectors, has grown mainly through acquisitions. However, there are also cultural factors at work in such a choice. Japanese firms tend to prefer entry through start-ups rather than acquisition, whereas British firms are more comfortable with acquisitive entry. Harzing (2002a) has shown that differences in MNC strategies also have an influence on the choice of entry mode. MNCs that are particularly focused on adapting their products and policies to the local market tend to prefer acquisitions because the acquired subsidiary will at the outset be aligned with host country conditions, while MNCs that regard their subsidiaries as pipelines for standardized, cost-efficient products will prefer start-ups. Finally, there is the impact of prior experience. MNCs that have successfully employed acquisitions will be more likely to choose acquisitions in subsequent entries (Chang and Rosenzweig, 2001).

Collaboration or internalization?

Initial entry mode choices are difficult to change without considerable loss of time and money, making entry mode selection a very important strategic decision for MNCs. In essence, the decision is whether to collaborate in some way with local partners in the host markets or whether to internalize operations. Collaboration allows the firm to extend its competitive advantages into more locations faster and with reduced cost and market uncertainty. This enables it to focus its resources on further developing its core competencies. Another advantage is that a local partner can provide knowledge of the local economy or product-specific knowledge. Despite these benefits there is a high level of managerial dissatisfaction with inter-firm collaboration. In part this is due to the costs associated with training partners and providing technology and management assistance. More important though are the costs involved in writing, enacting, and enforcing contracts with partners. This is a particular problem in dealing with firms in countries with low transparency, that is unclear legal systems and regulations, macro-economic and tax policies, accounting standards and practices, and corruption in the capital markets. PricewaterhouseCoopers have produced an index that weighs the effects of each of these factors for each of 35 countries. The results are displayed in figure 1.4.

However, internalization involves the costs of additional payrolls and overheads, investments in plant, property and equipment and added administrative costs. Because of this, in high-risk countries some form of IJV is often preferable to full ownership (Gatignon and Anderson, 1988). Internalization also means the loss of relevant market knowledge that a local partner might supply. This is particularly valuable when socio-cultural distance is high, explaining why partial ownership is preferred in settings that are regarded as very foreign (Gatignon and Anderson, 1988).

In trying to understand the circumstances under which collaboration is efficient or optimal it has been pointed out that because IJVs involve a partner and therefore considerable risks of free riding and other opportunistic behaviour, IJVs should be avoided whenever there is a significant proprietary content to the intangible

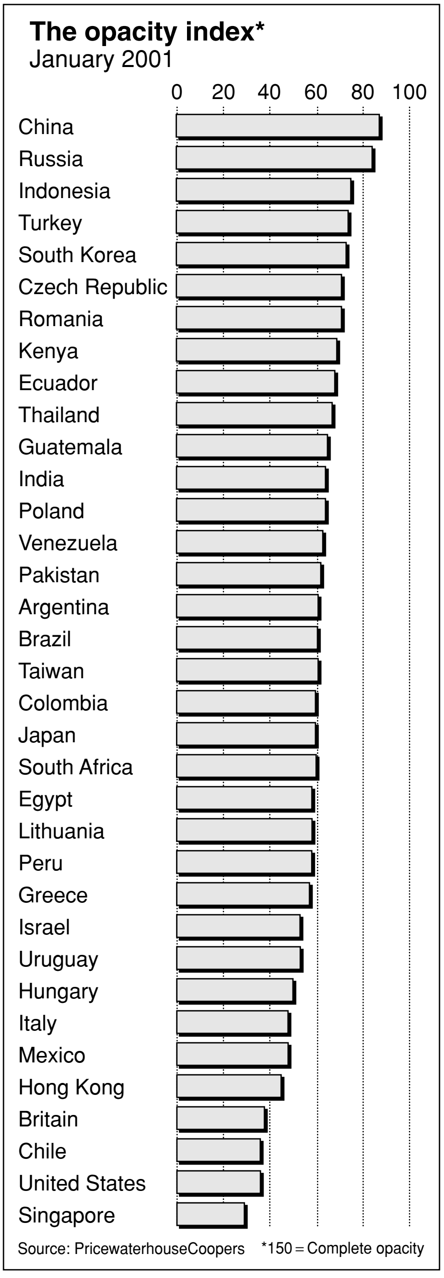

Figure 1.4 The opacity index
Source: © The Economist Newspaper Ltd, London, 3 March, 2001

assets, whether they be technology or brand loyalty. Indeed, empirical research has shown that entry by full ownership is positively related to intangible assets such as R&D intensity and advertising intensity (Anderson and Gatignon, 1986; Gatignon and Anderson, 1988). Another aspect to collaboration concerns the type of knowledge that is to be applied in a host market. Knowledge that is tacit or poorly codified is difficult and costly to transmit across organizational boundaries. In other words, MNCs should avoid collaboration if the international exploitation of tacit knowledge is involved (Shrader, 2001).

In this book we will largely disregard the non-equity modes of entry, export, licensing, franchising and contract manufacturing. Our primary focus is on firms that have fully owned subsidiaries or management responsibility for IJVs. It is these we regard as fully-fledged MNCs.

By MNC we therefore mean a firm which not only has substantial direct investments in foreign countries, but which also actively manages these in an integrated way. In other words, firms that simply export their products fall outside the parameters of this book, as do firms that license their products to foreign firms. Applying these two criteria consequently means that MNCs are a relatively recent development with most of them founded after World War II.

Summary

In this chapter we have defined what we mean by an MNC, i.e. actively managed substantial foreign direct investment made by firms that have a long-term commitment to operating internationally. We have thereby excluded several prevalent forms of internationalization such as licensing and contract manufacturing. MNCs are a historically recent phenomenon whose presence is particularly evident in certain sectors. Despite local resistance, sometimes explicit and sometimes tacit, MNCs have generally proved themselves, as their dramatic growth in numbers and proportions indicate, to be highly robust, at least within the context of their own triads. Nevertheless, their individual positions are always under threat because of their size and geographical dispersion, factors that make communication and control problematic. Success for individual MNCs is far from guaranteed. They are ‘playing away from home’ and must therefore have the organizational capabilities that enable them to leverage whatever unique strategic capabilities they possess. Increasingly these capabilities are knowledge-based. This book is therefore about the managerial challenges involved in creating and sustaining that necessary organizational capability that in turn enables the MNC to harness its knowledge resources.

The case that follows traces the process of internationalization of Vita, a European financial services company. In terms of entry mode it chose, at different times, both the acquisitions and start-ups route. The case illustrates the necessity of responding to institutional and cultural conditions, in other words, the necessity of some degree of local responsiveness. The issue of national identity is also a feature of the case. Finally, Vita also serves as a precursor for a dominant theme in this book, that of learning and the transfer of knowledge across boundaries.

Notes

1 UNCTAD (2001).
2 UNCTAD (2001).
3 See Geringer, Beamish and daCosta (1989) and Hitt, Hoskisson and Kim (1997).
4 *The Economist*, 3 November 2001.
5 Child, Faulkner and Pitkethly (2001).