The Necessity of Global Markets

by Sophia

WHAT'S COVERED

In this lesson, you will learn why it might be necessary for a company to go international, and how it might accomplish this goal. Specifically, this lesson will cover:

BEFORE YOU START

In this lesson, we explore some of the methods companies can use to go international and how they might implement them. As we have seen so many times before, each method for entering international markets has its advantages and disadvantages, and it is up to the international management team to figure out which is most suitable for its company and for the countries in which it operates.

1. Reasons for Internationalization

Before we get into how companies can go international, let's look at why a company might want to expand internationally in the first place. Because navigating cross-cultural environments is fraught with dangers but holds the possibility of great success, we must understand the compelling reasons to go international.

- *Trade Facilitation*. At a basic level, relying on a domestic market can be problematic. Because of the many factors enhancing globalization, companies of all sizes and types want to take advantage of global markets to expand and achieve sustainable competitive advantage. Despite some slowdown in trade, business-toconsumer e-commerce is expected to double to $2.2 trillion over the span 2018 to 2021 due to improvements in IT and the use of the web.

- *Growth Opportunities*. Another critical factor that supports internationalization is that emerging markets such as China, India, Brazil, and Malaysia will continue to grow and present companies with tremendous opportunities. Research from the Boston Consulting Group suggests that such emerging markets experienced growth (as measured by GDP growth rate), surpassing more developed economies by 2.2% (Waltermann et al., 2021). Furthermore, this research predicted that economic growth in emerging markets accounted for 68% of worldwide growth in 2013 despite an economic slowdown. Finally, experts also predict that incomes in emerging markets will continue to rise.

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2. How To Go International by Exporting

Given that it is critical for companies to go global, there are various means that companies can use to do so. The most basic and cost-effective approach is **exporting**, whereby a company sends its product to an international market and fills the order just as it fills a domestic order. Our earlier example of Dmitrii Dvornikov (who was selling jewelry and table clocks made from Russian semiprecious stones to international customers on Russia's eBay) is a simple example of exporting. However, companies can also become more involved in the process and have dedicated offices in another country to tackle exports. In fact, some companies may find that exporting is so critical that they create a dedicated export department.

Because exporting is one of the easiest ways to go international, it can bring many benefits (U.S. Dept. of Commerce, 2015).

KEY CONCEPT

Current research suggests that companies that export tend to be 17% more profitable than companies that don't. Additionally, exporting provides the ability for companies to defend their markets by becoming more competitive in other markets. Furthermore, by exploring international markets, a company can acquire critical cross-cultural management skills, thereby increasing the value of the company.

EXAMPLE Consider the case of DeFeet International, a U.S. maker of socks for cyclists (U.S. Dept. of Commerce, 2015). Despite several major disasters during the company's existence (it burned down in 2006), DeFeet has been able to survive and expand thanks to the global market. The company hired an international marketing manager to get advice on how to develop a market strategy for Europe. Because of its strong research and development, DeFeet International has been able to develop the best socks for cycling. While production still takes place in the U.S., exporting has resulted in distributors in over 35 countries.

DID YOU KNOW

Despite the many benefits of exporting, companies are often reluctant to do so. Much of such fear is based on some assumptions about how business is done.

Managers often assume that exporting can be too risky, but some argue that selling only to domestic markets is just as risky. Some companies believe that exporting is too cumbersome or that getting paid for exports is too complicated and not worth the time. However, experts believe that exporting is not complicated and can be easily done through the right channels.

Finally, some companies believe that they are too small to export. However, research shows that nearly 30% of all U.S. exporters in 2005 had 19 employees or less (U.S Department of Commerce, n.d.). This finding suggests that exporting is a viable strategy, even for small firms.

TERM TO KNOW

Exporting

International entry mode where a company sends a product to an international market and fills the order like a domestic order.

2a. Solving a Disadvantage of Exporting Through Licensing and Franchising

Although exporting is an easy way to go international, it has some disadvantages. Exporting does not give much control to the company in terms of how the product is presented in the international market. For instance, if the company decides to use an international intermediary to sell its product abroad, it is at the mercy of that intermediary. Additionally, exporting sometimes requires travelling and other tasks that may take managers away from domestic activities. In the light of such disadvantages, companies will often resort to licensing.

Licensing is a contractual agreement whereby, in exchange for a royalty or fee, a company gives the right to another company to use a trademark, know-how, or other proprietary technology. Similar to exporting, licensing is an easy way for a company to enter an international market quickly and without the need for laying out much capital. A licensor often has some asset that it can offer to the licensee in exchange for a fee. This asset might include a valuable patent, a trademark, technological know-how, or a company name that the licensor provides to the licensee in return for a payment.

A recent study of European firms' entry to the Vietnamese market shows that these companies relied on licensing (Simonet, 2012). For instance, consider Haymarket Media, one of the largest publishers in the United Kingdom. Haymarket enters into simple licensing agreements with the local affiliates to provide generic content to all worldwide licensees. This content is similar in all overseas editions of its magazines. However, through this licensing arrangement, the country affiliate adds local content. In this way, Haymarket has been able to increase sales of existing content by selling it in new global markets.

International franchising takes licensing up a notch. Rather than simply license some specific aspect of the value chain, a company will license the complete business model. The business model usually includes trademarks, business organization structures, technologies and know-how, and training. Similar to licensing, the franchisor owns a trademark that the franchisee pays a royalty for. Additionally, the franchisee will usually pay for the right to use the business model of the franchisor. Many fast food companies have relied on franchising agreements to enter the Indian market (Priya et al., 2015). As India has experienced economic growth, more people have greater amounts of disposable income. In addition, because more couples are now busy working, they rely more on fast food as a meal option. Companies such as McDonald's, KFC, Domino's Pizza, and Pizza Hut have all entered franchising agreements with local companies to sell their products. This move has proven to be very successful because the franchisors have been able to expand their markets while the franchisees have seen significant profits in the local Indian markets.

Similar to other forms of entry, licensing and franchising have benefits and disadvantages. In terms of benefits, both forms of entry provide the receiving company with an established brand or some other technological know-how that has already proven itself. The recipient of the franchise agreement doesn't need to build a new reputation but can rely on a well-known international competitor. For the franchisor, this often provides a quick way to expand revenue from an existing business model. Additionally, while licensing and franchising are cost-effective ways to go international, the companies granting the license or franchise still retain control over their product. If things don't work out as planned, the licensor can end the agreement. For the franchisee, an added benefit is that corporate support is provided to help the company succeed.

TERMS TO KNOW

Licensing

Contractual agreement whereby a company is given the right to another company's trademarks, know-how, and other intangible assets in return for a royalty or a fee.

International Franchising

Where a company will license the complete business model.

2b. Disadvantages of Licensing and Franchising

Both licensing and franchising have disadvantages that can affect both the recipient of the agreement and the grantor of the agreement. For instance, a study of Indian entrepreneurs entering into franchise agreements with fast food companies in the United States reported that the master franchisor had too much control (Priya et al., 2015). Furthermore, a franchise agreement can be risky and capital intensive for the local companies. For the licensor or franchisor, the biggest disadvantage is that the company can create a new competitor. While the host country laws may dictate the terms of agreement, local enforcement of these laws may not always be strong. Thus, a local company can therefore use the business model for its own purpose. Furthermore, compared to exporting, the licensor gives up additional control. Once the agreement is signed, it is possible for the licensee to sell the product at a lower price or with lower quality. This has the potential to affect the reputation of the licensor.

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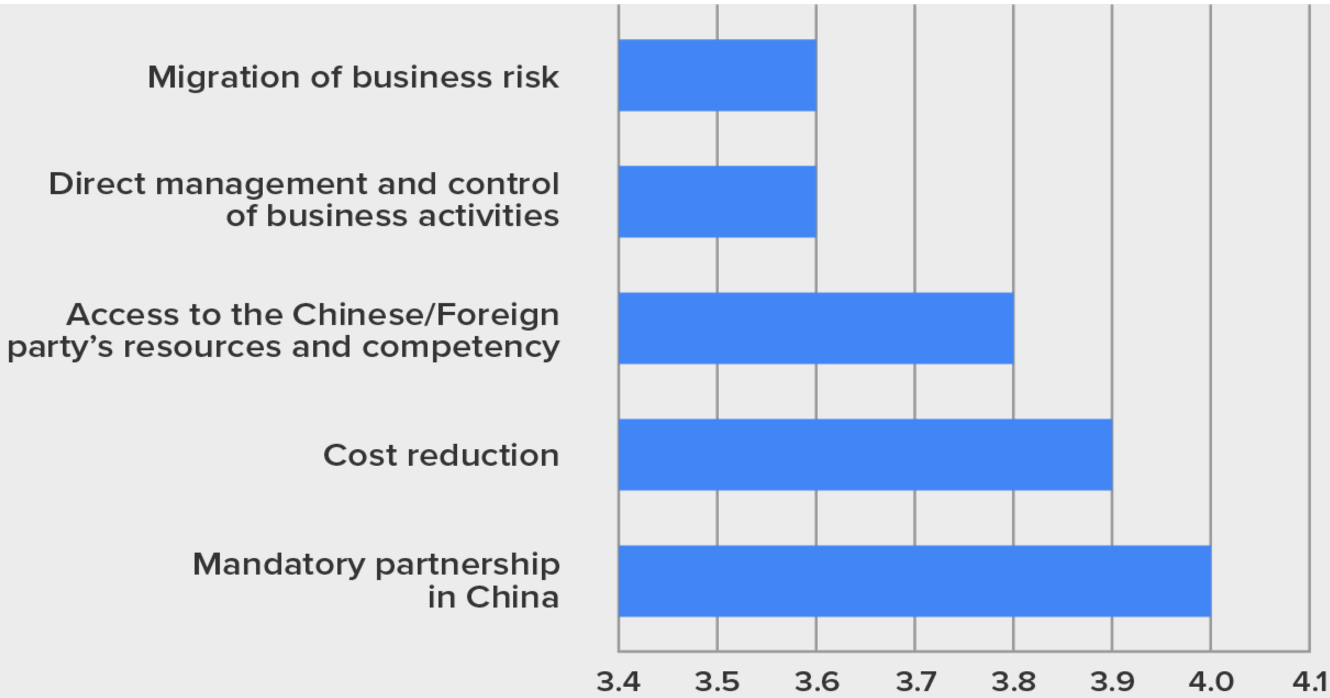
3. How To Go International by Forming Strategic Alliances

Because of some of the dangers of licensing and franchising, companies can often get even more involved in global operations by engaging in strategic alliances. **International strategic alliances** occur when two or more companies from different countries enter into an agreement to conduct joint business activities. Strategic alliances are often the preferred means of entry in emerging markets because they make it easier to do business in the country. A strategic alliance is a way for a foreign company to bypass barriers imposed by local governments.

Strategic alliances often provide both partners with sorely needed skills or capabilities. Strategic alliances also often provide access to new markets and customers. In terms of going global, a company may not always have the necessary know-how or financial assets to enter an international market. Strategic alliances therefore provide the means for a company to spring into the international domain. In that context, China remains an attractive destination for many multinationals. China's market presents tremendous potential given the increase in disposable income. A recent study sheds some light on the many aspects of entering alliances in China (PWC, 2015). The chart below provides you with some of the main benefits foreign companies expect to gain from strategic alliances.



Reasons to Enter Strategic Alliances

Source: Based on PWC, 2015, "Courting China Inc: Expectations, pitfalls, and success factors of Sino-foreign business partnerships in China," www.pwc.com.au/asia-practice/assets/courting-china-aug15.pdf

Strategic alliances also enable companies to share resources to develop new technologies and make technological advances. This issue is acknowledged by the South Korean government, which encourages South Korean small and medium enterprises to enter into strategic alliances with foreign partners as a way to gain access to advanced technology as well as getting management skills to expand internationally. A recent study examined data from South Korea and found that entering strategic alliances also allowed companies to enjoy higher productivity (Kim, 2015).

TERM TO KNOW

International Strategic Alliances

Two or more companies from different countries enter into an agreement to conduct joint business activities.

3a. Disadvantages of Strategic Alliances

DID YOU KNOW

Despite these advantages, strategic alliances are notorious for high failure rates. A major reason is that strategic alliances are very difficult to manage.

Additionally, strategic alliances often present partners with the possibility of acting opportunistically. This can occur when a partner tries to access technological know-how that they were not originally privy too. Alliance partners may also decide to refuse to agree to the original terms of the strategic alliance contracts. Finally, strategic alliances inevitably involve ambiguity and uncertainty. Properly managing such ambiguity is also necessary to avoid disadvantages associated with such alliances.

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4. How To Go International by Foreign Direct Investment

Given the difficulties associated with strategic alliances, some companies elect to be wholly vested in the host country. This final form of international entry, which we discussed at the beginning of the chapter, is **foreign direct investment (FDI)**, which occurs when a company invests in another country by constructing facilities and buildings in that country. FDI can also occur through mergers and acquisitions, whereby a multinational company fully acquires a company in another country. Many car companies, such as Toyota, Honda, BMW, and Nissan, have fully operational plants in the United States. For example, many of the BMW SUVs, such as the BMW X3 and X5, are fully built in the BMW plant in Spartanburg, South Carolina.

EXAMPLE For BMW, FDI allows the company to be closer to its customers and to also sell the car as an American car.

Additionally, because some countries may impose tariffs on imported products or otherwise discourage imports, building a plant locally allows a company to bypass such restrictions. Furthermore, FDI can also provide access to local expertise or to cheaper costs of labor, both of which can help a company become more competitive through reduced costs.

TERM TO KNOW

Foreign Direct Investment (FDI)

Involves a company investing in another country through the construction of facilities and buildings in another country.

4a. Disadvantages of FDI

As you might expect, FDI as an entry mode is not without difficulties. While this method gives the company the most control, it is also the most capital intensive. A multinational engaged in FDI is also exposed to the **political risk** of a country, the degree to which political decisions can impact a business's ability to survive in that country. For instance, throughout history, countries such as Venezuela have used governmental decrees to appropriate investment from U.S. oil companies. Finally, it is important to note that FDI also involves additional coordination risks and can drain resources from local operations. A company that engages in FDI must be able to coordinate and integrate foreign and domestic operations.

TERM TO KNOW

Political Risk

Degree to which political decisions can impact a business's ability to survive in a country.

5. The Uppsala Model

The above sections also provided some insights into how some companies can start small (say, with exporting) and eventually have FDI activities in some countries. One of the most popular ways to understand this development path of internationalization is the **Uppsala model**, which argues that "as firms learn more about a specific market, they become more committed by investing more resources into that market" (Chetty & Campbell-Hunt, 2004).

KEY CONCEPT

In this model, companies adopt an incremental approach to internationalizing. First, they develop a solid domestic market base. After they have a strong domestic foundation, they start exploring international markets and eventually export products to markets that they feel have close psychic distance. **Psychic distance** refers to the many differences that exist between countries because of language, cultural characteristics, social institutions, and business practices. Countries with close psychic distance are similar to each other in all these variables; those with greater psychic distance are less similar. As a firm continues to gain international experience, it will start exporting to countries with greater psychic distance. As the firm gains even more international experience and knowledge of international markets, it will eventually want to have production facilities in the overseas market (Chetty & Campbell-Hunt, 2004).

The Uppsala model has been criticized on many fronts. Experts argue that this approach may oversimplify a very complex process. It is also criticized as being too deterministic because some companies may skip stages. The latter criticism is valid when we consider the case of **born globals**, companies that operate internationally from the day they are created.

TERM TO KNOW

Uppsala Model

Model that argues that as firms learn more about a specific market, they become more committed by investing more resources into that market.

Psychic Distance

The differences that exist between countries because of language, cultural characteristics, social institutions, and business practices.

Born Globals

Companies that operate internationally from the day that they are created.

6. The All-In Approach to Internationalization: Born Globals

Born globals are considered key to most countries' economic development. A recent report suggests that born globals were significant contributors to exports in countries such as Poland and Australia. Additionally, the Organisation for Economic Co-operation and Development (OECD), a leading international organization comprising many of the world's leading economies, has argued that born globals were key engines that tackled the economic downturn that occurred after the financial crisis of 2007. It is therefore critical for the international management student to understand born globals.

KEY CONCEPT

Born globals have been made possible because of the many factors we discussed earlier that are making the world more global: the rapid development and decreasing costs of many types of information technologies have allowed companies to go international from the day they are created.

Current research suggests that born globals are unique in many ways (Choquette et al., 2017). When compared to other start-ups, born globals tend to have higher employment and job growth rates. Born globals also serve a wider global market than domestic start-ups. Additionally, while born globals tend to experience similar internationalization patterns of smaller entrepreneurial firms, they have much more aggressive learning strategies as a result of becoming global much faster than others (Chetty & Campbell-Hunt, 2004).

BRAINSTORM

Given the critical importance of born globals, what are the factors that contribute to their success?

Current research suggests that a number of factors, such as marketing competence, effective pricing, advertising and distribution capabilities, product quality, and so on, all contribute to the success of such companies (Danik & Kowalik, 2015). Studies also show that prior experience of managers in combining resources from different countries and having a global vision are also important.

In the above sections, you have learned about the different ways in which a company can go international. Some companies have minimal engagement and only export. Others are fully vested and build production plants overseas. Yet others choose to go global from inception. Each entry mode has its benefits and costs, advantages and disadvantages.

THINK ABOUT IT

How do companies choose among these entry types?

The primary factors in the internationalization decision are how much control the company wants to have over operations and how much of the company's resources (physical, financial, natural, human) it wants to expend to go international. For example, if a company doesn't want to invest or spend too much to access global markets but still wants to explore them, it can simply export. But with this method, the company has less control over operations, such as how the product is marketed and sold. However, if companies want to control all activities and if they have the resources, they can get involved in FDI. In such cases, the companies have significant control but at much higher costs.

A recent study of banks provides further insight into this issue (Petrou, 2009). For instance, the more a bank required local resources in the form of local reputation or the availability of a local branch network to offer services, the more likely the company was to use joint ventures or acquisitions as forms of international entry. If a bank wanted to have greater control in terms of being able to manage its activities to achieve its goals, it would be more likely to acquire local firms. In some cases, banks needed this degree of control so that they could coordinate the activities to achieve economies of scale.

Furthermore, all companies going international face risks, such as the barriers to export initiation (such as insufficient finances and knowledge of an international market) and other complexities associated with transferring money across borders (fluctuation in exchange rates, payment delays, etc.) (Danik & Kowalik, 2015). Companies also face political risk in terms of foreign government intervention in the form of tariffs or foreign exchange controls. Companies need to determine whether they can work around these barriers.

REFLECT

1. What are the factors and approaches that organizations can take when deciding to go global?
2. Explain the term born global and why it is important for companies to take this approach.

SUMMARY

In this lesson, you learned why it might be necessary for a company to go international, and how it might accomplish this goal. For instance, **reasons for internationalization** include trade facilitation and growth opportunities. You learned that there are various means that companies can use to go global. They can **go international by exporting**, the most basic and cost-effective approach, whereby a company sends its product to an international market and fills the order just as it fills a domestic order. Although exporting is an easy way to go international, there are some **disadvantages of exporting**, which can be **solved through licensing and franchising**, although **licensing and franchising** have their own set of **disadvantages**. You learned that another way a company can **go international is by forming strategic alliances**, when two or more companies from different countries enter into an agreement to conduct joint business activities. However, one of the **disadvantages of strategic alliances** are that they are difficult to manage. You also learned that a company can **go international by foreign direct investment** (FDI), which occurs when a company invests in another country by constructing facilities and buildings in that country, or through mergers and acquisitions. **Disadvantages of FDI** include it being the most capital intensive method and exposure to the political risk of a country. Some companies adopt an incremental approach to internationalizing, and one of the most popular ways to understand this development path of internationalization is the **Uppsala model**, which argues that as firms learn more about a specific market, they become more committed by investing more resources into that market. However, this model has been criticized, especially when considering **the all-in approach to internationalization** in the case of **born globals**, companies that operate internationally from the day they are created.

Best of luck in your learning!

Source: Access for free at https://openstax.org/books/principles-management/pages/1-introduction

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TERMS TO KNOW

Born Globals
Companies that operate internationally from the day that they are created.

Exporting

International entry mode where a company sends a product to an international market and fills the order like a domestic order.

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International Franchising

Where a company will license the complete business model.

International Strategic Alliances

Two or more companies from different countries enter into an agreement to conduct joint business activities.

Licensing

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Political Risk

Degree to which political decisions can impact a business's ability to survive in a country.

Psychic Distance

The differences that exist between countries because of language, cultural characteristics, social institutions, and business practices.

Uppsala Model

Model that argues that as firms learn more about a specific market, they become more committed by investing more resources into that market.