Chapter 15

Licensing, Franchising, and Other Contractual Strategies

Learning Objectives *After studying this chapter, you should be able to:*

- **15.1** Explain contractual entry strategies.
- **15.2** Understand licensing as an entry strategy.
- **15.3** Describe the advantages and disadvantages of licensing.
- **15.4** Understand franchising as an entry strategy.
- **15.5** Explain the advantages and disadvantages of franchising.
- **15.6** Understand other contractual entry strategies.
- **15.7** Understand infringement of intellectual property, a global problem.

How LEGO Built Global Value in the Toy Industry, Block by Block

From putting together a bright red fire-fighting engine, to a medieval castle, to a railway station over several decades, millions of children have honed their imagination and mechanical skills using small, colorful plastic blocks: the LEGO sets. Some 75 billion bricks are sold each year in over 140 countries. LEGO, a family company in Billund, Denmark, remains the most trusted toymaker in the building-block toy sector, with a market share of 85 percent worldwide. Production quality, adaptation to buyer preferences and a careful licensing strategy are the key drivers of the company's spectacular success in the $91.54 billion toy industry. And more than a third of the sales of toys and non-electronic games worldwide are generated through licenses.

LEGO is a late entrant in contractual licensing. Its management decided in 1999 that the company's traditional audience was changing in many respects: first, pre-school and school-age users wanted themes that reminded them of their favorite heroes from action movies and video games. Second, adults were increasingly attracted towards life-size interlocking constructions, such as cars, tractors, and even caravans! LEGO had the technology to respond. What it lacked was themes and the capabilities to design them. This is where licensing was opening a new window of opportunity, which other toy makers like Mattel and Hasbro had already exploited. LEGO was late to join the race but a quick mover; very soon, it began making and distributing the Dungeon and the Desert Outpost of *Minecraft* and Luke and Darth Vader from *Star Wars*. The *Indiana Jones*, *Harry Potter*, and *The Lord of the Rings* settings; the Vet Clinic from *Friend*s; and the Treetop Hideaway of the *Elve*s are now part of its catalog of brick-based construction.

Source: Steve Davey Photography/Alamy Stock Photo

Hollywood is now an indispensable partner of toy makers, as it constantly provides new ideas for sets and characters that stimulate the imagination of their users, young and old. Most toy manufacturers, Mattel and Hasbro included, acquire properties from studios and grant licenses to regional or local production and marketing companies. LEGO has followed a similar pattern. Its first property acquisition was *Star Wars*, a license from Lucasfilm. Its licensing strategy is two-fold: inbound and outbound. Inbound licenses refer to themes developed by third parties, like Disney or Warner Bros. Outbound licenses are issued by LEGO to companies that want to use its patents, trademarks, logo, and *The LEGO Movie* for their own end-products. DK publishing, Merlin Entertainment Plc, and the LEGOLAND theme parks are among such licensees. These inbound license agreements were worth $94 million in 2017. At the same time, outbound licenses cost LEGO nearly $400 million.

Licensing of games has become vital for the industry over the past decade. In the United States, 27 percent of all traditional toys and games sold are licensed, generating a value of $6 billion (€ 5.3 billion). The rate is higher in Asia, Latin America, and Turkey, where licensing ranges from 30 to 40 percent of total sales and is expected to reach 60 percent by 2019. The average annual spending per buyer in these regions is $28 (€24)—far below the $439 (€387) toy expenditure per child in the United Kingdom. For LEGO, which operates factories in Europe, Mexico, and China and is present in 130 countries through a combination of own offices, licensed producers, and distributors, the emerging markets offer the most promising opportunity for growth through licensing. However, they are also fraught with challenges, such as IPR protection. LEGO has already lost a few legal battles in this area, as some of its original patents have expired.

Companies drive a hard bargain in licensing out their properties, and Hollywood studios are notoriously demanding. For example, Hasbro, LEGO's second biggest competitor after Mattel, recently paid Marvel Comics a basic fee of $100 million (€88 million), with a potential for an additional $140 (€123) million in royalties. LEGO's outbound licensing conditions are relatively modest—less than 100 million base fees plus variable royalties—as the company wants to maintain strict control over the quality of its licensees. However, when it comes to licensing in, it is as powerless as its competitors.

The global monetary value of licensed toys and games is expected to grow annually at the rate of 2–3 percent till 2020. LEGO says that it is determined to secure a fair share without compromising its mission, which is to "redefine play and re-imagine learning."

AACSB and CKR Intangible Soft Skills to improve employability and success in the workplace: Analytical Thinking, Application of Knowledge

Questions

15-1. How does LEGO generate royalties by using contractual entry strategies?

15-2. What are the advantages of licensing as described in the case?

15-3. What risks does LEGO face from licensing its brand, logo, toy patents, and *The LEGO Movie*?

SOURCES: LEGO Group A/S company information, www.lego.com September 2015; www.LEGOFoundation.com September 2015; www.kirkbi.com September 2015; LEGO Group A/S Annual Report 2014, pp. 1–54; Jens Hansegard, "Oh, Snap! Lego Sales Surpass Mattel", *The Wall Street Journal*, September 4, 2014; Michael Paterniti, "How Lego Built the Coolest Company in the World," *Popular Mechanics*, March 19, 2015, www.popularmechanics.com; Graham Pomphrey, "Rebuilding Lego," *License Global*, November 1, 2006, www.licensemag. com; Jonathan Ringen, "How Lego Became the Apple of Toys," *Fast Company*, January 8, 2015, www.fastcompany.com; Andy Robertson, "New York Toy Fair: The Best Lego Sets," *Wired*, February 18, 2015, www.wired.co.uk; Sam Thielman, "How Lego Became the Most Valuable Toy Company in the World," *AdWeek*, April 15, 2013; www.adweek.com; Joint Press Release by Warner Bros, Interactive Entertainment, TT Games and the LEGO Group, *Business Wire*, April 9, 2015 www.businesswire.com; "Key Global and Regional Trends Shaping Toys Licensing", *Euromonitor International*, September 2015, pp. 6, 10, 16; Lucy Handley, "How Marketing Built Lego into the World's Favorite Toy Brand," *CNBC*, April 27, 2018, https://www.cnbc.com/2018/04/27/lego-marketing-strategy-made-it-world-favorite-toy-brand.html; "Global Toy Sales Grow 4 per cent to Hit $18.4bn in First Half of 2018," *ToyNews*, https://www.toynews-online.biz/retail/global-toy-sales-grow-4-per-cent-to-hit-18-4bn-in-first-half-of-2018.

This case was written by Jacques Couvas, Bilkent University.

Contractual entry strategies in international business
Cross-border exchanges in which the relationship between the focal firm and its foreign partner is governed by an explicit contract.

Intellectual property
Ideas or works that individuals or firms create, including discoveries and inventions; artistic, musical, and literary works; and words, phrases, symbols, and designs.

Intellectual property rights
The legal claim through which the proprietary assets of firms and individuals are protected from unauthorized use by other parties.

Licensing
Arrangement by which the owner of intellectual property grants a firm the right to use that property for a specific time period in exchange for royalties or other compensation.

Licensing—granting the right to others to use a legally protected property (a name, trademark, logo, design, etc.)—has grown enormously in international business. Transactions such as those between LEGO and *Star Wars* imply a contractual relationship between those who own the property and those given permission to use it. For companies that own licensable properties such as technology, artistic works, logos, and business systems, licensing can be a very lucrative business around the world.

In this chapter, we address licensing, franchising, and other types of cross-border contractual relationships. **Contractual entry strategies in international business** are cross-border exchanges in which the relationship between the focal firm and its foreign partner is governed by an explicit contract. **Intellectual property** describes ideas or works that individuals or firms create, including discoveries and inventions; artistic, musical, and literary works; and words, phrases, symbols, and designs. Intellectual property is safeguarded through **intellectual property rights**, the legal claim through which proprietary assets are protected from unauthorized use by other parties.[1]

15.1 Explain contractual entry strategies.

Royalty
A fee paid periodically to compensate a licensor for the temporary use of its intellectual property, often based on a percentage of gross sales generated from the use of the licensed asset.

Contractual Entry Strategies

Two common types of contractual entry strategies are licensing and franchising. **Licensing** is an arrangement by which the owner of intellectual property grants another firm the right to use that property for a specific time period in exchange for *royalties* or other compensation. As described in the opening case, a **royalty** is a fee paid periodically to compensate a licensor for the temporary use of its intellectual property. The royalty is usually a percentage of the gross sales generated from use of the licensed asset. As an entry strategy, licensing requires neither substantial capital investment nor extensive involvement of the licensor in the foreign market. Licensing is a relatively inexpensive way for the firm to establish a presence in foreign markets. Firms that use licensing often can avoid expensive entry as is usually required in foreign direct investment (FDI).

Franchising is an advanced form of licensing in which the firm allows another the right to use an entire business system in exchange for fees, royalties, or other forms of compensation.

Franchising Arrangement by which the firm allows another the right to use an entire business system in exchange for fees, royalties, or other forms of compensation.

The preceding types of contractual relationships are common in international business and allow companies to transfer their knowledge assets to foreign partners routinely. Professional service firms such as those in architecture, engineering, advertising, and consulting extend their international reach through contracts with foreign partners. Similarly, retailing, fast food, car rental, television programming, and animation firms rely on licensing and franchising agreements. The retailer 7-Eleven (www.7-eleven.com) operates the world's largest chain of convenience stores, with more than 61,000 stores in 18 countries. Entrepreneurs operate thousands of 7-Eleven stores around the world through franchising arrangements.

Unique Aspects of Contractual Relationships

Cross-border contractual relationships share several common characteristics.

- *They are governed by a contract that provides the focal firm with a moderate level of control over the foreign partner.* Control refers to the ability of the focal firm to influence the decisions, operations, and strategic resources of the foreign venture and ensure that the partner undertakes assigned activities and procedures. In such an arrangement, the focal firm relies largely or entirely on independent agents abroad to perform business activities on its behalf. Thus, compared to FDI, entry by a contractual agreement affords the focal firm substantially less control over its foreign operations.
- *They typically include the exchange of intangibles and services.* Intangibles that firms exchange include various intellectual property, production processes, technical assistance, and know-how. Firms also may supply products or equipment to support the foreign partner.
- *Firms can pursue them independently or in conjunction with other entry strategies.* In pursuing international opportunities, firms may employ contractual agreements alone, or they may combine them with FDI and exporting. The use of such agreements is context specific. The firm may use a contractual relationship with certain customers, countries, or products but not others. Whereas licensing is common for certain types of products, it is not appropriate for others.
- *They provide dynamic, flexible choice.* Some focal firms use contractual agreements to make their initial entry in foreign markets. Then, as conditions evolve, they switch to another, often more advanced entry strategy. For example, franchisors such as McDonald's or Coca-Cola occasionally acquire some of their franchisees and bottlers. In doing so, they switch from a contractual approach to a direct investment strategy.
- *They often reduce local perceptions of the focal firm as a foreign enterprise.* A contractual relationship with a local firm allows the focal firm to blend into the local market. This attracts less attention and less of the criticism sometimes directed at firms that enter through more visible strategies such as FDI.
- *They generate a consistent level of earnings from foreign operations.* In comparison to FDI, contractual arrangements are less susceptible to volatility and risk. Such arrangements tend to bring both parties a predictable stream of revenue.

Contractual relationships emphasize the exchange of intellectual property, which includes various types:

- A *patent* gives an inventor the right to prevent others from using or selling an invention for a fixed period—typically, up to 20 years.[2] It is granted to those who invent or discover a new and useful process, device, or manufactured product or an improvement on these.
- A *trademark* is a distinctive design, symbol, logo, word, or series of words placed on a product label. It identifies a product or service as coming from a common source and having a certain level of quality. Examples include Honda's H-shaped symbol, McDonald's golden arches, and Izod's alligator mark.

- A *copyright* protects original works of authorship, giving the creator the exclusive right to reproduce the work, display and perform it publicly, and authorize others to perform these activities. Copyrights cover music, art, literature, films, and computer software.
- An *industrial design* describes the appearance or features of a product. The design is intended to improve the product's aesthetics and usability as well as increase its production efficiency, performance, or marketability. The Apple iPod is a well-known industrial design.
- A *trade secret* is confidential expertise or information that has commercial value. Trade secrets include production methods, business plans, and customer lists. The formula to produce Coca-Cola is a trade secret.
- A *collective mark* is a logo belonging to an organization whose members use it to identify themselves and associate their products with a level of quality or accuracy, geographical origin, or other positive characteristic. DIN is the collective mark for the German Institute for Standardization, typically found on home appliances in Europe.

Intellectual property rights derive from legally protected patents, trademarks, copyrights, and other protections associated with intellectual property.[3] Such rights provide inventors with a monopoly advantage for a specified period of time so they can exploit their inventions not only to recoup their investment costs and create commercial advantage but also to acquire power and market dominance free of direct competition. The availability and enforcement of these rights vary from country to country. Without such legal protection and the assurance of commercial rewards, most firms and individuals would have little incentive to invent.[3]

15.2 Understand licensing as an entry strategy.

Licensing as an Entry Strategy

A licensing agreement specifies the nature of the relationship between the owner of intellectual property, the *licensor*, and the user of the property, the *licensee*. High-technology firms routinely license their patents and know-how to foreign companies. For example, Germany's Cognitec licensed the use of its face recognition technology to U.S. chip manufacturer Intel, which will use the technology to control access to laptops, tablets, and similar devices.[4]

In the opening case, Warner licenses images from the Harry Potter books and movies to companies worldwide. Disney (www.disney.com) licenses the right to use its cartoon characters to shirt and hat manufacturers in China. It also licenses its trademark names and logos to manufacturers of apparel, toys, and watches for sale worldwide. Licensing allows Disney to create synergies with foreign partners, who can then adapt materials, colors, and other design elements to suit local tastes and market a product similar to one Disney already may offer in the United States.

Exhibit 15.1 illustrates the nature of the licensing agreement.[5] Upon signing a licensing contract, the licensee pays the licensor a fixed amount up front *and* an ongoing royalty of typically 2 to 5 percent of gross sales generated from using the licensed asset. The fixed amount covers the licensor's initial costs of transferring the licensed asset to the licensee, including consultation, training in how to deploy the asset, engineering, or adaptation. Certain types of licensable assets, such as copyrights and trademarks, may have lower transfer costs. The royalty percentage may escalate with increasing sales.

A typical licensing contract runs five to seven years and is renewable at the option of the parties. Initially, the licensor provides technical information and assistance to the licensee. Once the relationship has been established and the licensee fully understands its role, the licensor usually plays an advisory role but usually has no direct involvement in the market and provides no ongoing managerial guidance. Most firms enter into *exclusive agreements*, in which the licensee is not permitted to share the licensed asset with any other company within a prescribed territory. In addition to operating in its domestic market, the licensee also may be permitted to export to other countries.

If the licensor is an MNE, it may enter a licensing arrangement with its own wholly or partly owned foreign affiliate. In this case, licensing is an efficient way to compensate the foreign

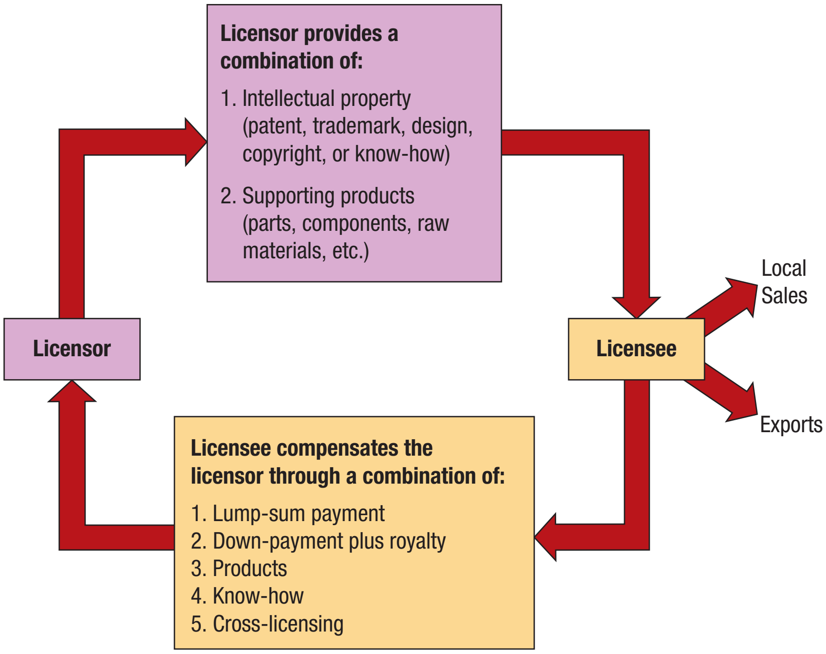

EXHIBIT 15.1

Licensing as a Foreign Market Entry Strategy

affiliate, especially when it is a separate legal entity, and transfer intellectual property to it within a formal legal framework.

In the fashion industry, Hugo Boss, Pierre Cardin, and other strong brands generate substantial profits from licensing deals for jeans, fragrances, and watches. Saks Inc. entered China by licensing its Saks Fifth Avenue name for a flagship department store in Shanghai. Saks generates revenue from the agreement and controls which merchandise is sold in China but has no other involvement. Licensing brings greater awareness of Saks Fifth Avenue to Asia without requiring Saks itself to operate the store, thereby reducing its risk.[6]

The national origin of some popular brands might surprise you. Planters and Sunkist are food and beverage brands owned by U.S. companies and sold in Singapore and the United Kingdom through licensing agreements with local companies. Kit Kat chocolate bars are owned by Switzerland's Nestlé and distributed in the United States through a licensing agreement with Nestlé's competitor, Hershey. Game shows such as *Price Is Right* and *Family Feud* are owned by FremantleMedia, a UK company that licenses these programs for broadcast around the world.

There are two major types of licensing agreements: (1) trademark and copyright licensing and (2) know-how licensing. Let's review each.

Trademark and Copyright Licensing

Trademark licensing grants a firm permission to use another firm's proprietary names, characters, or logos for a specified period of time in exchange for a royalty. Trademarks appear on such merchandise as clothing, games, food, beverages, gifts, novelties, toys, and home furnishings. Organizations and individuals with name-brand appeal benefit from trademark licensing, such as Disney, Nickelodeon, FIFA, Harley-Davidson, LeBron James, and even your favorite university. A famous trademark such as Harry Potter can generate millions of dollars for the owner. Worldwide retail sales of licensed merchandise exceed $260 billion annually.[7]

In Canada, the United States, and numerous other countries, firms acquire rights to trademarks through first use and continuous usage. In other countries, however, rights to trademarks are acquired through registration with government authorities. Many firms register their trademarks in the countries where they do business to protect the asset. When a firm registers its

Source: Wojtek Chmielewski/Shutterstock

The Walt Disney Company licenses its trademark characters to apparel and accessory manufacturers, generating substantial revenue. Shown here is the Disney store in Shanghai, China.

trademark, it formally notifies government authorities that it owns the trademark and is entitled to intellectual property protection. Many countries require local use of the registered mark to maintain the registration.

The convention of gaining ownership to a trademark simply through registration has caused concerns for many firms. When it sought to enter South Africa, McDonald's was frustrated to learn a local businessperson had already registered the McDonald's trademark for his own use. In a court case, the South African Supreme Court ruled in favor of the local entrepreneur. McDonald's eventually won on appeal but only after spending a significant sum in legal fees. In China, French apparel company Hermès lost the right to the Chinese version of its name because a local company had already registered it.[8]

Winnie the Pooh (winniethepooh.disney.com) is one of the biggest success stories of trademark licensing. Introduced as a character in children's literature in 1926, Pooh evolved into a multibillion-dollar licensing property. Disney acquired it in 1961. Pooh is the second-highest-earning fictional character of all time, behind only Mickey Mouse. The Pooh image is licensed to many manufacturers for inclusion on a range of products from baby merchandise to textiles to gardening products. There are roughly 1,000 Pooh licensees in Europe alone.[9]

In many countries, a copyright gives the owner the exclusive right to reproduce the work, prepare derivative works, distribute copies, or perform or display the work publicly. Original works include art, music, and literature as well as computer software. The term of protection varies by country, but the creator's life plus 50 years is typical. Because many countries offer little or no copyright protection, it is wise to investigate local copyright laws before publishing a work abroad.[10]

Know-How Licensing

Know-how agreement
Contract in which the focal firm provides technological or management knowledge about how to design, manufacture, or deliver a product or a service.

Gaining access to technology is an important rationale for licensing. A **know-how agreement** is a contract in which the focal firm provides technological or management knowledge about how to design, manufacture, or deliver a product or a service to a licensee in exchange for a royalty. The royalty may be a lump sum, a *running royalty* based on the volume of products produced from the know-how, or a combination of both.

In some industries, such as pharmaceuticals and semiconductors, inventions and other intellectual property are acquired in reciprocal licensing arrangements between firms in the same or similar industries. Known as *cross-licensing*, the practice is common in industries with rapid technological advances that often build on each other. Technology licensing from competitors reduces the cost of innovation by avoiding duplication of research while reducing the risk of excluding any one firm from access to new developments.

AT&T (www.att.com) once held most of the key patents in the semiconductor industry. As more firms entered the industry and the pace of research and development (R&D) quickened, AT&T risked being surpassed by competitors in Europe, Japan, and the United States, where thousands of semiconductor patents were being awarded. In such a complex network of patents, few firms would have succeeded without obtaining licenses from competitors. AT&T, Intel, Siemens, and numerous other competitors began licensing their patents to each other, creating synergies that greatly accelerated innovation in semiconductors.

In the pharmaceutical industry, the R&D expense to develop new drugs can reach billions of dollars. Pharmaceutical firms want to launch new medicines as quickly as possible to recoup these costs and to expedite product development. Thus, the firms frequently cross-license technologies to each other, exchanging scientific knowledge about producing specific products as well as the right to distribute them in certain geographic regions.[11] In other industries, firms may license technology and know-how from competitors to compensate for insufficient knowledge, fill gaps in their product lineups, enter new businesses, or save time and money.

The World's Top Licensing Firms

Licensing is a potentially lucrative entry strategy that provides numerous benefits in international business. Exhibit 15.2 lists the world's leading licensing firms by annual revenues. The greatest amount of licensing occurs in the apparel, games, and toy industries. Licensing sales have benefited immensely from the emergence of large-scale retailers such as Carrefour, Walmart, and Amazon.com, which have a strong presence around the world.

Rank	Firm Name	Annual Licensing Revenues (U.S. $ billions)	Typical Deals
1	The Walt Disney Company	$56.6	Toy and apparel licensing for Disney movies such as *Little Mermaid* and *Toy Story* and characters such as Winnie the Pooh and the Frozen princesses
2	Meredith	22.8	Bedding, furniture, and other products related to the *Better Homes and Gardens* brand
3	PVH Corporation	18.0	Apparel licensing for such brands as Tommy Hilfiger and Calvin Klein
4	ICONIX	12.0	Apparel licensing for such brands as OP, Umbro, and Danskin
5	Warner Bros. Consumer Products	6.5	Toy and apparel licensing from movies such as *Batman*, *Harry Potter*, and *The Hobbit*
6	Hasbro	6.2	Toy and apparel licensing for TV programs and movies such as *My Little Pony* and *Transformers*
7	Universal Brand Development	6.1	Toys and digital products licensing for movies such as *The Secret Life of Pets* and *Despicable Me*
8	Nickelodeon	5.5	Toy and apparel licensing for TV programs such as *SpongeBob SquarePants* and *Teenage Mutant Ninja Turtles*
9	Major League Baseball	5.5	Baseball-related video games, apparel, toys
10	IMG College Licensing (Collegiate Licensing Company)	4.5	Games, apparel, and accessories related to popular universities

EXHIBIT 15.2

Leading Licensors Ranked by Licensing Revenues (total retail sales of licensed products)

Source: Based on annual reports of the individual firms; company profiles at www.hoovers.com; UBM, *License Global*, "The Top 150 Global Licensors," April 1, 2017, www.licensemag.com/license-global/top-150-global-licensors-3.

Advantages and Disadvantages of Licensing

15.3 Describe the advantages and disadvantages of licensing.

Exhibit 15.3 summarizes the advantages and disadvantages of licensing from the perspective of the licensor. Let's highlight some key points.

Advantages	Disadvantages
Does not require capital investment or presence of the licensor in the foreign market	Revenues are usually more modest than with other entry strategies
Ability to generate royalty income from existing intellectual property	Difficult to maintain control over how the licensed asset is used
Appropriate for entering markets that pose substantial country risk	Risk of losing control of important intellectual property, or dissipating it to competitors
Useful when trade barriers reduce the viability of exporting or when governments restrict ownership of local operations by foreign firms	The licensee may infringe the licensor's intellectual property and become a competitor
Useful for testing a foreign market prior to entry via FDI	Does not guarantee a basis for future expansion in the market
Useful as a strategy to preemptively enter a market before rivals	Not ideal for products, services, or knowledge that are highly complex
	Dispute resolution is complex and may not produce satisfactory results

EXHIBIT 15.3

Advantages and Disadvantages of Licensing to the Licensor

Advantages of Licensing

Licensing requires neither substantial capital investment nor direct involvement of the licensor in the foreign market. Unlike other entry strategies, the licensor need not establish a physical presence in the market or maintain inventory there. Simultaneously, the licensee benefits by gaining access to a key technology at a much lower cost and in less time than if it had developed the technology itself.[12] Licensing makes entry possible in countries that restrict foreign ownership in security-sensitive industries such as defense and energy. Licensing also facilitates entry in markets that are difficult to enter because of trade barriers, tariffs, and bureaucratic requirements, which usually apply only to exporting or FDI.

Licensing can be used as a low-cost strategy to test the viability of foreign markets. By establishing a relationship with a local licensee, the foreign firm can learn about the target market and devise the best future strategy for establishing a more durable presence there. For example, Swiss pharmaceutical manufacturer Roche entered a licensing agreement with Chugai Pharmaceuticals in Japan, where success requires substantial knowledge of the local market and the drug approval process. The relationship accelerated Roche's penetration of the huge Japanese market.[13] Licensing can also help the firm develop its brand name in a target market and preempt the later entry of competitors.

Disadvantages of Licensing

From the licensor's standpoint, licensing is a relatively passive entry strategy. However, the licensor must take steps to enforce the licensing agreement. The licensor needs to ensure that licensees are paying the appropriate royalties and are not violating the licensor's intellectual property. Profits tend to be lower than those from exporting or FDI. Licensing does not guarantee a basis for future expansion. To earn royalties, the licensor must rely on the licensee's sales and marketing prowess. A weak partner will generate only meager royalties. Also, licensing provides limited control over how the licensor's asset is used. If the licensee produces a substandard product, the licensor's reputation can be harmed. To avoid such problems, experienced firms require foreign licensees to meet minimum quality and performance standards. For example, Budweiser beer is made and distributed in Japan through a licensing arrangement with Kirin (www.kirin.co.jp/company/english). Kirin is one of Japan's most reputable brewers and produces the beer according to Budweiser's strict standards.

If the licensee is very successful, the licensor may regret not entering the market through a more lucrative entry strategy. This happened to Disney, which developed Disneyland Tokyo through a licensing arrangement with a Japanese partner. When the theme park proved more successful than originally forecast, Disney management wished it had used FDI to develop Disneyland Tokyo itself. In Mexico, Televisa (www.televisa.com), the largest producer of Spanish-language TV programming, opted for a licensing arrangement with California-based Univision to enter the U.S. market. Although there are approximately 40 million native Spanish speakers in the United States, Televisa received only a fraction of Univision's Spanish market advertising revenue.

Because licensing requires sharing intellectual property with other firms, the risk of creating a future competitor is substantial.[14] The rival might exploit the licensor's intellectual property by entering third countries or creating products based on knowledge gained in the relationship. This has occurred in the automobile, computer chip, and consumer electronics industries in Asia as Western firms have transferred process technologies to firms in China, Japan, and South Korea. Japan's Sony (www.sony.com) originally licensed transistor technology from U.S. inventor Bell Laboratories to make hearing aids. But instead, Sony used the technology to create small, battery-powered transistor radios and soon grew to become a global leader in this product category.[15]

Source: Alepenny/123RF

Licensors run the risk of creating competitors, as Mattel discovered when it granted a license to a Brazilian firm to market Barbie dolls. The latter firm went on to create a competitor to Barbie, the Susi doll.

The U.S. toymaker Mattel licensed rights to distribute the Barbie doll to the Brazilian toymaker Estrela (www.estrela.com.br). Once the agreement expired, Estrela developed its own Barbie look-alike—Susi—which surpassed sales of Barbie dolls in Brazil. Estrela then launched the Susi doll throughout South America to great success. In Japan, Mattel entered a licensing agreement with local toymaker Takara (www.takaratomy.co.jp), which adapted the Barbie doll for Japanese girls. When the agreement expired, Takara continued to sell the doll under the name "Jenny," becoming a competitor to Mattel in the world's second-biggest toy market.[16]

Franchising as an Entry Strategy

15.4 Understand franchising as an entry strategy.

Franchising is an advanced form of licensing in which the focal firm, the *franchisor*, allows an entrepreneur, the *franchisee*, the right to use an entire business system in exchange for compensation. As with licensing, an explicit contract defines the terms of the relationship. McDonald's, Subway, Hertz, and FedEx are well-established international franchisors. Others that use franchising to expand abroad include Benetton, Body Shop, Yves Rocher, and Marks & Spencer. Franchising is common in international retailing. However, some retailers such as IKEA and Starbucks favor direct investment and internationalize through company-owned outlets. Ownership provides these firms with greater control over foreign operations but also typically restricts their ability to expand more rapidly abroad.

Franchises generate the biggest volume of sales in advanced economies such as the United States, Europe, and Japan. However, a large number of franchises are found in countries that are less economically developed in Asia. Many of these are *micro-franchises*, operated by one or two people. Franchising is a major job creator in developing economies in Asia and Latin America, helping to raise living standards. A large proportion of franchises in Africa and less-developed Asia are international.[17]

Exhibit 15.4 shows the nature of the franchising agreement. Most firms undertake *business format franchising* (sometimes called *system franchising*).[18] The franchisor transfers to the franchisee a total business method, including production and marketing methods, sales systems, procedures, and management know-how, as well as the use of its name and usage rights for products, patents, and trademarks.[19] The franchisor also provides the franchisee with training, ongoing support, incentive programs, and the right to participate in cooperative marketing programs.

In return, the franchisee pays some type of compensation to the franchisor, usually a royalty representing a percentage of the franchisee's revenues. The franchisee may be required to purchase certain equipment and supplies from the franchisor to ensure standardized products and consistent quality. Burger King and Subway require franchisees to buy food preparation equipment from specified suppliers.

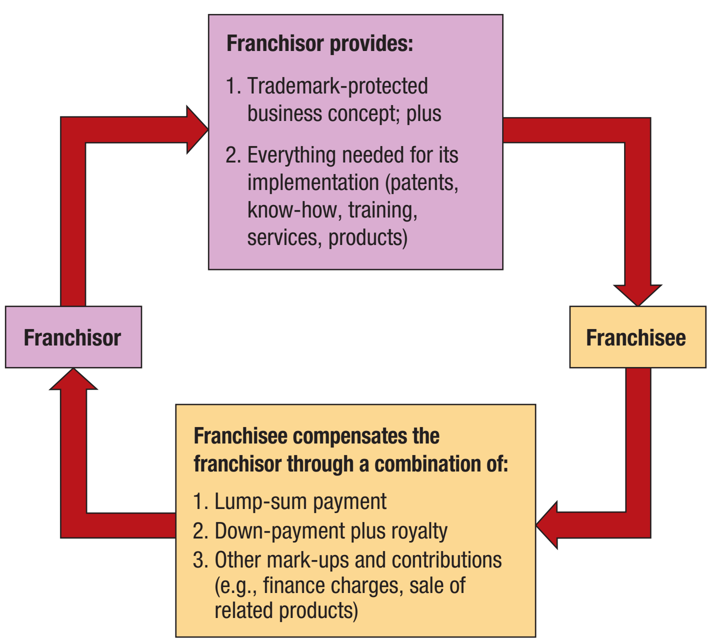

EXHIBIT 15.4
Franchising as a Foreign Market Entry Strategy

Whereas licensing relationships are often short-lived, franchising parties normally establish an ongoing relationship that may last many years. This results in a more stable long-term entry strategy. In addition, franchisors often combine franchising with other entry strategies. For example, about 70 percent of Body Shop's approximately 3,000 stores in some 65 countries are operated by franchisees. Body Shop (www.thebodyshop.com) headquarters owns the rest. Large retailers such as Carrefour often employ both franchising and FDI when expanding abroad.

Franchising is more comprehensive than licensing because the franchisor prescribes virtually all of the business activities of the franchisee. The franchisor tightly controls the business system to ensure consistent standards. International franchisors employ globally recognized trademarks and attempt to guarantee the customer a uniform retail experience and consistent product quality.

Completely standardized business activities, however, are difficult to replicate across diverse markets. Differences in local tastes, available ingredients, and physical space may necessitate changes to the franchise formula. McDonald's offers teriyaki burgers in Japan, wine in France, and a McPork sandwich in Spain. In China, KFC offers shredded carrots, fungus, and bamboo shoots instead of the coleslaw it sells in Western countries.[20] Limited land in Japan forced KFC to reconfigure its cooking equipment from a wide horizontal design to a narrower, more vertical design that saves space. Japanese KFCs are often multistoried restaurants to save on the high cost of land. The challenge is to strike the right balance, adapting the format to respond to local markets without affecting the overall image and service of the franchise.[21]

Master franchise
Arrangement in which an independent company is licensed to establish, develop, and manage the entire franchising network in its market and has the right to sub-franchise to other franchisees, assuming the role of local franchisor.

Some focal firms may choose to work with a single, coordinating franchisee in a particular country or region. In this **master franchise** arrangement, an independent company is licensed to establish, develop, and manage the entire franchising network in its market. The master franchisee has the right to sub-franchise to other independent businesses and thus assume the role of the local franchisor. McDonald's is organized this way in Japan. By delegating the responsibilities of identifying and working with its franchisees directly, the focal firm gives up considerable control over its foreign market operations. From the focal firm's perspective, however, the arrangement is the least capital- and time-intensive.

Master franchisees prefer this arrangement because it provides them with an exclusive, large, predefined territory (often an entire country) and substantial scale economies from operating numerous sales outlets simultaneously. They gain access to a proven retailing and marketing concept and partnership with a corporate headquarters and master franchisees in other territories, which typically provide support, know-how, and the latest innovations in the field. Master franchising accounts for as much as 80 percent of international franchising deals. Sbarro, Inc., the pizza chain, operates through master franchises in Belgium, Canada, Guatemala, Kuwait, the Philippines, and the United Kingdom.[22]

Source: Northfoto/Shutterstock

Franchising accounts for a large proportion of international retailing. This 7-Eleven store is in Copenhagen, Denmark.

Who Are the Top Global Franchisors?

Franchising is a global phenomenon and accounts for a large proportion of international trade in services, especially fast-food outlets, professional business services, home improvement, and various types of retailers. Yum! Brands, Inc., owns the KFC, Pizza Hut, and Taco Bell brands of franchised restaurants. In China, KFC has approximately 5,100 stores and Pizza Hut has about 1,900. Such numbers have made Yum! Brands one of the largest retail developers in China.[23] Exhibit 15.5 profiles several other leading global franchisors.

The United States is home to the largest number of franchisors and dominates international franchising. U.S. franchisors and their franchisees employ 21 million people, generate $2.3 trillion of economic activity, and account for nearly 50 percent of total U.S. retail sales. Europe is home to numerous home-grown franchisors such as Spar (Netherlands), Benetton (Italy), and Marston's Pub (United Kingdom). Annual

Franchisor	Type of Business	Total Number of Franchises	International Franchises	Example Markets
7-Eleven	Convenience stores	61,086	54,061 franchises in 18 countries	Japan, Thailand, Mexico, United States
McDonald's	Hamburger restaurants	34,279	18,827 franchises in 120 countries	France, United Kingdom, Australia, China
Subway	Submarine sandwiches, bagels, salad restaurants	44,608	17,950 franchises in 113 countries	Australia, Brazil, Canada, Mexico
KFC	Chicken, sandwiches, pot pies restaurants	19,463	15,537 franchises in 119 countries	Brazil, Canada, Japan, France
Pizza Hut	Pizza, pasta, chicken wings restaurants	14,645	8,760 franchises in 102 countries	China, Brazil, Canada, Japan
Kumon Math & Reading Centers	Learning and study centers	25,811	8,400 franchises in 60 countries	Canada, Ireland, Thailand, United States
Burger King	Hamburger restaurants	15,700	8,240 franchises in 98 countries	Denmark, Ecuador, South Africa, Thailand
Baskin-Robbins	Ice cream shops	7,982	5,422 franchises in 70 countries	Australia, China, Japan, Russia
RE/MAX	Real estate offices	7,560	3,831 franchises in 103 countries	Canada, Germany, Italy, Spain
Dunkin' Donuts	Donut and coffee shops	12,538	3,397 franchises in 60 countries	China, Germany, India, South Korea

EXHIBIT 15.5

Leading International Franchisors

Sources: Based on *Entrepreneur*, "2017 Top Global Ranking: Top Global Franchises," 2018, www.entrepreneur.com; *Franchise Direct*, "Top 100 Global Franchises—Rankings, 2018," 2018, www.franchisedirect.com; company profiles from Hoovers.com; company websites and reports.

franchised sales of fast food in the United Kingdom are thought to account for about 30 percent of all food eaten outside the home.[24]

The ability to exchange information instantaneously through the Internet enhances the franchisor's ability to control international operations and saves time and money. Some franchisees use electronic point-of-sale equipment that links their sales and inventory data to the franchisor's central warehouse and distribution network. Information technology also allows the franchisor to serve customers or franchisees with central accounting and other business process functions.

As markets in Europe and other advanced economies become saturated, franchisors are expanding to emerging markets. Subway is doing big business in Eastern Europe. Avis car rental enjoys much success in Latin America. Ben & Jerry's ice cream is a favorite in Thailand and Turkey. About 70 percent of the countries where KFC does business are developing economies.

Estimates suggest international franchised companies provide more than 3 million jobs in developing economies. Franchises help provide needed modernization in business methods, distribution networks, and commercial infrastructure. They help build local capabilities and skills by both bringing in expatriate staff and training local personnel. Because franchising is less risky, it is often preferred over FDI for entering developing economies.[25]

Advantages and Disadvantages of Franchising

15.5 Explain the advantages and disadvantages of franchising.

In an ideal relationship, franchisor and franchisee complement each other. The franchisor possesses economies of scale, a wealth of intellectual property, and know-how about its industry; the franchisee has entrepreneurial drive and substantial knowledge about the local market and how to run a business there. A large pool of well-chosen franchisees greatly enhances the speed and quality of the franchisor's performance abroad.[26] For example, Baskin-Robbins ice cream internationalized quickly and has performed well worldwide by developing franchisees in more than 70 countries with some 5,422 shops serving nearly a million customers per day.

The Franchisor Perspective

Exhibit 15.6 highlights the advantages and disadvantages of franchising to the franchisor. Firms prefer franchising when they lack the capital or international experience to establish themselves abroad through FDI or when offering the product through exporting or basic licensing is ineffective as an internationalization strategy. Foreign markets often provide greater profitability than the home market. For example, the Beijing KFC store has generated more sales than any other KFC outlet worldwide partly due to the novelty and popularity of the offering and the lack of direct competition. Governments in host countries often encourage franchising by foreign entrants because most of the profits and investment remain in the local economy.

For the franchisor, franchising is a low-risk, low-cost entry strategy. It offers the ability to develop international markets relatively quickly and on a larger scale than possible for most non-franchise firms. The franchisor can generate profit with only incremental investments in capital, staff, production, and distribution.

The major disadvantages include the need to maintain control over potentially thousands of outlets worldwide and the risk of creating competitors. When the franchising agreement is terminated, some franchisees leverage their newly acquired knowledge to remain in business, often by slightly altering the franchisor's brand name or trademark. Franchisees may also jeopardize the franchisor's image by not upholding its standards. Dunkin' Donuts experienced problems in Russia when it discovered some franchisees were selling vodka along with donuts.

When the franchisor depends heavily on a foreign partner as master franchisee, it is critical to cultivate friendly, durable relationships. However, even experienced franchisors encounter major problems. In 2010, nearly 30 years after opening its first outlet in Japan, restaurant chain Wendy's could not reach a new agreement with its Japanese master franchisee, Zensho Company, and chose to close its restaurants there. The move disappointed countless Japanese fans, who formed long lines in front of Wendy's outlets in the days before the chain shut down. By 2013, however, Wendy's reestablished itself in Japan through a joint venture with Higa Industries.[27]

Another major challenge is to become familiar with foreign laws and regulations. The European Union has strict laws that favor the franchisee, sometimes hampering the franchisor's ability to maintain control over operations. Laws and foreign exchange circumstances affect the payment of royalties.

The Franchisee Perspective

Exhibit 15.7 highlights the advantages and disadvantages of franchising from the franchisee's perspective. Entrepreneurs that open a franchised store benefit from the franchisor's established formula. Customers are more likely to patronize a well-known franchise, which helps the franchisee succeed more quickly. Franchising is especially beneficial to SMEs, many of which lack substantial resources and strong managerial skills. The big advantage is the ability to launch a business by using a tested business model. In essence, franchising amounts to cloning best practices. It greatly increases the small firm's chances for success by duplicating a tried-and-true business format.[28]

However, starting a franchise is usually costly and may require the franchisee to build a shop or invest in expensive equipment. Unlike independent store owners, franchisees must satisfy the franchisor's demands. This can be problematic for international franchisees when the franchisor knows little about foreign markets or how to do business there.

EXHIBIT 15.6

Advantages and Disadvantages of Franchising to the Franchisor

Advantages	Disadvantages
• Entry into numerous foreign markets can be accomplished quickly and cost-effectively • No need to invest substantial capital • Established brand name encourages early and ongoing sales potential abroad • The firm can leverage franchisees' knowledge to efficiently navigate and develop local markets	• Maintaining control over franchisee may be difficult • Conflicts with franchisee are likely, including legal disputes • Preserving franchisor's image in the foreign market may be challenging • Requires monitoring and evaluating performance of franchisees and providing ongoing assistance • Franchisees may take advantage of acquired knowledge and become competitors in the future

EXHIBIT 15.7

Advantages and Disadvantages of Franchising to the Franchisee

Advantages	Disadvantages
• Gain a well-known, recognizable brand name • Acquire training and know-how; receive ongoing support from the franchisor • Operate an independent business • Increase likelihood of business success • Become part of an established international network	• Initial investment or royalty payments may be substantial • Franchisee is required to purchase supplies, equipment, and products from the franchisor only • The franchisor holds much power, including superior bargaining power • Franchisor's outlets may proliferate in the region, creating competition for the franchisee • Franchisor may impose inappropriate technical or managerial systems on the franchisee

Managerial Guidelines for Licensing and Franchising

Licensing and franchising are complex undertakings and require skillful research, planning, and execution. The focal firm must conduct advance research on the host country's laws on intellectual property, repatriation of royalties, and contracting with local partners. Key challenges of the focal firm include establishing whose national law takes precedence for interpreting and enforcing the contract, deciding whether to grant an exclusive or nonexclusive arrangement, and determining the geographic scope of territory to be granted to the foreign partner.

As with other entry strategies, the key to success is often finding the right partner abroad. The focal firm should carefully identify, screen, and train potential partners who are unlikely to become competitors in the future. The most qualified franchisees tend to have entrepreneurial drive, access to capital and prime real estate, a successful business track record, good relationships with local and national government agencies, strong links to other firms (including facilitators), a pool of motivated employees, and a willingness to accept oversight and follow company procedures. In emerging markets, a knowledgeable, locally connected partner can help sort through various operational problems. In China and Russia, partnering with a state-owned enterprise may be necessary to gain access to key resources and navigate legal and political environments.

For franchisors, developing capable partners in local supply chains is also a prerequisite. Franchisees need a reliable supply chain to obtain input products and supplies. In developing economies and emerging markets, host-country suppliers may be inadequate for providing a sufficient quantity or quality of input goods. In Turkey, Little Caesars pizza franchisees found it difficult to locate dairy companies that could produce the cheese varieties they required. In other countries, KFC developed its own supply-chain network, ensuring dependable delivery of chicken and other critical inputs. In Russia and Thailand, McDonald's had to develop its own supply lines for potatoes to ensure the quality of its french fries. When McDonald's first entered India, it faced resistance from the government. Relations improved as the government recognized that McDonald's would work with Indian farmers to improve the country's agricultural practices and was committed to being a good corporate citizen.

Other Contractual Entry Strategies

15.6 Understand other contractual entry strategies.

Licensing and franchising are especially salient contractual entry strategies. In addition, firms employ other contract-based approaches to venture abroad. Global sourcing is a specific type of international contracting that we addressed in Chapter 13. Other types of contractual agreements deal with building major construction projects, manufacturing products under contract, providing management and marketing services, or leasing major assets. Here, we discuss turnkey contracting, build-operate-transfer arrangements, management contracts, and leasing.

Turnkey Contracting

Turnkey contracting Arrangement in which the focal firm or a consortium of firms plans, finances, organizes, manages, and implements all phases of a project abroad and then hands it over to a foreign customer after training local workers.

Turnkey contracting is an arrangement in which the focal firm or a consortium of firms plans, finances, organizes, manages, and implements all phases of a project abroad and then hands it over to a foreign customer after training local workers.

Contractors are typically firms in construction, engineering, design, and architectural services. In a typical turnkey project, a contractor builds a major facility (such as a nuclear power plant or a subway system), puts it into operation, and then hands it over to the project

Source: Wasin Pummarin/123RF

The spectacular Petronas Twin Towers complex in Kuala Lumpur, Malaysia, was a turnkey project built by Bovis Lend Lease, a leading project management and construction company. Among the firms with offices in the Towers are Accenture, Al Jazeera English, Huawei Technologies, Microsoft, and Reuters.

sponsor, often a national government. The contractor may provide follow-up services such as testing and operational support.

Among the most popular turnkey projects are extensions and upgrades to metro systems. These include bridges, roadways, and railways and the construction of airports, harbors, refineries, and hospitals. Such projects are financed largely from public budgets. Most large-scale infrastructure projects are in the Mideast and East Asia, where industrialization and growing affluence are driving demand. In Abu Dhabi, a collection of companies received a multibillion-dollar contract to build an integrated processing plant for natural gas. The team included JGC of Japan, Tecnimont of Italy, and Hyundai Engineering & Construction of South Korea (HDEC). HDEC has built industrial, infrastructure, commercial, and multifamily residential projects in about 50 countries.[29]

Other examples are Hochtief AG of Germany and Skanska AB of Sweden. These top construction companies have undertaken some of the world's most important infrastructure projects, such as the Three Gorges Dam in China and the Chunnel linking England to France. California-based Bechtel participated in projects such as the renovation of London's 140-year-old subway, the cleanup of the Chernobyl nuclear plant in Russia, and construction of nuclear power plants in South Korea. In Russia, a consortium of firms is building a huge power plant in the Arkhangelsk region to support the thriving mining industry there.[30]

Build-Operate-Transfer Arrangements (BOT)

Under a **build-operate-transfer (BOT)** arrangement, a firm or consortium of firms contracts to build a major facility abroad, such as a dam or water treatment plant; operates it for a specified period; and then transfers ownership to the project sponsor. The project sponsor is typically a government or public utility in the host country. In contrast to turnkey contracting, a unique feature of the BOT arrangement is that, instead of transferring control of the completed facility to the project sponsor, the builder first operates it for a number of years.

Build-operate-transfer (BOT) Arrangement in which the firm or a consortium of firms contracts to build a major facility abroad, operate it for a specified period, and then transfer control to the project sponsor, typically the host-country government or public utility.

Although the consortium operates the facility, it can charge user fees, tolls, and rentals to recover its investment and generate profits. Or the host-country government can pay the BOT partner for services provided by the facility, such as water from a treatment plant, at a price calculated over the life of the contract, to cover its construction and operating costs and provide a reasonable return.

Governments often grant BOT concessions to have needed infrastructure built cost-effectively. Typical projects include sewage treatment plants, highways, airports, mass transit systems, and telecommunications networks. In Pakistan, a growing population and economic development have increased the need for transportation infrastructure. The Pakistani government commissioned the construction of a freeway to connect populated areas near Karachi and Islamabad, from north to south. The motorway is a vital link for commerce and recreation and will cost more than $1.7 billion to build. The BOT project is being developed by a consortium of construction companies from around the world.[31]

Management Contracts

Under a **management contract**, a contractor supplies managerial know-how to operate a hotel, hospital, airport, or other facility in exchange for compensation. The client organization receives assistance in managing local operations, and the management company generates revenues without having to make a capital investment. Much of Disney's income from its theme parks in France and Japan comes from providing management services for the parks, which are largely owned by other interests. BAA Limited manages the retailing and catering operations of various airports in Europe and the United States. Using management contracts, Marriott and Four Seasons corporations run, but do not own, numerous luxury hotels around the world.

Management contract Arrangement in which a contractor supplies managerial know-how to operate a hotel, hospital, airport, or other facility in exchange for compensation.

Management contracts can help foreign governments with infrastructure projects when the country lacks local people with the appropriate skills to operate them. Occasionally the offering of a management contract is the critical element in winning a bid for other types of entry strategies, such as BOT deals and turnkey operations. A key disadvantage of management contracts is that they involve training foreign firms that may become future competitors.[32]

Leasing

In international leasing, another contractual strategy, a focal firm (the lessor) rents out machinery or equipment to corporate or government clients abroad (lessees), often for several years at a time. The lessor retains ownership of the property throughout the lease period and receives regular payments from the lessee. From the perspective of the lessee, leasing helps reduce the costs of using needed machinery and equipment. A major advantage for the lessor is the ability to gain quick access to target markets while putting assets to use earning profits. In some countries, firms opt to lease rather than buy needed equipment due to tax benefits. International leasing benefits developing economies that may lack the financial resources to purchase needed equipment.

Amsterdam-based ING Lease International Equipment Management owns and leases Boeing commercial aircraft to clients such as Brazil's Varig airlines. Dubai-based Oasis Leasing leases aircraft to Air New Zealand, Virgin Express, and Macedonian Airlines. One of the top leasing firms is Japan's ORIX (www.orix.co.jp), which leases everything from computers and measuring equipment to aircraft and ships. The firm operates 2,200 offices worldwide and generated more than $23 billion in sales in 2018.

The Special Case of Internationalization by Professional Service Firms

Professional services include such industries as accounting, advertising, market research, consulting, engineering, legal counsel, and IT services. Firms in these industries have internationalized rapidly during the past three decades. Some have simply followed their key clients abroad. The Internet supports the international spread of some business process services such as software engineering, which is increasingly centralized in cost-effective locations such as India and Eastern Europe.

When they internationalize, professional service firms encounter three unique challenges.

- Professional qualifications that allow firms to practice law, dentistry, medicine, or accounting in the home country are rarely recognized by other countries. If you are a licensed accountant in your country and want to practice accounting in some other country, you usually must earn local certification there.
- Professionals who work abroad for long periods generally must obtain employment visas in the countries where they are employed.
- Professional services often require intensive interaction with the local public, which necessitates language and cultural skills.[33]

Professional service firms employ a mix of direct investment and contractual strategies to enter foreign markets. Publicis Groupe is an advertising agency headquartered in France. It maintains a network of company-owned branches and enters contractual relationships with independent local firms around the world. Focal firms in professional services are likely to serve their major markets with direct investment and operate company-owned offices there. In small markets, however, they will enter contractual relationships with independent partner firms in the same line of business, typically known as *agents, affiliates*, or *representatives*. PricewaterhouseCoopers, a leading accounting firm, contracts with indigenous accounting firms in smaller markets where it chooses not to have its own offices. Focal firms with limited international experience often prefer to employ foreign partners that can provide international business know-how.

MyLab Management Watch It!

If your professor has assigned this, go to the Assignments section of **www.pearson.com/mylab/management** to complete the video exercise titled MyGym Entry Strategy and Strategic Alliances.

You Can Do It

RECENT GRAD IN IB

JUANITA VELEZ

Juanita's degrees: Bachelor's degree in psychology, master's degree in international business

Internships during college: International Marketing Intern, Atlanta Convention and Visitors' Bureau

Jobs held since graduating:

- Director of Digital Marketing, Georgia Hispanic Chamber of Commerce, Atlanta, USA
- International Digital Integrated Communications Supervisor, UPS, Sandy Springs, Georgia, USA
- International Social Media Strategist, Delta Air Lines, Atlanta, USA

While obtaining her undergraduate degree in psychology, Juanita Velez never imagined she would pursue a career in business. However, Juanita launched her business career as a Latina entrepreneur, co-founding a distribution and exporting company in Miami, Florida. She left Miami to advance her studies and pursue a master's degree in International Business at a state university in Atlanta, Georgia. While deepening her involvement in Atlanta's business community, Juanita gained a passion for international business. Human connectivity, communication, and globalization became Juanita's main passions, helping her land a position with UPS, a large global logistics company.

At UPS, Juanita worked as a global brand and sponsorships specialist, responsible for customer hospitality programs for various multinational firms. After promotion to the UPS digital marketing team, Juanita helped manage the development and execution of integrated digital communications for UPS's international marketing and business plans in regions around the world. Juanita accepted a position at Delta Air Lines as an international social media strategist where she led the development of the company's international social media strategy and presence in priority markets worldwide.

Success Factors

During the 1990s drug war in Medellin, Juanita immigrated with her family from Colombia to the United States. Sacrifices and hardships that she experienced as an immigrant helped her develop an empathetic approach to international cultures. In college, Juanita often sought the advice of mentors and leveraged her innate skills in communications and relationship-building. Whenever business leaders came to speak at her school, Juanita nurtured relationships with them and, by graduation, she had built a network of more than 30 business professionals. She also read inspirational and self-help books to better understand how to achieve her goals. Juanita believes her career success has been fueled by the combination of her passion, innate talents, and the skills she acquired at school and through internships.

Juanita's Advice for an International Career

Juanita believes that international commerce is integrating nations and making the world a smaller place. Domestic markets are interconnected with other markets, and provide unlimited opportunities for business growth. Juanita's experience as an immigrant combined with her educational background have helped her develop strong skills in international marketing. She says "you must immerse yourself into whatever role you see yourself from the beginning, so you can learn to become that professional. You are the only one with the keys to your career journey." Juanita wants to continue advancing her career while giving back by bridging multicultural communities.

Source: Courtesy of Juanita Velez.

Companies need the support of multicultural managers to attain success in their international operations. Read the *You Can Do It: Recent Grad in IB* feature on Juanita Velez, a young professional from Colombia who has attained much success in the work world.

15.7 Understand infringement of intellectual property, a global problem.

Infringement of Intellectual Property: A Global Problem

We have seen that working with independent partners through contractual arrangements provides the focal firm with only moderate control over foreign partners. Safeguarding intellectual property and foreign operations under contractual arrangements is usually challenging. Laws that govern contractual obligations are not always clear, conflicts arise due to cultural and language differences, and contract enforcement abroad is often costly or unattainable.

Infringement of intellectual property is the unauthorized use, publication, or reproduction of products and services protected by a patent, copyright, trademark, or other intellectual property right. Such a violation amounts to piracy—production and distribution of counterfeit goods. Counterfeiting and piracy can be particularly troublesome in emerging markets and developing economies, where intellectual property laws are often weak or poorly enforced.[34]

Infringement of intellectual property
Unauthorized use, publication, or reproduction of products or services protected by a patent, copyright, trademark, or other intellectual property right.

The total value of counterfeit and pirated products is expected to reach approximately $2 trillion annually by 2022. A large proportion of these goods are sold online.[35] The most commonly counterfeited goods include jewelry and accessories, apparel, consumer electronics, pharmaceutical drugs, and optical media such as CDs and DVDs. For example, annual piracy losses in CDs and music exceed $100 million in Brazil, and losses in business software exceed $1 billion in Russia.[36] Counterfeiters may use a product name that differs only slightly from that of a well-known brand; it is similar enough that buyers associate it with the genuine product but just different enough so that prosecution is hampered. Although firms such as Rolex and Tommy Hilfiger are well-known victims, counterfeiting is also common in such industrial products as medical devices and car parts. Counterfeiters even have faked entire motor vehicles. Authorities uncovered 23 unauthorized Apple stores in southeast China, selling fake iPads and counterfeit smartphones.[37]

Apple sued Samsung for alleged infringement of smartphone patents. Apple won $120 million in the case, which had been litigated over several years. Meanwhile, Samsung sued China's Huawei Technologies for alleged pirating of various smartphone patents.[38] Although Windows and Office products dominate the software market, Microsoft receives no payment when unauthorized parties copy and distribute its software. Up to 90 percent of computer software in Russia may be pirated. As a result, Microsoft sells its products mainly to corporate customers. The firm has battled piracy even among the employees in its Russian subsidiary.[39]

Ethical Connections

Counterfeiting is not confined to lower-income countries. Raids of retail outlets in the United States net millions of dollars' worth of counterfeit products every year. For example, city and federal authorities in New York arrested numerous people on charges of possessing millions of dollars in counterfeit fashions, including Gucci watches, Louis Vuitton handbags, North Face jackets, and much more.

Source: CBP Office of International Trade, "Intellectual Property Rights," 2017, www.cbp.gov; *WWD: Women's Wear Daily*, "Raid by N.Y. Police and Feds Nets $2 Million in Fakes," December 10, 2014, p. 1.

The Internet has added a new dimension to international piracy. In Russia, websites sell popular music downloads for as little as 5 cents each or less than $1 for an entire album. The sites can be accessed easily by shoppers worldwide, including in countries with strong intellectual property laws. Fake medications sold through the Internet account for a significant percentage of prescription drugs sold online. Consumers have died from consuming fake medications.[40]

When consumers buy counterfeit goods, payments accrue not to the firm that invented the product but, rather, to illicit enterprises. Counterfeiting negatively affects consumer attitudes about the branding and quality of legitimate goods. The quality of counterfeit goods is almost always inferior to that of the original, proprietary goods that they duplicate. In these and other ways, counterfeiting and piracy erode the firm's brand equity and competitive advantage. Where counterfeiting and piracy are commonplace, companies are reluctant to invent, innovate, and market legitimate products, which reduces consumer choices and ultimately lowers living standards

Guidelines for Protecting Intellectual Property

In advanced economies, intellectual property is usually protected within established legal systems and methods of recourse. A firm can initiate legal action against someone who infringes on its intellectual assets and will usually achieve a satisfactory remedy. Advanced economies have taken the lead in signing treaties that support international protection of intellectual property, including the Paris Convention for the Protection of Industrial Property, the Berne Convention for the Protection of Literary and Artistic Works, and the Rome Convention for the Protection of Performers and Broadcasting Organizations. The World Intellectual Property Organization (WIPO; www.wipo.int) is an agency of the United Nations that administers these multilateral agreements.

The World Trade Organization (WTO; www.wto.org) created the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), a comprehensive international treaty that lays out remedies, dispute-resolution procedures, and enforcements to protect intellectual property. The WTO is pressuring member countries to comply with the accord and can discipline violators through the dispute settlement mechanism. At the same time, TRIPS provides exceptions that benefit developing economies, such as the ability to access needed patent medication for ailments such as AIDS.

Although most countries are signatories to WIPO, TRIPS, and various treaties, intellectual property infringements remain a huge problem. Rights granted by a patent, trademark registration, or copyright apply only in the country where they are obtained; they confer no protection abroad. Enforcement depends on the attitudes of local officials, substantive requirements of the law, and court procedures. As a result, former licensees and franchisees can launch illicit businesses using proprietary knowledge to which they are no longer entitled.

Experienced firms devise sophisticated approaches to reduce the likelihood of intellectual property violations and help avoid their adverse effects, especially in countries with weak property rights protection.[41]

Protecting Intellectual Property (IP)

To protect its IP, the firm should:

- Research to understand IP laws and protections in target countries.
- Register core IP in each country where it does business.
- Separate value-chain activities to maintain IP secrecy. For example, keep R&D and manufacturing separate so suppliers cannot learn the entire production process.
- Emphasize leading-edge or hard-to-understand technologies. The latest know-how is usually harder to imitate than older technologies.
- Hire employees who maintain high ethical standards.
- Collaborate with ethical partners. Choose reputable suppliers with no history of IP violations.
- Regularly educate employees and partners about the harm of violating IP rights.
- Include provisions in partner contracts that protect IP.
- Develop trusting relations with partners.
- Perform audits to ensure that partners meet their responsibilities to protect the firm's IP.
- Pursue IP violators through prosecution and other legal means.
- Educate customers about the harm of infringing on IP.
- Cultivate contacts in local and national governments involved in IP laws and enforcement.
- Lobby governments for stronger IP protections.

Let's elaborate on some key strategies. Before undertaking contractual entry strategies abroad, management needs to understand local intellectual property laws and enforcement procedures, particularly when exposed assets are valuable. The firm should register patents, trademarks, trade secrets, and copyrights with local governments, especially in countries with weak antipiracy laws. Some companies lobby national governments and international organizations for stronger intellectual property laws and more vigilant enforcement, albeit with limited success.

Management must ensure that licensing and franchising agreements provide for oversight to ensure that intellectual property is used as intended. Licensing contracts should include provisions that require the licensee to share improvements or technological developments on the licensed asset with the licensor.[42] Noncompete clauses in employee contracts help prevent employees from serving competitors for some years after leaving the firm.[43]

Monitoring franchisee, distribution, and marketing channels for asset infringements helps avoid problems. The firm should monitor the activities of local business partners for potential leaks of vital information and assets.[44] Trade secrets must be guarded closely. Using password-based security systems, surveillance, and firewalls limits access to intellectual property. Intel and Microsoft release only limited information about key technologies to partner firms. The firm can deter much potential piracy by aggressively pursuing criminal prosecution or litigation against those who pilfer its logos, proprietary processes, and other key assets. Mead Data Central, Inc., owner of the Lexis-Nexis brand of computerized legal research services, sued Toyota when the Japanese firm began selling its new luxury automobiles under the Lexus name. The suit failed, but it showed Mead's determination to protect its assets.[45]

The firm should leverage technological approaches to minimize counterfeiting. Many companies build biotech tags, electronic signatures, or holograms into their products to differentiate them from fakes. In the long run, the best way to cope with infringement is to update technologies and products continuously. The firm that regularly renews its technologies can stay ahead of counterfeiters by marketing products that counterfeiters cannot imitate fast enough. Even when licensing violations occur, the firm is protected because the stolen property rapidly becomes obsolete.

Ultimately, when contractual strategies prove undesirable or ineffective, management may opt to enter target markets by FDI, through which the firm acquires ownership and, thus, greater control over important assets.

CLOSING CASE Subway and the Challenges of Franchising in China

Subway, the sandwich and salad fast-food chain, operates more than 44,000 stores in some 110 countries. The firm has 25 million Facebook fans and generates more than $17 billion in annual revenues.

The franchising chain opened its first international restaurant in Bahrain in 1984. Since then, Subway (www.subway.com) has expanded worldwide and generates about half of its annual sales internationally. Fast-food retailing is relatively saturated in Subway's home market, the United States. Senior management expects foreign markets to contribute most of the firm's future growth.

Subway has enjoyed success in the fast-food industry in China, where it operates about 600 stores. Fish and tuna salad sandwiches are the top sellers. When first launched in China, the franchise had its share of initial setbacks. Subway's master franchisee in Beijing, Jim Bryant, had to teach the franchising concept to a country that had never heard of it.

Cultural problems are still an ongoing challenge. After Bryant opened his first Subway shop, customers stood outside and watched for a few days. When they finally tried to buy a sandwich, many were confused, so Bryant printed signs explaining how to order. Some didn't believe the tuna salad was made from fish because they could not see the head or tail. Others didn't like the idea of touching their food, so they would gradually peel off the paper wrapping and eat the sandwich like a banana.

Subway—or Sai Bei Wei (Mandarin for "tastes better than others")—forged ahead. Bryant recruited numerous committed franchisees that he monitored closely to maintain quality. He recruited local entrepreneurs, trained them to become franchisees, and served as liaison between them and Subway headquarters. For this work, he received half of their $10,000 initial fee and one-third of their 8 percent royalty fees.

Multinational franchisors encounter various challenges in China, particularly in dealing with the ambiguous legal environment, finding qualified franchisees, and identifying the most suitable marketing, financing, and logistics strategies. Famous brands such as A&W, Dunkin' Donuts, McDonald's, and Pizza Hut have all experienced these issues.

Why China for Franchising?

Franchising is an advanced form of licensing. Franchising is attractive in China because of the country's huge market, long-term growth potential, and dramatic rise in disposable income among its urban population. Home to more than 1.3 billion people (contrast with 330 million in the United States), one-quarter of China's population earns more than $10,000 per-capita in annual income. Fast-food sales in China produce about $150 billion per year. China's urban population, the target market for casual dining has expanded rapidly, a trend expected to continue. Every year, millions of consumers acquire the additional spending power to pay premium prices. Increasingly hectic lifestyles have led to an increase in meals the Chinese eat outside the home. Surveys reveal that Chinese consumers are interested in sampling non-Chinese foods.

Market researchers have identified several major benefits to franchising in China.

- *A win–win proposition.* Franchising in China combines the Western expertise of franchisors with the local market knowledge of franchisees. Many Chinese have strong entrepreneurial instincts and are eager to launch their own businesses.
- *Minimal entry costs.* Because much of the cost of launching a restaurant is borne by local entrepreneurs, franchising minimizes the costs to franchisors of entering the market.
- *Rapid expansion.* By leveraging the resources of numerous local entrepreneurs, the franchisor can get set up quickly. Franchising is superior to other entry strategies for rapidly establishing many outlets throughout any new market.
- *Brand consistency.* Because franchisees are required to adhere strictly to company operating procedures and policies, brand consistency is easier to maintain.
- *Circumvention of legal constraints.* Trade barriers are common in China. Franchising allows the focal firm to avoid trade barriers associated with exporting and FDI.

Challenges of Franchising in China

China's market also poses many challenges for franchisors.

- *Knowledge gap*. Despite the likely pool of potential franchisees, Chinese entrepreneurs may have limited knowledge about how to start and operate a franchise business. There is still much confusion about franchising among lawmakers, entrepreneurs, and consumers. Focal firms must educate government officials, potential franchisees, and creditors on the basics of franchising, a process that consumes energy, time, and money.
- *Ambiguous legal environment*. China's legal system on franchising has ambiguities and loopholes. Some critical elements are not covered. The situation has led to diverse interpretations of franchising law in China. Franchisors must be vigilant about protecting trademarks. A local imitator can quickly dilute or damage a trademark that the focal firm has built up through much expense and effort. Branding is important to franchising success, but consumers become confused if several similar brands are present. Chinese imitators have launched restaurants that use similar logos and menus.
- *Escalating start-up costs*. Ordinarily, entry through franchising is cost-effective. However, various challenges combined with linguistic and cultural barriers can increase the up-front investment and resource demands of new entrants in China and delay profitability. The franchisor may need to invest in store equipment and lease it to the franchisee, at least until the franchisee can afford to buy it. Altogether the initial fee, equipment, and remodeling cost of launching a new restaurant in China can exceed $100,000, which is generally borne by the franchisee.
- *Growing competition*. More than 4,500 franchises and chain store companies have entered the Chinese market. Competition is intense. KFC, McDonald's, and Pizza Hut have operated in China for decades and have built up a substantial presence there. Franchise firms operate primarily in China's first-tier cities. Subway has already built a foundation in Beijing, Shanghai, and other major cities and is now attempting to expand by targeting smaller, second-tier cities.
- *Customer purchasing power*. Most Chinese have lower incomes, and few can afford to eat regularly in restaurants. An average Subway meal costs about $5 in China, which is more expensive than most other dining options. Most foreign franchise customers are white-collar workers in large cities. To succeed, foreign franchisors need to expand into smaller cities and suburban areas.

Perhaps the biggest challenge of launching franchises in China is finding the right partners. It is paradoxical that entrepreneurs with the capital to start a restaurant often lack the franchising business experience or entrepreneurial drive, whereas entrepreneurs with sufficient drive and expertise often lack the startup capital. Subway's franchise fee of $10,000 is equivalent to two years' salary for the average Chinese. The banking system in China is not fully developed for serving small businesses and capital sources are limited. Entrepreneurs often borrow funds from family members and friends to launch business ventures. Chinese banks are increasingly open to franchises that are backed by large organizations.

Additional considerations include the availability and financing of suitable real estate, particularly for initial showcase stores where location is critical. As more Chinese migrate to urban areas, prices for prime real estate are rising. According to established Chinese law, local and foreign investors are allowed to develop, use, and administer real estate. But in many cases, the Chinese government owns real estate that is not available for individuals to purchase. Private property laws are still developing, and franchisees occasionally risk eviction. Fortunately, a growing number of malls and shopping centers are good locations for franchised restaurants.

The Chinese authorities maintain restrictions on the repatriation of profits to the home country. Strict rules discourage repatriation of the initial investment, making this capital illiquid. To avoid this problem, firms make initial capital investments in stages to minimize the risk of not being able to withdraw overinvested funds. Fortunately, China is gradually relaxing its restrictions, and franchisors have been reinvesting their profits back into China to continue to fund the growth of their operations. Reinvesting profits also provide a natural hedge against exchange rate fluctuations.

Learning from the Success of Others

Subway's China success has come relatively slowly. McDonald's and KFC have more than 2,500 and 5,000 restaurants in China, respectively. Some observers have noted that Subway has been too slow to develop menu items better suited to Chinese tastes. For example, McDonalds added rice, *youtiao* (Chinese donuts), and local spices to its menu. The Chinese tend to prefer hot foods, and most reject cold sandwiches, which they find very different from traditional meals. In addition, most Chinese feel uncomfortable ordering food in Subway shops. Less accustomed to independent decision making, they feel unnatural having to choose different breads, meats, vegetables, and sauces, especially when they are not familiar with such ingredients.

In China, franchisors typically must adapt offerings to suit local tastes. Appropriate suppliers and business infrastructure are often lacking. Franchisors spend much money to develop supplier and distribution networks. They also may need to build logistical infrastructure to move inputs from suppliers to individual stores. McDonald's had to replicate its supply chain, bringing its key suppliers, such as potato supplier Simplot, to China. There is no one best approach in China. For example, TGI Friday's imports roughly half of its food supplies, which helps maintain quality, but heavy importing is expensive and exposes profitability to exchange rate fluctuations. Subway still faces various challenges as it expands in the Chinese marketplace.

AACSB and CKR Intangible Soft Skills to improve employability and success in the workplace: Ethical Understanding and Reasoning, Analytical Thinking, Diverse and Multicultural Work Environments, Reflective Thinking, Application of Knowledge.

Case Questions

15-4. Subway brings to China various intellectual property in the form of trademarks, patents, and an entire business system. What are the specific threats to Subway's intellectual property in China? What can Subway do to protect its intellectual property in China?

15-5. What are the advantages and disadvantages of franchising in China? What can Subway do to overcome the disadvantages? From Subway's perspective, is franchising the best entry strategy for China?

15-6. Subway faces various cultural challenges in China. What are these challenges, and what can Subway and its master franchisee do to overcome them?

15-7. What steps should Subway management take to better pursue franchising opportunities in China?

Sources: Carlye Adler, "How China Eats a Sandwich," *Fortune*, March 21, 2005, pp. F210B–F210D; Laurie Burkitt, Loretta Chao, Melissa Powers, and Yoli Zhang, "Made in China: Fake Stores," *Wall Street Journal*, August 3, 2011, pp. B1–B2; William Edwards, "The Pros and Consequences of Franchising in China," *Chinabusinessreview.com*, July–September, 2011, pp. 41–43; Richard Gibson, "Foreign Flavors: When Going Abroad, You Should Think of Franchising as a Cookie-Cutter Business; Unless, of Course, You Want to Succeed," *Wall Street Journal*, September 25, 2006, p. R8; Kristy Guo, "Franchising in China: An Excellent Business Opportunity but One Not to Take Lightly," *IP Pang Xingpu*, February 3, 2017, www.ipopang.com; Emily Guzman, "This Month in History: KFC Opens First Restaurant in China," *That's,* November 28, 2017, www.thatsmag.com; International Trade Administration, "China—Franchising Industry Sector," January 10, 2017, www.export.gov; Leslie Patton, "Subway's DeLuca Sees Sandwich Chain Expanding to 50,000 Shops," *Bloomberg Business,* February 27, 2013, www.bloomberg.com; Reuters, "Subway Says It Shut Hundreds of U.S. Restaurants Last Year," April 20, 2017, www.reuters.com; Subway corporate website at www.subway.com; Kit Tang, "Time for Chinese Fast Food Chains to Shine?" *CNBC,* July 27, 2014, www.cnbc.com; The Franchise King, "Subway Franchises Are on Fire in Asia," 2018, www.thefranchiseking.com; "Understanding The Challenges of Franchising in China," *Marketing to China*, January 16 2018 www.marketingtochina.com.

Note: This case was prepared by Professor Erin Cavusgil, University of Michigan-Flint, and updated by Bohua Fu, Willamette University, for classroom discussion.

END-OF-CHAPTER REVIEW

MyLab Management

Go to **www.pearson.com/mylab/management** to complete the problems marked with this icon ✪.

Key Terms

build-operate-transfer (BOT) 472
contractual entry strategies in international business 460
franchising 461
infringement of intellectual property 475
intellectual property 460
intellectual property rights 460
know-how agreement 464
licensing 460
management contract 472
master franchise 468
royalty 460
turnkey contracting 471

Summary

In this chapter, you learned about:

- **Contractual entry strategies**

  Contractual entry strategies in international business grant foreign partners permission to use the focal firm's **intellectual property** in exchange for a continuous stream of payments. **Intellectual property rights** are the legal claims through which the proprietary assets of firms and individuals are protected from unauthorized use by other parties. Firms run the risk of disclosing their intellectual property to outside partners. **Licensing** grants a firm the right to use another firm's intellectual property for a specified period of time in exchange for royalties or other compensation. **Franchising** allows one firm the right to use another's entire business system in exchange for fees, royalties, or other forms of compensation. A **royalty** is a fee paid to the licensor at regular intervals to compensate for the temporary use of intellectual property. Under a **know-how agreement**, the focal firm provides technological or managerial knowledge about how to design, manufacture, or deliver a product or service.

- **Licensing as an entry strategy**

  The agreement between the licensor and the licensee is for a specific time period in a specific country or region. The licensor may enter an exclusive agreement with the licensee to minimize competition with other licensees in the same territory. Once the relationship is established and the licensee fully understands its role, the licensor has little additional input. Licensing is widely used in the fashion and toy industries.

- **Advantages and disadvantages of licensing**

  Licensing's main advantage to the licensor is that it does not require substantial capital investment or physical presence in the foreign market. The licensor can avoid political risk, government regulations, and other risks associated with FDI. However, licensing generates lower profits and limits the firm's ability to control its intellectual property. The licensee may become a competitor when the licensing agreement expires.

- **Franchising as an entry strategy**

  Franchisors employ widely identifiable trademarks and attempt to guarantee the customer a consistent retail experience and product quality. A **master franchise** is an arrangement whereby a franchisee obtains the rights to and is responsible for developing franchised outlets to serve a country or a region. Franchising is common in international retailing but difficult to replicate across diverse markets.

- **Advantages and disadvantages of franchising**

  Franchising allows franchisees to gain access to well-known, well-established brand names and business systems, allowing them to launch successful businesses with minimal risk. The franchisor can rapidly internationalize by leveraging the drive and knowledge of local franchisees but risks disseminating its intellectual property to unauthorized parties.

- **Other contractual entry strategies**

  Under **build-operate-transfer (BOT)** arrangements, the firm contracts to build a major facility, such as a power plant, which it operates for a period of years and then transfers to the host-country government or other public entity. In turnkey contracting, one or several firms plan, finance, organize, and manage all phases of a project which, once completed, they hand over to a host-country customer. **Management contracts** occur when a company contracts with another to supply management know-how in the operation of a factory or service facility such as a hotel. With leasing, the firm rents machinery or equipment, usually for a long period, to clients located abroad.

- **Infringement of intellectual property: A global problem**

  Infringement of intellectual property rights takes place through counterfeiting and piracy, which cost companies billions of dollars per year. Several hundred billion dollars' worth of counterfeit and pirated goods cross national borders every year. The Internet facilitates much piracy worldwide. Counterfeiting affects many of the most well-known multinational firms, hurting company performance by eroding competitive advantage and brand equity. Managers must proactively safeguard their proprietary assets by registering patents, trademarks, and other assets in each country and minimizing operations in major counterfeiting countries and countries with weak intellectual property laws. Managers must also train employees and licensees in the proper legal use of intellectual property and vigilantly track down and prosecute violators.

Test Your Comprehension

AACSB and CKR Intangible Soft Skills to improve employability and success in the workplace: Analytical Thinking, Reflective Thinking, Diverse and Multicultural Work Environments, Application of Knowledge.

15-8. In a build-operate-transfer agreement, how does the business that built the facility ensure that they profit from the agreement?

15-9. Outline the challenges facing professional service firms when they internationalize.

15-10. What are the advantages and disadvantages of franchising from the perspective of franchisors and franchisees?

15-11. Name the industries that rely the most on franchising to tap foreign markets.

15-12. Define and distinguish the following contractual entry strategies: build-operate-transfer, turnkey projects, management contracts, and leasing.

15-13. What are the best practices in managing international contractual relationships?

Apply Your Understanding

AACSB and CKR Intangible Soft Skills to improve employability and success in the workplace: Written and Oral Communication, Ethical Understanding and Reasoning, Analytical Thinking, Diverse and Multicultural Work Environments, Reflective Thinking, Application of Knowledge.

15-14. The Organization for Economic Cooperation and Development (OECD) estimates that the global market for counterfeit goods is worth nearly $500 billion annually. These figures have seriously worried the CEO of your company, a South Africa–based business that designs, manufactures, and installs drilling and water pump systems and sells them to drought-threatened regions of the world. The next step in the roll-out was to enter the North African markets, including Algeria, Morocco, Tunisia, Libya, and Egypt. The CEO is deeply concerned that the firm's IP will be copied and manufactured by counterfeiters. As a researcher for the company, examine these countries in terms of their IP protection and counterfeiting and advise the business whether their IP might be under threat.

15-15. Following on from the situation in 15-14, the CEO is so impressed with your assessment of the situation in the North African countries that she has promoted you to Vice President North African Operations. She wants you to identify the most appropriate forms of entry into each of the countries that you have identified as exhibiting the least risk in terms of counterfeiting and IP issues. In each case you should attempt to identify the ideal way in which to enter the market and highlight any particular issues.

15-16. *Ethical Dilemma:* You are the president of Dynamic Publishing, a firm that publishes textbooks. During an overseas trip, you assess the prospects for marketing Dynamic's textbooks abroad. Upon visiting a university in a developing country, you discover that many students use photocopied or locally reproduced versions of Dynamic's books. Upon investigation, you are advised that most students could not afford to attend college if they were required to pay full price for the books. You are dismayed by the clear violation of intellectual property rights. You believe Dynamic cannot maintain profitability if its intellectual property is infringed. You also feel obligated to protect the rights of the authors of Dynamic's textbooks. At the same time, however, you are sympathetic to the students' plight. Using the ethical framework in Chapter 4, analyze the dilemma presented here. Should you try to enforce Dynamic's intellectual property rights, or should you look the other way and allow the illicit photocopying to continue? Is there a creative solution to this problem?

globalEDGE

INTERNET EXERCISES

Access globalEDGE™ at www.globalEDGE.msu.edu

AACSB and CKR Intangible Soft Skills to improve employability and success in the workplace: Written and Oral Communication, Ethical Understanding and Reasoning, Information Technology, Analytical Thinking, Diverse and Multicultural Work Environments, Application of Knowledge.

15-17. Suppose you get a job at the office of the International Intellectual Property Alliance (IIPA; www.iipa.org) or the World Intellectual Property Organization (WIPO; www.wipo.int). You learn that worldwide piracy of products is rampant. Your boss assigns you to draft a brief policy memo in which you address the following questions:

- What is the worldwide scope of piracy? What industries are most affected by piracy, and what is the financial loss from piracy in each of these industries?
- What are the top five countries that are the greatest sources of piracy?
- What strategies do you recommend for combating piracy?

In addition to globalEDGE™ and the IIPA and WIPO portals, other useful sites for this exercise are the Business Software Alliance (www.bsa.org), United Nations (www.un.org), and the Office of the United States Trade Representative (www.ustr.gov). Canada is home to the Canadian Intellectual Property Office (www.ic.gc.ca/eic/site/cipointernet-internetopic.nsf/eng/home), and Europe hosts the European Union Intellectual Property Office (https://euipo.europa.eu/ohimportal/en/home).

15-18. Suppose you are an international entrepreneur and want to open your own franchise somewhere in Europe. You decide to conduct research to identify the most promising franchise and learn how to become a franchisee. Entrepreneur.com publishes an annual list of the top 200 franchisors seeking international franchisees. Visit www.entrepreneur.com for the list or search for "franchising" at globalEDGE™. Choose the franchise that interests you most (for example, Anytime Fitness, Benetton, Century 21, Chipotle, Spar) and visit its corporate website. Based on information from the website as well as globalEDGE™ and Hoovers.com, address the following questions.

- How many franchised operations does this firm have outside its home country?
- What are the major countries in which the firm has franchises? Are there any patterns in terms of the countries where this firm is established?
- According to the application information provided at the corporate site, what qualifications is the firm seeking in new franchisees?
- What types of training and support does the firm provide for its franchisees?

15-19. The International Licensing Industry Merchandisers' Association (LIMA; www.licensing.org) is an organization with offices worldwide. It supports merchandise licensing through education, networking, and professional standards development. Suppose you work for an animation company that has developed several popular cartoon characters that have licensing potential in the same way that Disney licenses its cartoon characters. Your company wants to learn more about how to license its cartoon characters. Visit the LIMA website and write a memo that addresses the following:

- Who are the major members of LIMA?
- What are the major trade shows that your firm can attend to exhibit its licensable products and learn more about licensing?
- What types of seminars and training are available to learn more about becoming a licensor?
- Based on the information provided at the site, what can you learn about anti-counterfeiting activities and challenges in licensing?

Endnotes

1. Frontier Economics, *The Economic Impacts of Counterfeiting and Piracy*, 2017, https://cdn.iccwbo.org; International Centre for Trade and Sustainable Development (ICTSD), *Property Rights: Implications for Development Policy, Policy Discussion Paper*, Intellectual Property Rights & Sustainable Development Series (Geneva, Switzerland: ICTSD, and New York: UNCTAD, 2003); Peter Menell, Mark Lemley, and Robert P. Merges, *Intellectual Property in the New Technological Age 2017: Vol. I Perspectives, Trade Secrets and Patents* (Berkeley, CA: Clause 8 Publishing, 2017).
2. Menell, Lemley, and Merges, 2017.
3. Ronald V. Bettig, *Copyrighting Culture: The Political Economy of Intellectual Property* (New York: Routledge, 2018); Menell, Lemley, and Merges, 2017.
3. International Chamber of Commerce, *Roles and Responsibilities of Intermediaries: Fighting Counterfeiting and Piracy in the Supply Chain* (Paris: International Chamber of Commerce, April 2015); Menell, Lemley, and Merges, 2017.
4. *Marketwatch*, "Intel Licenses Cognitec's Face Recognition Technology for Device Access," December 3, 2014, www.marketwatch.com.
5. Bettig, 2018; Daniel Gervais, *International Intellectual Property: A Handbook of Contemporary Research* (Northampton, MA: Edward Elgar, 2015); Menell, Lemley, and Merges, 2017.
6. *Euromonitor International*, "Licensed to Wear: Licensed Fashion Is Exploding," August 10, 2017, www.euromonitor.com; Vanessa O'Connell and Mei Fong, "Saks to Follow Luxury Brands into China," *Wall Street Journal*, April 18, 2006, p. B1.
7. Marc Lieberstein, Stephen Feingold, Christine James, and Paul Rosenblatt, "Current Developments and Best Practices in Trademark Licensing (Part I)," *Licensing Journal*, February 2011, pp. 20–28; LIMA, "LIMA Study: Global Retail Sales of Licensed Goods and Services Hit US$262.9 Billion in 2016," May 22, 2017, www.licensing.org.
8. Dennis C. Blair and Keith Alexander, "China's Intellectual Property Theft Must Stop," *New York Times,* August 15, 2017, www.nytimes.com; "Management Brief: Johannesburgers and Fries," *Economist*, September 27, 1997, pp. 113–114; Gervais (2015); WWD: Women's Wear Daily, "Hermès' China Challenge," February 29, 2012, p. 1.
9. "History of Merchandising," *Licensing Journal*, April 2009, p. 23; Matt Reimann, "The Big Business of Winnie-the-Pooh," Jan 6, 2016, www.bookstellyouwhy.com; U.S. Department of Commerce, *A Basic Guide to Exporting* (Washington, DC: U.S. Government Printing Office, 2016).
10. Bettig, 2018; Menell, Lemley, and Merges, 2017.
11. IFPMA, *The Pharmaceutical Industry and Global Health* (Geneva: International Federation of Pharmaceutical Manufacturers & Associations, 2017); PhRMA, *2016 Profile: Biopharmaceutical Research Industry* (Washington, DC: Pharmaceutical Research and Manufacturers of America, 2017), www.phrma.org; Edward Safarian and Gilles Bertin, *Multinationals, Governments and International Technology Transfer* (New York: Routledge, 2014).
12. Jay Dratler Jr. and Stephen McJohn, *Licensing of Intellectual Property* (Newark, NJ: Law Journal Press, 2017); Noni Symeonidou and Johan Bruneel, "Determinants, Causal Connections and Outcomes of Corporate Technology Licensing: A Systematic Review and Research Agenda," *R&D Management*, 47 No. 4 (2017), pp. 620–636.
13. Chugai Pharmaceutical Co., Ltd., "Strategic Alliance with Roche," 2018, www.chugai-pharm.co.jp; "Roche Gains a Stronghold in Elusive Japanese Market," *Chemical Market Reporter*, December 17, 2001, p. 2.
14. Ray-Yun Chang, Hong Hwang, and Cheng-Hau Peng, "Competition, Product Innovation and Licensing," *B.E. Journal of Economic Analysis & Policy* 17, No. 1 (2017), pp. 23–36; Safarian and Bertin, 2014.
15. Bettig, 2017; Menell, Lemley, and Merges, 2017; Akio Morita, Edwin Reingold, and Mitsuko Shimomura, *Made in Japan: Akio Morita and Sony* (New York: EP Dutton, 1986).
16. Mattel, Inc., annual reports (various years); Helen Wang, "Why Barbie Stumbled in China and How She Could Re-invent Herself," *Forbes*, October 24, 2012, www.forbes.com; Yoshika Uematsu, "Licca-chan, Japan's Answer to Barbie, Still in Style 50 Years On," *Asahi Shimbun,* May 25, 2017, www.asahi.com.
17. Sharon Thiruchelvam, "Micro-Franchising: Helping the World's Poor Climb out of Poverty," *Raconteur,* September 5, 2017, www.raconteur.net; UNCTAD, *World Investment Report* (New York: United Nations, 2012).

18. F. Burton and A. Cross, “International Franchising: Market Versus Hierarchy,” in *Internationalisation Strategies*, G. Chryssochoidis, C. Millar, and J. Clegg, eds., pp. 135–152 (New York: St. Martin’s Press, 2001); Icon Group International, *The 2019–2024 World Outlook for Franchising* (San Diego, CA: Icon Group International, 2018).

19. Hachemi Aliouche and Udo Schlentrich, “Towards a Strategic Model of Global Franchise Expansion,” *Journal of Retailing* 87, No. 3 (2011), pp. 345–365; Lionel Bently, Brad Sherman, Dev Gangjee, and Phillip Johnson, *Intellectual Property Law* (Oxford, UK: Oxford University Press, 2018); Bill Merrilees, “International Franchising: Evolution of Theory and Practice,” *Journal of Marketing Channels* 21, No. 3 (2014), pp. 133–142.

20. Carlye Adler, “How China Eats a Sandwich,” *Fortune*, March 21, 2005, pp. F210; *The Telegraph,* “Weird McDonald’s Food You Can Order Around the World,” March 3, 2016, www.telegraph.co.uk.

21. K. Fladmoe-Lindquist, “International Franchising,” in *Globalization of Services*, Y. Aharoni and L. Nachum, eds., pp. 197–216 (London: Routledge, 2000); Icon Group International, 2018; Merrilees, 2014.

22. Icon Group International, 2018; Merrilees, 2014; *Entrepreneur*, “2017 Top Global Ranking: Top Global Franchises,” 2018, www.entrepreneur.com; *Franchise Direct*, “Top 100 Global Franchises—Rankings, 2018,” 2018, www.franchisedirect.com.

23. Robin Blumenthal, “At Yum China, Growth Is on the Menu” *Barron’s*, August 26, 2017, pp. 36–37; Laurie Burkitt and Ilan Brat, “Yum’s Novelty Fades in China,” *Wall Street Journal,* April 22, 2015, p. B4.

24. Franchise Direct, “Franchising in Europe—Introduction to the Top 500,” 2018, www.franchisedirect.co.uk; David Kaufmann, “The Big Bang: How Franchising Became an Economic Powerhouse the World Over—Franchise 500®,” *Entrepreneur*, January 2004, www.entrepreneur.com; Melih Madanoglu, Kyuho Lee, and Gary Castrogiovanni, “Franchising and Firm Financial Performance Among U.S. Restaurants,” *Journal of Retailing* 87, No. 3 (2011), pp. 406–417.

25. Kate Rogers, “The Franchise Industry Has Gotten More Good News,” *CNBC,* March 15, 2016, www.cnbc.com; UNCTAD, 2012.

26. Frank Hoy, Rozenn Perrigot, and Andrew Terry, *Handbook of Research on Franchising* (Northampton, MA: Edward Elgar, 2017).

27. “Wendy’s Shuts Doors in Japan,” *New York Times*, January 2, 2010, p. B3; Brian Mertens, “Hawaiian Ernie Higa Reintroduces Wendy’s Hamburgers to Japan,” *Forbes Asia*, December 10, 2012, p. 11; *Nikkei Asian Review*, “Wendy’s Japan Eyes Rebound Under McDonald’s Alumnus,” August 30, 2016, www.asia.nikkei.com.

28. Hoy, Perrigot, and Terry, 2017; Merrilees, 2014.

29. “Abu Dhabi Awards $9 Billion in Gas Project Contracts,” *Oil & Gas Journal*, July 27, 2009, pp. 32–33; Lukas Klee, *International Construction Contract Law* (Chichester, UK: John Wiley, 2018); Caroline Winter, “Who’s Building the Big Projects,” *Bloomberg Businessweek*, May 31–June 6, 2010, p. 12.

30. “MAN Power for a Diamond Project,” *Modern Power Systems*, February 2012, p. 24; UNCTAD, *World Investment Report 2017* (Geneva: United Nations Conference on Trade and Development, 2017).

31. *Pakistan Defence*, “M-6—Sukkur—Hyderabad Motorway,” April 23, 2018, www.defence.pk; *PPPIRC*, “Concessions, Build-Operate-Transfer (BOT) and Design-Build-Operate (DBO) Projects,” World Bank Group, February 8, 2018, www.ppp.worldbank.org; Amin Yusufzai, “Hyderabad-Sukkur Motorway to Cost an Estimated Rs. 163 Billion,” *Propakistani,* April, 2017, www.propakistani.pk.

32. Richard Clough, Glenn Sears, S. Keoki Sears, Robert Segner, and Jerald Rounds, *Construction Contracting: A Practical Guide to Company Management* (Hoboken, NJ: Wiley, 2015);

V. Panvisavas and J. S. Taylor, "The Use of Management Contracts by International Hotel Firms in Thailand," *International Journal of Contemporary Hospitality Management* 18 (2006), pp. 231–240; PPPIRC, "Management/Operation and Maintenance Contracts," World Bank Group, September 7, 2016, www.ppp.worldbank.org.

33. Geoffrey Jones and Alexis Lefort, "McKinsey and the Globalization of Consultancy," Harvard Business School case study 9–806–035 (Cambridge, MA: Harvard Business School, 2006); Tale Skjølsvik, Frida Pemer, and Bente Løwendahl, "Strategic Management of Professional Service Firms," *Journal of Professions and Organization* 4, No. 2 (2017), pp. 203–239.
34. Carter Dougherty, "One Hot List You Don't Want to Be On," *BloombergBusiness*, March 5, 2015, www.bloomberg.com; CBP Office of International Trade, *Intellectual Property Rights: Fiscal Year 2016 Seizure Statistics* (Washington, DC: U.S. Immigration and Customs Enforcement, 2017), www.cbp.gov; Mike Peng, David Ahlstrom, Shawn Carraher, and Weilei (Stone) Shi, "History and the Debate Over Intellectual Property," *Management and Organization Review* 13, No. 1, pp. 15–38.
35. CBP Office of International Trade, 2017; International Chamber of Commerce, "Global Impacts of Counterfeiting and Piracy to Reach US$4.2 Trillion by 2022," June 2, 2017, www.iccwbo.org.
36. CBP Office of International Trade, 2017; Frontier Economics, *The Economic Impacts of Counterfeiting and Piracy*, 2017, https://cdn.iccwbo.org; P. B. Jayakumar, "Patently Justified," *Business Today,* March 15, 2015, pp. 58–64.
37. *ABC News*, "China Big in Counterfeit Goods," April 21, 2018, www.abcnews.go.com; *Frontier Economics* (2017); Brendan Murphy, Andy Sun, Philip Warden, Ana Damonte, and Raj Davoe, "IP Problems Don't Just Need IP Solutions," *Managing Intellectual Property*, March 2012, p. 17.
38. Jonathan Cheng, "Samsung Sues Huawei Over Patent Infringement," *Wall Street Journal*, July 22, 2016; Jacob Kastrenakes, "Apple Has Finally Won $120 Million from Samsung in Slide-to-Unlock Patent Battle," *The Verge*, November 6, 2017, www.theverge.com.
39. David Aylen and Maria Aronikova, "Procedures and Strategies for Anti-Counterfeiting: Russia," *World Trademark Review,* May 18, 2017, www.worldtrademarkreview.com; BBC, "Russia Beefs Up Antipiracy Laws," May 1, 2015, www.bbc.com; B. Cassell, "Microsoft Battles Piracy in Developing Markets," *Wall Street Journal*, December 23, 2004, p. B4; Richard Lardner, "Microsoft struggles with viruses, counterfeit software," *USA Today,* September 13, 2012.
40. Kate Baggaley, "Counterfeit Drugs Are Putting the Whole World at Risk," *Popular Science*, March 2, 2017, www.popsci.com; Jack Goldsmith and Tim Wu, *Who Controls the Internet: Illusions of a Borderless World* (Oxford, UK: Oxford University Press, 2006); World Health Organization, "Counterfeit and Falsified Medical Products," *Fact Sheet*, January 2018, www.wto.int.
41. OECD, *Annual Report on the OECD Guidelines for Multinational Enterprises 2016* (Paris: Organisation for Economic Co-operation and Development, 2017).
42. Kathy Caprino, "How to Protect Your Intellectual Property the Right Way," *Forbes,* February 25, 2017, www.forbes.com; OECD, *World Corporate Top R&D Investors: Industrial Property Strategies in the Digital Economy* (Paris: Organisation for Economic Co-operation and Development, 2017).
43. Caprino, 2017; International Chamber of Commerce, 2015; Millonzi and Passannante, 1996; OECD, *Annual Report on the OECD Guidelines for Multinational Enterprises 2016* (Paris: Organisation for Economic Co-operation and Development, 2017).
44. Caprino, 2017; International Chamber of Commerce, 2017; OECD, 2017.
45. Ibid.

Chapter 16

Marketing in the Global Firm

Learning Objectives *After studying this chapter, you should be able to:*

16.1 Explain global market segmentation.

16.2 Understand standardization and adaptation of international marketing.

16.3 Describe global branding and product development.

16.4 Explain international pricing.

16.5 Understand international marketing communications.

16.6 Describe international distribution.

Michael Kors: The Global Affordable Luxury Market

Michael Kors established a company in New York to design and sell fashion apparel and accessories. The firm, Michael Kors Holdings Limited ("Kors") targets the affordable-luxury segment. Today, gross sales of Kors exceed $5 billion. About 15 percent of sales come from each of Europe and Asia. Top Asian markets include China and Japan. A growing global presence helped the firm double its sales between 2013 and 2017. Growth has been achieved partly through licensing agreements with partners such as Fossil (watches) and Estée Lauder (fragrances). Kors bought the luxury British shoe company Jimmy Choo in 2017, further enhancing the company brand.

Perfume, watches, handbags, and other accessories earn much higher margins than clothing due to the power of branding. Consumer awareness of the Kors brand is about 75 percent in the United States, 50 percent in Europe, and 30 percent in Japan. The United States is the largest market for fashion and personal luxury goods, followed by China, France, Italy, and Japan. The fashion industry emphasizes a global marketing strategy partly because international tourists account for a large proportion of total sales. Standardized marketing helps avoid confusing global consumers.

Marketing gained momentum when Michael Kors served as a judge on the reality TV program *Project Runway*. Kors exhibits enormous creative talent in producing and marketing distinctive styles. Women are the main target market. Kors handbags are especially popular among teenage girls. Major competitors include Coach, Donna Karan, and Ralph Lauren.

Alongside buyers in the advanced economies, affordable luxury appeals to the growing middle class in emerging markets. The Chinese spend about $50 billion on luxury goods annually, nearly as much as the $60 billion U.S. buyers spend. In China, to accommodate variation in spending power and sophistication, Kors