Analyzing Foreign Market Entry Strategies: Extending the Internalization Approach

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A new fully integrated analysis of the foreign market entry decision is presented, encompassing the choice between exporting, licensing, joint venturing and wholly owned foreign investment. The choice between acquisition and greenfield investment is examined, and so too are options based on subcontracting and franchising. The model extends the insights of internalization theory, and draws on concepts from the economics of industrial organization. A special feature of the model is the distinction between investment in production facilities and investment in distribution facilities - an important practical distinction that has been overlooked in much of the international business literature. The strength of competition from indigenous rivals is emphasized as a determinant of entry strategy into both production and distribution.

Empirical studies of foreign direct investment (FDI) have become much more ambitious in scope over the last 30 years. In the 1960s, the main focus of the Hymer-Kindleberger theory (Hymer 1976, Kindleberger, 1969) and the product cycle theory (Vernon 1966) was exporting versus FDI. In the 1970s the internalization approach identified licensing, franchising and subcontracting as other strategic options. The resurgence of mergers and acquisitions

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in the 1980s - often as a "quick fix" route to globalization - highlighted the choice between greenfield ventures and acquisitions. At the same time, the growing participation of U.S. firms in international joint ventures (IJVs) drew attention to the role of co-operative arrangements.

In the 1990s, the role of FDI in "transitional" or "emerging" economies (East and Central Europe, China, Vietnam, etc.) has brought back into focus some of the classic issues of the 1960s: The "costs of doing business abroad," and the importance of "psychic distance." It has renewed interest in the general questions as to why some modes of entry offer lower costs than others, and why certain circumstances seem to favor certain modes over others.

Linking all these issues together generates a high degree of complexity. Although the eclectic theory has been regularly revised and updated to accommodate the changing foci of applied research, it is too much of a "paradigm" or "framework" and too little of a "model" to provide detailed advice on research design and hypothesis testing (Dunning, 1980). Complexity appears to have created a degree of confusion amongst scholars, which only a formal modelling exercise can dispel.

The model presented below has three distinctive features. First, it is based on a detailed schematic analysis that encompasses all the major market entry strategies. In existing literature, most strategies are appraised as alternatives to exporting, or as alternatives to greenfield FDI. It is unusual to see a direct comparison between, say, licensing and joint ventures, or between franchising and subcontracting. The present model permits any strategy to be compared with any other strategy. It is therefore particularly useful when the leading strategies in contention do not include either exporting or conventional FDI.

The second feature of the model is that it distinguishes clearly between production and distribution. Historically, a large proportion of initial FDI relates to foreign warehousing and distribution facilities. Production facilities only come later, if at all. The distinction is obvious in empirical work, but it has not been properly reflected in theory up until now. The result has been some confusion as to how theory should be applied to situations in which investment in distribution has a prominent role.

Finally, the model takes account of the strategic interaction between the foreign entrant and its leading host-country rival after entry has taken place. Following recent developments in industrial organization theory (as summarized, for example, in Tirole, 1988), it is assumed that the entrant can foresee the reaction of its rival, and take this into account at the time of entry. It is argued that this theoretical refinement is of the utmost practical importance in explaining the choice between greenfield investment and acquisition as entry modes.

The model concentrates on FDI for market access reasons, and excludes resource-orientated FDI and offshore production.

HISTORICAL DEVELOPMENT OF THE THEORY

Much of the early literature on foreign market entry concerned the choice between exporting and FDI (for previous overviews, see Root, 1987; Young, et al.1989; Buckley and Ghauri,1993). The cost-based view of this decision suggested that the firm must possess a "compensating advantage" in order to overcome the "costs of foreignness"

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

Internalization

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

Stages Models of Entry

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

Non-Production Activities

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

Mergers and Acquisitions Versus Greenfield Ventures

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

the case of mergers. The theoretical issues have recently been surveyed by Svensson (1996) and Meyer (1997).

Joint Ventures Versus Wholly Owned Subsidiaries

The recent literature on IJVs is immense, and has spawned some innovative developments in international business theory and much insightful empirical work based on extensive data sets (Contractor and Lorange,1988; Beamish and Killing, 1997). Buckley and Casson (1988, 1996) summarize the conditions conducive to IJVs as: (i) the possession of complementary assets; (ii) opportunities for collusion, and (iii) barriers to full integration - economic, financial, legal or political (see also Beamish,1985; Beamish and Banks, 1987; Kogut, 1988; Hennart, 1988; and Contractor, 1990).

The IJV literature has focused particularly on partner selection, management strategy and the measurement of performance. Partner selection is examined by Beamish (1987), who relates selection to performance, Harrigan (1988b), who examines partner asymmetries, and Geringer (1991). Kogut and Singh (1987, 1988) relate partner selection to entry method. Management strategy in IJVs is analysed by Killing (1983) and Harrigan (1988), whilst Gomes-Casseres (1991) relates strategy to ownership preferences.

The performance of IJVs is the subject of much debate. It cannot be assumed that joint venture termination indicates failure — an IJV may end precisely because it has achieved its objectives. Similarly, the restructuring of joint ventures and alliances may indicate the exploitation of the flexibility of the organizational form, rather than a response to under-performance - see Franko (1971), Gomes-Casseres (1987), Kogut (1988, 1989), and Blodgett (1992). Other analyses of IJV performance include Geringer and Hebert (1991), Inkpen and Birkenshaw (1994) and Woodcock, Beamish and Makino (1994). Nitsch, Beamish and Makino (1996) relate entry mode to performance, and Gulati (1995) examines the role of repeated ties between partners as contributing to success - an interesting attempt to encompass "cultural" variables.

Cultural Factors

The relationship between (national) culture and entry strategy is explicitly examined (using a reductionist version of Hofstede's (1980) cultural classification) by Kogut and Singh (1988) (see also Shane, 1994). Cultural barriers are utilized in an examination of foreign market entry by Bakema, Bell and Pennings (1996), and a "cultural learning process" is invoked by Benito and Gripsrud (1994) to help explain the expansion of FDI.

Market Structure and Entry Strategy

It is one of the contributions of this paper to introduce market structure issues into the modelling of entry decisions. The relationship between entry behaviour and market structure was emphasized in Knickerbocker's (1973) study of oligopolistic reaction, which set up a crude game-theoretic structure for competitive entry into key national markets. Flowers (1976) and Graham (1978) emphasized "exchange of threats" in their respective studies of European and Canadian investment in the United States, and two-way investment between the United States and Europe. Yu and Ito (1988) more recently examined oligopolistic reaction and FDI in the U.S. tyre and textiles industry. Graham (1992) laments the lack of

attention to competitive structure in the international business literature, where the entrant is effectively a monopolist (Buckley and Casson, 1981). Indeed, Casson's (1985) study of cartelization versus multinationalization is one of the few economic models of multinational industrial organization available

Summary

Location costs, internalization factors, financial variables, cultural factors, such as trust and psychic distance, market structure and competitive strategy, adaptation costs (to the local environment), and the cost of doing business abroad are all identified in the literature as playing a role in determining firms' foreign market entry decisions. The model which follows includes all these variables, and analyzes their interactions in a systematic way.

THE MODEL

The model applies the economic theory of FDI presented in Buckley and Casson (1976, 1981), Buckley (1983), Casson (1991) and Buckley and Casson (1996) to the set of issues identified in the literature review above. Although the model involves a number of apparently restrictive assumptions, these assumptions can, if necessary, be relaxed, at the cost of introducing additional complications into the analysis. The assumptions are not so much restrictions upon the relevance of the model as indicators of key contextual issues on which every researcher into foreign market entry must pass judgement before their analysis begins. If some of the assumptions seem unfamiliar then it is because few researchers have actually made their assumptions sufficiently explicit in the past.

The Entrant

1. A firm based in a home country is seeking to sell for the first time in a foreign market. The emphasis on first-time entry makes it important to distinguish between the one-off set-up costs of an entry mode, and the recurrent costs of subsequent operation in that mode. It is assumed, unless otherwise stated, that recurrent operations take place in a stable environment.

2. Foreign market demand for the product is infinitely elastic at a price p_1, up to a certain volume at which it becomes totally inelastic. For example, each customer may desire just one unit of the product, which they value at p_1, and when everyone has bought that unit no more can be sold however far the price is dropped. The volume at which demand becomes inelastic is determined by the size of the foreign market, x.

3. The focus of the model on market entry makes it appropriate to distinguish between production activity *(P)* and distribution activity *(D)*. Distribution links production to final demand. It comprises warehousing, transport, and possibly retailing too. Distribution must be carried out entirely in the foreign market, but production may be located at either home or abroad.

4. The entrant's production draws upon proprietary technology generated by research and development activity (R). Effective distribution depends upon marketing activity (M). Marketing involves investigating customers' needs, and maintaining the reputation of the product by giving customers the service they require.

5. The entrant has no foreign activity M at the time of entry, and consequently lacks market knowledge. This knowledge can be acquired through experi-

ence (learning from mistakes) at the time of entry, incurring a once-and-for-all cost of entry, *m*. The knowledge can be obtained in other ways as well, as described below. One of the keys to successful entry strategy is to acquire *M* in the most appropriate way.

6. The flow of technology from *R* to *P* defines the first of three "intermediate products" in the model. The second is the flow of marketing expertise from *M* to *D*. The third is the physical flow of wholesale product from the factory or production unit *P* to the distribution facility *D*. (The internal flow of information between *R* and *M* is not discussed as it is a fixed cost, which is the same for every form of market entry considered in the model.)

7. Production at home means that the product must be exported. Exporting incurs transport costs and tariffs that foreign production avoids. On the other hand, foreign production incurs additional costs of communicating the technology, e.g., training foreign workers. Foreign production may also result in the loss of economies of scale. Exporting increases the utilization of the domestic plant, and allows it to be extended at low marginal cost. All of these factors are summarized in the net additional cost of home production, *z*, which is equal to transport costs and tariffs *less* savings on account of training costs and economies of scale.

8. The firm may enter the foreign market either by owning and controlling

* *P* and *D*;
* *P* only;
* *D* only; or
* Neither *P* nor *D*.

In the second case, it uses an independent distribution facility, which is franchised to handle the product. In the third case, it either exports from its home production facility, or subcontracts to an independent local facility. In the final case, the firm licenses an independent local firm to both produce and distribute the product. Because there is only one host-country rival (see 14 below), the possibility that the firm could subcontract to one firm and franchise another is ignored.

9. The transaction cost of operating an external market is normally greater than that of an internal one. The availability of alternative incentive structures in an internal market reduces the costs of haggling and default (Hennart, 1982). Indeed, it is assumed in the present model that the transaction cost of obtaining marketing expertise from an external consultant, rather than from the firm's own *M* activity, is prohibitive. The entrant can tap into an established *M* activity only by franchising the local rival, forming a joint venture with the rival, or acquiring its distribution facility.

10. The cost of external transfer of technology is also high, but acceptably so. One of the main problems in transferring technology is to monitor the output of the production process to make sure that the contract is being complied with. This is easier to do under a subcontracting agreement, where the product is "bought back," than under a licensing agreement, where it is not. The transactions costs of a subcontracting agreement exceed the internal costs of technology transfer by t_1, whilst the costs of licensing exceed internal costs by $t_2 \geq t_1$.

11. When the ownership of *P* differs from that of *D* then the flow of intermediate products between them is effected through an external market. When compared to the alternative of vertical integration of *P* and *D*, this incurs additional transaction costs, t_3.

12. Entry of any type can be effected by either greenfield investment or

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

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

The Host Country Rival

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

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

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

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

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

19. When the rival retains ownership of both its P and D facilities, then it remains a potential competitor. Although it may have switched some of its facilities out of the industry, it can, in principle, re-enter by switching them back again. If it has contracted out its P facility under a subcontracting arrangement, or contracted out its D facility under a franchising arrangement, then it can, in principle, re-enter competition when the agreements expire. Under a subcontracting arrangement, the entrant and the rival remain potential competitors in the final product market, since each has its own distribution facility. Any attempt by the entrant to charge the full monopoly price would encourage the rival to switch to producing its own output instead. The entrant must persuade the rival not to compete by reducing its price to a "limit price" $p_2<p_1$, at which it just pays the rival to keep its distribution facility out of the industry. Under a franchising arrangement, the local rival retains the option of switching back to supplying its distribution facility from its own production plant. To discourage this, the entrant must set an intermediate output price, which is equivalent (after deduction of distribution costs) to the same limit price p_2. The final customers pay the monopoly price, since the franchisee is the sole distributor, but the difference between the monopoly price and the limit price accrues to the franchisee. In either case, therefore, the persistence of rivalry costs the entrant $s=(p_1-p_2)x$ in lost sales revenue.

20. Matters are slightly different in the case of a licensing agreement. It is assumed that licensing is a long-term agreement, as opposed to short-term agreements like subcontracting and franchising. A licence, it is supposed, involves either an outright purchase of the right to use the technology, or a long-term agreement for the whole of the period over which patent protection is likely to extend. The licence agreement therefore confers effective monopoly power on the local licensee, but at the same time allows the entrant to appropriate all the monopoly rents by negotiating suitable terms for the licence agreement.

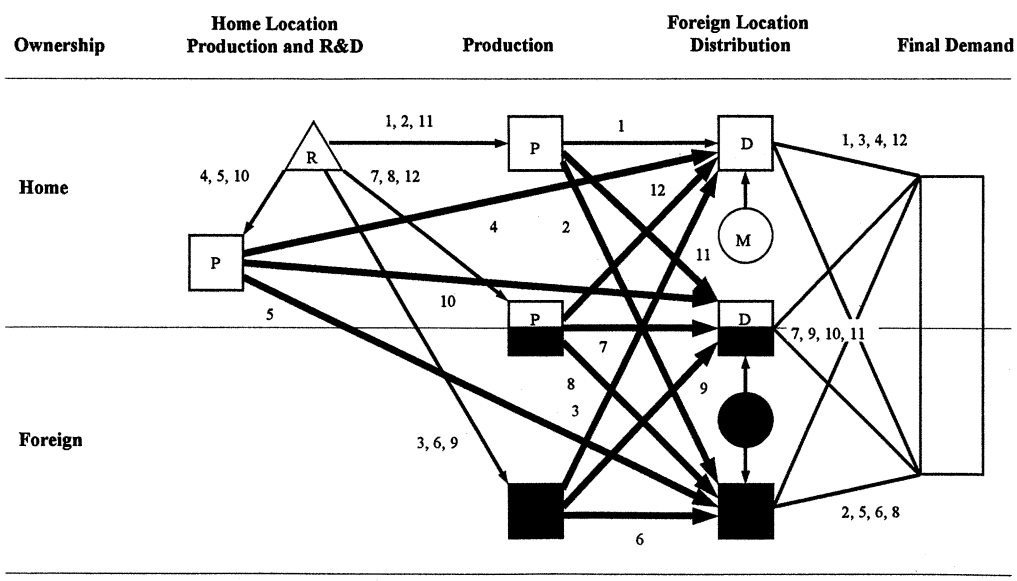
21. Apart from licensing, the only way to avoid the competitive threat is acquisition. Acquisition of either the rival's P or D facility will do. It is assumed that the costs at which these facilities can be acquired are equivalent to the cost of new construction under a greenfield strategy (although acquisition incurs additional conversion costs, as explained above).

Joint Ventures

22. Joint ventures are owned 50:50 by the two firms. Either the P or D plant, or both, can be jointly owned. It is assumed that when an IJV is undertaken, the partner is always the local rival. If both P and D are jointly owned, then they are both part of the same IJV, and so the market in intermediate output is internalized within the IJV. The IJV does not involve new facilities; it is assumed to be a "buy in" by the entrant to the local firm. This means that IJV production incurs the costs of adaptation described above. Greenfield IJVs can easily be included in the model, although its complexity increases considerably as a result. Because the local rival contributes its facilities to the IJV, the IJV enjoys monopoly power in the same way that an acquisition does.

23. When an IJV is linked to one of the entrant's wholly owned activities, the relevant intermediate product market is only partially internalized. It is assumed, however, that once the appropriate degree of trust has been built up,

FIGURE 1
TWELVE ENTRY STRATEGIES AND THEIR VARIANTS



the market can operate as though it was fully internal. The relevant costs of building trust are j_1 for technology transfer, j_2 for marketing expertise, and j_3 for intermediate output flow.

24. Where both entrant and rival possess *P* facilities with which to source an IJV *D* facility, they employ the IJV to maintain a monopoly price, but compete to supply it. The competition from the rival's *P* facility forces the entrant to supply the IJV at a limit price, and so allows the rival to obtain half the monopoly rent through its share in the IJV, even though it does not actually supply the IJV itself. If both entrant and rival possess *D* facilities able to draw upon an IJV P facility, then they can maintain a monopoly price by competing for a franchise to handle all the output. This forces the entrant to bid up the price for IJV output such that the profits are again shared with the rival through its stake in the IJV.

25. Learning costs m, adaptation costs a and trust-building costs j_i, q_i (i = 1,2,3) are once-and-for-all set up costs that are financed by borrowing at the given interest rate r. By contrast, the home location cost premium z and the transaction costs t_i (i=1,2,3) are recurrent costs incurred each period.

Defining the Strategy Set

The basic approach is to determine the set of all possible market entry strategies, to measure the profitability of each, and to identify the most profitable strategy. The dimensions of the strategy set are defined by the following issues:

(1) where production is located;
(2) whether production is owned by the entrant;
(3) whether distribution is owned by the entrant;
(4) whether ownership is outright, or shared through an IJV; and
(5) whether ownership is obtained through greenfield investment or acquisition.

The first four issues determine twelve main strategies of market entry. These twelve strategies are listed on the left

TABLE 1
TWELVE ENTRY STRATEGIES AND THEIR VARIANTS

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

TABLE 2
COSTS OF ALTERNATIVE STRATEGIES COMPARED WITH THE PROFIT NORM

$c_{1.1}$ =						$+ s$	$+ rm$
$c_{1.2}$ =		rq_1	$+ rq_2$		$+ ra$		
$c_{1.3}$ =			rq_2	$+ rq_3$			
$c_{1.4}$ =		rq_1		$+ rq_3$	$+ ra$		$+ rm$
$c_{2.1}$ =				t_3		$+ s$	
$c_{2.2}$ =		rq_1		$+ t_3$	$+ ra$		
$c_{3.1}$ =		t_1		$+ t_3$	$+ ra$	$+ s$	$+ rm$
c3.2 =		t_1	$+ rq_2$	$+ t_3$	$+ ra$		
$c_{4.1}$ =	z					$+ s$	$+ rm$
$c_{4.2}$ =	z		$+ rq_2$	$+ rq3$			
c_5 =	z			$+ t_3$		$+ s$	
c_6 =		t_2			$+ ra$		
c_7 =		rj_1	$+ rj_2$		$+ ra$		
c_8 =		rj_1		$+ rj_3$	$+ ra$		
c_9 =		$t1$	$+ rj_2$	$+ rj3$	$+ ra$		
c_{10} =	z		$+ rj_2$	$+ rj_3$		$+s/2$	
$c_{11.1}$ =			$+ rj_2$	$+ rj_3$		$+ s/2$	
$c_{11.2}$ =		rq_1	$+ rj_2$	$+ rj3$	$+ ra$		
$c_{12.1}$ =		rj_1		$+ rj_3$	$+ ra$	$+ s/2$	$+ rm$
$c_{12.2}$ =		rj_1	$+rj_2$	$+ rj3$	$+ ra$		

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

Deriving the Profit Equations

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

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

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

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

The advantages of this particular strategy are two-fold. It internalizes the transfer of technology within the entrant firm, and it internalizes the transfer of marketing expertise within the local firm. This can only be achieved, however, by externalizing the flow of intermediate output, which generates the transaction cost premium term t_3, which appears in the expressions for both $c_{2.1}$ and $c_{2.2}$. This is, in fact, the only term that is common to both expressions. The remaining terms are all accounted for by the difference between greenfield and acquisition methods of FDI. The greenfield strategy avoids the cost a of adapting an existing plant to the needs of a new technology. Thus the term ra, which appears in the expression for $c_{2.2}$, does not appear in the expression for $c_{2.1}$. The greenfield strategy also means that the internal transfer of technology is not bedevilled by a lack of trust, which arises when the production facility is acquired instead. The cost of building trust in internal technology transfer, rq_1, therefore appears in $c_{2.2}$, but not in $c_{2.1}$.

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

Dominance Relations

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

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

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

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

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

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

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

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

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

$c_{3.1} > c_{1.1}$

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

So far, no use has been made of restrictions on transactions costs. Suppose now that external market costs exceed the costs of building trust in internal markets after acquisition. In the context of production, this means that $t_1 > rq_1$ from whence it follows that:

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

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

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

$c_7 > c_{1.2}$; $c_{11.1} > c_{1.3}$; $c_{11.2} > c_{1.3}$

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

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

$c_{1.4} > c_{1.2} > c_{1.3}$

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

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

$c_8 > c_{1.3}$

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

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

$c_{1.1} > c_{2.1}$,

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

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

$c_{2.2} > c_{1.3}$,

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

Properties of the Solution

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

1.3. greenfield production combined with acquired distribution;

2.1. greenfield production combined with franchised distribution; and

6. licensing.

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

t3. The solution is to choose:

1.3. if $q \leq (t_3+s)/2r, (t_2/r)+a$

2.1. if $t_3+s \leq 2qr, t_2+ra$

6. if $t_2+ra \leq 2qr, t_3+s$

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

TABLE 3
COMPARATIVE STATIC ANALYSIS OF THE EFFECTS OF CHANGES IN THE VALUES OF THE EXPLANATORY VARIABLES ON THE CHOICE BETWEEN THE THREE DOMINANT STRATEGIES

		a	q	s	t_2	t_3	r
1.3	Acquisition	+	−	+	+	+	?
2.1	Franchising	+	+	−	+	−	+

Notes:
a Adaptation cost of production plant.
q Cost of building trust to access marketing expertise through a newly-acquired distribution facility.
s Value of profit-sharing collusion.
t_2 Additional transaction cost incurred by licensing technology.
t_3 Additional transaction cost incurred in using an external market for the wholesale product.
r Rate of interest.

the local rival in a position to compete. Strategy 6 is preferred when the transactions costs of licensing a technology, t_2, and adapting local production facilities, a, are low. This is reasonable because the licensing strategy is the only one of the three to utilize existing production facilities; the other two use only existing distribution facilities instead.

Deriving the Propensity to Adopt A Given Strategy

The logical structure of the model means that a change in any variable that increases the cost of certain strategies tends to inhibit the adoption of these strategies, and to encourage the adoption of alternative strategies instead. These alternative strategies are the ones whose costs are independent of the variable concerned. Indeed, apart from the rate of interest, r, and the cost of competition, s, every variable that enters into several cost functions enters into each of them in the same way. It is therefore impossible for a change in any variable of this kind to induce any switch between the strategies whose costs depend upon it.

In the case of r, however, the impact varies according to the particular set up costs involved, and so the impact of r upon the choice of any strategy cannot be determined unless the relative size of different set-up costs is known. An increase in r reduces the propensity to adopt any strategy that involves a set-up cost compared to any strategy that does not. If a strategy with a positive set up cost has a lower set-up cost than the best alternative strategy, then an increase in r will increase the propensity to adopt this strategy. Because its set-up cost is smaller than that of the best alternative, the strategy is more likely to be chosen when r is high.

In the case of s, the impact of an increase favors distribution joint ventures at the expense of wholly owned greenfield distribution facilities, but favors distribution acquisitions and licensing at the expense of both. The net effect on joint venture distribution strategies therefore depends upon whether the best alternative to joint ventures is greenfield distribution, or either acquisitions or licensing instead.

The implications of these general principles for the strategies of acquisition,

TABLE 4
COMPARATIVE STATIC ANALYSIS OF THE EFFECTS OF CHANGES IN THE VALUES OF THE EXPLANATORY VARIABLES ON THE PROPENSITY TO ADOPT EACH POSSIBLE ENTRY MODE

	a	j_1	j_2	j_3	m	q_1	q_2	q_3	r	s	t_1	t_2	t_3	z
1.1	+	+	+	+	-	+	+	+	+	-	+	+	+	+
1.2	-	+	+	+	+	-	-	+	?	+	+	+	+	+
1.3	+	+	+	+	+	+	-	-	?	+	+	+	+	+
1.4	-	+	+	+	-	-	+	-	?	+	+	+	+	+
2.1	+	+	+	+	+	+	+	+	+	-	+	+	-	+
2.2	-	+	+	+	+	-	+	+	?	+	+	+	-	+
3.1	-	+	+	+	-	+	+	+	?	-	-	+	-	+
3.2	-	+	+	+	+	+	-	+	?	+	-	+	-	+
4.1	+	+	+	+	-	+	+	+	+	-	+	+	+	-
4.2	+	+	+	+	+	+	-	-	?	+	+	+	+	-
5	+	+	+	+	+	+	+	+	+	-	+	+	-	-
6	-	+	+	+	+	+	+	+	?	+	+	-	+	+
7	-	-	-	+	+	+	+	+	?	+	+	+	+	+
8	-	-	+	-	+	+	+	+	?	+	+	+	+	+
9	-	+	-	-	+	+	+	+	?	+	-	+	+	+
10	+	+	-	-	+	+	+	+	?	?	+	+	+	-
11.1	+	+	-	-	+	+	+	+	?	?	+	+	+	+
11.2	-	+	-	-	+	-	+	+	?	+	+	+	+	+

Notes:

a Adaptation cost of production plant.

j_1 Cost of building trust to support technology transfer in a production joint venture.

j_2 Cost of building trust to access marketing expertise through a distribution joint venture.

j_3 Cost of building trust to support a flow of the wholesale product to, or from, a joint venture.

m Cost of acquiring knowledge of the market through wholly owned distribution.

q_1 Cost of building trust to transfer technology to a newly-acquired production facility.

q_2 Cost of building trust to transfer marketing expertise to a newly-acquired distribution facility.

q_3 Cost of building trust to support a flow of wholesale product to, or from, a newly-acquired facility.

r Rate of interest.

s Value of profit-sharing collusion.

t_1 Additional transaction cost incurred by subcontracting production.

t_2 Additional transaction cost incurred by licensing technology.

t_3 Additional transaction cost incurred in using an external market for the wholesale product.

z Net additional cost of serving the foreign market by export rather than production in the host market.

franchising and licensing discussed above are summarized in Table 3. The table indicates whether an increase in a given variable is likely to increase or decrease the propensity to adopt that strategy in preference to the other two. A question mark indicates that the direction of the effect cannot be known unless relative set-up costs are specified - in this context, the relative cost of building trust after an acquisition, q, and the relative cost of adapting a licensee's production plant, a. If $2q>a$, then an increase in r will favor acquisition and discourage licensing, so

that r will have a negative effect on licensing. The effect on acquisition will remain indeterminate, however, because although it becomes more favored relative to licensing, it becomes less favored relative to franchising. The direction of the effect therefore depends upon whether licensing or franchising is the best alternative to acquisition. If $2q>a$, then an increase in r will favor licensing and discourage acquisition, so that an increase in r will have a negative effect on acquisition. The effect on licensing will remain indeterminate, however, because although it becomes more favored relative to acquisition, it becomes less favored relative to franchising.

The wider implications of these principles are summarized in Table 4. The results reported in the table apply to the market entry problem in its most general form. The additional assumptions used to derive the dominance relations above are now set to one side. A wide range of hypotheses are generated by this table. A comprehensive discussion of all of them is beyond the scope of a single paper. Some of the results are fairly obvious, and appear in an intuitive form in the extant literature. Other results are more surprising. In some cases, the element of surprise is a consequence of the specific assumptions that have been made in order to simplify the model. In other cases, the element of surprise indicates a hypothesis which is plausible when considered in depth, but not immediately obvious to the intuition.

DISCUSSION OF RESULTS

Some of the more obvious results are as follows:

(1) An increase in z, caused by higher tariffs, transport costs, or a loss of economies of scale in domestic production, encourages production abroad. It encourages both licensing and wholly owned production. This underlines the importance of keeping the distinction between *location* effects and *internalization* effects very clear in any discussion of foreign market entry strategy.

(2) An increase in a, reflecting a highly specific type of entrant's technology, discourages acquisition and licensing, and favors greenfield production.

(3) An increase in the cost of building trust, q, discourages acquisition and favors either greenfield investment or arm's length contractual arrangements.

(4) A high cost of learning about the foreign market through experience, m, encourages acquisition, licensing and franchising, and discourages subcontracting or greenfield investment in distribution.

(5) A high transaction cost for intermediate output, t_3, encourages the vertical integration of production and distribution. This can be achieved either by the foreign entrant investing in both production and distribution, by the entrant exporting to a wholly owned distribution facility, or the entrant licensing the technology to a vertically integrated domestic firm. It can also be achieved by forming a vertically integrated IJV.

(6) A high transaction cost for arm's length technology transfer, t_1, favors FDI over arm's length arrangements, like subcontracting.

(7) In general, subcontracting is not a very attractive mode of foreign market entry. This is because it does not give access to the domestic rival's marketing expertise. It also leaves the domestic rival in a strong competitive position, since the contractual commitment to the entrant is of a short-term nature, and the rival's distribution facility is not com-

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

Three interesting and less obvious results are as follows:

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

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

(3) In general, the analysis confirms that market structure is a crucial factor in the choice between greenfield investment and acquisition. Entry through greenfield investment increases local capacity and intensifies competition, whereas entry through acquisition does not. This explains why governments so often compete to attract inward greenfield investment, whilst taking a restrictive attitude to acquisitions at the same time.

IMPLICATIONS FOR FUTURE RESEARCH

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

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

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

by introducing marketing and distribution activities in addition to production. By modifying the assumptions about the physical relationship between production and distribution in various ways, the model can be applied to a wide range of service industries.

There are many smaller ways in which the model can be modified as well. The analysis of duopolistic rivalry can be refined using models of Bertrand and Cournot competition (Gorg, 1998). The formation of IJVs through greenfield investment can be introduced to supplement the "buy in" strategy assumed above. Finally, the role of host-country production expertise can be modelled in greater detail by making more explicit the function of adapting foreign technology to local production conditions.

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