

See discussions, stats, and author profiles for this publication at: <https://www.researchgate.net/publication/5222817>

Analyzing Foreign Market Entry Strategies: Extending the Internalization Approach

Article in *Journal of International Business Studies* · February 1998

DOI: 10.1057/palgrave.jibs.8490006 · Source: RePEc

CITATIONS

509

READS

23,689

2 authors:



Peter J Buckley
University of Leeds

566 PUBLICATIONS 24,363 CITATIONS

[SEE PROFILE](#)



Mark Casson
University of Reading

283 PUBLICATIONS 16,590 CITATIONS

[SEE PROFILE](#)

Some of the authors of this publication are also working on these related projects:



Development of trust View project



Meta-Analytic Research in International Business and International Management View project

(Hymer, 1976; Kindleberger, 1969). This led to the identification of technological and marketing skills as the key elements in successful foreign entry (Hirsh, 1976; Horst, 1972). This tradition of firm-specific advantages (Caves, 1971; Rugman, 1981) connects with the literature on core competences arising from the Penrosian tradition (Penrose, 1959; Prahalad and Hamel, 1990). Sequential modes of internationalization were introduced by Vernon's "Product Cycle Hypothesis" (1966), in which firms go through an exporting phase before switching first to market-seeking FDI, and then to cost-orientated FDI. Technology and marketing factors combine to explain standardization, which drives location decisions.

Internalization

Buckley and Casson (1976) envisaged the firm as an internalized bundle of resources which can be allocated between product groups, and between national markets. Their focus on market-based versus firm-based solutions highlighted the strategic significance of licensing in market entry. Entry involves two interdependent decisions - on location and mode of control. Exporting is domestically located and administratively controlled, foreign licensing is foreign located and contractually controlled, and FDI is foreign located and administratively controlled. This model was formalised by Buckley and Casson (1981), and empirically tested by Buckley and Pearce (1979), Contractor (1984) and others.

Stages Models of Entry

The Scandinavian "stages" models of entry suggest a sequential pattern of entry into successive foreign markets, coupled with a progressive deepening of

commitment to each market. Increasing commitment is particularly important in the thinking of the Uppsala School (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977). Closely associated with stages models is the notion of "psychic distance," which attempts to conceptualise and, to some degree, measure the cultural distance between countries and markets (Hallen and Wiedersheim-Paul, 1979). For a more recent view see Casson, 1994.

Non-Production Activities

In explaining foreign market servicing policies, the role of non-production activities must be made explicit. The location of research activities is widely debated, especially in relation to spatial agglomeration (Kogut and Zander, 1993). There is also an extensive literature on the entry aspects of marketing and distribution (Davidson and McFetridge, 1980), much of it in a transactions cost framework (Anderson and Coughlan, 1987; Anderson and Gatignon, 1986; Hill, Hwang and Kim, 1990); Kim and Hwang, 1992; and Agarwal and Ramaswani, 1992).

Mergers and Acquisitions Versus Greenfield Ventures

Stopford and Wells (1972) examined takeovers versus acquisitions as part of their analysis of the organisation of the multinational firm. The predominance of entry via takeovers in most advanced economies has stimulated a number of good empirical studies (Dubin, 1975; Wilson, 1980; Zejan, 1990; Hennart and Park, 1993), which have drawn on both the internalization perspective and the strategy literature (Yip, 1982). Particular attention has been paid to the costs of adaptation and cultural integration that are encountered in

acquisition. Under greenfield investment the firm uses its funds to pay for the construction of a new facility. Under acquisition it uses its funds to purchase the facility second-hand as a going concern instead. This is done by acquiring the equity in the firm which previously owned the facility.

13. An effective internal market requires a high degree of trust within the organization. This trust is not available immediately after an acquisition. It costs q_1 to build trust in technology transfer when a P facility is newly acquired. It costs q_2 to build trust in the transfer of marketing expertise when a D facility is newly acquired, and q_3 to build trust in the transfer of intermediate product when either P or D (but not both) is newly acquired.

The Host Country Rival

14. The firm faces a single local rival who previously monopolized the foreign market. At the time of entry, this rival operates as a fully integrated firm. It has the expertise, conferred by an activity M , which the entrant lacks. However, the local rival has higher costs because of inferior technology, on account of having no activity R .

15. It is assumed that in all bargaining (for example, over an acquisition) the local rival plays an essentially passive role. The rival does not bargain for a share of the entrant's profits, but simply ensures that it receives full opportunity earnings for the resources it surrenders to the entrant firm. The rival realizes that the entrant has a superior technology, and believes that when confronted with such a competitor its best strategy is to exit the industry by selling to the entrant those resources it wishes to buy, and redeploying the others to their best alternative use.

16. If the entrant uses the rival's production facility, then a cost of adaptation is incurred. This is because the entrant uses a different technology from the rival, and equipment must be modified accordingly. This applies regardless of whether the entrant acquires the facility outright, or merely licenses, or subcontracts to the rival firm. However, the rival may have local production expertise, which the entrant lacks, providing savings to offset against the adaptation cost. The net cost of adaptation may therefore be negative. A negative adaptation cost, in this context, signifies that the cost of adapting the entrant's technology to local conditions using a greenfield plant is higher than the cost of adapting an existing local plant to the entrant's technology.

17. By contrast, use of a rival's D facility incurs no adaptation cost. This is because warehouses are normally more versatile than production plants. Use of the rival's D facility always brings with it the marketing expertise associated with M .

18. The rival's P and D facilities are the only existing facilities that can meet the needs of the market. Other local firms cannot enter the market, and the rival firm itself cannot invest in additional facilities. Under these conditions, acquisition of either a P or D facility gives the entrant monopoly power: Acquisition of a D facility gives the entrant a monopoly of final sales, whilst acquisition of a P facility gives the entrant a monopoly of supplies to D . Greenfield investment, however, confers no monopoly power because it eliminates no rival facility: greenfield investment in D creates duopoly in the sourcing of final demand, whilst greenfield investment in P creates duopoly in the sourcing of D .

TABLE 1
TWELVE ENTRY STRATEGIES AND THEIR VARIANTS

Ref.	Type	Description	Variants
1.	Normal FDI	Entrant owns foreign production and distribution facilities.	1.1 Both facilities are greenfield 1.2 Both facilities are acquired. 1.3 Production is greenfield and distribution is acquired. 1.4 Distribution is greenfield and production is acquired.
2.	FDI in production	Entrant owns foreign production, but uses independent distribution facilities.	2.1 Production is greenfield.
3.	Subcontracting	Entrant owns foreign distribution, but uses independent production facilities.	2.2 Production is acquired. 3.1 Distribution is greenfield. 3.2 Distribution is acquired.
4.	FDI in distribution	Entrant exports to own distribution facility.	4.1 Distribution is greenfield 4.2 Distribution is acquired.
5.	Exporting/ franchising	Entrant exports to independent distribution facility.	
6.	Licensing	Entrant transfers technology to independent integrated firm.	
7.	Integrated JV	Entrant jointly owns an integrated set of production and distribution facilities.	
8.	JV in production	Entrant jointly owns foreign production, but uses an independent distribution facility.	
9.	JV in distribution	Entrant jointly owns foreign distribution, but subcontracts production to an independent facility.	
10.	JV exporting	Entrant exports to a jointly owned distribution facility.	
11.	FDI/JV combination	Entrant owns foreign production and jointly owns foreign distribution.	11.1 Production is greenfield. 11.2 Production is acquired.
12.	JV/FDI combination	Entrant owns foreign distribution and jointly owns foreign production.	12.1 Distribution is greenfield. 12.2 Distribution is acquired.

TABLE 2
COSTS OF ALTERNATIVE STRATEGIES COMPARED WITH THE PROFIT NORM

$C_{1.1} =$					$+ s$	$+ rm$
$C_{1.2} =$	rq_1	$+ rq_2$		$+ ra$		
$C_{1.3} =$		rq_2	$+ rq_3$			
$C_{1.4} =$	rq_1		$+ rq_3$	$+ ra$		$+ rm$
$C_{2.1} =$			t_3		$+ s$	
$C_{2.2} =$	rq_1		$+ t_3$	$+ ra$		
$C_{3.1} =$	t_1		$+ t_3$	$+ ra$	$+ s$	$+ rm$
$C_{3.2} =$	t_1	$+ rq_2$	$+ t_3$	$+ ra$		
$C_{4.1} =$	z				$+ s$	$+ rm$
$C_{4.2} =$	z	$+ rq_2$	$+ rq_3$			
$C_5 =$	z		$+ t_3$		$+ s$	
$C_6 =$		t_2		$+ ra$		
$C_7 =$	rj_1	$+ rj_2$		$+ ra$		
$C_8 =$	rj_1		$+ rj_3$	$+ ra$		
$C_9 =$	t_1	$+ rj_2$	$+ rj_3$	$+ ra$		
$C_{10} =$	z	$+ rj_2$	$+ rj_3$		$+ s / 2$	
$C_{11.1} =$		$+ rj_2$	$+ rj_3$		$+ s / 2$	
$C_{11.2} =$	rq_1	$+ rj_2$	$+ rj_3$	$+ ra$		
$C_{12.1} =$	rj_1		$+ rj_3$	$+ ra$	$+ s / 2$	$+ rm$
$C_{12.2} =$	rj_1	$+ rj_2$	$+ rj_3$	$+ ra$		

hand side of Table 1, and summarized schematically in Figure 1. Six of these strategies have different variants generated by the fifth issue. These variants are indicated on the right hand side of the table. The figure distinguishes linkages involving the flow of information from *R* to *P* and *M* to *D*, and linkages involving the flow of physical product from *P* to *D*, and from *D* to final demand. Location is distinguished by the columns, and ownership by the rows. Ownership by the entrant is also identified by shading; facilities owned by the local rival are shown as clear. The strategies associated with each particular linkage are indicated by the numbers 1-12 in the figure.

Deriving the Profit Equations

A profit equation for each variant of each entry strategy can be derived by applying the assumptions given above to the schematic illustrations in Figure 1. Certain elements of cost and revenue are common to all the profit equations, and it simplifies matters to net these out. This generates a set of summary profit equations in which profitability is expressed in terms of deviations from a profit norm. An appropriate norm is the profit generated by pursuing strategy 1 under ideal conditions, in which the firm is already acquainted with the local market, and there is no indigenous rival. The profit norm is the revenue generated by sales at the monopoly price p_1 , less

the cost of greenfield foreign production, less the cost of greenfield foreign distribution, less the cost of internal technology transfer to a greenfield foreign plant, less the cost of internal transfer of goods from production to distribution.

If the actual profits of each strategy are compared with this norm, then every strategy incurs some additional cost. The relevant cost expressions are given in Table 2. The subscripts applied to the cost symbol c refer to the strategies and their variants listed in Table 1. The variables on the right hand side have already been explained when introducing the assumptions of the model. Set-up costs are multiplied by the rate of interest to convert a once-and-for-all cost into a continuous equivalent.

To see how the profit equations are derived, consider strategy 2. This involves FDI in production, with sales being handled by the rival firm. There are two variants of this strategy, depending upon whether the production plant is acquired or not. The only international transfer of resources under this strategy involves technology, which moves across the column boundary from R to P . The transfer is internalized because no change of ownership is involved. Change of ownership only occurs where the flow of intermediate output from P to D crosses the row boundary. From D the product is distributed to the entire foreign market, as indicated by the flow fanning out from D .

The advantages of this particular strategy are two-fold. It internalizes the transfer of technology within the entrant firm, and it internalizes the transfer of marketing expertise within the local firm. This can only be achieved, however, by externalizing the flow of intermediate output, which generates the transaction cost premium

term t_3 , which appears in the expressions for both $c_{2,1}$ and $c_{2,2}$. This is, in fact, the only term that is common to both expressions. The remaining terms are all accounted for by the difference between greenfield and acquisition methods of FDI. The greenfield strategy avoids the cost a of adapting an existing plant to the needs of a new technology. Thus the term ra , which appears in the expression for $c_{2,2}$, does not appear in the expression for $c_{2,1}$. The greenfield strategy also means that the internal transfer of technology is not bedevilled by a lack of trust, which arises when the production facility is acquired instead. The cost of building trust in internal technology transfer, rq_1 , therefore appears in $c_{2,2}$, but not in $c_{2,1}$.

The compensating advantage of the acquisition strategy is that it does not add to overall capacity in the foreign country. Indeed, because the entrant faces a single local rival, acquisition of the rival's production facility effectively prevents the rival from entering into competition with the entrant firm. Given that under strategy 2 the local firm retains control of distribution, it can threaten to source distribution from its own production plant instead of from the entrant's plant. Although the entrant may be able to constrain this threat in the short term by signing an exclusive franchise contract with its local rival, in the long run this contract will expire, and the threat will reappear. Only acquisition of one of the rival's facilities can eliminate this threat altogether. This means that the greenfield strategy incurs a loss of revenue s compared to the acquisition strategy.

Dominance Relations

Theory predicts that the strategy with the lowest cost will be chosen. Which

strategy is chosen depends on the relative magnitude of the different variables on the right hand side of Table 2. The easiest way to understand the general properties of the solution is first to eliminate any strategies that are clearly dominated by others, and then to compare the remaining ones in terms of the major trade-offs involved.

Whether strategies are dominated or not depends upon what restrictions are imposed upon the right-hand-side variables. So far, the only restrictions implied by the assumptions are $m, r, s, j_i, q_i, t_i > 0$ ($i = 1, 2, 3$) and $t_2 \geq t_1$. In particular, the variables a and z are unrestricted in sign. Under these conditions, only two of the strategies are dominated, namely the bottom two in the table:

$$c_{12.1} > c_8; c_{12.2} > c_8$$

These strategies involve a production IJV and a wholly owned sales subsidiary. They are inferior to a production IJV combined with the franchising of sales. This shows that if the entrant is to partner the IJV in production, then there is no point in buying back the product to distribute it afterwards.

Once additional restrictions are imposed, further dominance relations emerge. For example, if the net cost of home production is positive, $z > 0$, then all the export strategies are dominated by equivalent strategies involving greenfield foreign production:

$$c_{4.1} > c_{1.1}; c_{4.2} > c_{1.3}; c_5 > c_{2.1}; c_{10} > c_{11.1}$$

This illustrates the important point that location effects are independent of internalization effects in models of this kind.

If the net cost of technological adaptation of existing production facilities is positive, $a > 0$, then it follows that:

$$c_{3.1} > c_{1.1}$$

This means that the strategy of investing only in a greenfield distribution facility is inefficient compared to the strategy of investing in a greenfield production facility as well. Put simply, subcontracting production is not a good idea when the net cost of adapting existing plant to the new technology is positive.

So far, no use has been made of restrictions on transactions costs. Suppose now that external market costs exceed the costs of building trust in internal markets after acquisition. In the context of production, this means that $t_1 > r q_1$ from whence it follows that:

$$c_{3.2} > c_{2.2} \\ c_9 > c_{11.2}$$

The first inequality shows that subcontracting production in conjunction with the acquisition of a distribution facility is more costly than franchising distribution in conjunction with the acquisition of a production facility. The second inequality shows that subcontracting production in conjunction with a jointly owned distribution facility is more costly than acquiring a production facility in conjunction with a jointly owned distribution facility. These results underline the fact that high transaction costs in technology markets, combined with easy trust-building post-acquisition, discourage subcontracting and favor acquisition instead.

The process of elimination through dominance can be continued by postulating that the cost of building trust is lower after an acquisition than it is within a joint venture: $q_i < j_i$ ($i=1, 2, 3$). Not surprisingly, this eliminates several IJV strategies - though not all:

$$c_7 > c_{1,2}; c_{11,1} > c_{1,3}; c_{11,2} > c_{1,3}$$

It is inefficient to combine an IJV distribution facility with a production facility that is either wholly or jointly owned. Obviously, if the cost of building trust were thought to be lower in a IJV then the inequalities would be the other way round, and the three acquisitions-based strategies would be eliminated instead.

It is not only inequality restrictions that can be used to generate dominance relations: equality restrictions can be used as well. For example, if the costs of building trust after acquisition are the same in each internal market, $q_i = q$ ($i=1,2,3$), then:

$$c_{1,4} > c_{1,2} > c_{1,3}$$

This means that it is inefficient to acquire production when distribution is wholly owned; it is better to use greenfield production and acquire distribution instead.

If in addition the costs of building trust within IJVs are also the same in all markets, $j_j = j$ ($i = 1,2,3$) then:

$$c_8 > c_{1,3}$$

It is better to combine greenfield production with the acquisition of a distribution facility than to undertake an IJV in production, and franchise distribution to the partner firm.

Finally, consider two further restrictions. The first asserts that the cost of learning about a foreign market through a greenfield distribution facility exceeds the transaction cost of an external intermediate product market; $rm > t_3$. It follows that:

$$c_{1,1} > c_{2,1}$$

so that it is cheaper to combine greenfield production with greenfield distribution rather than with an independent distribution facility.

The second restriction asserts that the transaction cost of the external intermediate product market exceeds the cost of building trust in that market following an acquisition; $t_3 > rq_3$. It follows that (given that $q_1 = q_2$ from an earlier restriction):

$$c_{2,2} > c_{1,3}$$

so that it is cheaper to combine greenfield production with acquired distribution than to acquire production and franchise distribution instead.

Properties of the Solution

By carrying the process of elimination so far, only three of the original strategies are left in contention:

- 1.3. greenfield production combined with acquired distribution;
- 2.1. greenfield production combined with franchised distribution; and
- 6. licensing.

The choice between these strategies is governed by six of the original variables: $a, q, r, s, t_2,$

t_3 . The solution is to choose:

- 1.3. if $q \leq (t_3 + s)/2r, (t_2/r) + a$
- 2.1. if $t_3 + s \leq 2qr, t_2 + ra$
- 6. if $t_2 + ra \leq 2qr, t_3 + s$

It can be seen that strategy 1.3 is preferred wherever the cost of acquisition q is low. This is reasonable because 1.3 is the only one of the three strategies that involves acquisition. Strategy 2.1 is preferred when the transaction costs of the external market in intermediate output, t_3 , are low, and when the loss of monopoly profits from competitive distribution, s , is small. This is reasonable because strategy 2.1 is the only one to involve an arm's length sale of intermediate output, and the only one to leave

mitted at all. The reason why subcontracting is so often used is because of another motive for entering a foreign country, and that is for access to local resources - notably cheap labour for off shore processing. This motive, though important, is excluded from the present paper. This shows how important it is to distinguish different strategic motivations when discussing institutional arrangements in international business.

Three interesting and less obvious results are as follows:

(1) The existence of large monopoly rents, associated with a high cost of competition, s , favors strategies which give the entrant long term control over either the domestic rival's production facilities, or the domestic rival's distribution facilities. It favors acquisition over greenfield investment in either production or distribution. It also favors long-term arrangements, like licensing, over short-term arrangements, like subcontracting and franchising.

(2) Joint ventures in distribution are a useful mode of market entry when high costs of learning by experience, m , discourage greenfield distribution, high costs of building trust, q_1 , discourage the acquisition of distribution facilities, high costs in the arm's length intermediate output market, t_3 , discourage franchising, and high costs of arm's length technology transfer, t_2 , discourage licensing. However, joint ventures in production do not make much sense as a means of market entry, unless the production joint venture is part of an integrated joint venture that handles distribution as well.

(3) In general, the analysis confirms that market structure is a crucial factor in the choice between greenfield investment and acquisition. Entry through greenfield investment increases local capacity and intensifies competition,

whereas entry through acquisition does not. This explains why governments so often compete to attract inward greenfield investment, whilst taking a restrictive attitude to acquisitions at the same time.

IMPLICATIONS FOR FUTURE RESEARCH

The model is very flexible, in the sense that it is easy to modify the assumptions to address other issues. It can be extended to include two host country rivals, or two entrants vying with each other to enter the same market. This requires extending the analysis from duopoly to three-firm oligopoly. Introducing a third player not only increases the scope for competition, but also introduces new opportunities for co-operation too. The model can be rendered more dynamic by allowing entrants to determine the timing of entry - a particularly important consideration where growing markets, such as China or Eastern Europe, are concerned.

The host government plays a very passive role in the present model. Strategic interactions between the host government and the entrant can be introduced. The host government may offer tax incentives in return for commitments on local value added, or "job creation," which affect the choice of entry mode. Bargaining may take place over subsidies. Political risk may discourage FDI and encourage the use of arm's length contracts instead. The possibilities for the firm to minimize global tax liabilities through transfer pricing can also be taken into account.

The model can be extended to take account of foreign investment in services, as well as manufacturing. It already takes an important step in the direction of analyzing service industries

- performance. *Journal of International Business Studies*, 25: 253-73.
- Yip, George. 1982. Diversification entry: Internal development versus acquisition. *Strategic Management Journal*, 3: 331-45.
- Young, Stephen, James Hamill, Colin Wheeler & J. Richard Davies. 1989. *International market entry and development*. Hemel, Hempstead: Harvester Wheatsheaf.
- Yu, Chow-Ming & Kiyotaki Ito. 1988. Oligopolistic reaction and foreign direct investment: The case of the US tyre and textiles industries. *Journal of International Business Studies*, 19: 449-60.
- Zejan, Mario C. 1990. New ventures or acquisitions: The choice of Swedish multinational enterprises. *Journal of Industrial Economics*, 38: 349-55.