UNIVERSITY OF MARYLAND
GLOBAL CAMPUS

Learning Topic

Modes of Entry

What is the best way to enter a new market? Should a company first establish an export base or license its products to gain experience in a newly targeted country or region? Or does the potential associated with first-mover status justify a bolder move, such as entering an alliance, making an acquisition, or even starting a new subsidiary? Many companies move from exporting to licensing to a higher investment strategy, in effect treating these choices as a learning curve. Each has distinct advantages and disadvantages.

Exporting is the marketing and direct sale of domestically produced goods in another country. Exporting is a traditional and well-established method of reaching foreign markets. Since it does not require that the goods be produced in the target country, no investment in foreign production facilities is required. Most of the costs associated with exporting take the form of marketing expenses.

While relatively low risk, exporting entails substantial costs and limited control. Exporters typically have little control over the marketing and distribution of their products, face high transportation charges and possible tariffs, and must pay distributors for a variety of services. Further, exporting does not give a company firsthand experience in staking out a competitive position abroad, and it makes it difficult to customize products and services to local tastes and preferences.

Licensing essentially permits a company in the target country to use the property of the licensor. Such property, such as trademarks, patents, and production techniques, is usually intangible. The licensee pays a fee in exchange for the rights to use the intangible property and possibly for technical assistance.

Because little investment on the part of the licensor is required, licensing can provide a very large return on investment. However, because the licensee produces and markets the product, potential returns from manufacturing and marketing activities may be lost. Thus, licensing reduces cost and involves limited risk. However, it does not mitigate the substantial disadvantages associated with operating from a distance. As a rule, licensing strategies inhibit control and produce only moderate returns.

Strategic alliances and joint ventures have become increasingly popular in recent years. They allow companies to share the risks and resources required to enter international markets. And although returns also may have to be shared, these arrangements give companies a degree of flexibility not afforded by going it alone through direct investment.

There are several motivations for companies to consider a partnership as they expand globally, including facilitating market entry, risk and reward sharing, technology sharing, joint product development, and conforming to government regulations. Other benefits include political connections and distribution channel access that may depend on relationships.

Such alliances often are favorable when (1) the partners' strategic goals converge while their competitive goals diverge; (2) the partners' size, market power, and resources are small compared to the industry leaders; and (3) partners are able to learn from one another while limiting access to their own proprietary skills.

The key issues to consider in a joint venture are ownership, control, length of agreement, pricing, technology transfer, local firm capabilities and resources, and government intentions. Potential problems include (1) conflict over asymmetric new investments, (2) mistrust over proprietary knowledge, (3) performance ambiguity, that is, how to "split the pie," (4) lack of parent firm support, (5) cultural clashes, and (6) if, how, and when to terminate the relationship.

Ultimately, most companies will aim at building their own presence through company-owned facilities in important international markets. Acquisitions and greenfield start-ups represent this ultimate commitment. Acquisition is faster, but starting a new, wholly owned subsidiary might be the preferred option if no suitable acquisition candidates can be found.

Also known as foreign direct investment (FDI), acquisitions and greenfield start-ups involve the direct ownership of facilities in the target country and, therefore, the transfer of resources including capital, technology, and personnel. Direct ownership provides a high degree of control in the operations and the ability to better know the consumers and competitive environment. However, it requires a high level of resources and a high degree of commitment.

Coca-Cola and Illycaffé

In March 2008, the Coca-Cola company and Illycaffé Spa finalized a joint venture and launched a premium ready-to-drink espresso-based coffee beverage. The joint venture, Ilko Coffee International, was created to bring three ready-to-drink coffee products—caffè, an Italian chilled espresso-based coffee; cappuccino, an intense espresso, blended with milk and dark cacao; and latte macchiato, a smooth espresso, swirled with milk—to consumers in 10 European countries. The products will be available in stylish, premium cans (150 milliliters for caffè and 200 milliliters for the milk variants). All three offerings will be available in 10 European Coca-Cola Hellenic markets, including Austria, Croatia, Greece, and Ukraine. Additional countries in Europe, Asia, North America, Eurasia, and the Pacific were slated for expansion at a later date.

The Coca-Cola Company is the world's largest beverage company. Along with Coca-Cola, recognized as the world's most valuable brand, the company markets four of the world's top five nonalcoholic sparkling brands, including Diet Coke, Fanta, Sprite, and a wide range of other beverages, including diet and light beverages, waters, juices and juice drinks, teas, coffees, and energy and sports drinks. Through the world's largest beverage distribution system, consumers in more than 200 countries enjoy the company's beverages at a rate of 1.5 billion servings each day.

Based in Trieste, Italy, Illycaffé produces and markets a unique blend of espresso coffee under a single brand leader in quality. Over 6 million cups of Illy espresso coffee are enjoyed every day. Illy is sold in over 140 countries around the world and is available in more than 50,000 of the best restaurants and coffee bars. Illy buys green coffee directly from the growers of the highest quality Arabica through partnerships based on the mutual creation of value. The Trieste-based company fosters long-term collaborations with the world's best coffee growers—in Brazil, Central America, India, and Africa—providing know-how and technology and offering above-market prices.

Entry Strategies: Timing

In addition to selecting the right mode of entry, the timing of entry is critical. Just as many companies have overestimated market potential abroad and underestimated the time and effort needed to create a real market presence, so have they justified their overseas' expansion on the grounds of an urgent need to participate in the market early. Arguing that there existed a limited window of opportunity in which to act, which would reward only those players bold enough to move early, many companies made sizable commitments to foreign markets even though their own financial projections showed they would not be profitable for years to come. This dogmatic belief in the concept of a first-mover advantage (sometimes referred to as pioneer advantage) became one of the most widely established theories of business. It holds that the first entrant in a new market enjoys a unique advantage that later competitors cannot overcome (i.e., that the competitive advantage so obtained is structural and therefore sustainable).

Some companies have exemplified this concept. Procter & Gamble (P&G), for example, has always trailed rivals such as Unilever in certain large markets, including India and some Latin American countries, and the most obvious explanation is that its European rivals were participating in these countries long before P&G entered. Given that history, it is understandable that P&G erred on the side of urgency in reacting to the opening of large markets such as Russia and China. For many other companies, however, the concept of pioneer advantage was little more than an article of faith and was applied indiscriminately and with disastrous results to country-market entry, to product-market entry, and, in particular, to the new economy opportunities created by the Internet.

The get-in-early philosophy of pioneer advantage remains popular. And while there are clear examples of its successful application—the advantages gained by European companies from being early in colonial markets provide some evidence of pioneer advantage—first-mover advantage is overrated as a strategic principle. In fact, in many instances, there are disadvantages to being first. First, if there is no real first-mover advantage, being first often results in poor business performance, as the large number of companies that rushed into Russia and China can attest to. Second, pioneers may not always be able to recoup their investment in marketing required to kick-start the new market. When that happens, a fast follower can benefit from the market development funded by the pioneer and leapfrog into earlier profitability. For a more detailed discussion, see Tellis & Golder (2002).

This ability of later entrants to free-ride on the pioneer's market development investment is the most common source of first-mover disadvantage and suggests two critical conditions necessary for real first-mover advantage to exist. First, there must be a scarce resource in the market that the first entrant can acquire. Second, the first mover must be able to lock up that scarce resource in such a way that it creates a barrier to entry for potential competitors. A good example is provided by markets in which it is necessary for foreign firms to obtain a government permit or license to sell their products. In such cases, the license, and perhaps government approval, more generally, may be a scarce resource that will not be granted to all comers. The second condition is also necessary for first-mover advantage to develop. Many companies believed that brand preference created by being first constituted a valid source of first-mover advantage, only to find that, in most cases, consumers consider the alternatives available at the time of their first purchase, not which came first.

Starbucks' Global Expansion

Starbucks' decision to expand abroad came after an extended period of exclusive focus on the North American market. From its founding in 1971, it grew to almost 700 stores by 1995, all within the United States and Vancouver, Canada. It was not until the next decade that Starbucks made its first entry into other international markets. By 2006, Starbucks operated approximately 11,000 stores—with 70 percent in the United States and 30 percent in international markets—and international revenue had grown to almost 20 percent of Starbucks' total revenue. Starbucks offered the same basic coffee menu internationally as it did in the United States. However, the range of food products and other items, such as coffee mugs stocked, varied somewhat according to local customs and tastes.

Along with many other companies that pursue global expansion, Starbucks continually faces questions about where and how to further increase its global presence. Should the emphasis be on growth in existing countries or on increasing the number of countries in which it has a presence? How important is the fact that international markets so far have proven less profitable than US and Canadian markets?

Starbucks in Japan

Interestingly, Starbucks' first move outside the United States and Canada was a joint venture in Japan. At the time, Japan had the second-largest economy in the world and was consistently among the top five coffee importers.

The decision to use a joint venture to enter Japan followed intense internal debate. Concerns among senior executives centered on Starbucks' lack of local knowledge, and questions were raised about the company's ability to attract the local talent necessary to grow the Japanese business quickly enough.

Starbucks was acutely aware that there were significant differences between doing business in Japan and in the United States and that it might not have enough experience to be successful on its own.

Among other factors, operating costs were predicted to be double those of North America, and Starbucks would have to pay to ship coffee to Japan from its roasting facility in Kent, Washington (near Seattle). In addition, retail space in Tokyo was two to three times as expensive as in Seattle. Just finding rental space in such a populous city might prove to be a tremendous challenge. Starbucks concluded it needed to form an alliance with a local group that had experience with complex operations and real estate.

Starbucks executives worried that a licensing deal would not be the right solution. Specifically, they were concerned about a possible loss of control and insufficient knowledge transfer to learn from the experience. A joint venture was thought to be a better answer, and, after a long search, Starbucks approached Sazaby, Inc., operators of upscale retail and restaurant chains, whose president had approached Starbucks years earlier about the potential of opening Starbucks stores in Japan. Similarity in values, culture, and community development goals between Starbucks and Sazaby were important considerations in concluding the 50-50 deal. The two companies were equally represented on the board of directors of the newly created Starbucks Coffee Japan. Starbucks was the sole decision-making power in matters relating to brand, product line advertising, and corporate communications, while decisions regarding real-estate operational issues and human resources were handled by Sazaby. Despite strong local competition, the venture was successful from the start. By fiscal year 2000, Starbucks Coffee Japan became profitable more than two years ahead of schedule.

Starbucks in the United Kingdom

Unlike its expansion into Asia and later, the Middle East, Starbucks chose to enter the United Kingdom through acquisition rather than partnerships. Speed was a major factor in Starbucks' decision to enter the fast-growing UK market by acquisition. In addition, the culture, language, legal environment, management practices, and labor economics in the United Kingdom were considered sufficiently similar to those that Starbucks' management already knew. This meant that a wholly owned UK subsidiary could be successfully established from the outset. In May 1998, Starbucks acquired the Seattle Coffee Company, which had had a presence in the United Kingdom for some time. This fast-growing chain was modeled on its own style of operations and, at the time of the purchase, had 56 retail units. The Seattle Coffee Company was an attractive acquisition target because of its focus—relatively small market capitalization and established retail units. By 2005, Starbucks had 469 stores in the United Kingdom, which made it the third-largest country, after the United States and Japan, to serve Starbucks coffee.

Licensing in China

In a number of developing markets, including China, Starbucks chose to enter into minority share licensing agreements with high-quality, experienced local partners in order to minimize market-entry risks. Under these agreements, the local partners absorbed the capital costs (real estate, store construction) of bringing the Starbucks brand abroad. These steps eliminated the need for substantial general and administrative expenses by Starbucks and enabled it to establish a presence in foreign markets much more quickly than it would have if it had to invest its own capital and absorb start-up losses.

Risk was also a major consideration when Starbucks looked to enter China. While offering high-volume opportunities in an untapped coffee market, the prevailing culture and politics in China potentially posed significant problems. In April 2000, Beijing city authorities ordered Kentucky Fried Chicken to close its store near the Forbidden City when its lease expired in 2002. Similarly, under pressure from local authorities, McDonald's removed its golden arches from outlets near Tiananmen Square. These incidents demonstrated China's ambiguous attitude toward a growing Western economic and cultural influence.

Another major concern with starting operations in China was recruiting the right staff. Uniformity of customer experience and coffee quality was the key driver behind the Starbucks brand. Failure to recruit the staff to ensure these key criteria not only would mean failure for the Chinese retail outlets but also could harm the company's image globally.

Although these factors made licensing an attractive entry model, with growing experience in the Chinese market, Starbucks is steadily reducing its reliance on the licensing model and switching to its core company-operated business model to increase control and reap greater rewards.

Starbucks' globalization history shows that while it was a first mover in the United States, it was forced to push harder in international markets to compete with existing players. In Japan, Starbucks was initially a huge success and became profitable two years earlier than anticipated. However, just two years after Starbucks Japan had become profitable, the company announced a loss of $3.9 million in Japan, its second largest market at the time, reflecting a major increase in local competition. Additional international challenges were a result of Starbucks' chosen entry mode. Although joint ventures provided Starbucks with local knowledge about the market and a low-risk entry into unproven territory, joint ventures did not always reap the rewards that the partners had anticipated. One key factor was that it was often difficult for Starbucks to control the costs in a joint venture, resulting in lower profitability.

Glossary

exporting The marketing and direct sale of domestically produced goods in another country

fast follower A firm that uses the benefits from prior market development by a pioneering firm to achieve profitability more quickly

foreign direct investment (FDI) A firm's direct ownership of facilities in a target country market

greenfield start-ups Wholly-owned subsidiaries created by firms to gain entry in foreign markets

joint ventures Methods by which firms share the resources and risks required to enter international markets

licensing Permits a firm (licensee) in the target country to use the intangible property of the licensor for a fee

strategic alliances Methods by which firms share the resources and risks required to enter international markets

Key Points

- Selecting global target markets, entry modes, and deciding how much to adapt the company's basic value proposition are intimately related. The choice of customers to serve in a particular country or region with a particular culture determines how and how much a company must adapt its basic value proposition. Conversely, the extent of a company's capabilities in tailoring its offerings around the globe limits or broadens its options to successfully enter new markets or cultures.
- Few companies can afford to enter all markets open to them. The track record shows that picking the most attractive foreign markets, determining the best time to enter them, and selecting the right partners and level of investment has proven difficult for many companies, especially when it involves large emerging markets such as China.
- Research shows there is a pervasive the-grass-is-always-greener effect that infects global strategic decision making in many companies—especially those without global experience—and causes them to overestimate the attractiveness of foreign markets.
- Four key factors in selecting global markets are (1) a market's size and growth rate, (2) a particular country or region's institutional contexts, (3) a region's competitive environment, and (4) a market's cultural, administrative, geographic, and economic distance from other markets the company serves.
- There is a wide menu of options regarding market entry, from conservative strategies, such as first establishing an export base or licensing products to gain experience in a newly targeted country, to more aggressive options, such as entering an alliance, making an acquisition, or even starting a new subsidiary.

- Selecting the right timing of entry is equally critical. Many companies have overestimated market potential abroad, underestimated the time and effort needed to create a real market presence, and have they justified their overseas expansion on the grounds of an urgent need to participate in the market early.

References

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