CHAPTER 1

Expanding Abroad:
Motivations, Means, and Mentalities

In this chapter, we look at a number of important questions that companies must resolve before taking the leap to operate outside their home environment. What market opportunities, sourcing advantages, or strategic imperatives provide the *motivation* for their international expansion? By what *means* will they expand their overseas presence—through modes such as exports, licensing, joint ventures, wholly owned subsidiaries, or some other means? And how will the management *mentalities*—their embedded attitudes, assumptions, and beliefs—that they bring to their international ventures affect their chances of success? Before exploring these important questions, however, we need to develop a definition of this entity—the multinational enterprise (MNE)—that we plan to study, and develop a sense of its size and importance in the global economy.

This book focuses on the management challenges associated with developing the strategies, building the organizations, and managing the operations of companies whose activities stretch across national boundaries. Clearly, operating in an international rather than a domestic arena presents managers with many new opportunities. Having worldwide operations not only gives a company access to new markets and low-cost resources, it also opens up new sources of information and knowledge and broadens the options for strategic moves that the company might make to compete with its domestic and international rivals. However, with all these new opportunities come the challenges of managing strategy, organization, and operations that are innately more complex, diverse, and uncertain.

Our starting point is to focus on the dominant vehicle of internationalization, the multinational enterprise (MNE), and briefly review its role and influence in the global economy.[1] Only after understanding the origins, interests, and objectives of this key factor will we be in a position to explore the strategies it pursues and the organization it develops to achieve them.

In this chapter, we introduce the MNE by defining its key characteristics, discussing its origins, interests, and objectives, and reviewing its major role and influence in the global economy. We then describe the motivations that drive these companies abroad, the means they adopt to expand internationally, and the mentalities of management that shape the strategies MNEs pursue and the organizations they develop to achieve them.

[1]Such entities are referred to variously—and often interchangeably—as *multinational, international,* and *global enterprises.* (Note that we use the term *enterprise* rather than *corporation* because some of the cross-border entities that we will examine are nonprofit organizations whose strategies and operations are every bit as complex as that of their corporate brethren.) At the end of this chapter, we assign each of those terms—*multinational, international,* and *global*—specific meanings, but throughout the book, we adopt the widely used *MNE* abbreviation in a broader, more general sense to refer to all enterprises whose operations extend across national borders.

The MNE: Definition, Scope, and Influence

An economic historian could trace the origins of international business back thousands of years to the seafaring traders of Greece and Egypt,[2] through the merchant traders of medieval Venice and the great British and Dutch trading companies of the 17th and 18th centuries. By the 19th century, the newly emerged capitalists in industrialized Europe began investing in the less-developed areas of the world (including the United States), but particularly within the vast empires held by Britain, France, Holland, and Germany.

Definition

In terms of the working definition that we use, few if any of these entities throughout history could be called true MNEs. Most early traders would be excluded by our first qualification, which requires that an MNE have *substantial direct investment* in foreign countries, not just the trading relationships of an import-export business. And even most of the companies that had established international operations in the 19th century would be excluded by our second criterion, which requires that they be engaged in the *active management* of these offshore assets rather than simply holding them in a passive investment portfolio.

Thus, though companies that source their raw materials offshore, license their technologies abroad, export their products into foreign markets, or even hold minor equity positions in overseas ventures without any management involvement may regard themselves as "international," by our definition, they are not true MNEs unless they have substantial, direct investment in foreign countries *and* actively manage and regard those operations as integral parts of the company, both strategically and organizationally.

Scope

According to our definition, then, the MNE is a very recent phenomenon, with the vast majority developing only in the post–World War II years. However, the motivations for international expansion and the nature of MNEs' offshore activities have evolved significantly over this relatively short period, and we will explore some of these changes later in this chapter.

It is interesting to observe how the United Nations (U.N.) has changed its definition of the MNE as these companies have grown in size and importance.[3] In 1973, it defined such an enterprise as one "which controls assets, factories, mines, sales offices, and the like in two or more countries." By 1984, it had changed the definition to an enterprise (a) which comprises entities in two or more countries, regardless of the legal form and fields of activity of those entities; (b) which operates under a system of decision making that permits coherent policies and a common strategy through one or more decision-making centers; and (c) in which the entities are so linked, by ownership or otherwise, that one or more of them may be able to exercise a significant influence over the activities of the others, in particular to share knowledge, resources, and responsibilities.

[2] See Karl Moore and David Lewis, *The Origins of Globalization* (New York: Routledge, 2009).

[3] The generic term for companies operating across national borders in most U.N. studies is *transnational corporation* (TNC). Because we use that term very specifically, we continue to define the general form of organizations with international operations as MNEs.

Table 1-1 Selected Indicators of FDI and International Production, 2001–2010

Item	*Value at Current Prices (billions of dollars)* 2005–2007 average	2009	2010	*Annual Growth Rate or Change on Return (percent)* 2001–2005	2009	2010
FDI inflows	1,472	1,185	1,244	5.3	–32.1	4.9
FDI outflows	1,487	1,171	1,323	9.1	–38.7	13.1
FDI inward stock	14,407	17,950	19,141	13.4	17.4	6.6
FDI outward stock	15,705	19,197	20,408	14.7	20.1	6.3
Income on inward FDI	990	945	1,137	32.0	–11.3	20.3
Rate of return on inward FDI[a]	*5.9*	*7.0*	*7.3*	*0.1*	*–0.3*	*0.3*
Income on outward FDI[a]	1,083	1,037	1,251	31.3	–6.8	20.6
Rate of return on outward FDI[a]	*6.2*	*6.9*	*7.2*	—	*–0.2*	*0.3*
Cross-border M&As	703	250	339	0.6	–64.7	35.7
Sales of foreign affiliates	21,293	30,213[b]	32,960[b]	14.9	–9.3	9.1
Value-added (product) of foreign affiliates	3,570	6,129[b]	6,636[b]	10.9	–1.4	8.3
Total assets of foreign affiliates	43,324	53,601[b]	56,998[b]	15.5	–16.8	6.3
Exports of foreign affiliates	5,003	5,262[c]	6,239[c]	14.7	–20.3	18.6
Employment by foreign affiliates (thousands)	55,001	66,688[b]	68,218[b]	4.1	3.4	2.3

Source: UNCTAD.
[a]Calculated with FDI income for the countries that have the data for both this and FDI stock.
[b]Data for 2009 and 2010 are estimated based on a fixed effects panel regression of each variable against outward stock and a lagged dependent variable for the period 1980–2008.
[c]For 1998–2010, the share of exports of foreign affiliates in world export in 1998 (33.3 percent) was applied to obtain values.
Note: Not included in this table is the value of worldwide sales by foreign affiliates associated with their parent firms through nonequity relationships and of the sales of the parent firms themselves. Worldwide sales, gross product, total assets, exports, and employment of foreign affiliates are sometimes estimated.

In essence, the changing definition highlights the importance of both strategic and organizational integration, and thereby, the *active, coordinated management* of operations located in different countries, as the key differentiating characteristic of an MNE. The resources committed to those units can take the form of skilled people or research equipment just as easily as plants and machinery or computer hardware. What really differentiates the MNE is that it creates an internal organization to carry out key cross-border tasks and transactions internally, rather than depending on trade through the external markets, just as the companies in Table 1-1 do. This more recent U.N. definition also expands earlier assumptions of traditional ownership patterns to encompass a more varied set of financial, legal, and contractual relationships with different foreign affiliates. With this understanding, our definition of MNEs includes Apple, BP, and Honda Motors, but also Intercontinental Hotels, Deloitte Consulting, and McDonald’s.

MNE Influence in the Global Economy

Most frequent international business travelers have had an experience like this: A woman arrives on her Singapore Airlines flight, rents a Toyota at Hertz, and drives to the downtown Marriott Hotel. In her room, she flips on the LG television and absentmindedly gazes out at neon signs flashing “Pepsi,” “Samsung,” and “Lexus.” The latest episode of *Modern Family* is flickering on the screen when room service delivers dinner, along with a bottle of Perrier. All of a sudden, a feeling of disorientation engulfs her. Is she in Sydney, Shanghai, Sao Paulo, or San Francisco? Her surroundings and points of reference over the past few hours have provided few clues.

Such experiences, more than any data, provide the best indication of the enormous influence of MNEs in the global economy. As the cases and articles in this book show, few sectors of the economy and few firms—not even those that are purely domestic in their operations—are free of this pervasive influence. According to U.N. estimates, even in the midst of the 2010 recession, the total number of MNEs exceeded 65,000. Their collective operations, both abroad and at home, generated value added of approximately $16 trillion, about a quarter of total global gross domestic product (GDP). MNEs’ foreign affiliates generated value added of approximately $7 trillion, more than one-tenth of global GDP and one-third of world exports.

Not all MNEs are large, but most large companies in the world are MNEs. Indeed, the largest 100 MNEs, excluding those in banking and finance, accounted for $12.1 trillion of total worldwide assets in 2010, of which $7.5 trillion was located outside their respective home countries.

Moreover, as Table 1-1 shows, despite the 2008–2009 economic crisis international production is expanding, with sales, employment, and assets of foreign affiliates all increasing. This is due to the consistent high rates of return earned by MNEs on foreign direct investment (FDI). MNEs’ rate of return on outward FDI has gone back up to 7.3 percent in 2010 after a one-year dip during the crisis.

However, the importance of developing and transition economies is rising. As Table 1-2 shows, while the total worldwide assets of the 100 largest MNEs (or Transnational Corporations, as the United Nations refers to them) increased by 7 percent to $11,543 billion between 2008 and 2009, in the same period, the total assets of the 100 largest TNCs from developing and transition economies increased by 17.9 percent from $2,673 billion to $3,152 billion. In addition, the total employment of the 100 largest TNCs worldwide decreased by 3.7 percent to 15,144,000 between 2008 and 2009, in the same period, the total employment of the 100 largest TNCs from developing and transition economies increased by 21.9 percent to 8,259,000.

A different perspective on the size and potential impact of MNEs is provided in Table 1-3, which compares the overall revenues of several MNEs with the GDPs of selected countries. By comparing company revenues and country GDPs, it is clear that some of the world’s largest MNEs are equivalent in their economic importance to medium-sized economies such as Venezuela, Denmark, or Malaysia, and considerably more economically important than smaller or less developed economies such as Cameroon, Paraguay, or Barbados. They have considerable influence on the global economy, employ a high percentage of business graduates, and pose the most complex

Table 1-2 Internationalization Statistics of the 100 Largest Non-Financial MNEs Worldwide and from Developing and Transition Economies (Billions of dollars, thousands of employees, and percent)

	100 Largest MNEs Worldwide			*100 Largest MNEs from Developing and Transition Economies*	
Variable	**2008**	**2009**	**2010**	**2008**	**2009**
Assets					
Foreign	6,161	7,147	7,512	899	997
Total	10,790	11,543	12,075	2,673	3,152
Foreign as % of total	57	62	62	34	32
Sales					
Foreign	5,168	4,602	5,005	989	911
Total	8,406	6,979	7,847	2,234	1,914
Foreign as % of total	61	66	64	44	48
Employment					
Foreign	9,008	8,568	8,726	2,651	3,399
Total	15,729	15,144	15,489	6,778	8,259
Foreign as % of total	57	57	56	39	41

Source: UNCTAD.
Note: From 2009 onward, data refer to fiscal year results reported between April 1 of the base year to March 31 of the following year. 2010 data are unavailable for the 100 largest MNEs from developing and transition economies due to lengthier reporting deadlines in these economies.

strategic and organizational challenges for their managers. For the same reasons, they provide the focus for much of our attention in this book.

The Motivations: Pushes and Pulls to Internationalize

What motivates companies to expand their operations internationally? Although occasionally the motives may be entirely idiosyncratic, such as the desire of the CEO to spend time in Mexico or link to old family ties in Europe, an extensive body of research suggests some more systematic patterns.

Traditional Motivations

Among the earliest motivations that drove companies to invest abroad was the need to *secure key supplies*. Aluminum producers needed to ensure their supply of bauxite, tire companies went abroad to develop rubber plantations, and oil companies wanted to open new fields in Canada, the Middle East, and Venezuela. By the early part of the last

Table 1-3 Comparison of Top MNEs and Selected Countries: 2010

Company*	Revenues (Millions USD)	Company Rank	Country**	GDP (Current Millions, USD)	Country GDP Rank
Wal-Mart Stores	408,214	1	United States	14,586,736	1
Royal Dutch Shell	285,129	2	China	5,926,612	2
Exxon Mobil	284,650	3	Japan	5,458,836	3
BP	246,138	4	Germany	3,280,529	4
Toyota Motor	204,106	5	Venezuela	391,848	25
Sinopec	187,518	7	Denmark	311,989	30
AXA	175,257	9	Malaysia	237,797	35
China National Petroleum	165,496	10	Hungary	128,632	52
Chevron	163,527	11	Cameroon	22,480	90
General Electric (GE)	156, 779	13	Barbados	4,109	143

Note: The purpose of this table is merely illustrative of the economic importance of some of the world's largest MNEs. One has to be cautious when comparing the above company and country numbers. That is because country GDPs and company revenues are not perfectly comparable, while country value-added and company value-added are. A country's GDP represents its value-added, whereas a company's revenue is typically higher than its value-added. Thus, from a comparison point of view, the above company numbers may be somewhat inflated relative to the country numbers.
*Data are from Fortune Global 500 and CNN Money's Ranking of world's largest corporations in 2010 by revenue http://money.cnn.com/magazines/fortune/global500/2010/full_list/
**Data are from World Development Indicators published by the World Bank: http://data.worldbank.org/indicator/NY.GDP.MKTP.CD

century, Standard Oil, Alcoa, Goodyear, Anaconda Copper, and International Nickel were among the largest of the emerging MNEs.

Another strong trigger for internationalization could be described as *market-seeking* behavior. This motivation was particularly strong for companies that had some intrinsic advantage, typically related to their technology or brand recognition, which gave them a competitive advantage in offshore markets. Their initial moves were often opportunistic, frequently originating with an unsolicited export order. However, many companies eventually realized that additional sales enabled them to exploit economies of scale and scope, thereby providing a source of competitive advantage over their domestic rivals. This market seeking was a particularly strong motive for some European multinationals, whose small home markets were insufficient to support the volume-intensive manufacturing processes that were sweeping through industries ranging from food and tobacco to chemicals and automobiles. Companies like Philips, Volkswagen, and Unilever expanded internationally primarily in search of new markets.

Another traditional and important trigger of internationalization was the desire to *access low-cost factors* of production. Particularly as tariff barriers declined in the 1960s, the United States and many European countries, for which labor represented a major cost, found that their products faced a competitive disadvantage compared with imports. In response, a number of companies in clothing, electronics, household appliances, watch-making, and other such industries established offshore sourcing locations to produce components or even complete product lines. For example, General Electric (GE) moved production from its lamp plant in Virginia to China and GE Healthcare, one of

GE's most strategic businesses, invested in three world-class plants in India and more recently started manufacturing high-end CT imaging systems there for India and the world.

Labor was not the only productive factor that could be sourced more economically overseas. For example, the availability of lower-cost capital (often through a government investment subsidy) also became a strong force for internationalization. It was the provision of such government financial incentives that induced General Motors (GM) to expand its basic assembly operation in Brazil into a fully integrated operation that is now the company's fourth most important R&D facility worldwide.

These three motives traditionally were the main driving forces behind the overseas expansion of MNEs. The ways in which these motives interacted to push companies—particularly those from the United States—to become MNEs are captured in the well-known product cycle theory espoused by long time Harvard Professor Ray Vernon.[4]

This theory suggests that the starting point for an internationalization process is typically an innovation that a company creates in its home country. In the first phase of exploiting the development, the company—let's assume that it is in the United States—builds production facilities in its home market not only because this is where its main customer base is located, but also because of the need to maintain close linkages between research and production in this phase of its development cycle. In this early stage, some demand also may be created in other developed countries—in European countries, for example—where consumer needs and market developments are similar to those of the United States. These requirements normally would be met with home production, thereby generating exports for the United States.

During this pre-MNE stage, firms would typically establish an export unit within the home office, to oversee the growing export levels. Committing to this sort of organizational structure would in turn typically lead to stronger performance than would treating exports simply as part of the domestic business.[5]

As the product matures and production processes become standardized, the company enters a new stage. By this time, demand in the European countries has become quite sizable, and export sales, originally a marginal side benefit, have become an important part of the revenues from the new business. Furthermore, competitors probably have begun to see the growing demand for the new product as a potential opportunity to establish themselves in the markets served by exports. To prevent or counteract such competition and to meet the foreign demand more effectively, the innovating company typically sets up production facilities in the importing countries, thereby making the transition from being an exporter to becoming a true MNE.

Finally, in the third stage, the product becomes highly standardized, and many competitors enter the business. Competition focuses on price and, therefore, on cost. This trend activates the resource-seeking motive, and the company moves production to low-wage, developing countries to meet the demands of its customers in the developed markets at a lower cost. In this final phase, the developing countries may become net exporters of the product, while the developed countries become net importers.

[4] Raymond Vernon, "International Investment and International Trade in the Product Cycle," *Quarterly Journal of Economics,* May 1966, pp. 190–207.

[5] Paul W. Beamish, Lambros Karavis, Anthony Goerzen, and Christopher Lane, "The Relationship Between Organizational Structure and Export Performance," *Management International Review* 39 (1999), pp. 37–54.

Although the product cycle theory provided a useful way to describe much of the internationalization of the postwar decades,[6] by the 1980s, its explanatory power was beginning to wane, as Professor Vernon himself was quick to point out. As the international business environment became increasingly complex and sophisticated, companies developed a much richer rationale for their worldwide operations.

Emerging Motivations

Once MNEs had established international sales and production operations, their perceptions and strategic motivations gradually changed. Initially, the typical attitude was that the foreign operations were mere strategic and organizational appendages to the domestic business and should be managed opportunistically. Gradually, however, managers began to think about their strategy in a more integrated, worldwide sense. In this process, the forces that originally triggered their expansion overseas often became secondary to a new set of motivations that underlay their emerging global strategies.

The first such set of forces was the increasing *scale economies, ballooning R&D investments,* and *shortening product life cycles* that transformed many industries into global rather than national structures and made a worldwide scope of activities not a matter of choice, but an essential prerequisite for companies to survive in those businesses. These forces are described in detail in the next chapter.

A second factor that often became critical to a company's international strategy—though it was rarely the original motivating trigger—was its global *scanning and learning* capability.[7] A company drawn offshore to secure supplies of raw materials was more likely to become aware of alternative, low-cost production sources around the globe; a company tempted to go abroad by market opportunities was often exposed to new technologies or market needs that stimulated innovative product development. The very nature of an MNE's worldwide presence gave it a huge informational advantage that could result in it locating more efficient sources or more advanced product and process technologies. Thus, a company whose international strategy was triggered by a technological or marketing advantage could enhance that advantage through the scanning and learning potential inherent in its worldwide network of operations. (This has become an increasingly important strategic advantage, which we will explore in detail in Chapter 5.)

A third benefit that soon became evident was that being a multinational rather than a national company brought important advantages of *competitive positioning*. Certainly, the most controversial of the many global competitive strategic actions taken by MNEs in recent years have been those based on cross-subsidization of markets. For example, a Chinese energy company, such as China Petroleum and Chemical Group (Sinopec), could challenge a competitor in the United States by subsidizing its U.S. losses with funds from its profitable operations in the Middle East or South America.

[6] The record of international expansion of countries in the post–World War II era is quite consistent with the pattern suggested by the product cycle theory. For example, between 1950 and 1980, U.S. firms' foreign direct investment (FDI) increased from $11.8 billion to $200 billion. In the 1950s, much of this investment focused on neighboring countries in Latin America and Canada. By the early 1960s, attention had shifted to Europe, and the European Economic Community's share of U.S. firms' FDI increased from 16 percent in 1957 to 32 percent by 1966. Finally, in the 1970s, attention shifted to developing countries, whose share of U.S. firms' FDI grew from 18 percent in 1974 to 25 percent in 1980.

[7] This motivation is highlighted by Raymond Vernon in "Gone Are the Cash Cows of Yesteryear," *Harvard Business Review,* November–December 1980, pp. 150–55.

If the U.S. company did not have strong positions in the Chinese company's key markets, its competitive response could only be to defend its home market positions—typically by seeking government intervention or matching or offsetting the Chinese challenger's competitive price reductions. Recognition of these competitive implications of multicountry operations led some companies to change the criteria for their international investment decisions to reflect not only market attractiveness or cost-efficiency choices, but also the leverage that such investments provided over competitors.[8]

Although for the purposes of analysis—and to reflect some sense of historical development—the motives behind the expansion of MNEs have been reduced to a few distinct categories, it should be clear that companies were rarely driven by a single motivating force. More adaptable companies soon learned how to capitalize on the potential advantages available from their international operations—ensuring critical supplies, entering new markets, tapping low-cost factors of production, leveraging their global information access, and capitalizing on the competitive advantage of their multiple market positions—and began to use these strengths to play a new strategic game that we will describe in later chapters as *global chess*.

The Means of Internationalization: Prerequisites and Processes

Having explored *why* an aspiring MNE wants to expand abroad (i.e., its motivation), we must now understand *how* it does so by exploring the means of internationalization. Beyond the desire to expand offshore, a company must possess certain competencies—attributes that we describe as *prerequisites*—if it is to succeed in overseas markets. Then it must be able to implement its plan to expand abroad through a series of decisions and commitments that define the internationalization process.

Prerequisites for Internationalization

In each national market, a foreign company suffers from some disadvantages in comparison with local competitors, at least initially. Because of their greater familiarity with the national culture, industry structure, government requirements, and other aspects of doing business in that country, domestic companies have a huge natural advantage over foreign companies. Their existing relationships with relevant customers, suppliers, regulators, and so on provide additional advantages that the foreign company must either match or counteract with some unique strategic capability. Most often, this countervailing strategic advantage comes from the MNE's superior knowledge or skills, which typically take the form of advanced technological expertise or specific marketing competencies. At other times, scale economies in R&D, production, or some other part of the value chain become the main source of the MNE's advantage over domestic firms. It is important to note, however, that the MNE cannot expect to succeed in the international environment unless it has some distinctive competency to overcome the liability of its foreignness.[9]

[8] These competitive aspects of global operations are discussed in detail in Chapter 3.

[9] The need for such strategic advantages for a company to become an MNE is highlighted by the *market imperfections theory of MNEs*. For a comprehensive review of this theory, see Richard E. Caves, *Multinational Enterprise and Economic Analysis*, 2d ed. (Cambridge: Cambridge University Press, 1996).

Such knowledge or scale-based strategic advantages are, by themselves, insufficient to justify the internationalization of operations. Often with much less effort, a company could sell or license its technology to foreign producers, franchise its brand name internationally, or sell its products abroad through general trading companies or local distributors, without having to set up its own offshore operations. This approach was explicitly adopted by Dunkin' Donuts, which decided to proactively and aggressively franchise its brand domestically (in the United States) as well as internationally, rather than solely set up its own domestic and international restaurants. Dunkin's founder, Bill Rosenberg, was so enamored by the franchising concept that he founded the International Franchise Association (IFA) in 1960. He believed that franchising is a wonderful way to expand further and faster. By 2011, Dunkin' had around 10,000 restaurants worldwide in 31 countries, around 7,000 of which were in the United States and 3,000 abroad. Approximately 70 percent of these restaurants were franchised operations. Dunkin' claimed to serve more than 2.7 million customers a day! One may argue that Dunkin' could not have grown as fast domestically and internationally were it not for the franchising strategy that it followed.

The other precondition for a company to become an MNE, therefore, is that it must have the organizational capability to leverage its strategic assets more effectively through its own subsidiaries than through contractual relations with outside parties. If superior knowledge is the main source of an MNE's competitive advantage, for example, it must have an organizational system that provides better returns from extending and exploiting its knowledge through direct foreign operations than the return it could get by selling or licensing that knowledge.[10]

To summarize, three conditions must be met for the existence of an MNE. First, there must be foreign countries that offer certain location-specific advantages to provide the requisite *motivation* for the company to invest there. Second, the company must have some *strategic competencies* or ownership-specific advantages to counteract the disadvantages of its relative unfamiliarity with foreign markets. Third, it must possess some *organizational capabilities* to achieve better returns from leveraging its strategic strengths internally, rather than through external market mechanisms such as contracts or licenses.[11] Understanding these prerequisites is important not only because they explain why MNEs exist, but also, as we show in Chapter 3, because they help define the strategic options for competing in worldwide businesses.

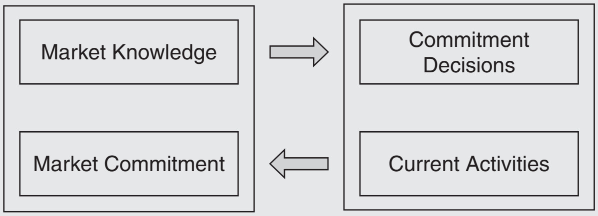
The Process of Internationalization

The process of developing these strategic and organizational attributes lies at the heart of the internationalization process through which a company builds its position in world markets. This process is rarely well thought out in advance, and it typically builds on

[10] The issue of organizational capability is the focus of what has come to be known as the *internalization theory of MNEs*. See Alan M. Rugman, "A New Theory of the Multinational Enterprise: Internationalization versus Internalization," *Columbia Journal of World Business,* Spring 1982, pp. 54–61. For a more detailed exposition, see Peter J. Buckley and Mark Casson, *The Future of Multinational Enterprise* (London: MacMillan, 1976).

[11] These three conditions are highlighted in John Dunning's eclectic theory. See John H. Dunning and Sarianna M. Lundan, *Multinational Enterprises and the Global Economy*, 2d ed. (Cheltenham, UK: Edward Elgar, 2008).

Figure 1-1 A Learning Model of Internationalization



Source: Johanson and Vahlne, 1977.

a combination of rational analysis, opportunism, and pure luck. Nonetheless, it is still possible to discern some general patterns of behavior that firms typically follow.

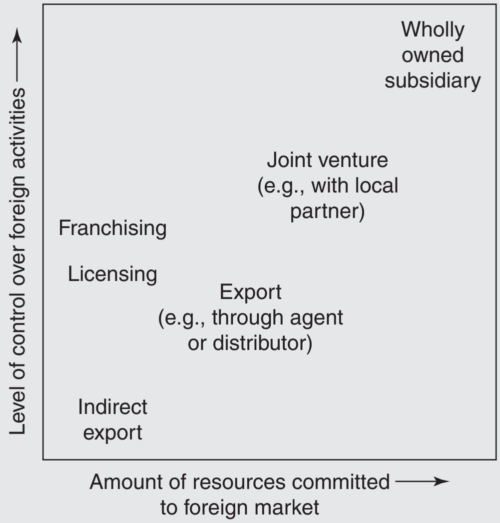
The best-known model for internationalization was developed by two Swedish academics based in Uppsala, who described foreign-market entry as a learning process.[12] The company makes an initial commitment of resources to the foreign market, and through this investment, it gains local market knowledge about customers, competitors, and regulatory conditions. On the basis of this market knowledge, the company is able to evaluate its current activities, the extent of its commitment to the market, and thus its opportunities for additional investment. It then makes a subsequent resource commitment, perhaps buying out its local distributor or investing in a local manufacturing plant, which allows it to develop additional market knowledge. Gradually, and through several cycles of investment, the company develops the necessary levels of local capability and market knowledge to become an effective competitor in the foreign country (see Figure 1-1).

Whereas many companies internationalize in the incremental approach depicted by the so-called Uppsala model, a great many do not.[13] Some companies invest in or acquire local partners to shortcut the process of building up local market knowledge. For example, Wal-Mart entered the United Kingdom by buying the supermarket chain ASDA rather than developing its own stores. Others speed up this process even more by starting up as "born globals" (see page 12 for a definition of a "born global" company). For example, Facebook, the social networking firm founded in 2004, became global at a surprising speed because it was started as an internet company. By 2012, Facebook had around 850 million monthly active users (MAUs) and around 500 million daily active users (DAUs) in more than 200 countries, and it managed its millions of users and thousands of advertisers and developers from just four regional centers, namely from California, Texas, Ireland, and India. Cases such as these highlight the complexity of the decisions that MNEs face in entering a foreign market.

[12]Jan Johanson and Jan-Erik Vahlne, "The Internationalization Process of the Firm—A Model of Knowledge Development and Increasing Foreign Market Commitments," *Journal of International Business Studies* 88 (1977), pp. 23–32.
Jan Johanson and Jan-Erik Vahlne, "The Uppsala Internationalization Process Model Revisited: From Liability of Foreignness to Liability of Outsidership," *Journal of International Business Studies* 40 (2009), pp. 1411–1431.

[13]Jonathan Calof and Paul W. Beamish, "Adapting to Foreign Markets: Explaining Internationalization," *International Business Review* 4 (1995), pp. 115–131.

Figure 1-2 Approaches to Foreign Market Entry



One important set of factors is the assimilation of local market knowledge by the subsidiary unit, as suggested by the Uppsala model. But other, equally important factors to the MNE include its overall level of commitment to the foreign market in question, the required level of control of foreign operations, and the timing of its entry. To help make sense of these different factors, it is useful to think of the different modes of operating overseas in terms of two factors: the level of market commitment made and the level of control needed (see Figure 1-2).

Some companies internationalize by gradually moving up the scale, from exporting through joint venturing to direct foreign investment. Others, like Wal-Mart, prefer to move straight to the high-commitment, high-control mode of operating, in part because they are entering mature markets in which it would be very difficult to build a business from nothing. Still others choose to adopt a low-commitment, low-control mode, such as some "born global" companies. "Born globals" establish significant international operations at or near their founding. Whether this is due to their internal orientation,[14] or the need to move quickly due to the nature of their product or services, such firms do not take such an incremental approach.

One of the most well-known "born globals" of our time is Google. Google was able to make this approach work because it started as an online search company whose users could access its web-based search engine from any country in the world without Google's brick-and-mortar investment in that country. To be clear, none of these approaches is necessarily right or wrong, but they should be consistent with the overall strategic intentions and motivations of the MNE.

[14]Jane Lu and Paul W. Beamish, "Internationalization and Performance of SMEs," *Strategic Management Journal* 22 (2001), pp. 565–586.

Similarly, not all MNEs are large firms. By definition, most large MNEs started out small. Yet many small and medium-sized enterprises (SMEs) retain such a size, while still being MNEs in their own right. Other SMEs, observing a positive impact on performance as a consequence of their FDI activity,[14] will grow.[15]

The Evolving Mentality: International to Transnational

Even from this brief description of the changing motivations for and means of internationalization, it should be clear that a gradual evolution has occurred in the strategic role that foreign operations play in emerging MNEs. We can categorize this evolutionary pattern into four stages that reflect the way in which management thinking has developed over time as changes have occurred in both the international business environment and the MNE as a unique corporate form.

Although such a classification is necessarily generalized and somewhat arbitrary, it enables us to achieve two objectives. First, it highlights that for most MNEs, the objectives that initially induced management to go overseas evolve into a very different set of motivations over time, thereby progressively changing management attitudes and actions. Second, such a classification provides a specific language system that we use throughout this book to describe the very different strategic approaches adopted by various MNEs.[16]

International Mentality

In the earliest stages of internationalization, many MNE managers tend to think of the company's overseas operations as distant outposts whose main role is to support the domestic parent company in different ways, such as contributing incremental sales to the domestic manufacturing operations. We label this approach the *international* strategic mentality.

The *international* terminology derives directly from the international product cycle theory, which reflects many of the assumptions implicit in this approach. Products are developed for the domestic market and only subsequently sold abroad; technology and other sources of knowledge are transferred from the parent company to the overseas operators; and offshore manufacturing represents a means to protect the company's home market. Companies with this mentality regard themselves fundamentally as domestic with some foreign appendages. Managers assigned to overseas operations may be selected because they happen to know a foreign language or have previously lived abroad. Decisions related to the foreign operations tend to be made in an opportunistic or ad hoc manner. Many firms at this stage will prefer to enter only countries where there is low "psychic distance" between it and the home market.

[15]In his Ivey Business Journal article entitled "Growing Big by Targeting Small," Wunker (2012) argues that leaders of internationalizing firms are typically trained to focus on growing their companies in established, large, attractive markets. However, some of the greatest sources of firm growth arise from new markets that start out as small footholds. To support his argument, he provides a table showing that 8 of the 10 most valuable U.S. companies started serving very small new markets that they developed over time. And that following this strategy, they grew along with their markets to become giants.

[16]The terms *international, multinational, global,* and *transnational* have been used very differently—and sometimes interchangeably—by various writers. We want to give each term a specific and different meaning and ask that readers put aside their previous usage of the terms—at least for the duration of this book.

Multinational Mentality

The exposure of the organization to foreign environments and the growing importance of sales and profits from these sources gradually convince managers that international activities can provide opportunities of more than marginal significance. Increasingly, they also realize that to leverage those opportunities, they must do more than ship out old equipment, technology, or product lines that had been developed for the home market. The success of local competitors in the foreign markets and the demands of host governments often accelerate the learning of companies that otherwise would retain an unresponsive, international mentality for too long.

A *multinational* strategic mentality develops as managers begin to recognize and emphasize the differences among national markets and operating environments. Companies with this mentality adopt a more flexible approach to their international operations by modifying their products, strategies, and even management practices country by country. As they develop national companies that are increasingly sensitive and responsive to their local environments, these companies undertake a strategic approach that is literally multinational: Their strategy is built on the foundation of the multiple, nationally responsive strategies of the company's worldwide subsidiaries.

In companies operating with such a multinational mentality, managers of foreign operations tend to be highly independent entrepreneurs, often nationals of the host country. Using their local market knowledge and the parent company's willingness to invest in these growing opportunities, these entrepreneurial managers often can build significant local growth and establish a considerable independence from headquarters.

Global Mentality

Although the multinational mentality typically results in very responsive marketing approaches in the different national markets, it also gives rise to an inefficient manufacturing infrastructure within the company. Plants are built more to provide local marketing advantages or improve political relations than to maximize production efficiency. Similarly, the proliferation of products designed to meet local needs contributes to a general loss of efficiency in design, production, logistics, distribution, and other functional tasks.

In an operating environment of improving transportation and communication facilities and falling trade barriers, some companies adopt a very different strategic approach in their international operations. These companies think in terms of creating products for a world market and manufacturing them on a global scale in a few highly efficient plants, often at the corporate center.

We define this approach as a classic *global* strategy mentality because it views the world, not individual national markets, as its basic unit of analysis. The underlying assumption is that national tastes and preferences are more similar than different, or that they can be made similar by providing customers with standardized products at adequate cost and with quality advantages over those national varieties that they know. Managers with this global strategic approach subscribe to Harvard marketing Professor Theodore Levitt's provocative argument in the mid-1980s that the future belongs to companies that make and sell "the same thing, the same way, everywhere."[17]

This strategic approach requires considerably more central coordination and control than the others and is typically associated with an organizational structure in which various product or business managers have worldwide responsibility. In such companies, R&D and manufacturing activities are typically managed from the headquarters, and most strategic decisions also take place at the center.

Transnational Mentality

In the closing decades of the twentieth century, many of these global companies seemed invincible, chalking up overwhelming victories over not only local competitors but international and multinational ones as well. Their success, however, created and strengthened a set of countervailing forces of localization.

To many host governments, for example, these global companies appeared to be a more powerful and thus more threatening version of earlier unresponsive companies with their unsophisticated international strategic mentality. Many host governments increased both the restrictions and the demands that they placed on global companies, requiring them to invest in, transfer technology to, and meet local content requirements of the host countries.

Customers also contributed to this strengthening of localizing forces by rejecting homogenized global products and reasserting their national preferences—albeit without relaxing their expectations of high quality and low costs that global products offered. Finally, the increasing volatility in the international economic and political environments, especially rapid changes in currency exchange rates, undermined the efficiency of such a centralized global approach.

As a result of these developments, many worldwide companies recognized that demands to be responsive to local market and political needs *and* pressures to develop global-scale competitive efficiency were simultaneous, if sometimes conflicting, imperatives.

In these conditions, the either/or attitude reflected in both the multinational and the global strategic mentalities became increasingly inappropriate. The emerging requirement was for companies to become more responsive to local needs while capturing the benefits of global efficiency—an approach to worldwide management that we call the *transnational* strategic mentality.

In such companies, key activities and resources are neither centralized in the parent company nor so decentralized that each subsidiary can carry out its own tasks on a local-for-local basis. Instead, the resources and activities are dispersed but specialized, to achieve efficiency and flexibility at the same time. Furthermore, these dispersed resources are integrated into an interdependent network of worldwide operations.

In contrast to the global model, the transnational mentality recognizes the importance of flexible and responsive country-level operations—hence the return of the word *national* into the terminology. And compared with the multinational approach, it provides for means to link and coordinate those operations to retain competitive effectiveness and economic efficiency, as is indicated by the prefix *trans*. The resulting need for

[17]See Theodore Levitt, "The Globalization of Markets," *Harvard Business Review,* May–June 1983, pp. 92–102.

intensive, organizationwide coordination and shared decision making implies that this is a much more sophisticated and subtle approach to MNE management. In subsequent chapters, we will explore its strategic, organizational, and managerial implications.

It should be clear, however, that there is no inevitability in either the direction or the endpoint of this evolving strategic mentality in worldwide companies. Depending on the industry, the company's strategic position, the host countries' diverse needs, and a variety of other factors, a company might reasonably operate with any one of these strategic mentalities. More likely, bearing in mind that ours is an arbitrary classification, most companies probably exhibit some attributes of each of these different strategic approaches.[18]

Concluding Comments

This chapter has provided the historical context of the nature of the MNE and introduced a number of important concepts on which subsequent chapters will build. In particular, we have described the evolving set of *motivations* that led companies to expand abroad in the first place; the *means* of expansion, as shaped by the processes of internationalization they followed; and the typical *mentalities* that they developed. Collectively, these motivations, means, and mentalities are the prime drivers of what we call a company's *administrative heritage,* the unique and deeply embedded structural, process, and cultural biases that play an important part in shaping every company's strategic and organizational capabilities. We will explore this concept in more detail in later chapters.

Chapter 1 Readings

- In Reading 1-1, "The Global Entrepreneur: A New Breed of Entrepreneur Is Thinking Across Borders—From Day One," Isenberg describes the unconventional business thinking and behavior of the global entrepreneur; how he or she sees the opportunity in the *distance* challenge; and the challenges he or she faces and the skills he or she needs to succeed.
- In Reading 1-2, "Distance Still Matters: The Hard Reality of Global Expansion," Ghemawat introduces the cultural, administrative, geographic, economic (CAGE) distance framework. The intent of this framework is to help managers understand which attributes create distance, and the impact that this has on various industries.
- In Reading 1-3, the now classic "The Tortuous Evolution of the Multinational Corporation," Perlmutter introduces the primary types of headquarters orientation toward subsidiaries: ethnocentric, polycentric, and geocentric, and the forces that move an organization toward—or away from—a geocentric mindset.

All three readings are intended to underscore the motivations, means, and mentalities required to expand abroad.

[18]Professor Howard Perlmutter was perhaps the first to highlight the different strategic mentalities. See his article, "The Tortuous Evolution of the Multinational Corporation," *Columbia Journal of World Business,* January–February 1969, pp. 9–18, reproduced in the Readings section of this chapter.

Case 1-1 Sher-Wood Hockey Sticks: Global Sourcing

In early 2011, the senior executives of Sher-Wood Hockey (Sher-Wood), the venerable Canadian hockey stick manufacturer, were pondering whether to move the remaining high-end composite hockey and goalie stick production to its suppliers in China. Sher-Wood had been losing market share for its high-priced, high-end, one-piece composite sticks as retail prices continued to fall. Would outsourcing the production of the iconic Canadian-made hockey sticks to China help Sher-Wood to boost demand significantly? Was there any other choice?

The History of Ice Hockey[1]

From the time of early civilization in places as diverse as Rome, Scotland, Egypt and South America, the "ball and stick" game has been played. The game has had different names, but its basic idea has been the same; the Irish, for instance, used the word "hockie" to refer to the sport. Some reports trace the origins of the game to 4,000 years ago, but it has survived to the present.

The modern version of ice hockey emerged from the rules laid down by two Canadians, James Creighton and Henry Joseph, when they studied at McGill University in the late nineteenth century. Their rules were used in the first modern game, which was played in Montreal, Quebec in 1875. In 1892, Canada's governor general, Lord Stanley, introduced the game's first national title, the "Lord Stanley's Dominion Challenge Trophy," later simply referred to as the Stanley Cup. In 1917, the National Hockey League (NHL) was founded in Montreal.

Ice hockey found its way to the United States in 1893. By the early 1900s, it had also become prevalent in Europe. Ice hockey was played as a part of the Olympic Summer Games for the first time in April 1920 in Antwerp, Belgium.

By the late twentieth century, ice hockey represented an important source of national pride to Canadians, and it had become popular in other countries in the northern hemisphere, especially the United States, Czech Republic, Finland, Russia and Sweden.

Ice Hockey Stick[2]

In ice hockey, players use specialized equipment both to facilitate their participation in the game and for protection from injuries. The equipment can be classified into five categories: goalie, head/face (helmet, neck guard), protective (shoulder pads, shin pads, elbow pads, hockey pants and gloves), sticks and skates. "Head-to-toe equipment suppliers" typically offered all equipment except for goalie equipment. Among the five categories of equipment, sticks and skates drove the industry, accounting for almost two-thirds of global equipment sales.[3]

A hockey stick is a piece of equipment used in ice hockey to shoot, pass and carry the puck. It is composed of a long, slender shaft with a flat extension

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Megan (Min) Zhang wrote this case under the supervision of Professor Paul W. Beamish solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

[1]Summarized from Jacqueline L. Longe, *How Products Are Made (Volume 4)* (Farmington Hills: Gale Research,1998); http://www.historyhockey.net, accessed on July 18, 2011; http://www.mcgilltribune.com, accessed on July 18, 2011; and http://www.madehow.com, accessed on July 18, 2011.

[2]Summarized from J. L. Longe, *How Products Are Made,* 1999, http://www.prohockeystuff.com, accessed on July 18, 2011; and http://www.nhlhockeyice.com, accessed on July 18, 2011.

[3]http://www.thehockeysource.tv, accessed on July 18, 2011.

at one end called the blade. The goaltender (goalie) has a slightly modified shaft with a wider paddle. Hockey stick dimensions can vary to suit a player's comfort, size, usage and stickhandling skills.

Hockey sticks are manufactured either as one-piece sticks with the blade permanently fused to the shaft or as two-piece sticks, where the blade and shaft are made as separate pieces that are joined later in the manufacturing process. One-piece hockey sticks emerged more recently with the advent of new component materials.

The three qualities that players seek in a hockey stick are lightness, responsiveness and "the feel." There were three characteristics which professional players looked for: lie, flex and blade pattern. The lie of a stick refers to the angle between the shaft and the blade. Players usually seek a lie that will put the blade flat on the ice when they are in their skating stance. Hockey stick shafts are highly flexible, and this flexibility is a key component in their performance. Flex, bend, stiffness and whip are all terms used to describe the amount of force required to bend a given length of stick shaft.

Until the late 1950s, hockey stick blades were rarely curved. However, in the 1960s, players began asking their stick manufacturers to create sticks with pre-curved blades for better performance. Soon after, many NHL players became proponents of the "banana blade." In 2011, the legal limit for hockey blade curves in the NHL was 19 mm, or ¾ of an inch. In addition, players generally expected a hockey stick to be light enough to use easily and flexibly.

To satisfy these qualities, the greatest change came in the materials used to make a hockey stick. One consequence of employing more advanced (composite) materials was that the manufacturing process became more complicated and required more innovations. Custom designs were prevalent among professional players who wanted their sticks to fit their own physical features (i.e., height and strength) and skills.

The three primary materials for manufacturing hockey sticks were wood, aluminum and composite. The earliest hockey sticks were made with solid wood. These sticks were not very durable and were inconsistent in length and shape. In the 1940s, laminated sticks were created with layers of wood glued together to create a more flexible and durable design. In the 1960s, manufacturers began adding additional fibreglass lamination or other synthetic coatings, which further enhanced the durability of the sticks.

In the early 1980s, Easton Hockey introduced single piece, all-aluminum sticks that were much lighter than wooden sticks. Because the stiff aluminum did not have the proper "feel" to players, manufacturers then developed a light aluminum shaft with a replaceable wooden blade. The design became popular in the late 1980s and early 1990s.

In the mid-1990s, advanced composite sticks were developed. Composites were comprised of reinforcing fibres, such as graphite (carbon) and Kevlar, and binders such as polyester, epoxy or other polymeric resins that held the fibres together. In the following decade, graphite had become by far the most popular material for sticks used in the NHL, and it was growing rapidly in popularity for amateur and recreational players. Although graphite sticks were originally sold as shafts alone while a separate blade was purchased by the hockey player, one-piece sticks that included both the shaft and the blade eventually predominated. Some manufacturers also used titanium to produce composite sticks. Moreover, Sher-Wood used foam materials, such as polyurethane, to fill blades and paddles of goalie sticks for shock absorption and stiffness.

New, lighter and more durable composites were always being developed. Ice hockey sticks, roller hockey sticks, lacrosse sticks, baseball bats, softball bats and hockey skates required similar technologies to manufacture because almost all of these athletic products incorporated composite materials. R&D, manufacturing and quality control processes continued to advance in the industry. Increasingly, precise technologies were employed throughout the production process.

For most composite and aluminum sticks, the stick's flex characteristic was expressed numerically. This number, which ranged from 50 through 120, was printed on the stick and corresponded to the amount of force (in pounds-force) that it took to deflect or bend the shaft one inch. By contrast, the flex characteristic of their wooden counterparts could not be derived precisely, because the sticks were produced using a high-volume production process that yielded sticks with variable flex properties.

Basics of Hockey Equipment Industry[4]

According to most industry analysts, the global hockey equipment market was showing signs of maturity, growing at just 1 to 2 per cent per annum.[5] The global hockey equipment market in 2010 was $555 million, with skates and sticks accounting for an estimated 62 per cent of industry sales.

Ice hockey equipment sales were driven primarily by global ice hockey participation rates (registered and unregistered). There were about 600,000 hockey players in Canada in 2010. The number of registered hockey players in Canada between the ages of 5 and 25 was expected to shrink by 30,000 players, or 5 per cent, over the next five years. Nevertheless, some industry analysts believed that growth rates of casual and unregistered hockey participation, especially in the United States, as well as growth rates in Eastern Europe (particularly Russia) and women's hockey had exceeded that of the registered segment as a whole. Other drivers of equipment sales included demand creation efforts, the introduction of innovative products, a shorter product replacement cycle, general macroeconomic conditions and the level of consumer discretionary spending.

Relative to European football (soccer) or American baseball, all of the equipment required to participate in organized hockey was more expensive to purchase. Outfitting a teenager or an adult to play recreational hockey cost approximately $600. The equipment for younger players was less expensive. However, nearly 40 per cent of all ice hockey players lived in homes where the annual household income was more than $100,000 per year.

The hockey sticks endorsed by professional hockey players enjoyed a strong position in the hockey stick market. Children and amateur players liked to have sticks embossed with specific players' names. Hockey stick manufacturers typically paid NHL players to use their sticks and provided the players with custom designed sticks.

Competitor Brands and Strategies[6]

Before a Montreal company began manufacturing ice hockey sticks in the late 1880s, most players made their own. By the early twenty-first century, more than 20 brands of ice hockey sticks existed in North America and Europe, and many of the smaller equipment manufacturers had failed or been purchased by larger competitors. The main brands were Easton (Easton-Bell Sports), Bauer (Bauer Performance Sports), CCM (Reebok-CCM Hockey), Warrior (Warrior Sports), Sher-Wood (Sher-Wood Hockey), Mission ITECH (acquired by Bauer) and Louisville/TPS (acquired by Sher-Wood). Bauer, CCM and Sher-Wood originated in Canada, and Easton and Warrior originated in the United States.

Over 80 per cent of the ice hockey equipment market was shared by three major competitors: Bauer, Reebok (which owned both the Reebok and CCM brands) and Easton, each of which was a head-to-toe supplier offering players a full range of products (skates, sticks and full protective equipment). Moreover, Bauer and Reebok also provided goalie equipment. The balance of the equipment market was highly fragmented with many smaller equipment manufacturers, such as Warrior and Sher-Wood, offering specific products and

[4] Summarized from Preliminary Prospectus of Bauer Performance Sports Ltd. (January 27, 2011), http://www.secure.globeadvisor.com/servlet/ArticleNews/story/gam/20110614/GIVOXBAUERMILSTEADATL, accessed on July 18, 2011; http://www.sgma.com/press/93_Sanctioned-Team-Sports-Play-In-the-US-Remains-Strong-But, accessed on July 18, 2011; and http://www.ehow.com/way_5191903_ice-hockey-equipment-guide.html, accessed on July 18, 2011.

[5] Source: https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20110614/GIVOXBAUERMILSTEADATL, accessed on July 18, 2011.

[6] Summarized from Preliminary Prospectus of Bauer Performance Sports Ltd., http://www.fundinguniverse.com, accessed on July 18, 2011; http://www.eastonbellsports.com, accessed on July 18, 2011; http://www.bauer.com, accessed on July 18, 2011; http://www.sher-wood.com, accessed on July 18, 2011; http://www.adidas-group.corporate-publication.com, accessed on July 18, 2011; http://www.warrior.com, accessed on July 18, 2011; http://www.stickshack.com, accessed on July 18, 2011; and http://www.hockeystickexpert.com, accessed on July 18, 2011.

Exhibit 1 NHL Share of Hockey Stick Brands and Their Manufacturing Sites

Company	NHL Share	Manufacturing Sites
Easton	45.1%	Tijuana, Mexico, and China
Bauer	15.7%	Composite sticks made in China and Thailand
RBK/CCM	13.7%	Composites sticks in China, wooden sticks in Canada and Finland
Warrior	11.8%	Tijuana, Mexico (insourcing), China (outsourcing)
Sher-Wood	2.3%	Composite, high-end wood goalie sticks in Canada and China, most wood stick production in Eastern Europe
Louisville TPS, Mission, and others	11.4%	N/A

Source: http://www.usatoday.com/, January 2008, accessed on May 29, 2011.

catering to niche segments within the broader market. **Exhibit 1** lists the proportion of NHL players using sticks made by the five major suppliers. Each of the five major companies sought new growth in diverse categories.

Easton-Bell Sports operated divisions dedicated to hockey, baseball, lacrosse and softball. Easton established itself as a worldwide leader in designing, developing and marketing performance sports equipment, as well as a broad spectrum of accessories for athletic and recreational activities. Easton Hockey's technical prowess made its stick the number one choice among NHL players and amateurs alike and kept its gloves, skates and helmets at the forefront of technological advance. For years, Easton Hockey had signed head-to-toe contract extensions with NHL players. Easton's innovation processes followed a unique routine—developing new technologies for composite ice hockey sticks first and then applying the advances in materials to skates, baseball bats and softball bats. In 2011, Easton-Bell offered 48 types of player and goalie sticks in its Synergy and Stealth lines. Easton-Bell's net sales for 2006 were $639 million compared to $379.9 million in 2005, an increase of 68 per cent. Gross profit for 2006 was $212.9 million or 33.3 per cent of net sales, as compared to $134.9 million or 35.5 per cent of net sales for 2005.

Bauer Performance Sports manufactured ice hockey, roller hockey and lacrosse equipment as well as related apparel. Bauer was focused on building a leadership position and growing its market share in all ice hockey and roller hockey equipment products through continued innovation at all performance levels. It produced products at competitive prices using alternative materials, sourcing arrangements and supply-chain efficiencies. It also targeted emerging and underdeveloped consumer segments, including Russian players and female players. In 2008, Bauer Performance implemented several strategic acquisitions to enter new industries and to enhance its market leadership in its chosen categories. In 2011, Bauer offered 20 types of player and goalie sticks in its Supreme and Vapor lines. Bauer was the number one manufacturer of skates, helmets, protective gear and goalie equipment, and a close number two to Easton of sticks in 2010. It enjoyed a 45 per cent share of the global hockey equipment market. Bauer's profit margin as a percentage of net revenues was 37 per cent.

Reebok-CCM Hockey concentrated on providing hockey equipment and apparel. The company leveraged its multi-brand approach to target different consumer segments. In particular, it developed innovative technologies that appealed to image-conscious consumers. Its products were best suited to the physical side of the game and were frequently purchased by consumers seeking performance and quality. In 2011, they offered 32 types of player and goalie sticks. Reebok-CCM's net sales in

Exhibit 2 Types of Global Sourcing

	Insourcing	Outsourcing
Offshoring	Keeping work in a wholly owned subsidiary in a distant country.	Contracting work with a service provider in a distant country.
Near-shoring	Keeping work in a wholly owned subsidiary in a neighbouring country.	Contracting work with a service provider in a neighbouring country
On-shoring	Keeping work in a wholly owned subsidiary in the home country.	Contracting work with a service provider in the home country.

Source: Derived from Oshri, Korlarksy, and Willcocks, *The Handbook of Global Outsourcing and Offshoring,* 2009; Macmillan Publishers.

2010 were $280 million, and its key markets were Canada, the United States, Scandinavia and Russia.

Warrior Sports concentrated on providing lacrosse and ice hockey equipment, apparel and footwear. The company was dedicated to a core set of philosophies and strengths: technical superiority, grassroots marketing, original and creative youthful expression, and strong partnerships with retailers and suppliers. In 2011, Warrior offered 15 types of player and goalie sticks.

Generally, hockey companies provided one type of hockey sticks at three different price points—junior, intermediate and senior. The reference retail prices of the five competitors' best senior composite sticks varied. The Bauer Supreme TotalOne Composite, Easton Stealth S19 Composite and Warrior Widow Composite Senior were all priced at $229.99. The CCM U+ Crazy Light Composite and Reebok 11K Sickkick III Composite came in at $209.99, while the Sher-Wood T90 Pro Composite was priced at $139.99.[7]

Global Sourcing in the Hockey Equipment Industry

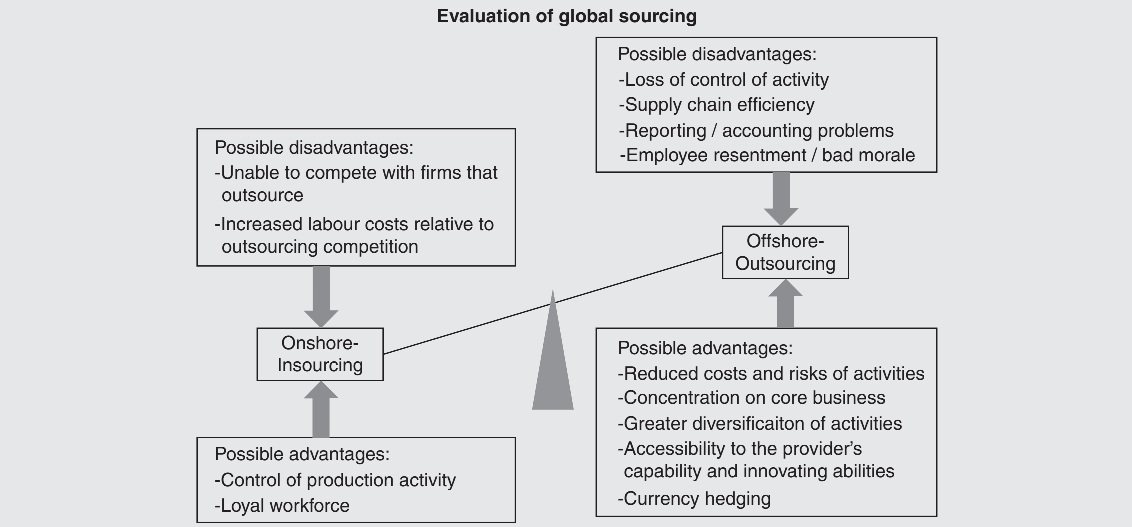
Similar to other industries, the hockey industry eventually entered the global sourcing era. Global sourcing is the process by which the work is contracted or delegated to a company that may be situated anywhere in the world.[8] Sourcing activities can be categorized along both organizational and locational dimensions (**Exhibit 2** lists several types of global sourcing). From an organizational perspective, the choice between insourcing and outsourcing involves deciding whether to keep the work within the firm or contract it out to an independent service provider. From a locational perspective, three choices are available—onshoring (within the nation), nearshoring (to a neighbouring country) and offshoring (to a geographically distant country). To optimize the overall benefits and hedge risks, companies often seek to balance their global outsourcing and insourcing activities. **Exhibit 3** lists several of the factors typically considered by manufacturers faced with the decision of whether to onshore insource or offshore outsource.

As early as the 1980s, western sports equipment manufacturers, such as Nike and Reebok, started to outsource the manufacture of sporting goods, such as running shoes, to Asia. Nevertheless, before the year 2000, hockey companies preferred insourcing over outsourcing and executed this strategic focus through organic growth, strategic acquisitions and establishing company-owned factories in other countries; for example, Easton and Warrior had factories in Tijuana, Mexico. During the past decade, the hockey industry began to outsource. In 2004, Bauer Nike Hockey shut down or downsized three plants in Ontario and Quebec, eliminating 321 manufacturing jobs. The company outsourced about 90 per cent of its production to other makers

[7]Source for all, http://www.amazon.com, accessed on May 29, 2011.

[8]This paragraph is summarized from Ilan Oshri, Julia Kotlarsky, and Leslie P. Willcocks, *The Handbook of Global Outsourcing and Offshoring* (Hampshire: Macmillan, 2009); and Marc J. Schniederjans, Ashlyn M. Schniederjans, and Dara G. Schniederjans, *Outsourcing and Insourcing in an International Context* (New York: M.E. Sharpe, 2005).

Exhibit 3 Evalution of Global Sourcing



Source: Adapted from Schniederjans, Schniederjans, and Schniederjans, *Outsoucing and Insourcing in an International Context,* 225; M.E. Sharpe.

in Canada and the rest to international suppliers. From 2002 to 2008, Reebok-CCM closed five plants in Ontario and Quebec and outsourced manufacturing to other countries, eliminating about 600 manufacturing jobs. Easton and Warrior also outsourced part of their manufacturing to Asia but still kept their factories in Mexico. The capacity of Warrior's Mexican factory was estimated to be 4,000 composite sticks per week produced by 250 employees in 2008. (Exhibit 1 lists the manufacturing sites associated with several of the leading hockey stick brands.)

Global manufacturing outsourcing was characterized by some drawbacks. It separated manufacturing activities from R&D and marketing activities and challenged a company's ability to coordinate initiatives between these functions, such as product innovation, designing for manufacturability, supply chain efficiency and quality control. Especially in offshore outsourcing, cultural differences caused miscommunication, technology distance necessitated extra training, and geographic distance resulted in extra lead time or cycle time.[9] In March 2010, Bauer Hockey recalled 13 models of junior hockey sticks, manufactured outside of Canada, due to excessive lead levels in the sticks' paint that was detected by public health officials in random testing.

Offshore outsourcing also threatened to negatively impact a company's public image if it reduced domestic employment. In November 2008, UNITE HERE[10] launched a national campaign to persuade Reebok to repatriate the production of its hockey equipment and jerseys.[11]

Additionally, global economic dynamics, such as changing labour costs, raw material costs and exchange rates, introduced new uncertainties into global sourcing. **Exhibit 4** lists a sample of comparative labour rates prevailing in Canada, the United States, Mexico and China. In 2011, the Boston Consulting Group (BCG) concluded that with Chinese wages rising and the value of the Yuan

[9] This paragraph is summarized from Masaaki Kotabe, *Global Sourcing Strategy: R&D, Manufacturing, and Marketing Interfaces* (New York: Quorum Books, 1992.)

[10] UNITE HERE: a union representing 50,000 food service, apparel, textile, hotel and distribution workers across Canada.

[11] http://www.cbc.ca/news/story/2010/03/18/nike-hockeystick-recall.html, accessed on July 18, 2011.

Exhibit 4 Hourly Compensation Costs in Manufacturing (US$)

Year	China (urban)	China[1]	Canada	USA	Mexico	Estonia	Finland
2002	0.95	0.41	18.39	27.01	5.33	3.09	22.65
2003	1.07	0.44	21.49	28.18	5.06	4.07	28.15
2004	1.19	0.45	24.14	28.94	5.02	4.81	32.50
2005	1.30	0.49	26.81	29.74	5.36	5.44	33.72
2006	1.47	0.53	29.21	29.98	5.59	6.43	35.27
2007	1.83	0.64	31.92	31.51	5.87	8.49	39.45
2008	2.38	0.82	32.70	32.23	6.12	10.34	44.68
2009	N/A	N/A	29.60	33.53	5.38	9.83	43.77

[1]The data is for town or village.
Source: http://www.bls.gov, accessed on July 18, 2011.

continuing to increase, the gap between U.S. and Chinese wages was narrowing rapidly.

Industries other than sporting goods had already begun to practice repatriating manufacturing, also known as reshoring or backshoring. In fact, reshoring had been an alternative in global sourcing planning from the beginning. For German manufacturing companies in the period 1999 to 2006, every fourth to sixth offshoring activity was followed by a reshoring activity within the following four years, mainly due to lack of flexibility and quality problems at the foreign location. This served as a short-term correction of the prior location misjudgement rather than a long-term reaction to slowly emerging economic trends.[12]

Sher-Wood Hockey Inc.: Company Timeline[13]

Sher-Wood Hockey Inc. manufactured and distributed hockey sticks and equipment in Canada. Based in Sherbrooke, Quebec, it was founded in 1949 and was formerly known as Sherwood-Drolet, Ltd. For more than 60 years, it had been one of Canada's best-known hockey equipment manufacturers. In 1976, Sherwood-Drolet introduced its flagship wooden stick, the PMP 5030, which was described as "the best stick in the world" by NHL legend Guy Lafleur. By 2007, the company had made more than 6 million PMP 5030s.

In 2006, Sherwood-Drolet sold about one million wooden and 350,000 composite sticks. The company anticipated that the composite stick business would continue to grow in terms of volume and profitability. Earlier, Sherwood-Drolet had started contracting out the production of its lower end wooden models to producers in Estonia and China. In 2007, it outsourced the production of PMP 5030 (mid to high end wooden) sticks to a local provider in Victoriaville, Quebec. Meanwhile, the company concentrated on making composite sticks fashioned from graphite, Kevlar and other synthetics. Notwithstanding the company's efforts to move its wooden stick production offshore, it claimed that it would continue to make custom wooden models for professional hockey players, such as Jason Spezza of the Ottawa Senators.

However, when Spezza learned that Sherwood-Drolet would no longer be manufacturing his favourite wooden sticks in Canada, he decided to move to another company. "They [local manufacturers] can get sticks to me in a week now. If it's over there [China], the process will probably be just too much," said Spezza.[14] Ultimately, Montreal-based

[12]Source: S. Kinkel and S. Maloca. "Drivers and Antecedents of Manufacturing Offshoring and Backshoring: A German Perspective," *Journal of Purchasing and Supply Management* 15.3 (2009): 154–65.

[13]Summarized from http://www.sher-wood.com, accessed on July 18, 2011; http://hockeystickexpert.com, accessed on July 18, 2011; http://www.canada.com/topics/sports/story.html?id=87c5d6b3-8872-496a-8d4f-01f5f4e36342, accessed on July 18, 2011; and http://www.thestar.com/News/Canada/article/273561, accessed on July 18, 2011.

[14]http://www.canada.com/topics/sports/story.html?id=87c5d6b3-8872-496a-8d4f-01f5f4e36342, accessed on July 18, 2011

Reebok designed and produced a stick for him that had a graphite shaft and wooden blade, but the look of a one-piece. In November 2008, Reebok issued a press release announcing that Spezza would start using their sticks, ". . . we are excited to work with Jason, not only on marketing initiatives, but also on the research, design and development of future Reebok Hockey equipment."[15]

By May 2008, Sherwood-Drolet had filed a proposal to its creditors under the Bankruptcy and Insolvency Act. CBC News reported, "It has been hurt in recent years by shift from wooden hockey sticks to composite sticks."[16] Richmond Hill, Ontario-based Carpe Diem Growth Capital bought the company and changed its name to Sher-Wood Hockey Inc.

In September 2008, Sher-Wood purchased the hockey novelty and licensed assets of Inglasco. In December that same year, it purchased TPS Sports Group, a leading manufacturer and distributor of hockey sticks and protective equipment. Sher-Wood transported TPS's assets from Wallaceburg and Strathroy, Ontario to Quebec, consolidated three companies and invested an additional $1.5 million to set up the new factory.

Production

As of March 2011,[17] Sher-Wood produced sticks (sticks, shafts, blades), protective equipment (gloves, pants, shoulder pads, elbow pads, shin pads), goalie gear (goalie pads, catcher, blocker, knee protector, arm and body protector, pants) and other accessories (pucks, bags, puck holders, mini sticks, bottles, carry cases) for ice hockey. The company also sold some equipment and accessories for street hockey (goalie kit, sticks, pucks, balls), as well as sports novelties for hockey fans.

The company introduced new sticks twice a year—in May/June and at the end of October. The life cycle of a product line in the market was about 18 to 24 months. By the end of 2010, Sher-Wood provided 27 types of player and goalie sticks. Thirteen of them were wooden.

Although Sher-Wood had targeted various NHL players in order to support the credibility of the brand, the company mostly targeted junior teams, AAA teams and a couple of senior leagues. Sher-Wood only conducted a low volume of custom design for high-end players and mainly provided custom products from a cosmetic standpoint. For example, personalizing the graphic or colour of the sticks. Sher-Wood used to need two to three weeks to produce customized sticks for an NHL player.

In 2010, Sher-Wood sales volume for sticks produced in Sherbrooke dropped almost 50 per cent compared to 2009. Its Chinese partners manufactured most of their composite hockey sticks. Sher-Wood's plant manufactured the remaining high-end, one-piece composite sticks and goalie foam sticks, about 100,000 units annually, with 33 workers in the factory and seven staff in the office. The return on investment of the fixed cost in Canada was low.

Executives believed that they needed to provide a competitive retail price to boost the demand. To do so, they also needed to afford retailers a higher margin than their competitors did, so that retailers would help with product presentations in stores and marketing efforts. These approaches called for low cost production as well as decent quality. To reduce the cost and fully utilize the facilities, they could outsource the remaining production to the partner based in Victoriaville and move facilities there. However, according to regulations in Quebec, Sher-Wood did not have enough latitude to move or sell the equipment to their subcontractor in Quebec. They also considered backshoring the manufacturing out of China. They concluded that it would be more advantageous to stay in China from both cost reduction and R&D standpoints.

Chinese Partners' Condition and Collaboration

Sher-Wood's suppliers were located in Shanghai, Shenzhen and Zhongshan City near Hong Kong. They were producing tennis and badminton rackets,

[15] http://www.reebokhockey.com/labs/labs-blog/entries/2008/Nov/25/entry/jason-spezza-reebok-hockey-family/, accessed on July 18, 2011.
[16] http://www.cbc.ca/news/business/story/2008/05/05/sherwood-filing.html?ref=rss, accessed on July 18, 2011.
[17] Summarized from http://www.sher-wood.com, accessed on May 29, 2011.

developing the expertise in composite technology and relevant sporting goods production. Sher-Wood began to cooperate with them about 10 years ago when it started selling composite sticks. For years, these suppliers manufactured one-piece and two-piece composite hockey sticks for hockey companies around the world. Gradually, they accumulated manufacturing capacity and R&D capability. Sher-Wood's main supplier in Zhongshan City operated two shifts for 10 hours a day, six days a week. Their annual capacity was more than 1 million units. Moreover, they possessed an R&D team with 10 to 15 engineers, which was able to produce a prototype within one day with full information. On the contrary, it would cost Sher-Wood four to five months with a team of two to three engineers to produce a similar prototype. More importantly, as a consequence of their long-term cooperation, the main supplier had developed a certain feeling about hockey so that language and cultural barriers were not problems any more. "They were becoming a partner rather than one section within the supply chain," said Eric Rodrigue, Sher-Wood's marketing vice president.

Sher-Wood and its Chinese supplier partner needed to collaborate closely. On one hand, Sher-Wood had to send their experts to China to coach the partner about how to produce sticks according to their specifications. On the other hand, although Sher-Wood and the partner had similar on-site labs to conduct product tests, Sher-Wood mainly focused on the feeling of the stick, that is, the reproduction of how the slap shot, passes, reception, etc., would feel when a player placed his or her hands a certain way on the stick. Sher-Wood also conducted tests on ice with professional players, something their supplier could not do.

Moreover, with young, passionate and knowledgeable new managers in management and marketing, company executives thought they were ready to meet the extra cost and effort in market collaboration between Sher-Wood, the partner in China and retailers.

Company executives were concerned with rising labour costs, material costs and the currency exchange rate in China. Nevertheless, the overall cost of manufacturing in China was still lower than the cost in Quebec. They estimated that cost reduction was 0 to 15 per cent per unit depending on the model, with good quality and fast turnaround time. Moreover, some industries such as textiles had started to relocate their manufacturing to new emerging countries, such as Vietnam and Cambodia, for low labour and equipment costs; however, there was no R&D advantage in composite materials in these alternative locales.

Executives were also concerned with other issues. First, although the main supplier was able to produce customized sticks for an NHL player within 24 hours, the shipping was quite expensive from China to Quebec. Second, the main supplier used to produce huge volumes fast but without product personalization. Third, the game of hockey was perceived as a Western cultural heritage sport, so anything relevant to hockey which was made in China had the potential to negatively influence the market perception. However, all their competitors had outsourced manufacturing to China for years.

The Challenge

In early 2011, the question for Sher-Wood senior executives was how to boost their hockey stick sales. They believed that they should cope with this challenge by providing sticks with better quality, better retail price and better margin for retailers. They wondered whether they should move the manufacturing of the remaining high-end composite sticks to their suppliers in China or whether there was any alternative.

If they decided to shift their remaining manufacturing outside of the company, they needed to deal with a variety of issues. To fully utilize the facilities in Sherbrooke, they needed to move equipment to China, which was difficult and time-consuming because of export regulations. To set up the manufacturing machines and guide the manufacturing team, they would need to send experts there. To complete the coming hockey season between September and April but still implement the decision, they needed to plan every phase precisely. They also needed to figure out what to say and do about the 40 affected employees. Many had worked for Sher-Wood for more than 30 years, and their average age was 56. How could this be communicated to the public? They needed to make a final decision soon.

Case 1-2 Jollibee Foods Corporation (A): International Expansion

Christopher A. Bartlett

Protected by his office air conditioner from Manila's humid August air, in mid-1997, Manolo P. ("Noli") Tingzon pondered an analysis of demographic trends in California. As the new head of Jollibee's International Division, he wondered if a Philippine hamburger chain could appeal to mainstream American consumers or whether the chain's proposed U.S. operations could succeed by focusing on recent immigrants and Philippine expatriates. On the other side of the Pacific, a possible store opening in the Kowloon district of Hong Kong raised other issues for Tingzon. While Jollibee was established in the region, local managers were urging the company to adjust its menu, change its operations, and refocus its marketing on ethnic Chinese customers. Finally, he wondered whether entering the nearly virgin fast food territory of Papua New Guinea would position Jollibee to dominate an emerging market—or simply stretch his recently-slimmed division's resources too far.

With only a few weeks of experience in his new company, Noli Tingzon knew that he would have to weigh these decisions carefully. Not only would they shape the direction of Jollibee's future internalization strategy, they would also help him establish his own authority and credibility within the organization.

Professor Christopher A. Bartlett and Research Associate Jamie O'Connell prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Company History

Started in 1975 as an ice cream parlor owned and run by the Chinese-Filipino Tan family, Jollibee had diversified into sandwiches after company President Tony Tan Caktiong (better known as TTC) realized that events triggered by the 1977 oil crisis would double the price of ice cream. The Tans' hamburger, made to a home-style Philippine recipe developed by Tony's chef father, quickly became a customer favorite. A year later, with five stores in metropolitan Manila, the family incorporated as Jollibee Foods Corporation.

The company's name came from TTC's vision of employees working happily and efficiently, like bees in a hive. Reflecting a pervasive courtesy in the company, everyone addressed each other by first names prefaced by the honorific "Sir" or "Ma'am," whether addressing a superior or subordinate. Friendliness pervaded the organization and become one of the "Five Fs" that summed up Jollibee's philosophy. The others were flavorful food, a fun atmosphere, flexibility in catering to customer needs, and a focus on families (children flocked to the company's bee mascot whenever it appeared in public). Key to Jollibee's ability to offer all of these to customers at an affordable price was a well developed operations management capability. A senior manager explained:

> It is not easy to deliver quality food and service consistently and efficiently. Behind all that fun and friendly environment that the customer experiences is a well oiled machine that keeps close tabs on our day-to-day operations. It's one of our key success factors.

Jollibee expanded quickly throughout the Philippines, financing all growth internally until 1993. (**Exhibit 1** shows growth in sales and outlets.)

Exhibit 1 Jollibee Philippines Growth, 1975–1997

Year	Total Sales (millions of pesos)	Total Stores at End of Year	Company-Owned Stores	Franchises
1975	NA	2	2	0
1980	NA	7	4	3
1985	174	28	10	18
1990	1,229	65	12	54
1991	1,744	99	21	80
1992	2,644	112	25	89
1993	3,386	124	30	96
1994	4,044	148	44	106
1995	5,118	166	55	113
1996	6,588	205	84	124
1997 (projected)	7,778	223	96	134

NA = Not available

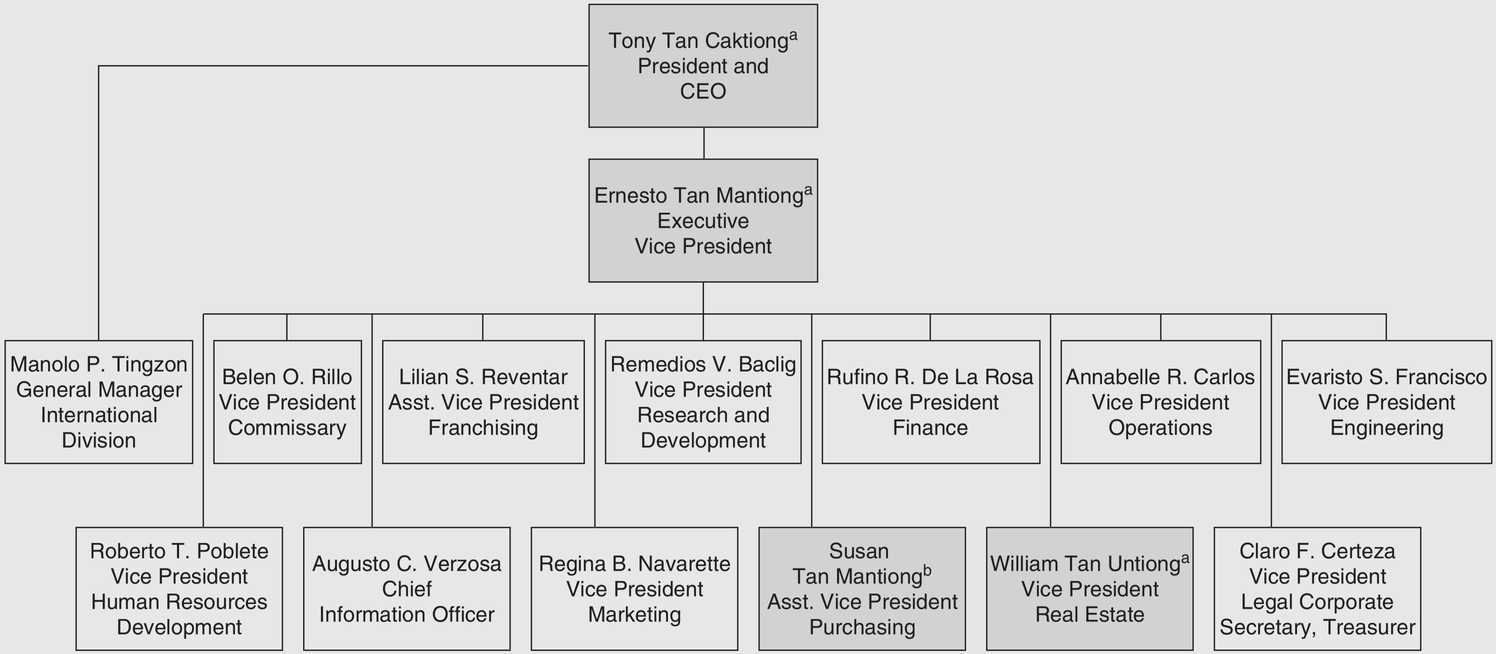
Tan family members occupied several key positions particularly in the vital operations functions, but brought in professional managers to supplement their expertise. "The heads of marketing and finance have always been outsiders," TTC noted. (**Exhibit 2** shows a 1997 organization chart.) Many franchisees were also members or friends of the Tan family.

In 1993, Jollibee went public and in an initial public offering raised 216 million pesos (approximately US $8 million). The Tan family, however, retained the majority ownership and clearly controlled Jollibee. Although the acquisition of Greenwich Pizza Corporation in 1994 and the formation of a joint venture with Deli France in 1995 diversified the company's fast food offerings, in 1996 the chain of Jollibee stores still generated about 85% of the parent company's revenues. (**Exhibit 3** and **4** present Jollibee's consolidated financial statements from 1992 through 1996.)

McDonald's: Going Burger to Burger The company's first serious challenge arose in 1981, when McDonald's entered the Philippines. Although Jollibee already had 11 stores, many saw McDonald's as a juggernaut and urged TTC to concentrate on building a strong second-place position in the market. A special meeting of senior management concluded that although McDonald's had more money and highly developed operating systems, Jollibee had one major asset: Philippine consumers preferred the taste of Jollibee's hamburger by a wide margin. The group decided to go head to head with McDonald's. "Maybe we were very young, but we felt we could do anything," TTC recalled. "We felt no fear."

McDonald's moved briskly at first, opening six restaurants within two years and spending large sums on advertising. Per store sales quickly surpassed Jollibee's and, by 1983, McDonald's had grabbed a 27% share of the fast food market, within striking range of Jollibee's 32%. The impressive performance of the Big Mac, McDonald's largest and best-known sandwich, led Jollibee to respond with a large hamburger of its own, called the Champ. Jollibee executives bet that the Champ's one wide hamburger patty, rather than the Big Mac's smaller two, would appeal more to Filipinos' large appetites. Market research indicated that Filipinos still preferred Jollibee burgers' spicy taste to McDonald's plain beef patty, so the Champ's promotions focused on its taste, as well as its size.

Exhibit 2 Jollibee Corporation Organization Chart, 1997 (members of Tan family shaded)



[a]Brothers.
[b]Spouse of Ernesto Tan Mantiong.

Exhibit 3 Jollibee Foods Corporation Consolidated Balance Sheets (in Philippine pesos)

	Years Ended December 31,				
	1996	**1995**	**1994**	**1993**	**1992**
Assets					
Current assets					
Cash and cash equivalents	480,822,919	355,577,847	474,480,298	327,298,749	116,716,643
Accounts receivable:					
Trade	579,089,680	206,045,303	135,663,597	107,680,327	86,885,668
Advances and others	105,836,646	70,731,546	66,224,534	35,838,295	15,091,648
Inventories	323,019,198	201,239,667	183,154,582	135,263,988	116,828,086
Prepaid expenses and other current assets	223,680,221	132,077,935	88,995,824	41,462,780	66,028,987
Total current assets	1,712,448,664	965,672,298	948,518,835	647,544,139	401,551,032
Investments and advances	283,758,590	274,878,713	132,277,028	67,000,362	60,780,936
Property and equipment	2,177,944,193	1,181,184,783	753,876,765	568,904,831	478,857,474
Refundable deposits and other assets—net	363,648,234	224,052,247	91,575,543	92,035,464	72,310,079
Total assets	4,537,799,681	2,645,788,041	1,926,248,171	1,375,484,796	1,013,499,521
Liabilities and Stockholders' Equity					
Current liabilities:					
Bank loans	771,690,724	—	—	—	—
Accounts payable and accrued expenses	1,274,801,219	715,474,384	497,238,433	323,029,967	297,029,436
Income tax payable	58,803,916	28,103,867	17,205,603	23,206,109	19,851,315
Notes payable	—	—	—	—	133,000,000
Current portion of long-term debt	6,707,027	7,524,098	—	—	22,034,635
Dividends payable	16,810,812	—	—	—	—
Total current liabilities	2,128,813,698	751,102,349	514,444,036	346,236,076	471,915,386
Long-term debt	28,936,769	33,725,902	—	—	21,127,827
Minority interest	45,204,131	1,479,723	1,331,529	—	—
Stockholders' equity					
Capital stock—par value	880,781,250	704,625,000	563,315,000	372,000,000	66,000,000
Additional paid-in capital	190,503,244	190,503,244	190,503,244	190,503,244	—
Retained earnings	1,263,560,589	964,351,823	656,654,362	466,745,476	454,456,308
Total stockholders' equity	2,334,845,083	1,859,480,067	1,410,472,606	1,029,248,720	520,456,308
Total liabilities	4,537,799,681	2,645,788,041	1,926,248,171	1,375,484,796	1,013,499,521
Average exchange rate during year: pesos per US$	26.22	25.71	26.42	27.12	25.51

Exhibit 4 Jollibee Foods Corporation Consolidated Statements of Income and Retained Earnings (in Philippine pesos)

	Years Ended December 31				
	1996	**1995**	**1994**	**1993**	**1992**
Systemwide Sales (incl. franchisees)	8,577,067,000	6,894,670,000	5,277,640,000	4,102,270,000	NA
Company sales	6,393,092,135	4,403,272,755	3,277,383,084	2,446,866,690	2,074,153,386
Royalties and franchise fees	511,510,191	448,200,271	328,824,566	255,325,825	221,884,104
	6,904,602,326	4,851,473,026	3,606,207,650	2,702,192,515	2,296,037,490
Cost and Expenses					
Cost of sales	4,180,809,230	2,858,056,701	2,133,240,206	1,663,600,632	1,469,449,458
Operating expenses	1,943,536,384	1,403,151,840	1,013,999,640	674,288,268	545,749,275
Operating income	780,256,712	590,264,485	458,967,804	364,303,615	280,838,757
Interest and other income—net	44,670,811	102,134,296	83,342,805	32,716,223	(13,599,219)
Minority share in net earnings of a subsidiary	—	—	499,770	—	—
Provision for income tax	219,900,353	168,589,520	138,001,953	104,230,670	66,172,056
Income before minority interest and cumulative effect of accounting change	605,027,170	523,809,261	403,808,886	292,789,168	201,067,482
Minority interest	2,829,654	137,694	—	—	—
Cumulative effect of accounting change		13,733,644			
Net income	602,197,516	537,405,211	403,808,886	292,789,168	201,067,482
Earnings per share	0.68	0.61	0.81	0.59	0.58
Average exchange rate (pesos per $US)	26.22	25.71	26.42	27.12	25.51

But the Champ's intended knockout punch was eclipsed by larger events. In August 1983, political opposition leader Benigno Aquino was assassinated as he returned from exile. The economic and political crisis that followed led most foreign investors, including McDonald's, to slow their investment in the Philippines. Riding a wave of national pride, Jollibee pressed ahead, broadening its core menu with taste-tested offerings of chicken, spaghetti and a unique peach-mango dessert pie, all developed to local consumer tastes. By 1984, McDonald's foreign brand appeal was fading.

In 1986, dictator Ferdinand Marcos fled the Philippines in the face of mass demonstrations of "people power" led by Aquino's widow, Corazon. After she took office as president, optimism returned to the country, encouraging foreign companies to reinvest. As the local McDonald's franchisee once again moved to expand, however, its management found that Jollibee now had 31 stores and was clearly the dominant presence in the market.

Industry Background

In the 1960s, fast food industry pioneers, such as Ray Kroc of McDonald's and Colonel Sanders of Kentucky Fried Chicken, had developed a value proposition that became the standard for the industry in the United States and abroad. Major fast food outlets in the United States, which provided a model for the rest of the world, aimed to serve time-constrained customers by providing good-quality food in a clean dining environment and at a low price.

Managing a Store At the store level, profitability in the fast food business depended on high customer traffic and tight operations management. Opening an outlet required large investments in equipment and store fittings, and keeping it open imposed high fixed costs for rent, utilities, and labor. This meant attracting large numbers of customers ("traffic") and, when possible, increasing the size of the average order (or "ticket"). The need for high volume put a premium on convenience and made store location critical. In choosing a site, attention had to be paid not only to the potential of a city or neighborhood but also to the traffic patterns and competition on particular streets or even blocks.

Yet even an excellent location could not make a store viable in the absence of good operations management, the critical ingredient in reducing waste, ensuring quality service and increasing staff productivity. Store managers were the key to motivating and controlling crew members responsible for taking orders, preparing food, and keeping the restaurant clean. Efficient use of their time-preparing raw materials and ingredients in advance, for example—not only enabled faster service, but could also reduce the number of crew members needed.

Managing a Chain The high capital investment required to open new stores led to the growth of franchising which enabled chains to stake out new territory by rapidly acquiring market share and building brand recognition in an area. Such expansion created the critical mass needed to achieve economies of scale in both advertising and purchasing.

Fast food executives generally believed that chain-wide consistency and reliability was a key driver of success. Customers patronized chains because they knew, after eating at one restaurant in a chain, what they could expect at any other restaurant. This not only required standardization of the menu, raw material quality, and food preparation, but also the assurance of uniform standards of cleanliness and service. Particularly among the U.S. chains that dominated the industry, there also was agreement that uniformity of image also differentiated the chain from competitors: beyond selling hamburger or chicken, they believed they were selling an image of American pop culture. Consequently, most major fast food chains pushed their international subsidiaries to maintain or impose standardized menus, recipes, advertising themes, and store designs.

Moving Offshore: 1986–1997

Jollibee's success in the Philippines brought opportunities in other Asian countries. Foreign businesspeople, some of them friends of the Tan family, heard about the chain's success against McDonald's and began approaching TTC for franchise rights in their countries. While most of his family and other executives were caught up in the thriving Philippine business, TTC was curious to see how Jollibee would fare abroad.

Early Forays: Early Lessons

Singapore Jollibee's first venture abroad began in 1985, when a friend of a Philippine franchisee persuaded TTC to let him open and manage Jollibee stores in Singapore. The franchise was owned by a partnership consisting of Jollibee, the local manager, and five Philippine-Chinese investors, each with a one-seventh stake. Soon after the first store opened, however, relations between Jollibee and the local manager began to deteriorate. When corporate inspectors visited to check quality, cleanliness, and efficiency in operations, the franchisee would not let them into his offices to verify the local records. In 1986, Jollibee revoked the franchise agreement and shut down the Singapore store. "When we were closing down the store, we found that all the local company funds were gone, but some suppliers had not been paid," said TTC. "We had no hard evidence that something was wrong, but we had lost each other's trust."

Taiwan Soon after the closure in Singapore, Jollibee formed a 50/50 joint venture with a Tan family friend in Taiwan. Although sales boomed immediately after opening, low pedestrian traffic by the site eventually led to disappointing revenues. Over time, conflict arose over day-to-day management issues between the Jollibee operations staff assigned to maintain local oversight and the Taiwanese partner. "Because the business demands excellent operations, we felt we had to back our experienced Jollibee operations guy, but the partner was saying, 'I'm your partner, I've put in equity. Who do you trust?'" When the property market in Taiwan took off and store rent increased dramatically, Jollibee decided to dissolve the joint venture and pulled out of Taiwan in 1988.

Brunei Meanwhile, another joint venture opened in August 1987 in the small sultanate of Brunei, located on the northern side of the island of Borneo. (**Exhibit 5** shows the locations of Jollibee International stores as of mid-1997.) The CEO of Shoemart, one of the Philippines' largest department stores, proposed that Jollibee form a joint-venture with a Shoemart partner in Brunei. By the end of 1993, with four successful stores in Brunei, TTC identified a key difference in the Brunei entry strategy: "In Singapore and Taiwan, the local partners ran the operation, and resented our operating control. In Brunei, the local investor was a silent partner. We sent managers from the Philippines to run the operations and the local partner supported us."

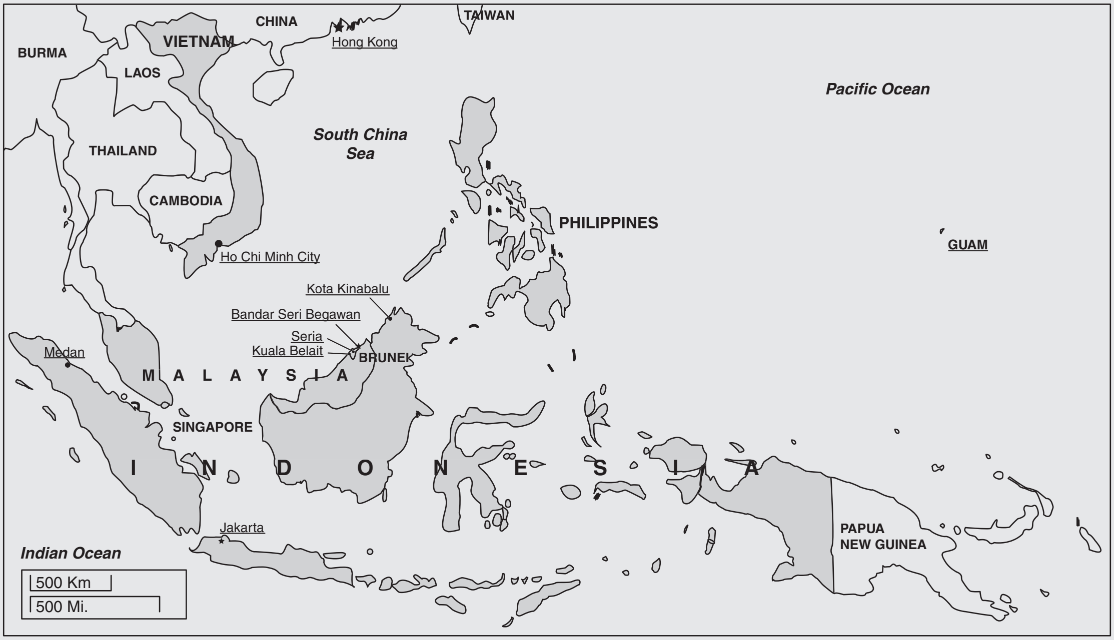
Indonesia An opportunity to enter southeast Asia's largest market came through a family friend. In 1989, Jollibee opened its first store, in Jakarta. Initially, the operation struggled, facing competition from street vendors and cheap local fast food chains. When conflict between the local partners and the manager they had hired paralyzed the operation, in late 1994, Jollibee dissolved the partnership and sold the operation to a new franchisee. Nevertheless, the company viewed the market as promising.

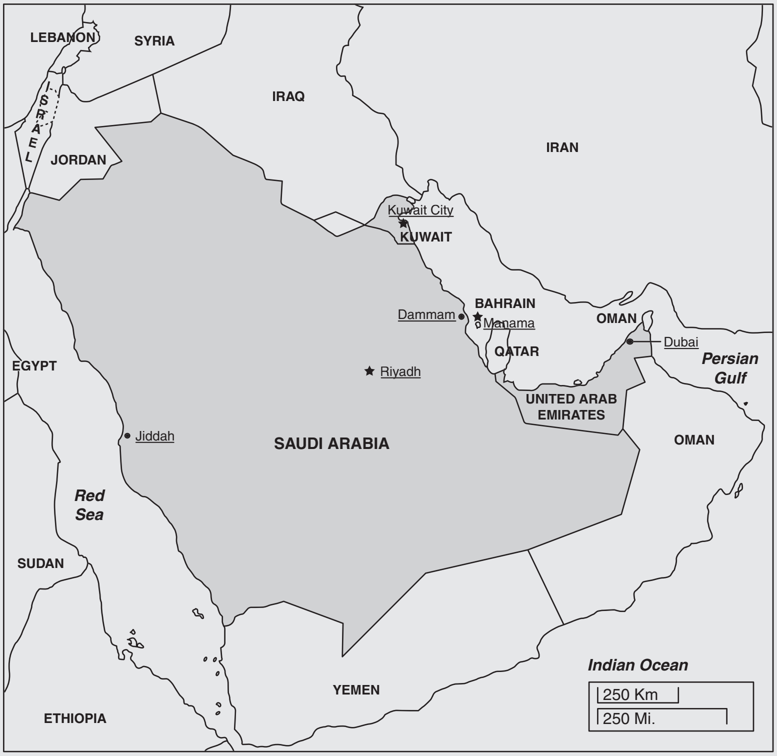
TTC summed up the lessons Jollibee had learned from its first international ventures:

> McDonald's succeeded everywhere because they were very good at selecting the right partners. They can get 100 candidates and choose the best—we don't have the name to generate that choice yet.
>
> Another key factor in this business is location. If you're an unknown brand entering a new country or city, you have trouble getting access to prime locations. McDonald's name gets it the best sites. People were telling us not to go international until we had solved these two issues: location and partner.

Building an Organization In 1993, TTC decided that Jollibee's international operations required greater structure and more resources. Because most of his management team was more interested in the fast-growing domestic side of the business, in January 1994, he decided to hire an experienced outsider as Vice President for International Operations.

Exhibit 5 Locations of Jollibee International Division stores, mid-1997
(Locations with Jollibee outlets are underlined.)





He selected Tony Kitchner, a native of Australia, who had spent 14 years in Pizza Hut's Asia-Pacific regional office in Hong Kong. Reporting directly to TTC, Kitchner asked for the resources and autonomy to create an International Division.

Kitchner felt that his new division needed to be separate from Jollibee's Philippine side, with a different identity and capabilities. He agreed with TTC that attracting partners with good connections in their markets should be a priority, but worried that Jollibee's simple image and basic management approach would hamper these efforts. To project an image of a world-class company, he remodeled his division's offices on the seventh floor of Jollibee's Manila headquarters and instituted the company's first dress code, requiring his managers to wear ties. As one manager explained, "We had to look and act like a multinational, not like a local chain. You can't have someone in a short-sleeved open-neck shirt asking a wealthy businessman to invest millions."

Within weeks of his arrival, Kitchner began recruiting experienced internationalists from inside and outside Jollibee. To his inherited three-person staff, he quickly added seven more professionals, including new managers of marketing, finance, and quality control and product development that he brought in from outside Jollibee. The addition of two secretaries rounded out his staff. He claimed that greater internal recruiting had been constrained by two factors—Philippine management's resistance to having their staff "poached," and employees' lack of interest in joining this upstart division.

Strategic Thrust While endeavoring to improve the performance of existing stores in Indonesia and Brunei, Kitchner decided to increase the pace of international expansion with the objective of making Jollibee one of the world's top ten fast food brands by 2000. Kitchner's strategy rested on two main themes formulated during a planning session in the fall of 1994—"targeting expats" and "planting the flag."

The Division's new chief saw the hundreds of thousands of expatriate Filipinos working in the Middle East, Hong Kong, Guam, and other Asian territories as a latent market for Jollibee and as a good initial base to support entry. Looking for a new market to test this concept, he focused on the concentrations of Filipino guest-workers in the Middle East. After opening stores in Dubai, Kuwait, and Dammam, however, he found that this market was limited on the lower end by restrictions on poorer workers' freedom of movement, and on the upper end by wealthier expatriates' preference for hotel dining, where they could consume alcohol. Not all overseas Filipinos were potential customers, it seemed.

The other strategic criterion for choosing markets rested on Kitchner's belief in first-mover advantages in the fast food industry. Jay Visco, International's Marketing manager, explained:

> We saw that in Brunei, where we were the pioneers in fast food, we were able to set the pace and standards. Now, we have six stores there, while McDonald's has only one and KFC has three. . . . That was a key learning: even if your foreign counterparts come in later, you already have set the pace and are at top of the heap.

The International Division therefore began to "plant the Jollibee flag" in countries where competitors had little or no presence. The expectation was that by expanding the number of stores, the franchise could build brand awareness which in turn would positively impact sales. One problem with this approach proved to be its circularity: only after achieving a certain level of sales could most franchisees afford the advertising and promotion needed to build brand awareness. The other challenge was that rapid expansion led to resource constraints—especially in the availability of International Division staff to support multiple simultaneous startups.

Nonetheless, Kitchner expanded rapidly. Due to Jollibee's success in the Philippines and the Tan family's network of contacts, he found he could choose from many franchising inquiries from various countries. Some were far from Jollibee's home base—like the subsequently abandoned plan to enter Romania ("our gateway to Europe" according to one manager). In an enormous burst of energy, between November 1994 and December 1996, the company entered 8 new national markets and opened 18 new stores. The flag was being planted. (See **Exhibit 6.**)

Exhibit 6 Jollibee International Store Openings

Location	Date Opened	
Bandar Seri Begawan, *Brunei*	August 1987	
Bandar Seri Begawan, Brunei (second store)	June 1989	
Seria, Brunei	August 1992	
Jakarta, *Indonesia*	August 1992	
Jakarta, Indonesia (second store)	March 1993	
Bandar Seri Begawan, Brunei (third store)	November 1993	International Division created
Kuala Belait, Brunei	November 1994	
Dubai, *United Arab Emirates*	April 1995	
Kuwait City, *Kuwait*	December 1995	
Dammam, *Saudi Arabia*	December 1995	
Guam	December 1995	
Jiddah, Saudi Arabia	January 1996	
Bahrain	January 1996	
Kota Kinabalu, *Malaysia*	February 1996	
Dubai (second store)	June 1996	
Riyadh, Saudi Arabia	July 1996	
Kuwait City, Kuwait (second store)	August 1996	
Kuwait City, Kuwait (third store)	August 1996	
Jiddah, Saudi Arabia (second store)	August 1996	
Hong Kong	September 1996	
Bandar Seri Begawan, Brunei (fourth store)	October 1996	
Ho Chi Minh City, *Vietnam*	October 1996	
Medan, Indonesia	December 1996	
Hong Kong (second store)	December 1996	
Dammam, Saudi Arabia	April 1997	
Hong Kong (third store)	June 1997	
Jakarta, Indonesia (third store)	July 1997	
Jakarta, Indonesia (fourth store)	September 1997	

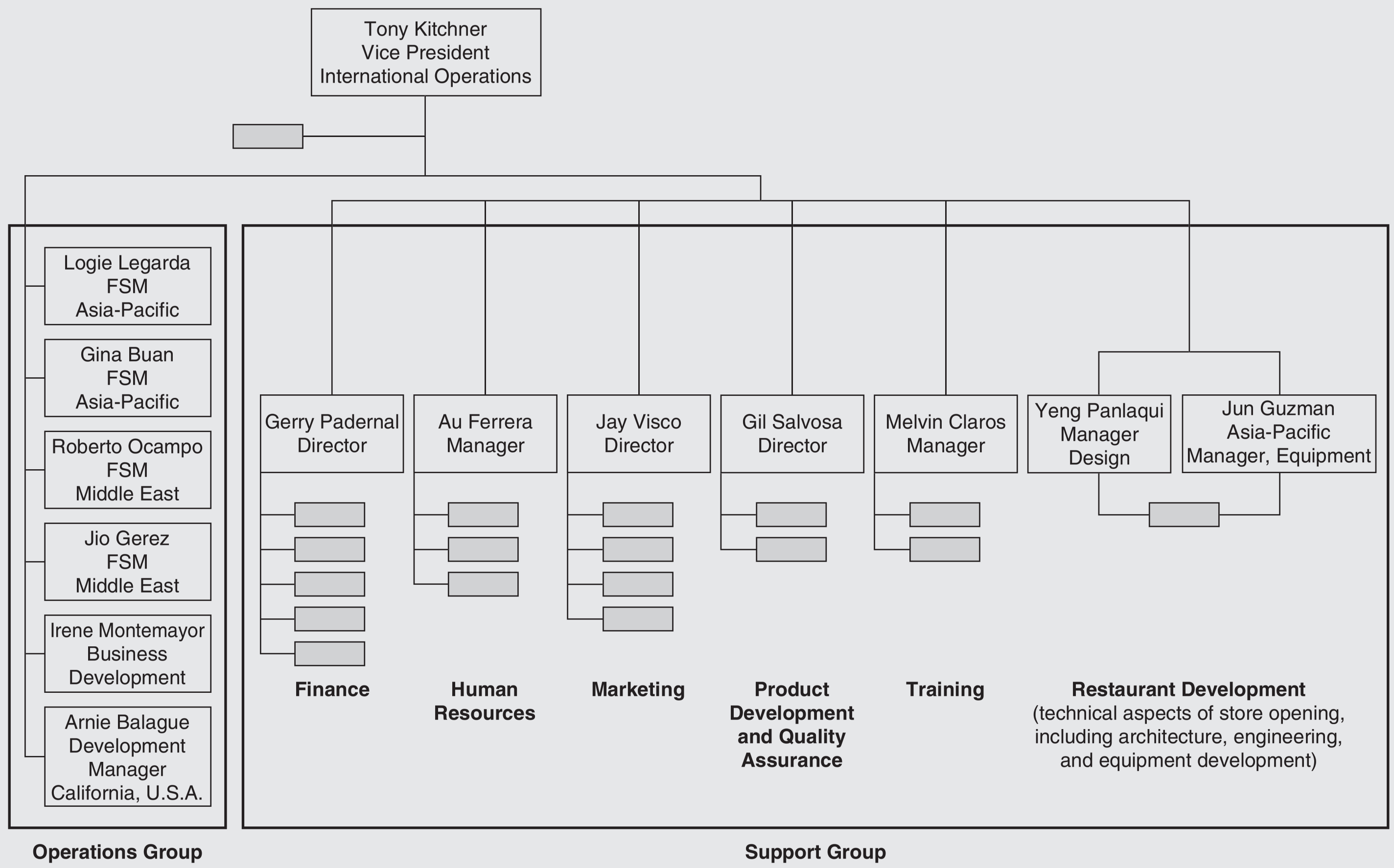
Italics represent new market entry.

Operational Management

Market entry Once Jollibee had decided to enter a new market, Tony Kitchner negotiated the franchise agreement, often with an investment by the parent company, to create a partnership with the franchisee. At that point he handed responsibility for the opening to one of the division's Franchise Services Managers (FSM). These were the key contacts between the company and its franchisees, and Kitchner was rapidly building a substantial support group in Manila to provide them with the resources and expertise they needed to start up and manage an offshore franchise. (See **Exhibit 7.**)

About a month before the opening, the FSM hired a project manager, typically a native of the new market who normally would go on to manage the first store. The FSM and project manager made most of the important decisions during the startup process, with the franchisees' level of involvement varying from country to country. However, one responsibility in which franchisee was deeply involved was the key first step of selecting and securing the site of the first store, often with advice from International Division staff, who visited the country several times to direct market research. (Sometimes the franchisee had been chosen partly for access to

Exhibit 7 International Division Organization Chart, Late 1996 (pre-restructuring)



particularly good sites.) Once the franchisee had negotiated the lease or purchase, the project manager began recruiting local store managers.

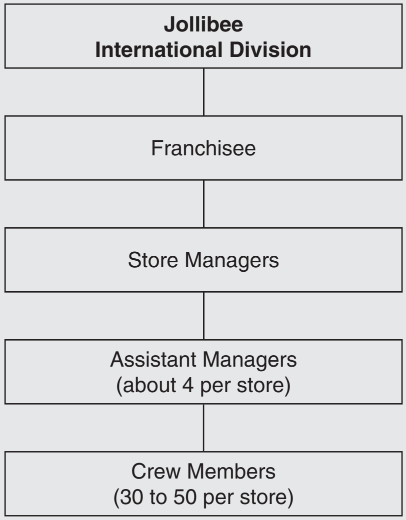
The FSM was responsible for engaging local architects to plan the store. The kitchen followed a standard Jollibee design that ensured proper production flow, but Kitchner encouraged FSMs to adapt the counter and dining areas to the demands of the space and the preferences of the franchisee. A design manager in the International Division provided support

During the planning phase, the project manager worked with International Division finance staff to develop a budget for raw materials, labor, and other major items in the operation's cost structure. He or she also identified local suppliers, and—once International Division quality assurance staff had accredited their standards—negotiated prices. (Some raw materials and paper goods were sourced centrally and distributed to franchisees throughout Asia.)

Once architectural and engineering plans were approved, construction began. As it often did in other offshore activities, the International Division staff had to develop skills very different from those of their Jollibee colleagues working in the Philippines. For example, high rents in Hong Kong forced them to learn how to manage highly compacted construction schedules: construction there could take one-third to one-half the time required for similar work in the Philippines.

Under FSM leadership, the International Division staff prepared marketing plans for the opening and first year's operation. They included positioning and communications strategies and were based on their advance consumer surveys, aggregate market data, and analysis of major competitors. Division staff also trained the local marketing manager and the local store manager and assistant managers who typically spent three months in Philippine stores. (Where appropriate local managers had not been found, the store managers were sometimes drawn from Jollibee's Philippine operations.) Just before opening, the project manager hired crew members, and International Division trainers from Manila instructed them for two weeks on cooking,

Exhibit 8 Organization of Typical Jollibee International Franchise



serving customers, and maintaining the store. (See **Exhibit 8** for a typical franchise's organization.)

Oversight and Continuing Support After a store opened, the FSM remained its key contact with Jollibee, monitoring financial and operational performance and working to support and develop the store manager. For approximately two months after opening, FSMs required stores in their jurisdictions to fax them every day their figures for sales by product, customer traffic, and average ticket. As operations stabilized and the store manager started to see patterns in sales and operational needs, FSMs allowed stores to report the same data weekly and provide a monthly summary.

FSMs used this information not only to project and track royalty income for corporate purposes, but also to identify ways they could support the local franchisee. When the data suggested problems, the FSM would contact the store manager, highlight the issue, and ask for an appropriate plan of action. For example, if FSM Gina Buan saw a decline in sales for two consecutive weeks, she demanded specific plans within 24 hours of her call. If managers could not come up with solutions themselves, she would coach them to help them generate answers. "My aim," she remarked with a smile, "is to turn them into clones of me—or at least teach them my expertise."

In addition to the required sales reports, many stores voluntarily reported on their costs, because they found their FSM's analysis so helpful. This open partnership fit with TTC's view of franchise relations. "We get data from franchisees more to help us provide consulting assistance than for control," he said. Ernesto Tan, TTC's brother, explained that although Jollibee's royalty was a percentage of franchisees' sales, and local operations were focused more on profits, both interests were similar: "We want sales to grow, so that our royalty grows. But this will not happen if stores are not profitable, because our franchisees will not push to expand."

As well as support, however, the International Division was also concerned with control—especially in quality. Unannounced on-site inspections every quarter were Jollibee's primary tool. Over two days, the FSM evaluated every aspect of operations in detail, including product quality and preparation (taste, temperature, freshness, availability, and appearance), cleanliness, restaurant appearance, service speed, and friendliness. The manual for intensive checks was several inches thick. All international staff had been trained in Jollibee's quality standards and conducted less detailed "quick checks" whenever they traveled. Based on a 15-page questionnaire, a quick check took roughly two hours to complete and covered all of the areas that intensive ones did, although with less rigor and detail. Each store received an average of two quick checks per quarter.

In addition to FSMs' own rich industry experiences—Gina Buan, for example, had managed stores, districts, and countries for Jollibee and another chain—these field managers engaged the expertise of International Division functional staff. While they tried to shift responsibility gradually to the franchisee, division support staff often bore much of the responsibility long after startup. For example, the marketing staff tried to limit their franchise support role to creating initial marketing plans for new openings and reviewing new store plans. However, often they were drawn into the planning of more routine campaigns for particular stores, work they felt should be handled by the franchisee and store managers.

International vs. Domestic Practice As operations grew, Kitchner and his staff discovered that international expansion was not quite as simple as the metaphor of "planting flags" might suggest. It sometimes felt more like struggling up an unconquered, hostile mountain. After numerous market entry battles, the international team decided that a number of elements of Jollibee's Philippine business model needed to be modified overseas. For example, the company's experience in Indonesia led Visco to criticize the transplantation of Jollibee's "mass-based positioning":

> When Jollibee arrived in Indonesia, they assumed that the market would be similar to the Philippines. But the Indonesian masses are not willing to spend as much on fast food as the Philippine working and lower-middle class consumers, and there were lots of cheap alternatives available. We decided that we needed to reposition ourselves to target a more up-market clientele.

Kitchner and Visco also felt that Jollibee needed to present itself as "world class," not "local" or "regional." In particular, they disliked the Philippine store design—a "trellis" theme with a garden motif—which had been transferred unchanged as Jollibee exported internationally. Working with an outside architect, a five-person panel from the International Division developed three new store decors, with better lighting and higher quality furniture. After Kitchner got TTC's approval, the Division remodeled the Indonesian stores and used the designs for all subsequent openings.

International also redesigned the Jollibee logo. While retaining the bee mascot, it changed the red background to orange and added the slogan, "great burgers, great chicken." Visco pointed out that the orange background differentiated the chain's logo from those of other major brands, such as KFC, Coca-Cola, and Marlboro, which all had red-and-white logos. The slogan was added to link the Jollibee name and logo with its products in people's minds. Visco also noted that, unlike Wendy's Old

Fashioned Hamburgers, Kentucky Fried Chicken, and Pizza Hut, Jollibee did not incorporate its product in its name and market tests had found that consumers outside the Philippines guessed the logo signified a toy chain or candy store.

Kitchner and his staff made numerous other changes to Jollibee's Philippine business operating model. For example, rather than preparing new advertising materials for each new promotion as they did in the Philippines, the international marketing group created a library of promotional photographs of each food product that could be assembled, in-house, into collages illustrating new promotions (e.g., a discounted price for buying a burger, fries, and soda). And purchasing changed from styrofoam to paper packaging to appeal to foreign consumers' greater environmental consciousness.

Customizing for Local Tastes While such changes provoked grumbling from many in the large domestic business who saw the upstart international group as newcomers fiddling with proven concepts, nothing triggered more controversy than the experiments with menu items. Arguing that the "flexibility" aspect of Jollibee's "Five Fs" corporate creed stood for a willingness to accommodate differences in customer tastes, managers in the International Division believed that menus should be adjusted to local preferences.

The practice had started in 1992 when a manager was dispatched from the Philippines to respond to the Indonesian franchisee's request to create a fast food version of the local favorite *nasi lema,* a mixture of rice and coconut milk. Building on this precedent, Kitchner's team created an international menu item they called the Jollimeal. This was typically a rice-based meal with a topping that could vary by country–in Hong Kong, for example, the rice was covered with hot and sour chicken, while in Vietnam it was chicken curry. Although it accounted for only 5% of international sales, Kitchner saw Jollimeals as an important way to "localize" the Jollibee image.

But the International Division expanded beyond the Jollimeal concept. On a trip to Dubai, in response to the local franchisee's request to create a salad for the menu, product development manager Gil Salvosa spent a night chopping vegetables in his hotel room to create a standard recipe. That same trip, he acquired a recipe for chicken masala from the franchisee's cook, later adapting it to fast food production methods for the Dubai store. The International Division also added idiosyncratic items to menus, such as dried fish, a Malaysian favorite. Since other menu items were seldom removed, these additions generally increased the size of menus abroad.

Although increased menu diversity almost always came at the cost of some operating efficiency (and, by implication, complicated the task of store level operating control), Kitchner was convinced that such concessions to local tastes were necessary. In Guam, for example, to accommodate extra-large local appetites, division staff added a fried egg and two strips of bacon to the Champ's standard large beef patty. And franchisees in the Middle East asked the Division's R&D staff to come up with a spicier version of Jollibee's fried chicken. Although Kentucky Fried Chicken (KFC) was captivating customers with their spicy recipe, R&D staff on the Philippine side objected strenuously. As a compromise, International developed a spicy sauce that customers could add to the standard Jollibee chicken.

Overall, the International Division's modification of menus and products caused considerable tension with the Philippine side of Jollibee. While there was no controversy about reformulating hamburgers for Muslim countries to eliminate traces of pork, for example, adding new products or changing existing ones led to major arguments. As a result, International received little cooperation from the larger Philippine research and development staff and customization remained a source of disagreement and friction.

Strained International-Domestic Relations As the International Division expanded, its relations with the Philippine-based operations seemed to deteriorate. Tensions over menu modifications reflected more serious issues that had surfaced soon after Kitchner began building his international group. Philippine staff saw International as newcomers who, despite their lack of experience in Jollibee, "discarded practices built over 16 years." On the other side, International Division staff reported that they found the Philippine organization bureaucratic and slow-moving. They felt stymied by requirements to follow certain procedures and go through proper channels to obtain assistance.

The two parts of Jollibee continued to operate largely independently, but strained relations gradually eroded any sense of cooperation and reduced already limited exchanges to a minimum. Some International Division staff felt that the Philippine side, which controlled most of Jollibee's resources, should do more to help their efforts to improve and adapt existing products and practices. Visco recalled that when he wanted assistance designing new packaging, the Philippine marketing manager took the attitude that international could fend for itself. Similarly, Salvosa wanted more cooperation on product development from Philippine R&D, but was frustrated by the lengthy discussions and approvals that seemed to be required.

However, the domestic side viewed things differently. Executive Vice President Ernesto Tan, who was in charge of Jollibee in the Philippines, recalled:

> The strains came from several things. It started when International tried to recruit people directly from the Philippine side, without consulting with their superiors. There also was some jealousy on a personal level because the people recruited were immediately promoted to the next level, with better pay and benefits.
>
> The international people also seemed to develop a superiority complex. They wanted to do everything differently, so that if their stores did well, they could take all the credit. At one point, they proposed running a store in the Philippines as a training facility, but we thought they also wanted to show us that they could do it better than us. We saw them as lavish spenders while we paid very close attention to costs. Our people were saying, "We are earning the money, and they are spending it!" There was essentially no communication to work out these problems. So we spoke to TTC, because Kitchner reported to him.

Matters grew worse throughout 1996. One of the first signs of serious trouble came during a project to redesign the Jollibee logo, which TTC initiated in mid-1995. Triggered by International's modification of the old logo, the redesign project committee had representatives from across the company. Having overseen International's redesign, Kitchner was included. During the committee's deliberations, some domestic managers felt that the International vice-president's strong opinions were obstructive, and early in 1996 Kitchner stopped attending the meetings.

During this time, TTC was growing increasingly concerned about the International Division's continuing struggles. Around November 1996, he decided that he could no longer support Kitchner's strategy of rapid expansion due to the financial problems it was creating. Many of the International stores were losing money, but the cost of supporting these widespread unprofitable activities was increasing. Despite the fact that even unprofitable stores generated franchise fees calculated as a percentage of sales, TTC was uncomfortable:

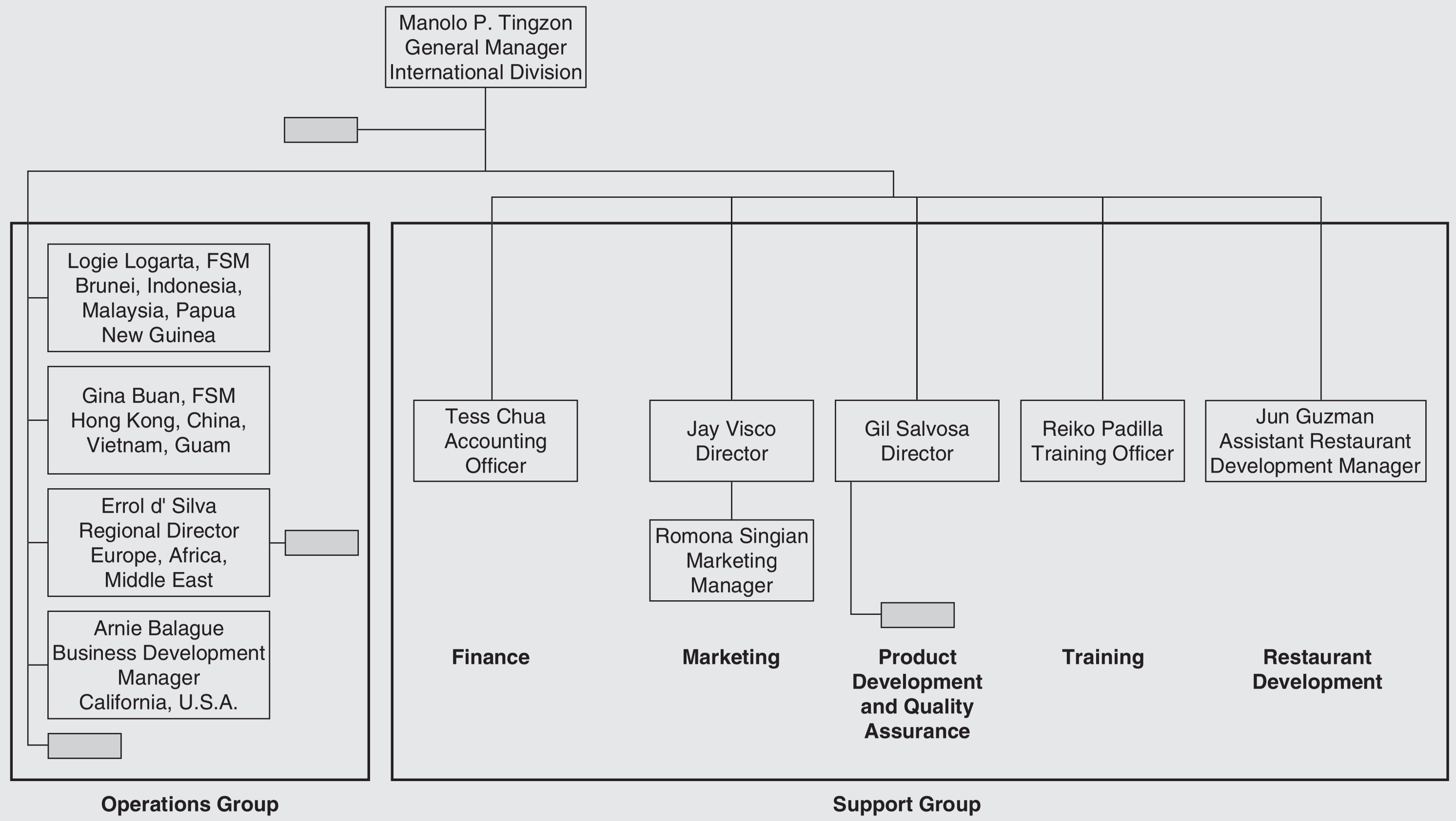
> Kitchner wanted to put up lots of stores, maximizing revenue for Jollibee. Initially, I had supported this approach, thinking we could learn from an experienced outsider, but I came to believe that was not viable in the long term. We preferred to go slower, making sure that each store was profitable so that it would generate money for the franchisee, as well as for us. In general, we believe that whoever we do business with—suppliers and especially franchisees—should make money. This creates a good, long-term relationship.

In February 1997, Kitchner left Jollibee to return to Australia. A restructuring supervised directly by TTC shrank the International Division's staff from 32 to 14, merging the finance, MIS and human resources functions with their bigger Philippine counterparts. (See **Exhibit 9.**) Jay Visco became interim head of International while TTC searched for a new Division leader.

A New International Era: 1997

In the wake of Kitchner's departure, TTC consulted intensively with Jollibee's suppliers and other contacts in fast food in the Philippines regarding a replacement. The name that kept recurring was

Exhibit 9 International Division Organization Chart, March 1997 (post-restructuring)



Manolo P. ("Noli") Tingzon, one of the industry's most experienced managers. Although based in the Philippines his entire career, Tingzon had spent much of this time helping foreign chains crack the Philippine market. In 1981 he joined McDonald's as a management trainee and spent the next 10 years in frustrating combat with Jollibee. After a brief experience with a food packaging company, in 1994 he took on the challenge to launch Texas Chicken, another U.S. fast food chain, in its Philippines entry. When TTC contacted him in late 1996, he was intrigued by the opportunity offered by his old nemesis and joined the company in July 1997 as general manager, International Division.

A Fresh Look at Strategy Upon his arrival, Tingzon reviewed International's current and historical performance. (See **Exhibit 10.**) He concluded that because of the scale economies of fast food franchising, an "acceptable" return on investment in international operations would require 60 Jollibee restaurants abroad with annual sales of US$800,000 each, the approximate store level sales at McDonald's smaller Asian outlets. Feeling that Jollibee's international expansion had sometimes been driven less by business considerations than by a pride in developing overseas operations, Tingzon thought that a fresh examination of existing international strategies might reveal opportunities for improvement. As he consulted colleagues at Jollibee, however, he heard differing opinions.

Many of his own staff felt that the rapid expansion of the "plant-the-flag" approach had served Jollibee well and should be continued. For example, Visco argued that establishing a presence in each market before competitors conferred important first-mover advantages in setting customer expectations, influencing tastes and building brand. He and others felt that Jollibee's success in the Philippines and Brunei illustrated this point especially well.

Others, particularly on Jollibee's domestic side, felt the flag-planting strategy was ill-conceived, leading the company into what they saw as rash market choices such as the Middle East, where outlets continued to have difficulty attracting either expatriates or locals. For example, Ernesto Tan advised Tingzon to "focus on expanding share in a few countries while making sure each store does well." He urged Tingzon to consolidate and build on existing Jollibee markets that had either high profit potential, such as Hong Kong, or relatively mild competition, such as Malaysia and Indonesia.

With respect to the strategy of initially focusing on Filipino expatriates in new markets, Tingzon appreciated that this approach had eased Jollibee's entry into Guam and Hong Kong, but wondered whether it

Exhibit 10 International Store Sales by Country: 1996 (in U.S. dollars at contemporary exchange rates)

		1996	
		Sales	**Number of Stores**
Bahrain		262,361	1
Brunei		2,439,538	6
Guam		1,771,202	1
Hong Kong		1,142,240	2
Indonesia		854,259	3
Kuwait		864,531	3
Malaysia		391,328	1
Saudi Arabia		976,748	4
United Arab Emirates		487,438	2
Vietnam		112,578	1
Total	US$	9,302,223	24

might trap the chain. “Might we risk boxing ourselves into a Filipino niche that prevents us from growing enough to support operations in each country?” he asked. Again opinion was divided between those favoring the expatriate-led strategy and those who felt it was time for Jollibee to shake its Philippine identity and target the mainstream market wherever it went.

Strategy in Action: Three Decisions Although he eventually wanted to resolve these issues at the level of policy, Tingzon faced three immediate growth opportunities that he knew would shape the emergence of the future strategy.

Papua New Guinea: Raising the Standard In early 1996, at the recommendation of Quality Assurance Manager Gil Salvosa, a local New Guinea entrepreneur in the poultry business approached Tony Kitchner about a Jollibee franchise. He described a country of five million people served by only one poorly managed, 3-store fast-food chain, that had recently broken ties with its Australian chicken restaurant franchise. “Port Moresby does not have a single decent place to eat,” he told Kitchner. He believed Jollibee could raise the quality of service and food enough to take much of the Australian chain’s market share while discouraging further entrants.

Although the original plan had been to open just one store in the foreseeable future—in the capital, Port Moresby—Tingzon was certain that the franchisee could only cover the costs of developing the market if he put in at least three or four stores soon after. But he was uncertain whether Papua New Guinea could support the 20 stores that he saw as the target critical mass for new markets. (For comparison, in the Philippines, approximately 1,200 fast food outlets competed for the business of 75 million people. GNP per capita in both countries was almost at US$2,500.)

When Tingzon explained his concerns, the would-be franchisee’s response was that he would negotiate with a major petroleum retailer and try to open stores in five of their service stations around the country. Furthermore, he emphasized that he was willing to build more stores if necessary and would put up all the capital so that Jollibee would risk no equity in the venture.

Hong Kong: Expanding the Base Also on Tingzon’s plate was a proposal to expand to a fourth store in Hong Kong. The franchise, owned by Jollibee in partnership with local businessmen and managed by Tommy King, TTC’s brother-in-law, opened its first store in September 1996 to instant, overwhelming success. Located near a major transit hub in the Central district, it became a gathering place for Filipino expatriates, primarily domestic workers. However, appealing to the locals had proven more difficult. While volume was high on weekends, when the Filipinos came to Central to socialize, it fell off during the week, when business was primarily from local office workers.

Although two more stores in Central had attracted many Filipinos, they both relied extensively on Chinese customers and generated sales of only about one-third of the first outlet. One problem was that, despite strenuous efforts, Jollibee had been unable to hire many local Chinese as crew members. According to one manager, Chinese customers who did not speak English well were worried that they would be embarrassed if they were not understood by the predominantly Philippine and Nepalese counter staff. Another problem was that in a city dominated by McDonald’s, Jollibee’s brand recognition among locals was weak. Working with Henry Shih, the sub-franchisee who owned the second store, Jollibee staff were trying to help launch a thematic advertising campaign, but due to the Hong Kong operation’s small size, the franchise could not inject sufficient funds.

Shih also blamed rigidity over menu offerings for Jollibee’s difficulties appealing to Chinese customers. In early 1997, his Chinese managers had suggested serving tea the Hong Kong way—using tea dust (powdered tea leaves) rather than tea bags and adding evaporated milk. More than six months later, he had still not received a go-ahead. His proposal to develop a less-fatty recipe for Chicken Joy, one of Jollibee’s core menu items, had met more direct resistance. “The Chinese say that if you eat lots of deep-fried food you become hot inside and will develop health problems,” said Shih who believed that the domestic side had pressured the International Division to reject any experimentation with this “core” menu item.

Meanwhile, staffing problems were worsening. The four locally-recruited Chinese managers clashed with the five Filipinos imported from Tommy King's Philippine franchise, with the Chinese calling the Filipinos' discipline lax and their style arrogant, while the Filipinos saw the Chinese managers as uncommitted. By August 1997, all of the Chinese managers had resigned, leaving Jollibee with only Filipinos in store-level management positions. Shih was afraid this would further undermine Jollibee's ability to hire local crews, as Chinese preferred to work for Chinese.

Partly due to staff turnover, store managers were focused on dealing with day-to-day operations issues such as uneven product quality and had little time to design even short-term marketing strategies. King's focus on his Philippine stores slowed decision-making. And while Gina Buan, the FSM, had visited Hong Kong more often than any other markets she supervised (including for an extraordinary month-long stay), she had been unable to resolve the management problems. In June, King appointed Shih General Manager to oversee the entire Hong Kong venture.

In this context, Shih and King proposed to open a fourth store. The site in the Kowloon district was one of the busiest in Hong Kong, located at one of just two intersections of the subway and the rail line that was the only public transport from the New Territories, where much of the city's workforce resided. However, the area saw far fewer Filipinos than Central and the store would have to depend on locals. Acknowledging that the fourth store would test Jollibee's ability to appeal to Hong Kong people, Shih argued that the menu would have to be customized more radically. However, Tingzon wondered whether expansion was even viable at this time, given the Hong Kong venture's managerial problems. Even if he were to approve the store, he wondered if he should support the menu variations that might complicate quality control. On the other hand, expansion into such a busy site might enhance Jollibee's visibility and brand recognition among locals, helping increase business even without changing the menu. It was another tough call.

California: Supporting the Settlers Soon after signing his contract, Tingzon had learned of a year-old plan to open one Jollibee store per quarter in California starting in the first quarter of 1998. Supporting TTC's long-held belief that Jollibee could win enormous prestige and publicity by gaining a foothold in the birthplace of fast food, Kitchner had drawn up plans with a group of Manila-based businessmen as 40% partners in the venture. Once the company stores were established, they hoped to franchise in California and beyond in 1999.

Much of the confidence for this bold expansion plan came from Jollibee's success in Guam, a territory of the U.S. Although they initially targeted the 25% of the population of Filipino extraction, management discovered that their menu appealed to other groups of Americans based there. They also found they could adapt the labor-intensive Philippine operating methods by developing different equipment and cooking processes more in keeping with a high labor cost environment. In the words of one International Division veteran, "In Guam, we learned how to do business in the United States. After succeeding there, we felt we were ready for the mainland."

The plan called for the first store to be located in Daly City, a community with a large Filipino population but relatively low concentration of fast-food competitors in the San Francisco area. (With more than a million immigrants from the Philippines living in California, most relatively affluent, this state had one of the highest concentrations of Filipino expatriates in the world.) The menu would be transplanted from the Philippines without changes. After initially targeting Filipinos, the plan was to branch out geographically to the San Francisco and San Diego regions, and demographically to appeal to other Asian-American and, eventually, Hispanic-American consumers. The hope was that Jollibee would then expand to all consumers throughout the U.S.

Like the expansion strategies in PNG and Hong Kong, this project had momentum behind it, including visible support from Filipino-Americans, strong interest of local investors, and, not least, TTC's great interest in succeeding in McDonald's back-yard. Yet Tingzon realized that he would be the one held accountable for its final success and wanted to bring an objective outsider's perspective to this plan before it became accepted wisdom. Could Jollibee hope to succeed in the world's most competitive fast-food market? Could they provide the necessary support and control to operations located 12 hours by plane and eight time zones away? And was the Filipino-to-Asian-to-Hispanic-to-mainstream entry strategy viable or did it risk boxing them into an economically unviable niche?

Looking Forward Noli Tingzon had only been in his job a few weeks, but already it was clear that his predecessor's plan to open 1000 Jollibee stores abroad before the turn of the century was a pipe dream. "It took McDonald's 20 years for its international operations to count for more than 50% of total sales," he said. "I'll be happy if I can do it in 10." But even this was an ambitious goal. And the decisions he made on the three entry options would have a significant impact on the strategic direction his international division took and on the organizational capabilities it needed to get there.

Case 1-3 Mahindra & Mahindra in South Africa

In May 2011, Pravin Shah, chief executive, International Operations (Automotive and Farm Equipment Sectors) at Mahindra & Mahindra Ltd. (M&M), a leading multinational automotive manufacturer headquartered in Mumbai, India, was weighing his options on the company's growth strategy in the South African market. Shah's dilemma was four-fold. Since 2005, Mahindra & Mahindra South Africa (Proprietary) Ltd. (M&M (SA)), the company's fully owned subsidiary based in Pretoria, South Africa, had grown the market by importing completely built units (CBUs) from its Indian operations. Shah needed to decide whether M&M (SA) should move to the next logical step of an agreement with a local vendor to use the latter's surplus facility for contract assembly of M&M vehicles. Or, M&M (SA) could skip that step altogether and invest in its own manufacturing facility. Alternatively, Shah could wait and watch until the subsidiary logged a critical mass of vehicle sales volumes that would be sustainable in the long term. The fourth option would be to grow the current business model of importing CBUs from India by using South Africa as the hub from which to sell them to other countries in the African continent and, thereby, expand the export market. Said Shah:

> Each option involves tradeoffs. They have to be evaluated in light of M&M (SA)'s long-term view of the South African automotive market, which, in some ways, is unlike other international markets where we are present. South Africa is clearly a growth market. It is also competitive and fragmented. The basic question is: what is the fit that we want in it? There are issues about how we can build on the competencies we have developed during the last six years and the skills we need to develop, going forward, locally. The larger consideration for whatever call we take in South Africa is the globalization strategy of M&M, which defines the boundary.

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R Chandrasekhar wrote this case under the supervision of Professor Jean-Louis Schaan solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

Shah needed to present his recommendation to the four-member board of M&M (SA). The board, of which he was himself a member, was chaired by Dr. Pawan Goenka, president (Automotive and Farm Equipment Sectors), M&M. The decision of the board of the South African subsidiary would need to be, in turn, formally approved by the board of M&M, which, as the parent company, had 12 directors, more than half of whom were independent directors. The M&M board was meeting an average of six times in a year to discuss and decide on matters of strategic importance.

Context

M&M, the parent company, had six assembly plants worldwide. One was located in Egypt as part of a non-exclusive arrangement between M&M in India and a contract-manufacturing vendor in Egypt. M&M exported components from India for assembly in Egypt of vehicles intended either for local sales or for export. The Egyptian vendor assembled an average of 200 vehicles per month for M&M when the plant capacity was partially dedicated to M&M, thus proving the basic viability of local assembly as a strategic option for M&M (SA).

South Africa was one of M&M's biggest and most important export markets and was crucial to M&M's strategic growth. M&M had long-term plans to launch a global sport-utility vehicle (SUV) brand from South Africa. It was also planning to launch a new SUV for the South African market built on an altogether new platform. Both plans supported M&M launching its own manufacturing facility.

The wait-and-watch policy was a result of the South African automotive industry having just recovered from a sharp decline in new-vehicle sales in three consecutive years—2007, 2008 and 2009. In 2010, sales growth had turned positive and was expected to gather momentum. However, the global automotive market had not yet fully recovered from the recession, which had led to the downturn in the South African automotive market. An annual survey of auto executives worldwide, had pointed to over-capacity as the major concern globally during 2011.[1] Over-capacity prevailed in both mature automotive markets (e.g., in the United States, Germany and Japan) and in emerging automotive markets (e.g., China and India). In the automobile industry, which was cyclical in nature, over-capacity was not a unique problem but it always made everyone cautious.

Finally, with the exceptions of Egypt and South Africa, none of the 54 countries in the African continent had a sizeable middle class that could warrant M&M having a presence along the lines of the inroads M&M had made in South Africa or Egypt. Each individual market needed to be developed over time. In the interim, M&M could cater to the African markets from its South African base, which could be used as a re-export hub. Said Shah:

> Contract assembly is the way to go for companies with low volumes [of less than a few thousand vehicles per annum]. Of late, a growing number of multi-brand assemblers are coming up in Eastern Cape Province. It is also noteworthy that contract manufacturing is common in the industry even between established players who are otherwise competing for market share. Fiat, for example, assembles vehicles for Nissan, which assembles vehicles for Renault. The major factor for consideration is the availability of surplus capacity. On the other hand, it is possible for a company to set up its own manufacturing facility in South Africa once it has reached annual sales of 6,000 units in which a single brand in its portfolio sells approximately 1,500 units annually. It places you firmly on the path of both localization of content and scaling up, which are major issues in auto manufacturing globally. A volume of that order also helps build brand equity in the local market.

South African Automotive Industry

South Africa fared better than its neighbors (both in and out of African continent) in the business environment rankings from 2006 to 2010. The country was expected to retain the lead for the period 2010 to 2015 in several of the 55 parameters used as the basis for rankings (see **Exhibit 1**).

The South African automotive industry accounted for about 10 per cent of the country's manufacturing

[1]Dieter Becker et al, *"Global Automotive Executive Survey 2011: Creating a Future Roadmap for the Automotive Industry,"* pp. 24–26, www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/Global-Auto-Executive-Survey-2011.pdf, accessed August 25, 2011.

Exhibit 1 South Africa—Business Environment Rankings

#	Indicators	2006–2010 South Africa	2006–2010 Regional average	2010–2015 South Africa	2010–2015 Regional average
	Political environment				
1	Risk of armed conflict	4	3.2	5	3.4
2	Risk of social unrest	3	2.8	2	2.1
3	Constitutional mechanisms for the orderly transfer of power	3	2.4	3	2.4
4	Government and opposition	4	3.2	3	3.1
5	Threat of politically motivated violence	3	2.6	3	2.7
6	International disputes or tensions	3	2.8	4	2.9
7	Government policy towards business	3	3.1	3	3.1
8	Effectiveness of system in policy formulation and execution	3	2.6	3	2.7
9	Quality of the bureaucracy	3	2.2	2	2.2
10	Transparency and fairness of legal system	2	1.8	4	2.2
11	Efficiency of legal system	4	2.4	4	2.4
12	Corruption	3	2.4	3	2.4
13	Impact of crime	1	3.3	1	3.2
	Taxes				
1	Corporate tax burden	4	3.4	4	3.9
2	Top marginal personal income tax	3	3.9	3	4.0
3	Value-added tax	4	4.2	4	4.1
4	Employers' social security contributions	5	3.7	4	3.9
5	Degree of encouragement for new investment	2	2.5	3	3.0
6	Consistency and fairness of the tax system	2	2.5	3	2.6
7	Tax complexity	4	3.2	4	3.4
	Financing				
1	Openness of the banking sector	3	2.9	3	2.9
2	Stockmarket capitalization	4	2.9	3	3.2
3	Distortions in financial markets	3	3.2	3	3.3
4	Quality of the financial regulatory system	3	2.4	3	2.9
5	Access of foreigners to local capital market	4	2.6	4	2.8
6	Access to medium-term finance for investment	3	2.8	3	2.8

(*Continued*)

Exhibit 1 South Africa—Business Environment Rankings (*Continued*)

		2006–2010		2010–2015	
#	Indicators	South Africa	Regional average	South Africa	Regional average
	Labour market				
1	Labour costs adjusted for productivity	3	3.9	3	3.9
2	Availability of skilled labour	2	2.3	3	2.6
3	Quality of workforce	3	2.5	3	2.8
4	Quality of local managers	3	2.5	3	2.6
5	Language skills	4	3.0	4	3.2
6	Health of the workforce	1	2.9	1	2.9
7	Level of technical skills	3	2.9	3	2.9
8	Cost of living	4	2.8	4	2.2
9	Incidence of strikes	3	3.5	3	3.3

Source: Pratibha Thaker, ed., *Economist Intelligence Unit—Country Forecast—South Africa,* May 2011, www.eiu.com/countries, accessed November 10, 2011.
Notes: 1. Rankings are on a scale from 1 (very bad for business) to 10 (very good for business); 2. Regional average is the total for 17 countries: Algeria, Bahrain, Egypt, Iran, Israel, Jordan, Kuwait, Libya, Morocco, Qatar, Saudi Arabia, Tunisia, UAE, Angola, Kenya, Nigeria and South Africa.

exports. Although its annual vehicle production was less than one per cent of global vehicle production, the industry contributed about 7.5 per cent to the gross domestic product (GDP) of South Africa.

The industry was picking up momentum after three consecutive years of negative growth, which had been preceded by three consecutive years of record-breaking growth. According to the National Association of Automobile Manufacturers of South Africa (NAAMSA), new vehicle sales fell by 5.1 per cent in 2007, 21.1 per cent in 2008 and 25.9 per cent in 2009. The decline was largely due to the global recession, which had reduced the flow of credit in the financial system. Locally, the South African government had passed the National Credit Act[2] in July 2007, which regulated the flow of credit and further limited its availability. In 2010, however, a turnaround began. The industry had grown at 24 per cent over the previous year, exceeding initial projections of a 7 per cent increase. The momentum was expected to be sustainable. The government had targeted a production of 1.2 million vehicles in 2020 from about 0.5 million in 2010 (see **Exhibit 2**).

[2]Republic of South Africa, *National Credit Act, 2005,* www.ncr.org.za/pdfs/NATIONAL_CREDIT_ACT.pdf, accessed August 28, 2011.

South Africa exported vehicles to more than 70 countries, mainly Japan, Australia, the United Kingdom and the United States. African export destinations included Algeria, Botswana, Zambia, Zimbabwe, Lesotho, Mozambique, Namibia and Nigeria.

South Africans drove 1,390 variants of cars, recreational vehicles and light commercial vehicles. Domestic consumption was limited to well-known brands, such as Toyota, Volkswagen, Ford, Mazda and BMW. These brands together accounted for more than 80 per cent of new-vehicle sales in the country (see **Exhibit 3**). Present in South Africa were eight of the top 10 global vehicle makers, which sourced components and assembled vehicles for both local and overseas markets. South Africa also had three of the world's largest tire manufacturers. More than 200 automotive component manufacturers were located in South Africa, including several multinationals.

Growth Catalyst

The catalyst for the growth of the South African auto industry had been the government's Motor Industry Development Programme (MIDP).

Exhibit 2 South Africa: Total Vehicle Sales, Production, Exports and Imports, 2006–2010

	2010	2009	2008	2007	2006
Cars					
a) Local sales	113,740	94,379	125,454	169,558	215,311
b) Exports (CBUs)	181,654	128,602	195,670	106,460	119,171
c) Total domestic production	295,394	222,981	321,124	276,018	334,482
d) CBU imports	223,390	163,750	203,808	265,095	266,247
e) Total car market (a+d)	337,130	258,129	329,262	434,653	481,558
Light Commercial Vehicles					
a) Local sales	96,823	85,663	118,641	156,626	159,469
b) Exports (CBU)	56,950	45,514	87,314	64,127	60,149
c) Total domestic production	163,773	131,777	205,955	220,763	219,618
d) CBU imports	36,911	32,496	50,825	47,760	40,208
e) Total LCV market (a+d)	133,734	118,159	169,466	204,386	199,677
Medium & Heavy Vehicles					
Sales including imports	22,021	18,934	34,659	37,069	33,080
Exports	861	831	1,227	650	539
Total MCV/HCV market	22,021	18,934	34,659	37,069	33,080
Total Aggregate Market	492,907	395,222	533,387	676,108	714,315
Total Aggregate Exports	239,465	174,947	284,211	171,237	179,859
Total Domestic Production	472,049	373,923	562,965	534,490	587,719
GDP Growth Rate (%)	2.8	(1.7)	3.7	5.5	5.6

Source: National Association of Automobile Manufacturers of South Africa, "New Vehicle Sales Statistics," www.naamsa.co.za/flash/total.asp?/total_market_at_a_glance, accessed August 22, 2011.
Note: CBUs = completely built units; LCV = light commercial vehicle; MCV = medium commercial vehicle; HCV = heavy commercial vehicle; GDP = gross domestic product

Exhibit 3 Mahindra & Mahindra South Africa—Leader Brands' Production

#	Market Segment	Leader Brands	2010	2009	2008	2007	2006
1	Light Commercial Vehicles	Toyota	34,709	29,444	32,273	38,816	28,009
		Isuzu	10,886	10,550	17,191	18,754	22,135
		Nissan	13,082	10,217	12,406	21,102	23,554
		Ford	7,433	7,184	9,938	10,813	12,107
		Mazda	3,835	3,585	4,992	5,097	5,748
2	Sport-Utility Vehicles	Toyota	16,083	10,349	10,362	11,570	10,315
		Land Rover	4,349	3,630	4,363	5,363	4,380
		BMW	4,713	2,831	3,223	3,692	3,050
		Mercedes	3,713	3,070	3,445	5,207	3,970
		Chrysler	2,735	2,299	2,523	3,745	3,583
		M&M	1,555	1,148	1,662	3,160	3,315

Source: Company files

Introduced in 1995, MIDP had been legislated to last until 2009 and was to be phased out by 2012. It would be replaced in 2013 by the Automotive Production and Development Programme (APDP).

Pre-MIDP, the import duty rates for CBUs and completely knocked-down (CKD) components were 115 per cent and 80 per cent, respectively. The high duty rates were aimed at protecting the local industry from global competition. In 1995, under the MIDP, the tariffs were reduced to 65 per cent and 49 per cent, respectively. They had continued to decline at a steady rate, reducing year-on-year to 25 per cent for CBUs and 20 per cent for CKDs in 2012.

Several MIDP provisions had helped boost automotive exports from South Africa. For example, the MIDP enabled local vehicle manufacturers to import goods duty-free to the extent of the value of their exports, thus allowing them to concentrate on manufacturing for export. The MIDP also granted vehicle manufacturers a production-asset allowance to invest in new plant and equipment, reimbursing 20 per cent of their capital expenditure in the form of import-duty rebates over a period of five years.

The APDP was meant to create long-term sustainability by concentrating on localization of vehicle content. Meant to last until 2020, the APDP was built around four key elements: tariffs, local assembly allowance, production incentives and automotive investment allowance. The program aimed to create a stable and moderate import tariffs regime from 2013, set at 25 per cent for CBUs and 20 per cent for components. It would also offer a local assembly allowance (LAA), which would enable vehicle manufacturers with a plant volume of at least 50,000 units per annum to import a percentage of their components duty-free. The investment allowance of 20 per cent would also be carried forward from the MIDP regime.

All rebates of import duty were given in the form of certificates that were tradable in the open market and could, therefore, be converted into cash. However, many automotive manufacturers used the certificates themselves to offset the cost of their imports. For example, to reduce the cost of their imports trading companies such as M&M (SA) purchased these certificates, when they were available at low prices in the open market. Said Nico M. Vermeulen, director, NAAMSA:

> A trading company, which imports CBUs at 25 per cent duty and sells them either in the domestic or export markets, will not get any certificate because it is neither manufacturing nor adding value locally. An assembly plant, which imports CKDs at 20 per cent import duty, must meet with three conditions in order to be eligible for a certificate: be registered with the Department of Trade and Industry; assemble a minimum of 50,000 vehicles per annum; and export. The value of the certificate for an assembly plant is linked to the value of export income it generates. A manufacturing company must produce 50,000 vehicles per annum to be eligible for a certificate which is linked, not to exports as in an assembly plant, but to the value added in the form of local content. A manufacturer gets the certificate, irrespective of whether the products are sold locally or exported, as long as it provides evidence of content localization.[3]

MIDP differed from APDP because it incentivized exports of vehicles and components, whereas APDP incentivized value added through local production. Both incentives were in tune with the outcomes the government was seeking at different points of time. The gradual decline in tariff protection was aimed at helping the domestic auto manufacturing companies become efficient in several ways. They could secure economies of scale, rationalize product platforms, focus on exports, compete globally and benchmark their operations against the best in the world. NAAMSA had estimated that the average annual volumes of production per platform would need to increase to a minimum of 80,000 units for a local company to become globally competitive. Similarly, employee productivity would need to improve from 15 vehicles to 30 vehicles per employee per annum.

Consumer Classification

South Africa had a population of 50.6 million, of which the black Africans comprised 40.2 million, white Africans 4.6 million, coloured Africans 4.5 million and Indian/Asian Africans 1.27 million.[4]

[3] Interview with case author, September 02, 2011.

[4] South Africa.info, "South Africa's Population," www.southafrica.info/about/people/population.htm, accessed August 18, 2011.

The South African Advertising Research Foundation (SAARF), an independent trade body, had segmented South African adult consumers (ranging in age from 15 to 50-plus) into 10 categories known as Living Standards Measures (LSMs). The measures graded people from 1 to 10 in an ascending order of their standard of living. Instead of using traditional metrics such as race and income, the SAARF LSM, which had won an award as the "media innovator of the year," grouped people by using such criteria as degree of urbanization and ownership of cars and major appliances. The grading was meant to help marketers and advertisers of goods and services to identify, as accurately as possible, their target markets (see **Exhibit 4**).

The data for the year ending December 2010 had reiterated a major trend that had long been evident in South African marketing. The buying power of black African consumers, comprising the largest group in the middle-income (LSM 5–8) market, was rising. Said Ashok Thakur, CEO of M&M (SA):

> The mindset of white African consumers, who have been the bedrock of the vehicles market in South Africa, is similar to the mindset of consumers in the countries of West Europe. They buy well-known brands because they trust them. That explains why there has been

Exhibit 4 South Africa—Customer Segmentation, December 2010

	LSM1	LSM2	LSM3	LSM4	LSM5	LSM6	LSM7	LSM8	LSM9	LSM10
Population ('000s)	808	1,944	2,394	4,744	5,636	6,891	3,621	2,830	3,038	2,114
Population Group (%)										
• Black African	98.4	98.0	98.8	96.8	94.9	82.3	58.7	48.6	34.0	18.9
• Coloured African	1.6	1.9	1.2	3.2	4.3	11.3	18.8	16.1	13.9	6.4
• White African	—	—	—	—	0.2	1.5	4.6	6.7	8.1	9.9
• Indian/Asian African	—	—	—	0.1	0.7	4.9	17.9	28.6	44.0	64.7
Household income (%)										
• >R799	23.1	13.9	12.7	6.8	4.5	1.1	0.3	0.2	0.1	—
• R800–R1,399	38.0	33.8	28.2	22.1	16.1	6.9	2.2	0.9	0.2	—
• R1,400–R2,499	28.0	32.9	30.8	23.3	17.2	9.8	3.6	1.8	0.7	0.2
• R2,500–R4,999	9.7	17.5	23.4	33.4	34.7	25.2	13.3	6.2	2.3	0.6
• R5,000–R7,999	1.1	1.0	4.4	11.5	18.6	28.0	24.3	16.1	8.9	2.5
• R8,000–R10,999	0.1	0.6	0.1	2.1	6.0	16.3	25.2	22.0	17.6	7.2
• R11,000–R19,999	—	0.4	0.5	0.9	2.6	10.6	23.2	31.3	32.2	18.4
• >R20,000	—	—	—	—	0.4	2.1	7.9	21.4	38.1	71.0
Age (% of population)										
• 15–24	30.6	29.5	31.4	32.0	33.9	29.3	25.5	25.9	26.3	26.9
• 25–34	21.2	18.9	20.3	23.1	23.6	26.1	25.7	21.3	19.7	17.2
• 35–49	17.3	22.8	24.7	22.8	23.4	25.1	27.3	28.0	28.8	29.0
• 50 plus	30.8	28.8	23.6	22.1	19.1	19.5	21.5	24.7	25.2	26.9
Community (%)										
• Metro (250,000 plus)	—	29.5	31.4	32.0	33.9	29.3	25.5	25.9	26.3	26.9
• Urban (<250,000)	—	18.9	20.3	23.1	23.6	26.1	25.7	21.3	19.7	17.2
• Villages (<40,000)	—	22.8	24.7	22.8	23.4	25.1	27.3	28.0	28.8	29.0
• Rural	100	28.8	23.6	22.1	19.1	19.5	21.5	24.7	25.2	26.9

Source: www.saarf.co.za/SAARF_LSM/SAARF_Demographics/Table 40, accessed August 26. 2011.

> a strong influence, for decades, of German brands in the South African automotive market. However, as the percentage of black African consumers entering higher income bands goes up, one would think that black Africans will acquire the buying habits and preferences of white Africans who are already in those bands. But, our experience in South Africa proves the opposite.

The black African consumers were buying Western European brands, and more recently Japanese and Korean brands, not because they trusted them but because they did not trust the local brands. This element of rebound had strategic implications for companies such as M&M (SA). The brand savviness of black Africans provided room for automotive brands other than those from Europe, Japan and Korea to strengthen their brand equity so that they could lock in sales from the growing black African consumers. M&M (SA) saw this situation as an entry-level opportunity.

A June 2010 *McKinsey Quarterly* research article into South African consumer goods had led to similar conclusions. It showed that 49 per cent of middle-income black consumers but only 26 per cent of middle-income white consumers agreed with the statement: "I purchase branded food products because they make me feel good." Among upper-income black Africans, those agreeing with the statement jumped to 65 per cent, while only 22 per cent of upper-income white Africans agreed. Of all black African consumers surveyed, 71 per cent agreed with the statement: "I have to pay careful attention so stores do not cheat me." In electronic goods, more than 60 per cent of black African consumers agreed that "products with no brands or less-known brands might be unsafe to use." In both cases, far fewer white consumers concurred.[5]

According to Thakur, the South African automotive market was also witness to three other trends that contrasted white African and black African consumers. White Africans earned more and also spent more, leaving them with less disposable income to invest in discretionary purchases, such as automobiles. Black Africans earned less but also spent less and seemed to have higher disposable incomes. Second, white Africans were buying used vehicles rather than new vehicles although their brand preferences remained. Black Africans, on the other hand, were buying new vehicles. Third, white Africans preferred functional attributes (such as good mileage), whereas black Africans preferred features, based on aesthetics, design and comfort, in their automobiles.

M&M Company Background

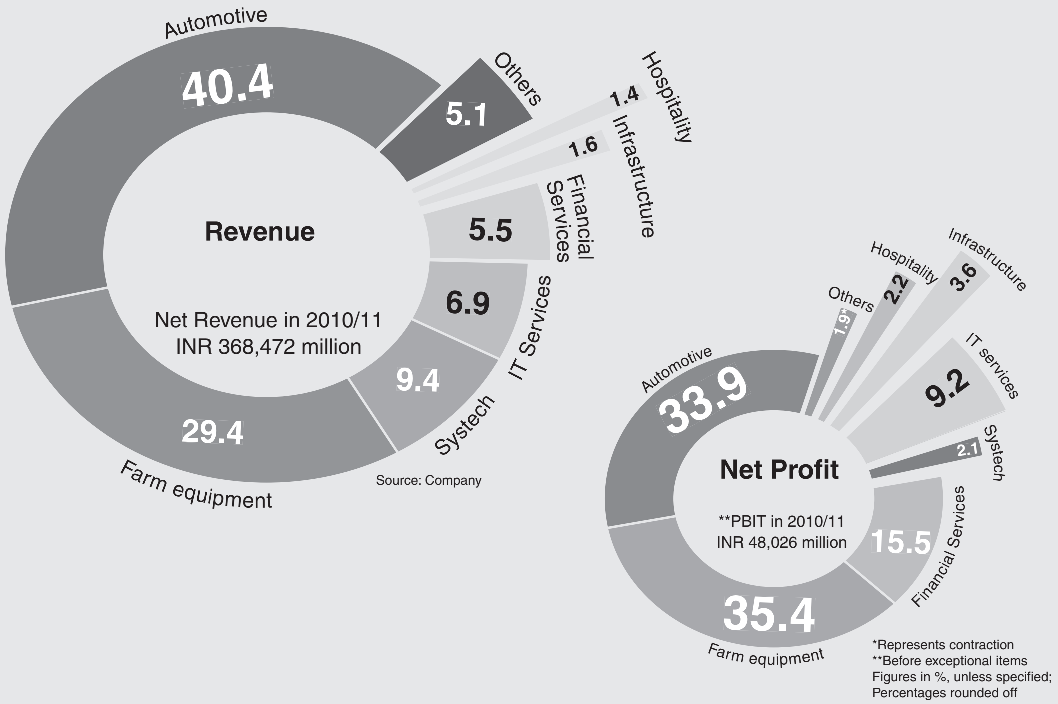
M&M was founded as a steel trading company in Mumbai, India, in 1945, by two brothers, J. C. Mahindra and K. C. Mahindra. Two years later, M&M entered into automotive manufacturing by launching Willys, the iconic World War II jeep, on a franchise from Willys-Overland Motors, the American maker of general purpose utility vehicles (UVs). Willys was the country's first UV. The company began manufacturing farm equipment in 1960. The UV and tractor platform gradually became the company's core competence.

The company had extended its core competence, over time, into the full spectrum of the automotive value chain. By 2011, it was producing two-wheelers at one end, small turbo prop aircraft at the other, and trucks, buses, pickups and cars in between. Positioning itself on the platform of "motorized mobility," the company had also started making powerboats, securing a presence in the transportation media across "land, sea and sky."

The mobility platform had generated opportunities for synergies across the company's auto categories. Broadly, they prevailed in sourcing, product development and quality control. Common for all products was the use of raw materials such as steel and aluminum, which were used in castings and forgings. The automotive and tractor divisions had a common engine development team. The processes for quality improvements at the supplier end were uniform across categories. Synergies also prevailed at the level of operations. For example, transmissions and other aggregates were shared between different vehicles.

[5] Bronwen Chase et al., "A Seismic Shift in South Africa's Consumer Landscape," *McKinsey Quarterly,* June 2010, www.mckinseyquarterly.com/search.aspx?q=south Africa, accessed August 16, 2011.

Exhibit 5 Mahindra and Mahindra—Business Segments



Source: Kushan Mitra, "How Anand Mahindra Built His $12.5-Billion Empire," http://businesstoday.intoday.in/story/anand-mahindra-mandm-company-acquisitions/1/18656.html *Business Today,* October 2, 2011, accessed October 20, 2011.

M&M had also diversified into unrelated areas branching into financial services, information technology (IT), hospitality, infrastructure and other areas. The group was in a total of eight businesses (see **Exhibit 5**). Each business operated autonomously under its own CEO. Some of the CEOs were members of the Group Executive Board of the parent company. Each was a growing business in an emerging market like India. The group had 45 operating companies, some of which were listed on local stock exchanges.

M&M was one of India's leading multinationals and had 113,000-plus employees, of whom 12 per cent were foreigners and Indian expatriates, located across 79 countries. It had consolidated revenues of ₹370 billion for the year ending March 2011 and profit before tax of ₹45 billion (see **Exhibit 6**). The group was cash flow positive. It had $650 million surplus and internal accruals were growing every year.

[6] Indian rupee (₹44.9908 = 1US$), www.exchange-rates.org/Rate/USD/INR/5-20-2011, accessed November 16, 2011.

Business Model

The business model followed by M&M was rooted in what the company called "engine theory." The parent company was viewed as an engine with multiple pistons. Each business vertical was in the nature of a piston. For example, the automotive sector was one piston, IT was another and so on. Each piston was a driver in its own right, focused not only on what it did best but also on improving the performance of the engine. The more verticals the company added, the longer and stronger the crankshaft grew. Each vertical was also receiving

Exhibit 6 Mahindra & Mahindra—Consolidated Income Statement

(in million ₹)	2011	2010	2009
Net sales	**370,264**	**316,880**	**269,198**
Less			
• Raw materials	199,970	152,679	130,637
• Personnel	42,183	45,825	42,749
• Interest	9,742	9,798	7,501
• Depreciation	9,724	8,735	7,493
Profit before taxation	**45,149**	40,328	**22,541**
Net profit	**30,797**	**24,786**	**14,054**

Source: Mahindra & Mahindra Annual Report, 2010–11, page 129 and Mahindra & Mahindra Annual Report, 2009–10, page 138.
Note: Net sales includes other income.

the horizontal benefit, or the crankshaft benefit, of group synergies that, in turn, improved its performance. Each vertical was free to form joint ventures to acquire new skills and leverage sourcing, manufacturing and technology of partners outside M&M.

The company had mandated what it called the "50 per cent rule" for each business, wherein even if demand fell by as much as 50 per cent, each business had to remain profitable. The objective was not only to provide enough room for business cycles, global shocks and other external factors but also to create a multiplier effect when volumes grew in times of more consistent activity.

The analyst community was treating M&M as a conglomerate on the ground that it had ventured, over the years, into newer businesses, which they considered to be non-core areas. While valuing the company, analysts were, therefore, giving it a conglomerate discount of 10 to 15 per cent. But the management of M&M saw the group as a federation of independent companies, benefiting from both business focus and group synergies. It was of the view that unlike a conglomerate, M&M provided an opportunity for investors in the parent company to participate in the equity of distinctive businesses that were creating shareholder value. Thus, according to the management, M&M should have received a federation premium, instead of a conglomerate discount.

The parent company saw its role as an allocator of capital. The group was trying to find a sweet spot between being a private equity firm (which juggled a diverse portfolio of investments and used leverage to create short-term value for each investment) and a family-run conglomerate (which focused on skill development and took a longer-term view of business).

Automotive Products

In addition to the production facilities that had become part of M&M as a result of acquisitions over the years, both in India and overseas, M&M had six assembly plants outside of India and nine manufacturing plants of its own within India. The company had an 88,000 square foot assembly unit in Houston, Texas, and one smaller unit each in Red Bluff, California, and in Chattanooga, Tennessee. These units were assembling tractors from completely knocked down (CKD) kits imported from India. M&M also had one assembly facility each in Brazil, Australia and Egypt. These units were assembling commercial vehicles and pickups from CKDs imported from India.

M&M had entered the India urban UV segment in 2002 with the launch of the Scorpio. The UV segment was small in India and growing at about 14 per cent per annum. Although the Scorpio was a UV, it was billed as "more than a car" (or "car plus")—a new segment M&M had created on a price-value proposition (of between ₹500,000 and ₹700,000) aimed at both the B segment (cars selling up to ₹500,000) and the C segment (cars selling at ₹700,000). By positioning the Scorpio as a mid-size car competing with car makers in B and C segments rather than with UV makers, M&M was able to grow the Scorpio sales in India at 30 per cent.

M&M had a 60 per cent share of the domestic UV market by value and 52 per cent by volume (see **Exhibit 7**). Its UV products consisted of multipurpose vehicles, sport-utility vehicles (SUV) and pickup trucks characterized by ruggedness and reliability. The company's long-term goal was to build a global brand in the SUV and pickups segment.

Exhibit 7 Mahindra & Mahindra—Indian Domestic Market Shares by Volume

	2011			*2010*		
Category	**Total Domestic sales**	**M&M sales**	**M&M share (%)**	**Total Domestic sales**	**M&M sales**	**M&M share (%)**
Utility Vehicles	323,896	169,205	52.2	272,741	150,726	55.2
Light Commercial Vehicles	353,621	114,856	32.4	287,777	86,217	—
Three-wheelers	526,022	62,142	11.8	440,392	44,438	3.0
Two-wheelers	11,790,305	163,914	1.4	9,371,231	70,008	0.7
Cars	1,982,990	10,009	0.5	1,528,337	5,332	0.3
Medium/Heavy Commercial Vehicles	322,749	843	0.4	244,944	—	—
Multi-Purpose Vehicles	213,507	966	0.4	150,256	—	—
Total Auto Products	15,513,090	521,935		12,295,678	356,721	
Tractors	480,377	—	—	400,203	—	—

Source: Mahindra & Mahindra Annual Report, 2010–11 pages 28 and 29 of 172.
Note: Industry sales attributed in the report to the Society of Indian Automotive Manufacturers (SIAM).

M&M was also the largest producer of tractors in the world by volume.

Globalization

A global perspective was a hallmark at M&M from the beginning. The company had entered into a series of joint ventures with overseas companies. The launch of economic reforms by the federal government of India in July 1991 had given the ongoing perspective a new push. M&M was of the view that it each of its businesses would be facing new competition from international companies entering India; consequently, it had to prepare to defend its turf on the home ground. Said Shah:

> The anchor of our globalization strategy is that competing with multinational companies in overseas markets helps us compete with them better in India. Globalization gives us access to new technologies, new markets and new skill sets. It makes us competitive in emerging markets like Brazil, Russia, India and China and, of late, South Africa, which will be the growth markets of the future. M&M believes in the Africa story. South Africa, in particular, is of interest to us not just because it is one of the most important export markets for M&M but because it is a springboard for the larger African market. South Africa is also where there is a good fit between what the customers need and what we can provide and between the price we offer and the value perceived by the customer

The long-term aspiration of M&M was to be recognized as a global SUV brand. In line with that aspiration, M&M had acquired a majority stake in SsangYong Motor Company (SsangYong) of Korea in February 2011. SsangYong was a major SUV manufacturer and a natural fit for M&M. The product range, the markets and the price range created a continuum for M&M, opening up new markets for M&M's SUV brands in Russia, China and Korea.[7]

[7] Mahindra & Mahindra, "Inside an International Acquisition," video clip, http://rise.mahindra.com/rise_topics/inside-an-international-acquisition, between 3:11 and 4:35 of 7:45-minute video, accessed September 1, 2011.

M&M in South Africa

M&M formally entered the South African market in February 2005, by setting up a 51 per cent subsidiary, Mahindra & Mahindra SA (M&M (SA)). The balance of 49 per cent was held by a local partner whose investment wing of the business had helped finance the venture. M&M had been exporting its automobiles to South Africa since October 2004 and had appointed dealers in all nine provinces of South Africa. M&M (SA) had also created a network of customer service outlets and collaborated with a local logistics company to ensure distribution of spare parts to service outlets countrywide within 24 hours.

By October 2004, M&M (SA) started importing two of its leading Indian brands—Bolero and Scorpio—both SUVs, in five models, fully assembled. Subsequently, it was importing two other SUV brands, Xylo and Thar, from M&M's plants in India. Before being launched in South Africa, all models had been tested in the hazardous terrains of Australia and Europe, in high altitudes, low levels, deserts and cold conditions, in addition to being tested in the local terrain by local testing agencies. Said Thakur:

> Our entry strategy into South Africa was two-fold. First, we wanted a niche in the SUV segment straddling both cargo and passenger traffic. We did not want to play in the mass market. We identified four-wheeler passenger vehicles and pickups and delivery vehicles carrying cargo as our market segments. Second, we offered a value proposition by pricing Bolero, our launch vehicle, at between 20 per cent and 30 per cent lower than the prevailing competition. Bolero caught up with farming and small business segments and did very well with customers in semi-urban and rural areas and in villages where it was identified with "toughness"—an attribute which is valued in an African terrain. Scorpio reinforced it. We now need to build on it in the urban markets.

The global launch of the Scorpio pickup range of vehicles was held in South Africa in 2006, highlighting the strategic importance of South Africa as a market in the company's global growth plans. The company was making new brands available in South Africa, around the same time it launched the brands in India. For example, Xylo, a multi-purpose vehicle, was launched in India in January 2009 and in South Africa in March 2009.

M&M (SA) bought out its local partner's stake in August 2009, with a view to fully control and manage the business. It had the mission of "providing world-class products and services, at an unbeatable all round value to the customer, by unleashing the power of our people to benefit both partner countries and the communities we serve."[8] In five years of doing business in South Africa, M&M (SA) had sold a total of 11,000 vehicles. By 2011, it had a turnover of $40.3 million for the year ending March 2010 (see **Exhibit 8**). It had secured a market share of about 1.2 per cent in the pickup market and in the low to medium range SUV markets, and the goal was to increase these markets to 5 per cent (see **Exhibit 9**).

The Mahindra brand in South Africa used different SUVs to target different segments—individuals, families, mining companies and farmers. It competed with Kia, Hyundai and Nissan for SUVs and with Toyota for pickups. Soon, M&M (SA) was a player of choice in the used-car market. Many local customers were becoming second-time buyers, indicating a strong loyalty for the Mahindra brand.

The medium to long-term plan was to make M&M (SA) the entry point into Africa. A major constraint M&M (SA) faced in this regard was the vehicle ordering cycle from India, which took more than two months. This long cycle was a limitation when bidding for contracts from the African governments, particularly those in the sub-Sahara region, which were the single largest buyers of new vehicles. A short lead time was often a competitive advantage in winning those contracts.

Issues Before Shah

Contract Assembly M&M (SA) had been in talks with a few vendors in South Africa regarding the assembly of pickup vehicles, which were being shipped out of India to countries in West Africa. Local

[8] www.mahindra.com/spotlight, accessed September 10, 2011.

Exhibit 8 Mahindra & Mahindra South Africa—Income Statement

Year ending March	*2011*	*2010*	*2009*
	in South African Rand (ZAR)		
Sale of Vehicles	235,876,218	161,563,355	157,855,190
Sales of Spares	34,448,679	29,318,826	30,217,514
Sale of Tractors	273,000	1,511,999	9,483,660
Sale of Accessories	169,051	69,583	176,020
Sale of Services	—	—	952,766
Total Revenue	**270,766,948**	**192,463,763**	**198,685,150**
Less Cost of sales	221,703,228	166,470,257	199,642,431
Gross Profit	49,063,720	25,993,506	(957,281)
Add Other Income	138,082	1,653,520	369,597
Add Investment Revenue	3,145,901	2,970,225	1,138,512
Less Finance Cost	2,409,208	4,518,481	11,985,817
Less Operating Expenses	23,900,437	22,425,423	41,954,297
Profit Before Tax	26,038,058	**3,673,347**	**(53,389,286)**
Tax	7,293,834	1,044,461	14,664,466
Profit After Tax	**18,744,224**	**2,628,886**	**(38,724,820)**

Source: www.mahindra.com/investors/mahindra&mahindra/resources/2010-11/subsidiary_annual_report_part_2 and www.mahindra.com?investors/mahindra &mahindra/resources/2009-10/subsidiary_annual_report, p. 6 and p. 13 of the Subsidiary Annual Report, 2010–11 Part 2 and p. 746 of the Subsidiary Annual Report, 2009–10, accessed October 01, 2011.
Note: 1 ZAR = US$ 0.148954.

assembly would improve margins by reducing, by about 25 per cent, the cost of shipping CBUs from India to African destinations. The vehicles could be assembled in South Africa for export to African destinations. Costs could be further reduced by launching variants that were in demand and by locally sourcing some of the components and extra fitments. Once M&M (SA) made the decision to assemble the vehicles locally, only three-months lead time would be needed to commence operations. Local assembly also meant that M&M (SA) would not need to make any major upfront investment in the vendor's facilities.

Brand equity was a major driver in the South African automobile market, where consumers bought cars and trucks on the basis of brand recall. Consumers preferred global brands because South Africa had no home-grown automobile brands. In spite of more than five years of presence in South Africa, M&M (SA)'s volume of sales was not comparable to global players operating in South Africa. Its brand equity was also not comparable with such global competitors as Toyota, Nissan and others.

M&M was accustomed to occupying the driver's seat. The mindset of being in charge prevailed throughout the organization, from the way it structured joint ventures (in which it invariably held the majority shareholding), to its staffing of key positions at the top with its own people. As a result, a contract assembly, in which the vendor ruled, particularly in mobilizing and deploying resources, would be a difficult proposition for M&M managers.

For the past two years, the company had contracted an assembly plant in Egypt for the Scorpio vehicle and another in Brazil for a pickup vehicle. When using local assembly, the vehicle ordering cycle would be about 10 days. The choice of contract assembly depended upon the availability of surplus capacity, the ability of the vendor to ramp up capacity consistent with changing needs and the vendor's knowledge and technical know-how, financial capability and management bandwidth.

Certification of the locally assembled vehicles local agencies was an area in which M&M (SA) did not have competence since it was only importing

Exhibit 9 Mahindra & Mahindra South Africa — Sales Volume

#	M&M Models	Models	Year of launch	Main attributes	Target customer segments	2010	2009	2008	2007	2006	2005
1	Bolero 	S/Cab D/Cab	2004	Tough Durable Work and play	Contractors Farmers Service providers	387	342	725	1,429	1,442	579
2	Scorpio 	Manual Auto Petrol Diesel	2004	7–8 seater Off-road use Safety features	Urban consumers	211	267	355	810	1,128	366
3	Scorpio Pickup 	S/Cab D/Cab 2-Wheel 4-Wheel	2006	Multi-Utility Vehicle	Contractors Farmers Small businesses	612	375	582	921	745	—
4	Mahindra Thar 	4 by 4	2010	Sports Utility Vehicle	Outdoor customers Off-roaders Retro-look seekers	107	—	—	—	—	—
5	Mahindra Xylo 	E8 E2	2009 2009	Luxury People mover	Taxi operators Ferry owners Shuttle providers	238	164	—	—	—	—
	Total					1,555	1,148	1,662	3,160	3,315	945

Source: Company files.

CBUs from its Indian operations. The certification could be outsourced in South Africa; however, doing so would be a departure from the norm at M&M, which typically retained all critical business processes under its control.

Own Manufacturing

Setting up a manufacturing plant in South Africa would be consistent with M&M's mission of being a long-term player. It would also demonstrate to customers its commitment to the local market, which would be a major factor in an industry where after-sales service, such as a warranty, was a crucial factor in attracting sales. Setting up its own manufacturing plant would also present an opportunity to lock in customers at the beginning of the growth curve in the South African market, which was the biggest export market for the parent company M&M. Raising funds in this option was not an area of concern because M&M had always operated as a cash surplus company.

Manufacturing was the easier part in automobiles. The real challenge, particularly in South-Africa, was localization of content. Gross margins in the automobile industry fluctuated with production volume because many of the costs related to vehicle production were fixed. Once M&M (SA) got into manufacturing, it would be under pressure to sustain high production levels just to break even. Beyond the break-even point, fixed costs could be spread over more units, opening the doors for profitability.

Wait and Watch

M&M (SA) sales had suffered during the downturn but the confidence levels of the subsidiary had been high. The subsidiary had used the recessionary period to reduce fixed costs (through outsourcing, among other solutions), streamline operations (particularly for shipping and port-related work), improve its business processes and enlarge the reach and quality of its dealer network so that when the recession ended, M&M (SA) could become stronger and would be better prepared to face competition.

M&M (SA) could continue its prevailing business model of importing automotive products from India and exporting them from South Africa. This approach would help the company tide over the recession from which it was only mid-way to recovery. However, it would need to bear the higher rate of import duty of 25 per cent compared with local assemblers and manufacturers.

Use South Africa as a Hub

M&M (SA) had an opportunity to develop markets in the 54 countries on the African continent, which were just opening up. Africa and Asia (with the exception of Japan) were the only continents that grew during the recession years of 2007 to 2009. Africa's GDP growth slowed to 2 per cent in 2009 but recovered to 4.7 per cent in 2010 and was expected to move upward. Companies entering the African continent at the beginning of the new growth period could take the lead in shaping industry structures, segmenting markets and establishing brands.

The boom in commodity prices in early 2007 had led global companies to show interest in the African region, which, in addition to having rich deposits of minerals and metals, had 10 per cent of the world's oil reserves. But many companies were guarded in developing entry strategies for the region because of the ongoing recession. The political turmoil in countries such as Algeria, Egypt, Libya, Morocco and Tunisia added to the uncertainty. The paradox for a multinational was that the fastest growing economies in the region also carried the highest macro-economic risks.

In a study entitled "Lions on the Move" published in June 2010, McKinsey Global Institute had categorized the African economies into four buckets: oil exporters, diversified economies, transition economies and pre-transition economies. It had further categorized the African economies on the basis of GDP per capita. Algeria, Botswana, Equatorial Guinea, Gabon, Libya and Mauritius ranked first with South Africa, with per capita GDP in excess of $5,000 per annum. Congo Republic, Morocco, Namibia and Tunisia ranked second with GDP per capita ranging between $2,000 and $5,000. Cameroon, Côte d'Ivoire, Egypt, Nigeria, Sudan, Senegal and Zambia ranked third with GDP per capita ranging between $1,000 and $2,000.[9] These 17 countries together comprised the first line of target for re-exports from South Africa. Said Shah:

The board would be interested in understanding the trade-offs involved in each of the four options. The members would, of course, want to know the level of investment and the expected return. These are quantitative and it would not take long to reach a consensus on them. The litmus test would be qualitative; it will be about the growth potential of the South African market. Their question would be something like, "Where will our decision now take M&M (SA) by 2015?"

[9] McKinsey Global Institute, *Lions on the Move: The Progress and Potential of African Economies,* www.mckinsey.com/mgi/publications/progress_and_potential_of_african_economies/index.asp, p. 5, accessed September 12, 2011.

Case 1-4 Acer, Inc: Taiwan's Rampaging Dragon

With a sense of real excitement, Stan Shih, CEO of Acer, Inc., boarded a plane for San Francisco in early February 1995. The founder of the Taiwanese personal computer (PC) company was on his way to see the Aspire, a new home PC being developed by Acer America Corporation (AAC) Acer's North American subsidiary. Although Shih had heard that a young American team was working on a truly innovative product, featuring a unique design, voice recognition, ease-of-use, and cutting-edge multimedia capabilities, he knew little of the project until Ronald Chwang, President of AAC had invited him to the upcoming product presentation. From Chwang's description, Shih thought that Aspire could have the potential to become a blockbuster product worldwide. But he was equally excited that this was the first Acer product conceived, designed, and championed by a sales-and-marketing oriented regional business unit (RBU) rather than one of Acer's production-and-engineering focused strategic business units (SBUs) in Taiwan.

Somewhere in mid-flight, however, Shih's characteristic enthusiasm was tempered by his equally well-known pragmatism. Recently, AAC had been one of the company's more problematic overseas units, and had been losing money for five years. Was this the group on whom he should pin his hopes for Acer's next important growth initiative? Could such a radical new product succeed in the highly competitive American PC market? And if so, did this unit—one of the company's sales-and-marketing-oriented

Professor Christopher A. Bartlett and Research Associate Anthony St. George prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. Some historical information was drawn from Robert H. Chen, "Made in Taiwan: The Story of Acer Computers," Linking Publishing Co., Taiwan, 1996, and Stan Shih, "Me-too is Not My Style," Acer Foundation, Taiwan, 1996. We would like to thank Eugene Hwang and Professor Robert H. Hayes for their help and advice.

Exhibit 1 Selected Financials: Sales, Net Income, and Headcount, 1976–1994

	1976	1977	1978	1979	1980	1981	1982	1983	1984
Sales ($M)	0.003	0.311	0.80	0.77	3.83	7.08	18.1	28.3	51.6
Net Income ($M)	N/A	N/A	N/A	N/A	N/A	N/A	N/A	1.4	0.4
Employees	11	12	18	46	104	175	306	592	1,130

RBUs—have the resources and capabilities to lead the development of this important new product, and, perhaps, even its global rollout?

Birth of the Company

Originally known as Multitech, the company was founded in Taiwan in 1976 by Shih, his wife, and three friends. From the beginning, Shih served as CEO and Chairman, his wife as company accountant. With $25,000 of capital and 11 employees, Multitech's grand mission was "to promote the application of the emerging microprocessor technology." It grew by grasping every opportunity available—providing engineering and product design advice to local companies, importing electronic components, offering technological training courses, and publishing trade journals. "We will sell anything except our wives," joked Shih. Little did the founders realize that they were laying the foundations for one of Taiwan's great entrepreneurial success stories. (See **Exhibit 1.**)

Laying the Foundations Because Multitech was capital constrained, the new CEO instituted a strong norm of frugality. Acting on what he described as "a poor man's philosophy," he leased just enough space for current needs (leading to 28 office relocations over the next 20 years) and, in the early years, encouraged employees to supplement their income by "moonlighting" at second jobs. Yet while Multitech paid modest salaries, it offered key employees equity, often giving them substantial ownership positions in subsidiary companies.

Frugality was one of many business principles Shih had learned while growing up in his mother's tiny store. He told employees that high-tech products, like his mother's duck eggs, had to be priced with a low margin to ensure turnover. He preached the importance of receiving cash payment quickly and avoiding the use of debt. But above all, he told them that customers came first, employees second, and shareholders third, a principle later referred to as "Acer 1-2-3."

Shih's early experience biased him against the patriarch-dominated, family-run company model that was common in Taiwan. "It tends to generate opinions which are neither balanced nor objective," he said. He delegated substantial decision-making responsibility to his employees to harness "the natural entrepreneurial spirit of the Taiwanese." With his informal manner, bias for delegation, and "hands-off" style, Shih trusted employees to act in the best interests of the firm. "We don't believe in control in the normal sense. . . . We rely on people and build our business around them," he said. It was an approach many saw as the polar opposite of the classic Chinese entrepreneur's tight personal control. As a result, the young company soon developed a reputation as a very attractive place for bright young engineers.

Shih's philosophy was reflected in his commitment to employee education and his belief that he could create a company where employees would constantly be challenged to "think and learn." In the early years, superiors were referred to as "shifu," a title usually reserved for teachers and masters of the martial arts. The development of strong teaching relationships between manager and subordinate was encouraged by making the cultivation and grooming of one's staff a primary criterion for promotion. The slogan, "Tutors conceal nothing from their pupils" emphasized the open nature

1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
94.8	165.3	331.2	530.9	688.9	949.5	985.2	1,259.8	1,883	3,220
5.1	3.9	15.3	26.5	5.8	(0.7)	(26.0)	(2.8)	85.6	205
1,632	2,188	3,639	5,072	5,540	5.711	5,216	5,352	7,200	5,825

of the relationship and reminded managers of their responsibility.

This created a close-knit culture, where coworkers treated each other like family, and the norm was to do whatever was necessary for the greater good of the company. But is was a very demanding "family," and as the patriarch, Stan Shih worked hard to combat complacency—what he called "the big rice bowl" sense of entitlement—by creating a constant sense of crisis and showering subordinates with ideas and challenges for their examination and follow-up. As long as the managers took responsibility for their actions—acted as responsible older sons or daughters—they had the freedom to make decisions in the intense, chaotic, yet laissez-faire organization. Besides his constant flow of new ideas, Shih's guidance came mainly in the form of the slogans, stories, and concepts he constantly communicated.

This philosophy of delegation extended to organizational units, which, to the extent possible, Shih forced to operate as independent entities and to compete with outside companies. Extending the model externally, Shih began experimenting with joint ventures as a way of expanding sales. The first such arrangement was struck with a couple of entrepreneurs in central and southern Taiwan. While capturing the partners' knowledge of those regional markets, this approach allowed Multitech to expand its sales without the risk of hiring more people or raising more capital.

Early successes through employee ownership, delegated accountability, management frugality, and joint ventures led to what Shih called a "commoner's culture." This reflected his belief that the way to succeed against wealthy multinationals—"the nobility"—was to join forces with other "commoners"—mass-market customers, local distributors, owner-employees, small investors and supplier-partners, for example. The "poor man's" values supported this culture and guided early expansion. As early as 1978, Shih targeted smaller neighboring markets that were of lesser interest to the global giants. At first, response to Multitech's promotional letters was poor since few foreign distributors believed that a Taiwanese company could supply quality hi-tech products. Through persistence, however, Multitech established partnerships with dealers and distributors in Indonesia, Malaysia, Singapore, and Thailand. Shih described this early expansion strategy:

> It is like the strategy in the Japanese game *Go*—one plays from the corner, because you need fewer resources to occupy the corner. Without the kind of resources that Japanese and American companies had, we started in smaller markets. That gives us the advantage because these smaller markets are becoming bigger and bigger and the combination of many small markets is not small.

Expansion abroad—primarily through Asia, Middle East and Latin America—was greatly helped by a growing number of new products. In 1981, Multitech introduced its first mainstream commercial product, the "Microprofessor" computer. Following the success of this inexpensive, simple computer (little more than an elaborate scientific calculator), Shih and his colleagues began to recognize the enormous potential of the developing PC market. In 1983, Multitech began to manufacture IBM-compatible PCs—primarily as an original equipment manufacturer (OEM) for major brands but also under its own Multitech brand. In 1984 sales reached $51 million, representing a sevenfold increase on revenues three years earlier.

By 1986, the company felt it was ready to stake a claim in Europe, establishing a marketing office in Dusseldorf and a warehouse in Amsterdam. Multitech also supplemented the commission-based purchasing unit it had previously opened in the United States with a fully-fledged sales office.

Birth of the Dragon Dream By the mid-1980s, Multitech's sales were doubling each year and confidence was high. As the company approached its tenth anniversary, Shih announced a plan for the next ten years that he described as "Dragon Dreams." With expected 1986 revenues of $150 million, employees and outsiders alike gasped at his projected sales of $5 billion by 1996. Critics soon began quoting the old Chinese aphorism, "To allay your hunger, draw a picture of a big cake."

But Shih saw huge potential in overseas expansion. After only a few years of international experience, the company's overseas sales already accounted for half the total. In several Asian countries Multitech was already a major player: in Singapore, for example, it had a 25% market share by 1986. To build on this Asian base and the new offices in Europe and the United States, Shih created the slogan, "The Rampaging Dragon Goes International." To implement the initiative, he emphasized the need to identify potential overseas acquisitions, set up offshore companies, and seek foreign partners and distributors.

When the number of Acer employees exceeded 2000 during the tenth year anniversary, Shih held a "Renewal of Company Culture Seminar" at which he invited his board and vice presidents to identify and evaluate the philosophies that had guided Multitech in its first ten years. Middle-level managers were then asked to participate in the process, reviewing, debating, and eventually voting on the key principles that would carry the company forward. The outcome was a statement of four values that captured the essence of their shared beliefs: an assumption that human nature is essentially good; a commitment to maintaining a fundamental pragmatism and accountability in all business affairs; a belief in placing the customer first; and a norm of pooling effort and sharing knowledge. (A decade later, these principles could still be found on office walls worldwide.)

Finally, the anniversary year was capped by another major achievement: Acer became the second company in the world to develop and launch a 32-bit PC, even beating IBM to market. Not only did the product win Taiwan's Outstanding Product Design Award—Acer's fifth such award in seven years—it also attracted the attention of such major overseas high-tech companies as Unisys, ICL and ITT, who began negotiations for OEM supply, and even technology licensing agreements.

Rebirth as Acer: Going Public Unfortunately, Multitech's growing visibility also led to a major problem. A U.S. company with the registered name "Multitech" informed its Taiwanese namesake that they were infringing its trademark. After ten years of building a corporate reputation and brand identity, Shih conceded he had to start over. He chose the name "Acer" because its Latin root meant "sharp" or "clever", because "Ace" implied first or highest value in cards—but mostly because it would be first in alphabetical listings. Despite advice to focus on the profitable OEM business and avoid the huge costs of creating a new global brand, Shih was determined to make Acer a globally recognized name.

Beyond branding, the success of the 32-bit PC convinced Shih that Acer would also have to maintain its rapid design, development and manufacturing capability as a continuing source of competitive advantage. Together with the planned aggressive international expansion, these new strategic imperatives—to build a brand and maintain its technological edge—created investment needs that exceeded Acer's internal financing capability. When officials from Taiwan's Securities and Exchange Commission approached Shih about a public offering, he agreed to study the possibility although he knew that many Taiwanese were suspicious of private companies that went public.

A program that allowed any employee with one year of company service to purchase shares had already diluted the Shihs' original 50% equity to about 35%, but in 1987 they felt it may be time to go further. (Shih had long preached that it was "better to lose control but make money" and that "real control came through ensuring common interest.") An internal committee asked to study the issue of going public concluded that the company would not only raise needed funds for expansion but also would provide a market for employee-owned shares. In 1988, Acer negotiated a complex multi-tiered financing involving investments by companies (such as Prudential, Chase Manhattan, China Development Corporation, and Sumitomo), additional sales to employees and, finally, a public offering. In total, Acer raised NT $2.2 billion (US $88 million). Issued at NT $27.5, the stock opened trading at NT $47 and soon rose to well over NT $100. After the IPO, Acer employees held about 65% of the equity including the Shihs' share, which had fallen to less than 25%.

The Professionalization of Acer

While the public offering had taken care of Acer's capital shortage, Shih worried about the company's acute shortage of management caused by its rapid growth. In early 1985, when the number of employees first exceeded 1,000, he began to look outside for new recruits "to take charge and stir things up with new ideas." Over the next few years, he brought in about a dozen top-level executives and 100 middle managers. To many of the self-styled "ground troops" (the old-timers), these "paratroopers" were intruders who didn't understand Acer's culture or values but were attracted by the soaring stock. For the first time, Acer experienced significant turnover.

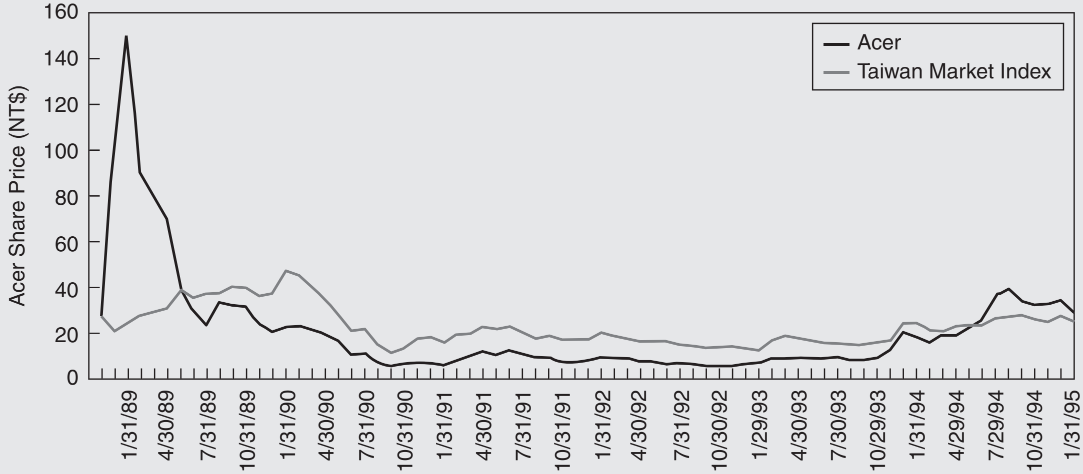
Paratroopers and Price Pressures Because internally-grown managers lacked international experience, one of the key tasks assigned to the "paratroopers" was to implement the company's ambitious offshore expansion plans. In late 1987, Acer acquired Counterpoint, the U.S.-based manufacturer of low-end minicomputers—a business with significantly higher margins than PCs. To support this new business entry, Acer then acquired and expanded the operations of Service Intelligence, a computer service and support organization. Subsequently, a dramatic decline in the market for minicomputers led to Acer's first new product for this segment, the Concer, being a dismal disappointment. Worse still, the substantial infrastructure installed to support it began generating huge losses.

Meanwhile, the competitive dynamics in the PC market were changing. In the closing years of the 1980s, Packard Bell made department and discount stores into major computer retailers, while Dell established its direct sales model. Both moves led to dramatic PC price reductions, and Acer's historic gross margin of about 35% began eroding rapidly, eventually dropping ten percentage points. Yet despite these problems, spirits were high in Acer, and in mid-1989 the company shipped its one millionth PC. Flush with new capital, the company purchased properties and companies within Taiwan worth $150 million. However, Acer's drift from its "commoner's culture" worried Shih, who felt he needed help to restore discipline to the "rampaging dragon." The ambition to grow had to be reconciled with the reality of Acer's financial situation.

Enter Leonard Liu Projected 1989 results indicated that the overextended company was in a tailspin. Earnings per share were expected to fall from NT $5 to NT $1.42. The share price, which had been as high as NT $150, fell to under NT $20. (See **Exhibit 2.**) Concerned by the growing problems, Shih decided to bring in an experienced top-level executive. After more than a year of courting, in late 1989, he signed Leonard Liu, Taiwan-born, U.S.-based, senior IBM executive with a reputation for a no-nonsense professional management style. In an announcement that caught many by surprise, Shih stepped down as president of the Acer Group, handing over that day-to-day management role to Liu. In addition, Liu was named CEO and Chairman of AAC, the company's North American subsidiary.

Given Shih's desire to generate $5 billion in sales by 1996, Liu began to focus on opportunities in the networking market in the United States. Despite the continuing problems at Counterpoint and Service Intelligence, he agreed with those who argued that Acer could exploit this market by building on its position in high-end products, particularly in the advanced markets of the United States and Europe. In particular, Liu became interested in the highly regarded multi-user minicomputer specialist, Altos. Founded in 1977, this Silicon Valley networking company had 700 employees, worldwide distribution in 60 countries, and projected sales of $170 million for 1990. Although it had generated losses of $3 million and $5 million in the previous two years, Liu felt that Altos's $30 million in cash reserves and $20 million in real estate made it an attractive acquisition. In August 1990, Acer paid $94 million to acquire the respected Altos brand,

Exhibit 2 Acer Share Price History, November 1988–January 1995



Source: Datastream.
Note: Acer stock price in Taiwan dollars.

its technology and its distribution network.[1] Almost immediately, however, powerful new PCs began to offer an alternative means of multi-user networking, and, as if to remind management of the eclipse of Counterpoint's minicomputers, within a year of its purchase, Altos was losing $20 million. Through the 1990s, AAC's losses increased.

In addition to this strategic thrust, Liu also began working on Acer's established organization and management approaches. For example, under Shih's leadership, while managers had been given considerable independence to oversee their business units, they had not been given profit and loss responsibility. Furthermore, because of the family-style relationship that existed among long-time company members, inter-company transfers were often priced to do friends a favor and ensure that a buyer did not "lose face" on a transaction. Even outsourced products were often bought at prices negotiated to make long-term suppliers look good. With no accountability for the profits of their business units, managers had little incentive to ensure quality or price, and would let the group absorb the loss. As one Acer observer noted, the company was "frugal and hard-working, but with little organizational structure or procedure-based administration."

As Shih had hoped, Liu brought to Acer some of IBM's professional management structures, practices and systems. To increase accountability at Acer, the new president reduced management layers, established standards for intra-company communications, and introduced productivity and performance evaluations. Most significantly, he introduced the Regional Business Unit/Strategic Business Unit (RBU/SBU) organization. Acer's long-established product divisions became SBUs responsible for the design, development, and production of PC components and system products, including OEM product sales. Simultaneously, the company's major overseas subsidiaries and marketing companies became RBUs responsible for developing distribution channels, providing

[1]Because this was a much larger deal than either Counterpoint (acquired for $1 million plus a stock swap) or Service Intelligence (a $500,000 transaction), Shih suggested the deal be structured as a joint venture to maintain the Altos managers' stake in the business. However, Liu insisted on an outright acquisition to ensure control, and Shih deferred to his new president's judgment.

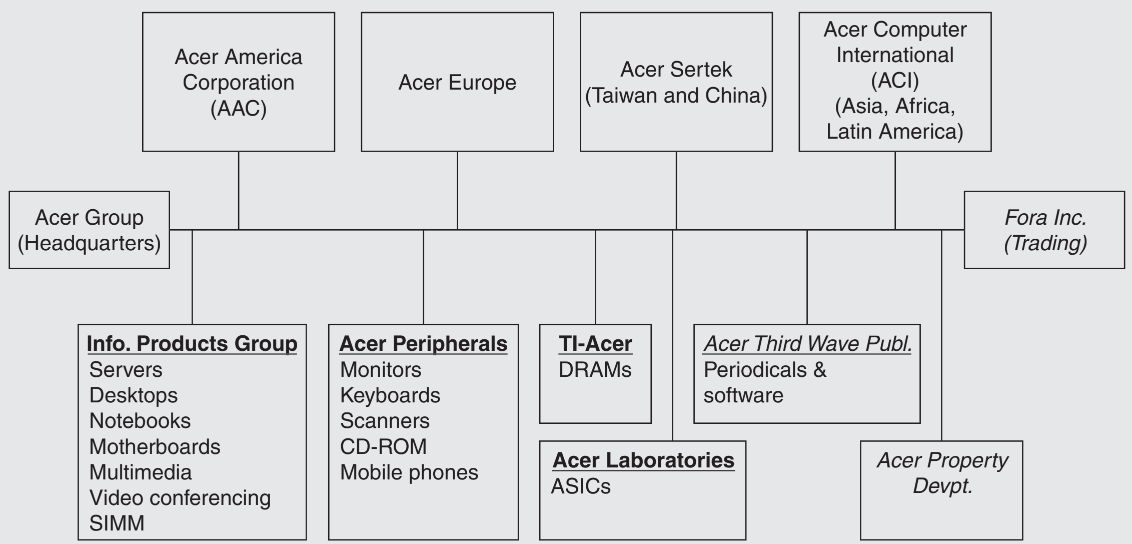
support for dealers, distributor networks, and customers, and working to establish JVs in neighboring markets. All SBUs and RBUs had full profit responsibility. "The pressure definitely increased. I was eating fourteen rice boxes a week," said one RBU head, referring to the practice of ordering in food to allow meetings to continue through lunch and dinner.

By 1992, in addition to the four core SBUs, five RBUs had been established: Acer Sertek covering China and Taiwan; Acer Europe headquartered in the Netherlands; Acer America (AAC) responsible for North America; and Acer Computer International (ACI), headquartered in Singapore and responsible for Asia, Africa, and Latin America. (See **Exhibits 3a** and **3b.**) One of the immediate effects of the new structures and systems was to highlight the considerable losses being generated by AAC, for which Liu was directly responsible. While no longer formally engaged in operations, Shih was urging the free-spending Altos management to adopt the more frugal Acer norms, and even began preaching his "duck egg" pricing theory. But demand was dropping precipitously and Liu decided stronger measures were required. He implemented tight controls and began layoffs.

Meanwhile, the company's overall profitability was plummeting. (See **Exhibits 4** and **5**.) A year earlier, Shih had introduced an austerity campaign that had focused on turning lights off, using both sides of paper, and traveling economy class. By 1990, however, Liu felt sterner measures were called for, particularly to deal with a payroll that had ballooned to 5,700 employees. Under an initiative dubbed Metamorphosis, managers were asked to rank employee performance, identifying the top 15% and lowest 30%. In January 1991, 300 of the Taiwan-based "thirty percenters" were terminated—Acer's first major layoffs.

The cumulative effect of declining profits, layoffs, more "paratroopers," and particularly the new iron-fisted management style challenged Acer's traditional culture. In contrast to Shih's supportive, family-oriented approach, Liu's "by-the-numbers" management model proved grating. There was

Exhibit 3a The Acer Group in 1994



Names in plain text are RBUs, names in **bold** are SBUs, and names in *italics* are classified as "Other."

Exhibit 3b Acer's Geographical Distribution in 1994

Exhibit 4 Acer Combination Income Statement, 1988–1994

Income Statement ($ millions)	1988	1989	1990	1991	1992	1993	1994
TURNOVER	530.9	688.9	949.5	985.2	1,260	1,883	3,220
Cost of sales	(389.4)	(532.7)	(716.7)	(737.7)	(1,000)	(1,498)	(2,615)
GROSS PROFIT	141.6	156.3	232.8	247.5	260	385	605
SG&A expenses	(88.2)	(118.2)	(192.2)	(217.2)	(217)	(237)	(316)
R&D and other expenses	(17.9)	(25.4)	(47.7)	(42.3)	(38)	(48)	(59)
OPERATING PROFIT/(LOSS)	35.6	12.7	(7.1)	(12.0)	5	100	230
Non-operating profit/(loss)	(8)	(6.3)	(1.5)	(15)	(4)	(11)	(19)
PROFIT BEFORE TAX	27.6	6.4	(8.6)	(27.0)	1	89	212
Tax	(1.2)	(1)	(1.2)	1	(3)	(3)	(7)
PROFIT (LOSS) AFTER TAX	26.4	5.4	(9.8)	(26.0)	(3)	86	205
Sales by Region (%)							
North America	na	31	31	31	38	44	39
Europe	na	32	28	28	22	23	17
Rest of World	na	37	41	41	40	33	44
Combination Revenue by Product (%)							
Portables	na	na	3.2	2.9	7.9	18	60%
Desktops and Motherboards	na	na	60.9	56.3	54.9	47	
Minicomputers	na	na	13.9	11.3	6.6		
Peripherals and Other	na	na	22	29.5	30.6	35	40%
Combination Revenue by Business (%)							
Brand	na	53	47	na	58	68	56%
OEM	na	34	22	na	18	32	36%
Trading	na	13	31	na	24	na	7%

Source: Company Annual Reports Year ending December 31.

Exhibit 5 Consolidated Balance Sheet, 1988–1994

Acer Group Balance Sheet ($ millions)	1988	1989	1990	1991	1992	1993	1994
Current Assets	277.30	448.80	579.50	600.90	700.20	925.00	1355.00
Fixed Assets							
Land, Plant, and Equipment (after depreciation)	53.10	126.90	191.10	161.50	179.60	590.00	645.00
Deferred charges and other assets	11.50	22.90	60.90	239.50	212.30	69.00	82.00
Total Assets	341.90	598.60	831.50	1001.90	1092.10	1584.00	2082.00
Total Current Liabilities	189.40	248.60	464.60	505.80	504.20	752.00	1067.00
Long-Term Liabilities	11.20	16.60	43.70	168.50	214.30	342.00	312.00
Total Liabilities	200.6	265.20	508.40	674.30	718.50	1094.00	1379.00
Stockholders Equity and Minority Interest (including new capital infusions)	141.30	333.40	323.10	327.60	373.60	490.00	703.00

Source: Company documents.

also growing resentment of his tendency to spend lavishly on top accounting and law firms and hire people who stayed at first-class hotels, all of which seemed out of step with Acer's "commoner's culture." Soon, his credibility as a highly respected world-class executive was eroding and Acer managers began questioning his judgement and implementing his directives half-heartedly.

In January 1992, when Shih realized that Acer's 1991 results would be disastrous, he offered his resignation. The board unanimously rejected the offer, suggesting instead that he resume his old role as CEO. In May 1992, Leonard Liu resigned.

Rebuilding the Base

Shih had long regarded mistakes and their resulting losses as "tuition" for Acer employees' growth—the price paid for a system based on delegation. He saw the losses generated in the early 1990s as part of his personal learning, considering it an investment rather than a waste. ("To make Acer an organization that can think and learn," he said, "we must continue to pay tuition as long as mistakes are unintentional and long-term profits exceed the cost of the education.") As he reclaimed the CEO role, Shih saw the need to fundamentally rethink Acer's management philosophy, the organizational model that reflected it, and even the underlying basic business concept.

"Global Brand, Local Touch" Philosophy At Acer's 1992 International Distributors Meeting in Cancun, Mexico, Shih articulated a commitment to linking the company more closely to its national markets, describing his vision as "Global Brand, Local Touch." Under this vision, he wanted Acer to evolve from a Taiwanese company with offshore sales to a truly global organization with deeply-planted local roots.

Building on the company's long tradition of taking minority positions in expansionary ventures, Shih began to offer established Acer distributors equity partnerships in the RBU they served. Four months after the Cancun meeting, Acer acquired a 19% interest in Computec, its Mexican distributor. Because of its role in building Acer into Mexico's leading PC brand, Shih invited Computec to form a joint venture company responsible for all Latin America. The result was Acer Computec Latin America (ACLA), a company subsequently floated on the Mexican stock exchange. Similarly, Acer Computers International (ACI), the company responsible for sales in Southeast Asia planned an initial public offering in Singapore in mid-1995. And in Taiwan, Shih was even considering taking some of Acer's core SBUs public.

As these events unfolded, Shih began to articulate an objective of "21 in 21," a vision of the Acer Group as a federation of 21 public companies, each with significant local ownership, by the 21st century. It was what he described as "the fourth way," a strategy of globalization radically different from the control-based European, American or Japanese models, relying instead on mutual interest and voluntary cooperation of a network of interdependent companies.

Client Server Organization Model To reinforce the more networked approach of this new management philosophy, in 1993, Shih unveiled his client-server organization model. Using the metaphor of the network computer, he described the role of the Taiwan headquarters as a "server" that used its resources (finance, people, intellectual property) to support "client" business units, which controlled key operating activities. Under this concept of a company as a network, business units could leverage their own ideas or initiatives directly through other RBUs or SBUs without having to go through the corporate center which was there to help and mediate, not dictate or control. Shih believed that this model would allow Acer to develop speed and flexibility as competitive weapons.

While the concept was intriguing, it was a long way from Acer's operating reality. Despite the long-established philosophy of decentralization and the introduction of independent profit-responsible business units in 1992, even the largest RBUs were still viewed as little more than the sales and distribution arms of the Taiwan-based SBUs. To operationalize the client server concept, Shih began to emphasize several key principles. "Every man is lord of his castle," became his battle cry to confirm the independence of SBU and RBU heads. Thus, when two SBUs—Acer Peripherals (API) and Information Products (IPG)—both decided to produce CD-ROM drives, Shih did not intervene to provide a top-down decision, opting instead to let the market decide. The result was that both units succeeded, eventually supplying CD-ROMs to almost 70% of PCs made in Taiwan, by far the world's leading source of OEM and branded PCs.

In another initiative, Shih began urging that at least half of all Acer products and components be sold outside the Group, hoping to ensure internal sources were competitive. Then, introducing the principle, "If it doesn't hurt, help," he spread a doctrine that favored internal suppliers. However, under the "lord of the castle" principle, if an RBU decided to improve its bottom line by sourcing externally, it could do so. But it was equally clear that the affected SBU could then find an alternative distributor for its output in that RBU's region. In practice, this mutual deterrence—referred to as the "nuclear option"—was recognized as a strategy of last resort that was rarely exercised. Despite Shih's communication of these new operating principles, the roles and relationships between SBU and RBUs remained in flux over several years as managers worked to understand the full implications of the client server model on their day-to-day responsibilities.

The Fast Food Business Concept But the biggest challenges Shih faced on his return were strategic. Even during the two and a half years he had stepped back to allow Liu to lead Acer, competition in the PC business had escalated significantly, with the product cycle shortening to 6 to 9 months and prices dropping. As if to highlight this new reality, in May 1992, the month Liu left, Compaq announced a 30% across-the-board price reduction on its PCs. Industry expectations were for a major shakeout of marginal players. Given Acer's financial plight, some insiders urged the chairman to focus on OEM sales only, while others suggested a retreat from the difficult U.S. market. But Shih believed that crisis was a normal condition in business and that persistence usually paid off. His immediate priority was to halve Acer's five months of inventory—two months being inventory "in transit."

Under Shih's stimulus, various parts of the organization began to create new back-to-basics initiatives. For example, the System PC unit developed the "ChipUp" concept. This patented technology allowed a motherboard to accept different types of CPU chips—various versions of Intel's 386 and 486 chips, for example—drastically reducing inventory of both chips and motherboards. Another unit, Home Office Automation, developed the "2-3-1 System" to reduce the new product introduction process to two months for development, three months for selling and one month for phase-out. And about the same time, a cross-unit initiative to support the launch of Acer's home PC, Acros, developed a screwless assembly process, allowing an entire computer to be assembled by snapping together components, motherboard, power source, etc.[2] Integrating all these initiatives and several others, a team of engineers developed Uniload, a production concept that configured components in a standard parts palette for easy unpacking, assembly, and testing, facilitating the transfer of final assembly to RBU operations abroad. The underlying objective was to increase flexibility and responsiveness by moving more assembly offshore.

Uniload's ability to assemble products close to the customer led the CEO to articulate what he termed his "fast-food" business model. Under this approach, small, expensive components with fast-changing technology that represented 50%–80% of total cost (e.g., motherboards, CPUs, hard disc drives) were airshipped "hot and fresh" from SBU sources in Taiwan to RBUs in key markets, while less-volatile items (e.g., casings, monitors, power supplies) were shipped by sea. Savings in logistics, inventories and import duties on assembled products easily offset higher local labor assembly cost, which typically represented less than 1% of product cost.

[2]To promote the innovative idea, Shih sponsored internal contests to see who could assemble a computer the fastest. Although his personal best time was more than a minute, experts accomplished the task in 30 seconds.

As Shih began promoting his fast-food business concept, he met with some internal opposition, particularly from SBUs concerned that giving up systems assembly would mean losing power and control. To convince them that they could increase competitiveness more by focusing on component development, he created a presentation on the value added elements in the PC industry. "Assembly means you are making money from manual labor," he said. "In components and marketing you add value with your brains." To illustrate the point, Shih developed a disintegrated value added chart that was soon dubbed "Stan's Smiling Curve." (See **Exhibit 6.**)

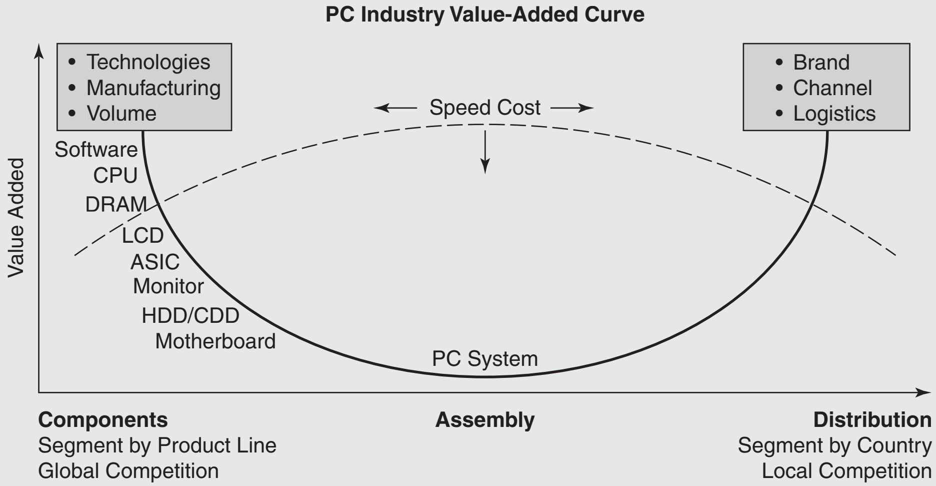
The Turnaround Describing his role as "to provide innovative stimulus, to recognize the new strategy which first emerges in vague ideas, then to communicate it, form consensus, and agree on action," Shih traveled constantly for two years, taking his message to the organization. Through 1993, the impact of the changes began to appear. Most dramatically, the fast-food business concept (supported by Liu's systems) caused inventory turnover to double by late 1993, reducing carrying costs, while lowering the obsolescence risk. In early 1994, the Group reported a return to profit after three years of losses.

Acer America and the Aspire

After Liu's resignation in April 1992, Shih named Ronald Chwang to head AAC. With a Ph.D. in Electrical Engineering, Chwang joined Acer in 1986 in technical development. After overseeing the start-up of Acer's peripherals business, in 1991 he was given the responsibility for integrating the newly acquired Altos into AAC as president of the Acer/Altos Business Unit.

Because AAC had been losing money since 1987, Chwang's first actions as CEO focused on stemming further losses. As part of that effort, he embraced the dramatic changes being initiated in Taiwan, making AAC's Palo Alto plant the first test assembly site of the Uniload system. Under the new system, manufacture and delivery time was cut

Exhibit 6 Stan Shih's PC Industry Conceptualization



Source: Company document.

from 80 days to 45 days, reducing inventory levels by almost 45%. To support its Uniload site, AAC established a department of approximately 20 engineers, primarily to manage component testing, but also to adapt software design to local market needs. By 1994, AAC was breaking even. (See **Exhibit 7.**)

Birth of Aspire Despite these improvements, AAC and other RBUs still felt that Acer's Taiwan-based SBUs were too distant to develop product configurations that would appeal to diverse consumer and competitive situations around the globe. What might sell well in Southeast Asia could be a year out of date in the United States, for example. However, the emerging "global brand, local touch" philosophy and the client server organization model supporting it gave them hope that they could change the situation.

In January 1994, Mike Culver was promoted to become AAC's Director of Product Management, a role that gave him responsibility for the product development mandate he felt RBUs could assume under the new client-server model. The 29-year-old engineer and recent MBA graduate had joined Acer America just 2½; years earlier as AAC's product manager for notebook computers. Recently, however, he had become aware of new opportunities in home computing.

Several factors caught Culver's attention. First, data showed an increasing trend to working at home—from 26 million people in 1993 to a projected 29 million in 1994. In addition, there was a rapidly growing interest in the Internet. And finally, developments in audio, telecom, video, and computing technologies were leading to industry rumblings of a new kind of multimedia home PC. Indeed, rumor had it that competitors like Hewlett Packard were already racing to develop new multimedia systems. Sharing this vision, Culver believed the time was right to create "the first Wintel-based PC that could compete with Apple in design, ease-of-use, and multimedia capabilities."

In October of 1994, Culver commissioned a series of focus groups to explore the emerging opportunity. In one of the groups, a consumer made a comment that had a profound impact on him. She said she wanted a computer that wouldn't remind her of work. At that moment, Culver decided that Acer's new home PC would incorporate radically new design aesthetics to differentiate it from the

Exhibit 7 AAC Selected Financials (1990–1994)

AAC Results ($ millions)	1990	1991	1992	1993	1994
Revenue	161	235	304	434	858
Cost of Sales	133	190	283	399	764
Selling and Marketing	27	61	25	23	55
General Administration	20	16	17	19	20
Research and Development	5	8	6	4	4
Operating Profit/(Loss)	(24)	(40)	(26)	(11)	15
Non-operating Profit/(Loss)	(1)	(7)	(3)	(5)	(3)
Profit/(Loss) Before Tax	(25)	(47)	(29)	(16)	12
Tax	1	(2)	0	0	1
Net Income/(Loss)	(26)	(45)	(29)	(16)	11
Current Assets	155	153	123	144	242
Fixed Assets (net)	39	43	28	25	25
Other Assets (net)	37	37	31	19	11
TOTAL Assets	231	233	182	188	278
Current Liabilities	155	169	154	136	218
Long-term debt	17	15	18	58	47
Stockholder Equity (including additional capita)	58	50	10	(6)	12
Total Liabilities	231	233	182	188	278

Source: Company documents.
(*Note*: Totals may not add due to rounding.)

standard putty-colored, boxy PCs that sat in offices throughout the world.

By November, Culver was convinced of the potential for an innovative multimedia consumer PC, and began assembling a project team to develop the concept. While the team believed the Acer Group probably had the engineering capability to develop the product's new technical features, they were equally sure they would have to go outside to get the kind of innovative design they envisioned. After an exhaustive review, the team selected Frog Design, a leading Silicon Valley design firm that had a reputation for "thinking outside of the box." Up to this point, Culver had been using internal resources and operating within his normal budget. The selection of Frog Design, however, meant that he had to go to Chwang for additional support. "The approval was incredibly informal," related Culver, "it literally took place in one 20 minute discussion in the hallway in late November. I told Ronald we would need $200,000 for outside consulting to create the cosmetic prototype." Chwang agreed on the spot, and the design process began.

In 1994, Acer was in ninth place in the U.S. market, with 2.4% market share, largely from sales of the Acros, Acer's initial PC product, which was an adaptation of its commercial product, the Acer Power. (See **Exhibit 8** for 1994 market shares.) Culver and Chwang were convinced they could not only substantially improve Acer's U.S. share, but also create a product with potential to take a larger share of the global multimedia desktop market estimated at 10.4 million units and growing at more than 20% annually, primarily in Europe and Asia.

Working jointly with designers from Frog Design, the project team talked to consumers, visited computer retail stores and held discussions to brainstorm the new product's form. After almost two months, Frog Design developed six foam models of possible designs. In January 1995, the Acer team

Exhibit 8 Top Ten PC Manufacturers in the U.S. and Worldwide in 1994

Company	U.S. Market Share	Worldwide Market Share
Compaq	12.6%	9.8%
Apple	11.5%	8.1%
Packard Bell	11.4%	5.1%
IBM	9.0%	8.5%
Gateway 2000	5.2%	2.3%
Dell	4.2%	2.6%
AST	3.9%	2.7%
Toshiba	3.6%	2.4%
Acer	2.4%	2.6%
Hewlett Packard	2.4%	2.5%

Source: Los Angeles Times, January 31, 1996.

chose a striking and sleek profile that bore little resemblance to the traditional PC. Market research also indicated that customers wanted a choice of colors, so the team decided that the newly named Aspire PC would be offered in charcoal grey and emerald green. (See **Exhibit 9.**)

Meanwhile, the team had been working with AAC software engineers and a development group in Taiwan to incorporate the new multimedia capabilities into the computer. One significant introduction was voice-recognition software that enabled users to open, close, and save documents by voice commands. However, such enhancements also required new hardware design: to accommodate the voice-recognition feature, for example, a microphone had to be built in, and to properly exploit the machine's enhanced audio capabilities, speakers had to be integrated into the monitor. The multimedia concept also required the integration of CD-ROM capabilities, and a built-in modem and answering machine incorporating fax and telephone capabilities. This type of configuration was a radical innovation for Acer, requiring significant design and tooling changes.

In early 1995 the price differential between upper-tier PCs (IBM, for example) and lower-end products (represented by Packard Bell) was about 20%. Culver's team felt the Aspire could be positioned

Exhibit 9 First Generation Aspire Prototype Design

between these two segments offering a high quality innovative product at a less-than-premium price. They felt they could gain a strong foothold by offering a product range priced from \$1,199 for the basic product to \$2,999 for the highest-end system with monitor. With a September launch, they budgeted U.S. sales of \$570 million and profits of \$17 million for 1995. A global rollout would be even more attractive with an expectation of breakeven within the first few months.

Stan Shih's Decisions

On his way to San Jose in February 1995, Stan Shih pondered the significance of the Aspire project. Clearly, it represented the client-server system at work: this could become the first product designed and developed by an RBU, in response to a locally sensed market opportunity. Beyond that, he had the feeling it might have the potential to become Acer's first global blockbuster product.

Despite its promise, however, Shih wanted to listen to the views of the project's critics. Some pointed out that AAC had just begun to generate profits in the first quarter of 1994, largely on the basis of its solid OEM sales, which accounted for almost 50% of revenues. Given its delicate profit position, they argued that AAC should not be staking its future on the extremely expensive and highly competitive branded consumer products business. Established competitors were likely to launch their own multimedia home PCs—perhaps even before Acer. Building a new brand in this crowded, competitive market was extremely difficult as proven by many failed attempts, including the costly failure of Taiwan-based Mitac, launched as a branded PC in the early 1990s.

Even among those who saw potential in the product, there were several who expressed concern about the project's implementation. With all the company's engineering and production expertise located in Taiwan, these critics argued that the task of coordinating the development and delivery of such an innovative new product was just too risky to leave to an inexperienced group in an RBU with limited development resources. If the project were to be approved, they suggested it be transferred back to the SBUs in Taiwan for implementation.

Finally, some wondered whether Acer's client-server organization model and "local touch" management would support Aspire becoming a viable global product. With the growing independence of the RBUs worldwide, they were concerned that each one would want to redesign the product and marketing strategy for its local market, thereby negating any potential scale economies.

As his plane touched down in San Francisco, Shih tried to resolve his feelings of excitement and concern. Should he support the Aspire project, change it, or put it on hold? And what implications would his decisions have for the new corporate model he had been building?

Reading 1-1 The Global Entrepreneur

by Daniel J. Isenberg

For a century and more, companies have ventured abroad only after establishing themselves at home. Moreover, when they have looked overseas, they haven't ventured too far afield, initially. Consumer health care company Johnson & Johnson set up its first foreign subsidiary in Montreal in 1919—33 years after its founding in 1886. Sony, established in 1946, took 11 years to export its first product to the United States, the TR-63 transistor radio. The Gap, founded in 1969—the year Neil Armstrong walked on the moon—opened its first overseas store in London in 1987, a year after the *Challenger* **space shuttle disaster.**

Companies are being born global today, by contrast. Entrepreneurs don't automatically buy raw materials from nearby suppliers or set up factories close to their headquarters. They hunt for the planet's best manufacturing locations because political and economic barriers have fallen and vast quantities of information are at their fingertips. They also scout for talent across the globe, tap investors wherever they may be located, and learn to manage operations from a distance—the moment they go into business.

Take Bento Koike, who set up Tecsis to manufacture wind turbine blades in 1995. The company imports raw materials from North America and Europe, and its customers are located on those two continents. Yet Koike created his globe-girding start-up near São Paulo in his native Brazil because a sophisticated aerospace industry had emerged there, which enabled him to develop innovative blade designs and manufacturing know-how. Tecsis has become one of the world's market leaders, having installed 12,000 blades in 10 countries

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in the past decade and racked up revenues of $350 million in 2007.

Standing conventional theory on its head, start-ups now do business in many countries before dominating their home markets. In late 2001, Ron Zwanziger, David Scott, and Jerry McAleer teamed up to launch their third medical diagnostics business, even though Zwanziger lives in the United States and Scott and McAleer live in England. They started Inverness Medical Innovations by retaining the pieces of their company that Johnson & Johnson didn't acquire and immediately gained a presence in Belgium, Germany, Ireland, Israel, the United Kingdom, and the United States. The troika didn't skip a beat. In seven years, they wanted to grow the new venture into an enterprise valued at $7 billion and believed that being born global was the way to do it. They're getting there: Inverness Medical's assets were valued at $5 billion as of August 2008.

Today's entrepreneurs cross borders for two reasons. One is defensive: To be competitive, many ventures, like Tecsis and Inverness Medical, have to globalize some aspects of their business—manufacturing, service delivery, capital sourcing, or talent acquisition, for instance—the moment they start up. That may sound obvious today, but until a few years ago, it was standard practice for U.S. venture capitalists, in particular, to require that the companies they invested in focus on domestic markets.

The other reason is to take the offense. Many new ventures are discovering that a new business opportunity spans more than one country or that they can use distance to create new products or services. Take Racing ThePlanet, which Mary Gadams founded in 2002 to stage marathons, each 250 kilometers long and lasting seven days, in the world's most hostile environments. Her team works out of a small Hong Kong office, but the company operates in the Gobi Desert in Mongolia, the Atacama Desert in Chile, the Sahara Desert in Egypt, and Antarctica. Distance has generated the opportunity: If the deserts were accessible, participants and audiences would find the races less attractive, and the brand would be diluted. Racing ThePlanet isn't just about running; it's also about creating a global lifestyle brand, which Gadams uses to sell backpacks, emergency supplies, clothing, and other merchandise, as well as to generate content for the multimedia division, which sells video for websites and GPS mapping systems. The company may be just six years old, but brand awareness is high, and RacingThePlanet is already profitable.

In this article, I'll describe the challenges start-ups face when they are born global and the skills entrepreneurs need to tackle them.

Key Challenges Global entrepreneurs, my research shows, face three distinct challenges.

Distance. New ventures usually lack the infrastructure to cope with dispersed operations and faraway markets. Moreover, physical distances create time differences, which can be remarkably tough to navigate. Even dealing with various countries' workweeks takes a toll on a start-up's limited staff: In North America, Europe, China, and India, corporate offices generally operate Monday through Friday. In Israel, they're open Sunday through Thursday. In Saudi Arabia and the UAE, the workweek runs Saturday through Wednesday, but in other predominantly Muslim countries like Lebanon, Morocco, and Turkey, people work from Monday through Friday or Saturday.

A greater challenge for global entrepreneurs is bridging what the British economist Wilfred Beckerman called in 1956 "psychic distance." This arises from such factors as culture, language, education systems, political systems, religion, and economic development levels. It can heighten—or reduce—psychological barriers between regions and often prompt entrepreneurs to make counterintuitive choices. Take the case of Encantos de Puerto Rico, set up in 1998 to manufacture and market premium Puerto Rican coffee. When founder-CEO Angel Santiago sought new markets in 2002, he didn't enter the nearby U.S. market but chose Spain instead. That's because, he felt, Puerto Ricans and Spaniards have similar tastes in coffee and because of the ease of doing business in Spanish, which reduced the psychic distance between the two countries. When two years later, Encantos de Puerto Rico did enter the United States, it focused initially on Miami, which has a large Hispanic population.

Context. Nations' political, regulatory, judicial, tax, environmental, and labor systems vary. The choices entrepreneurs make about, say, where to locate their companies' headquarters will affect shareholder returns and also their ability to raise capital. When the husband-and-wife team of Andrew Prihodko, a Ukrainian studying at MIT, and Sharon Peyer, a Swiss-American citizen studying at Harvard, set up an online photo management company, they thought hard about where to domicile Pixamo. Should they incorporate it in Ukraine, which has a simple and low tax structure but a problematic legal history? Or Switzerland, where taxes are higher but the legal system is well established? Or Delaware, where taxes are higher still but most U.S. start-ups are domiciled? Prihodko and Peyer eventually chose to base the company in the relatively tax-friendly Swiss canton of Zug, a decision that helped shareholders when they sold Pixamo to NameMedia in 2007.

Some global entrepreneurs must deal with several countries simultaneously, which is complex. In 1994, Gary Mueller launched Internet Securities to provide investors with data on emerging markets. Three years later, the start-up had offices in 18 countries and had to cope with the jurisdictions of Brazil, China, and Russia on any given day. By learning to do so, Internet Securities became a market leader, and in 1999, Euromoney acquired 80% of the company's equity for the tidy sum of $43 million.

Resources. Customers expect start-ups to possess the skills and deliver the levels of quality that larger companies do. That's a tall order for resource-stretched new ventures. Still, they have no option but to do whatever it takes to retain customers. In 1987, Jim Sharpe acquired a small business, XTech, now a manufacturer of faceplates for telecommunications equipment. Initially, the company made its products in the United States and sold them overseas through sales representatives and distributors. However, by 2006, Cisco, Lucent, Intel, IBM, and other XTech customers had shifted most of their manufacturing to China. They became reluctant to do business with suppliers that didn't make products or have customer service operations in China. So Sharpe had no choice but to set up a subsidiary in China at that stage.

Competencies Global Entrepreneurs Need All entrepreneurs must be able to identify opportunities, gather resources, and strike deals. They all must also possess soft skills like vision, leadership, and passion. To win globally, though, they must hone four additional competencies.

Articulating a global purpose. Developing a crystal clear rationale for being global is critical. In 1999, for example, Robert Wessman took control of a small pharmaceuticals maker in his native Iceland. Within weeks, he concluded that the generics player had to globalize its core functions—manufacturing, R&D, and marketing—to gain economies of scale, develop a large product portfolio, and be first to market with drugs as they came off patent. Since then, Actavis has entered 40 countries, often by taking over local companies. Wessman faced numerous hurdles, but he stuck to the strategy. Actavis now makes 650 products and has 350 more in the pipeline. In 2007, it generated revenues of $2 billion and had become one of the world's top five generics manufacturers.

Alliance building. Start-ups can quickly attain global reach by striking partnerships with large companies headquartered in other countries. However, most entrepreneurs have to enter into such deals from positions of weakness. An established company has managers who can conduct due diligence, the money to fly teams over for meetings, and the power to extract favorable terms from would-be partners. It has a reasonable period within which to negotiate a deal, and it has options in case talks with one company fail. A start-up has few of those resources or bargaining chips.

Start-ups also have problems communicating with global partners because their alliances have to span geographic and psychic distances. Take the case of Trolltech, an open-source software company founded in 1994 in Oslo by Eirik Chambe-Eng and Haavard Nord. In 2001, the start-up landed a contract to supply a Japanese manufacturer with a Linux-based software platform for personal digital assistants (PDAs). The dream order quickly turned into a nightmare. There were differences between what the Japanese company thought it would get and what the Norwegian supplier felt it should provide, and the start-up struggled to deliver the modifications its partner began to demand. Suspecting that Trolltech wouldn't deliver the software on time, the Japanese company offered to send over a team of software engineers. However, when it suggested that both companies work through the Christmas break to meet a deadline—a common practice in Japan—Trolltech refused, citing the importance of the Christmas vacation in Norway. The relationship almost collapsed, but Chambe-Eng and Nord managed to negotiate a new deadline that they could meet without having to work during the holiday season.

Supply-chain creation Entrepreneurs must often choose suppliers on the other side of the world and monitor them without having managers nearby. Besides, the best manufacturing locations change as labor and fuel costs rise and as quality problems show up, as they did in China.

Start-ups find it daunting to manage complex supply networks, but they gain competitive advantage by doing so. Sometimes the global supply chain lies at the heart of the business opportunity. Take the case of Winery Exchange, cofounded by Peter Byck in 1999. The California-based venture manages a 22-country network of wineries and breweries. Winery Exchange works closely with retail chains, such as Kroger, Tesco, and Costco, to develop premium private label products, and it gets its suppliers to produce and package the wines as inexpensively as possible. The venture has succeeded because it links relatively small market-needy suppliers with mammoth product-hungry retailers and provides both with its product development expertise. In 2006, Winery Exchange sold 2 million cases of 330 different brands of wine, beer, and spirits to retailers on four continents.

In addition to raw materials and components, start-ups are increasingly buying intellectual property from across the world. Hands-On Mobile, started by David Kranzler, is a Silicon Valley-based developer of the mobile versions of Guitar Hero III, Iron Man, and other games. When the company started in 2001, the markets for mobile multimedia content were developing faster in Asia and Europe than in the United States, and gamers were creating attractive products in China, South Korea, and Japan. Kranzler realized that his company had to acquire intellectual property and design capacity overseas in order to offer customers a comprehensive catalog of games and the latest delivery technologies. Hands-On Mobile therefore picked up MobileGame Korea, as well as two Chinese content development companies, which has helped it become a market leader.

Multinational organization In 2006, I conducted a simulation exercise called the **Virtual Entrepreneurial Team Exercise** (VETE) for 450 MBA students in 10 business schools in Argentina, Austria, Brazil, England, Hong Kong, Liechtenstein, the Netherlands, Japan, and the United States. The teams, each composed of students from different schools and different countries, developed hypothetical pitches for Asia Renal Care, a Hong Kong-based medical services start-up, that had raised its first round of capital in 1999. They experienced a slice of global entrepreneurial life in real time, using technologies like Skype, wikis, virtual chat rooms, and, of course, e-mail to communicate with one another. The students learned how to build trust, compensate for the lack of visual cues, respect cultural differences, and deal with different institutional frameworks and incentives—the competencies entrepreneurs need for coordination, control, and communication in global enterprises. The would-be entrepreneurs' emotions ranged from elation to frustration, and their output varied from good to excellent.

Start-ups cope with the challenges of managing a global organization in different ways. Internet Securities used a knowledge database to share information among its offices around the world, increasing managers' ability to recognize and solve problems. RacingThePlanet used intensive training to ensure that volunteers perform at a consistently high level during the events it holds. Trolltech worked round the clock to meet deadlines, passing off development tasks from teams in Norway to those in Australia as the day ends in one place and begins in the other. Inverness Medical hired key executives wherever it could and organized the company around them rather than move people all over the world.

Still, there are no easy answers to the challenges of managing a start-up in the topsy-turvy world of global entrepreneurship. Take the case of Mei Zhang, who founded WildChina, a high-end adventure-tourism company in China, in 2000. Three years later, Zhang hired an American expatriate, Jim Stent, who had a deep interest in Chinese history and culture, as her COO. Zhang moved to Los Angeles in 2004, anointing Stent as CEO in Beijing and appointing herself chairperson. Thus, a Chinese expatriate living in the United States had to supervise an American expatriate living in Beijing. And when the two amicably parted ways in 2006, Zhang started managing the Chinese company from Los Angeles. These are contingencies no textbook provides for.

How Diaspora Networks Help Start-Ups Go Global

Many entrepreneurs have taken advantage of ethnic networks to formulate and execute a global strategy. The culture, values, and social norms members hold in common forge understanding and trust, making it easier to establish and enforce contracts.

Through diaspora networks, global entrepreneurs can quickly gain access to information, funding, talent, technology—and, of course, contacts. In the late 1990s, for instance, Boston-based Desh Deshpande, who had set up several high-tech ventures in the United States, was keen to start something in his native India. In April 2000, he met an optical communications expert, Kumar Sivarajan, who had worked at IBM's Watson Research Center before returning to India to take up a teaching position at the Indian Institute of Science in Bangalore. Deshpande introduced Sivarajan to two other Indians, Sanjay Nayak and Arnob Roy, who had both worked in the Indian subsidiaries of American high-tech companies. The trust among the four enabled the creation of the start-up Tejas Networks in two months' time. Deshpande and Sycamore Networks, the major investors, wired the initial capital of $5 million, attaching few of the usual conditions to the investment. Tejas Networks has become a leading telecommunications equipment manufacturer, generating revenues of around $100 million over the past year.

The research that my HBS colleague William Kerr and I have done suggests that entrepreneurs who most successfully exploit diaspora networks take these four steps:

Map networks. The members of a diaspora often cluster in residential areas, public organizations, or industries. For instance, in Tokyo, Americans tend to work for professional service firms such as Morgan Stanley and McKinsey, live in Azabu, shop in Omotesandō,and hang out at the American Club.

Identify organizations that can help. Many countries have offices overseas that facilitate trade and investment, and they open their doors to people visiting from home. These organizations can provide the names of influential individuals, companies, and informal organizations, clubs, or groups.

Tap informal groups. Informal organizations of ethnic entrepreneurs and executives are usually located in communities where immigrant professionals are concentrated. In the United States, for instance, they thrive in high-tech industry neighborhoods such as Silicon Valley or universities like MIT.

Identify the influentials. It can be tough to identify people who have standing with local businesses and also within the diaspora network. A board member or coach that both respect is an invaluable resource for a would-be entrepreneur.

How Social Entrepreneurs Think Global

Atsumasa Tochisako is an unlikely entrepreneur. When he was in his mid-fifties, he left a senior position at the Bank of Tokyo-Mitsubishi to set up Microfinance International, a global for-profit social enterprise (FOPSE, for short), based in Washington, D.C. Having also been stationed in Latin America for many years, Tochisako had observed the large cash remittances coming from immigrants in the United States, as well as the exorbitant charges they paid commercial banks and the poor service they received. Sensing a business opportunity and the chance to do some good, he decided to provide immigrant workers with inexpensive remittance, check-cashing, insurance, and microlending services.

MFI was international from its birth in June 2003, with operations in the United States and El Salvador. Since then, it has expanded into a dozen Latin American countries and further extended its reach by allowing multinational financial institutions, such as the UAE Exchange, to use its proprietary Internet-based settlement platform.

Like Tochisako, many entrepreneurs today combine social values, profit motive, and a global focus. Social entrepreneurs are global from birth for three reasons. First, disease, malnutrition, poverty, illiteracy, and other social problems exist on a large scale in many developing countries. Second, the resources—funds, institutions, and governance systems—to tackle those issues are mainly in the developed world. Third, FOPSEs that tackle specific conditions can often be adapted to other countries. For instance, in 2002, Shane Immelman founded The Lapdesk Company to provide portable desks to South African schoolchildren, a third of whom are taught in schoolrooms that don't have adequate surfaces on which to write. The company asks large corporations in South Africa to donate desks—with some advertising on them—for entire school districts. By doing so, these companies are able to meet the South African government's requirement that they invest part of their profits in black empowerment programs. Since then, Immelman has adapted the business model to Kenya, Nigeria, and the Democratic Republic of Congo and has launched programs in India and Latin America.

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Entrepreneurs shouldn't fear the fact that the world isn't flat. Being global may not be a pursuit for the fainthearted, but even start-ups can thrive by using distance to gain competitive advantage.

Reading 1-2 Distance Still Matters: The Hard Reality of Global Expansion

by Pankaj Ghemawat

When it was launched in 1991, Star TV looked like a surefire winner. The plan was straightforward: The company would deliver television programming to a media-starved Asian audience. It would target the top 5% of Asia's socioeconomic pyramid, a newly rich elite who could not only afford the services but who also represented an attractive advertising market. Since English was the second language for most of the target consumers, Star would be able to use readily available and fairly cheap English-language programming rather than having to invest heavily in creating new local programs. And by using satellites to beam

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programs into people's homes, it would sidestep the constraints of geographic distance that had hitherto kept traditional broadcasters out of Asia. Media mogul Rupert Murdoch was so taken with this plan—especially with the appeal of leveraging his Twentieth Century Fox film library across the Asian market—that his company, News Corporation, bought out Star's founders for $825 million between 1993 and 1995.

The results have not been quite what Murdoch expected. In its fiscal year ending June 30, 1999, Star reportedly lost $141 million, pretax, on revenues of $111 million. Losses in fiscal years 1996 through 1999 came to about $500 million all told, not including losses on joint ventures such as Phoenix TV in China. Star is not expected to turn in a positive operating profit until 2002.

Star has been a high-profile disaster, but similar stories are played out all the time as companies pursue global expansion. Why? Because, like Star, they routinely overestimate the attractiveness of foreign markets. They become so dazzled by the sheer size of untapped markets that they lose sight of the vast difficulties of pioneering new, often very different territories. The problem is rooted in the very analytic tools that managers rely on in making judgments about international investments, tools that consistently underestimate the costs of doing business internationally. The most prominent of these is country portfolio analysis (CPA), the hoary but still widely used technique for deciding where a company should compete. By focusing on national GDP, levels of consumer wealth, and people's propensity to consume, CPA places all the emphasis on potential sales. It ignores the costs and risks of doing business in a new market.

Most of those costs and risks result from barriers created by distance. By distance, I don't mean only geographic separation, though that is important. Distance also has cultural, administrative or political, and economic dimensions that can make foreign markets considerably more or less attractive. Just how much difference does distance make? A recent study by economists Jeffrey Frankel and Andrew Rose estimates the impact of various factors on a country's trade flows. Traditional economic factors, such as the country's wealth and size (GDP), still matter; a 1% increase in either of those measures creates, on average, a .7% to .8% increase in trade. But other factors related to distance, it turns out, matter even more. The amount of trade that takes place between countries 5,000 miles apart is only 20% of the amount that would be predicted to take place if the same countries were 1,000 miles apart. Cultural and administrative distance produces even larger effects. A company is likely to trade ten times as much with a country that is a former colony, for instance, than with a country to which it has no such ties. A common currency increases trade by 340%. Common membership in a regional trading bloc increases trade by 330%. And so on. (For a summary of Frankel and Rose's findings, see the exhibit "Measuring the Impact of Distance.")

Much has been made of the death of distance in recent years. It's been argued that information technologies and, in particular, global communications are shrinking the world, turning it into a small and relatively homogeneous place. But when it comes to business, that's not only an incorrect assumption, it's a dangerous one. Distance still matters, and companies must explicitly and thoroughly account for it when they make decisions about global expansion. Traditional country portfolio analysis needs to be tempered by a clear-eyed evaluation of the many dimensions of distance and their probable impact on opportunities in foreign markets.

The Four Dimensions of Distance

Distance between two countries can manifest itself along four basic dimensions: cultural, administrative, geographic, and economic. The types of distance influence different businesses in different ways. Geographic distance, for instance, affects the costs of transportation and communications, so it is of particular importance to companies that deal with heavy or bulky products, or whose operations require a high degree of coordination among highly dispersed people or activities. Cultural distance, by contrast, affects consumers' product preferences. It is a crucial consideration for any consumer goods or media company, but it is much less important for a cement or steel business.

Each of these dimensions of distance encompasses many different factors, some of which are readily apparent; others are quite subtle. (See the exhibit "The CAGE Distance Framework" for an overview of the factors and the ways in which they affect particular industries.) In this article, I will review the four principal dimensions of distance, starting with the two overlooked the most—cultural distance and administrative distance.

Cultural Distance. A country's cultural attributes determine how people interact with one another and with companies and institutions. Differences in religious beliefs, race, social norms, and language are all capable of creating distance between two countries. Indeed, they can have a huge impact on trade: All other things being equal, trade between countries that share a language, for example, will be three times greater than between countries without a common language.

Some cultural attributes, like language, are easily perceived and understood. Others are much more subtle. Social norms, the deeply rooted system of unspoken principles that guide individuals in their everyday choices and interactions, are often nearly invisible, even to the people who abide by them. Take, for instance, the long-standing tolerance of the Chinese for copyright infringement. As William Alford points out in his book *To Steal a Book Is an Elegant Offense* (Stanford University Press, 1995), many people ascribe this social norm to China's recent communist past. More likely, Alford argues, it flows from a precept of Confucius that encourages replication of the results of past intellectual endeavors: "I transmit rather than create; I believe in and love the Ancients." Indeed, copyright infringement was a problem for Western publishers well before communism. Back in the 1920s, for example, Merriam Webster, about to introduce a bilingual dictionary in China, found that the Commercial Press in Shanghai had already begun to distribute its own version of the new dictionary. The U.S. publisher took the press to a Chinese court, which imposed a small fine for using the Merriam Webster seal but did nothing to halt publication. As the film and music industries well know, little has changed. Yet this social norm still confounds many Westerners.

Most often, cultural attributes create distance by influencing the choices that consumers make between substitute products because of their preferences for specific features. Color tastes, for example, are closely linked to cultural prejudices. The word "red" in Russian also means beautiful. Consumer durable industries are particularly sensitive to differences in consumer taste at this level. The Japanese, for example, prefer automobiles and household appliances to be small, reflecting a social norm common in countries where space is highly valued.

Sometimes products can touch a deeper nerve, triggering associations related to the consumer's identity as a member of a particular community. In these cases, cultural distance affects entire categories of products. The food industry is particularly sensitive to religious attributes. Hindus, for example, do not eat beef because it is expressly forbidden by their religion. Products that elicit a strong response of this kind are usually quite easy to identify, though some countries will provide a few surprises. In Japan, rice, which Americans treat as a commodity, carries an enormous amount of cultural baggage.

Ignoring cultural distance was one of Star TV's biggest mistakes. By supposing that Asian viewers would be happy with English-language programming, the company assumed that the TV business was insensitive to culture. Managers either dismissed or were unaware of evidence from Europe that mass audiences in countries large enough to support the development of local content generally prefer local TV programming. If they had taken cultural distance into account, China and India could have been predicted to

Measuring the Impact of Distance

Economists often rely on the so-called gravity theory of trade flows, which says there is a positive relationship between economic size and trade and a negative relationship between distance and trade. Models based on this theory explain up to two-thirds of the observed variations in trade flows between pairs of countries. Using such a model, economists Jeffrey Frankel and Andrew Rose[1] have predicted how much certain distance variables will affect trade.

Distance Attribute	Change in International Trade (%)
Income level: GDP per capita (1% increase)	+0.7
Economic size: GDP (1% increase)	+0.8
Physical distance (1% increase)	−1.1
Physical size (1% increase)*	−0.2
Access to ocean*	+50
Common border	+80
Common language	+200
Common regional trading bloc	+330
Colony-colonizer relationship	+900
Common colonizer	+190
Common polity	+300
Common currency	+340

[1]Jeffrey Frankel and Andrew Rose, "An Estimate of the Effects of Currency Unions on Growth," unpublished working paper, May 2000.
*Estimated effects exclude the last four variables in the table.

require significant investments in localization. TV is hardly cement.

Administrative or Political Distance. Historical and political associations shared by countries greatly affect trade between them. Colony-colonizer links between countries, for example, boost trade by 900%, which is perhaps not too surprising given Britain's continuing ties with its former colonies in the commonwealth, France's with the franc zone of West Africa, and Spain's with Latin America. Preferential trading arrangements, common currency, and political union can also increase trade by more than 300% each. The integration of the European Union is probably the leading example of deliberate efforts to diminish administrative and political distance among trading partners. (Needless to say, ties must be friendly to have a positive influence on trade. Although India and Pakistan share a colonial history—not to mention a border and linguistic ties—their mutual hostility means that trade between them is virtually nil.)

Countries can also create administrative and political distance through unilateral measures. Indeed, policies of individual governments pose the most common barriers to cross-border competition. In some cases, the difficulties arise in a company's home country. For companies from the United States, for instance, domestic prohibitions on bribery and the prescription of health, safety, and environmental policies have a dampening effect on their international businesses.

More commonly, though, it is the target country's government that raises barriers to foreign competition: tariffs, trade quotas, restrictions on foreign direct investment, and preferences for domestic competitors in the form of subsidies and favoritism in regulation and procurement. Such measures are expressly intended to protect domestic industries, and they are most likely to be implemented if a domestic industry meets one or more of the following criteria:

- *It is a large employer.* Industries that represent large voting blocs often receive state support in the form of subsidies and import protection. Europe's farmers are a case in point.
- *It is seen as a national champion.* Reflecting a kind of patriotism, some industries or companies serve as symbols of a country's modernity and competitiveness. Thus the showdown between Boeing and Airbus in capturing the large passenger-jet market has caused feelings on both sides of the Atlantic to run high and could even spark a broader trade war. Also, the more that a government has invested in the industry, the more protective it is likely to be, and the harder it will be for an outsider to gain a beachhead.
- *It is vital to national security.* Governments will intervene to protect industries that are deemed vital to national security—especially in high tech sectors such as telecommunications and aerospace. The FBI, for instance, delayed Deutsche Telekom's acquisition of Voicestream for reasons of national security.
- *It produces staples*. Governments will also take measures to prevent foreign companies from dominating markets for goods essential to their citizens' everyday lives. Food staples, fuel, and electricity are obvious examples.
- *It produces an "entitlement" good or service.* Some industries, notably the health care sector, produce goods or services that people believe they are entitled to as a basic human right. In these industries, governments are prone to intervene to set quality standards and control pricing.
- *It exploits natural resources.* A country's physical assets are often seen as part of a national heritage. Foreign companies can easily be considered robbers. Nationalization, therefore, is a constant threat to international oil and mining multinationals.
- *It involves high sunk-cost commitments.* Industries that require large, geography-specific sunk investments—in the shape, say, of oil refineries or aluminum smelting plants or railway lines—are highly vulnerable to interference from local governments. Irreversibility expands the scope for holdups once the investment has been made.

Finally, a target country's weak institutional infrastructure can serve to dampen cross-border economic activity. Companies typically shy away from doing business in countries known for corruption or social conflict. Indeed, some research suggests that these conditions depress trade and investment far more than any explicit administrative policy or restriction. But when a country's institutional infrastructure is strong—for instance, if it has a well-functioning legal system—it is much more attractive to outsiders.

Ignoring administrative and political sensitivities was Star TV's other big mistake. Foreign ownership of broadcasting businesses—even in an open society like the United States—is always politically loaded because of television's power to influence people. Yet shortly after acquiring the company, Rupert Murdoch declared on record that satellite television was "an unambiguous threat to totalitarian regimes everywhere" because it permitted people to bypass government-controlled news sources. Not surprisingly, the Chinese government enacted a ban on the reception of foreign satellite TV services soon thereafter. News Corporation has begun to mend fences with the Chinese authorities, but it has yet to score any major breakthroughs in a country that accounts for nearly 60% of Star TV's potential customers. Murdoch of all people should have foreseen this outcome, given his experience in the United States, where he was required to become a citizen in order buy the television companies that now form the core of the Fox network.

Geographic Distance. In general, the farther you are from a country, the harder it will be to conduct business in that country. But geographic distance is not simply a matter of how far away the country is in miles or kilometers. Other attributes that must be considered include the physical size of the country, average within-country distances to borders, access

The CAGE Distance Framework

The cultural, administrative, geographic, and economic (CAGE) distance framework helps managers identify and assess the impact of distance on various industries. The upper portion of the table lists the key attributes underlying the four dimensions of distance. The lower portion shows how they affect different products and industries.

Cultural Distance	Administrative Distance	Geographic Distance	Economic Distance
Attributes Creating Distance			
Different languages Different ethnicities; lack of connective ethnic or social networks Different religions Different social norms	Absence of colonial ties Absence of shared monetary or political association Political hostility Government policies Institutional weakness	Physical remoteness Lack of a common border Lack of sea or river access Size of country Weak transportation or communication links Differences in climates	Differences in consumer incomes Differences in costs and quality of: • natural resources • financial resources • human resources • infrastructure • intermediate inputs • information or knowledge
Industries or Products Affected by Distance			
Products have high linguistic content (TV) Products affect cultural or national identity of consumers (foods) Product features vary in terms of: • size (cars) • standards (electrical appliances) • packaging Products carry country-specific quality associations (wines)	Government involvement is high in industries that are: • producers of staple goods (electricity) • producers of other "entitlements" (drugs) • large employers (farming) • large suppliers to government (mass transportation) • national champions (aerospace) • vital to national security (telecommunications) • exploiters of natural resources (oil, mining) • subject to high sunk costs (infrastructure)	Products have a low value-to-weight or bulk ratio (cement) Products are fragile or perishable (glass, fruit) Communications and connectivity are important (financial services) Local supervision and operational requirements are high (many services)	Nature of demand varies with income level (cars) Economies of standardization or scale are important (mobile phones) Labor and other factor cost differences are salient (garments) Distribution or business systems are different (insurance) Companies need to be responsive and agile (home appliances)

How Far Away Is China, Really?

As Star TV discovered, China is a particularly tough nut to crack. In a recent survey of nearly 100 multinationals, 54% admitted that their total business performance in China had been "worse than planned," compared with just 25% reporting "better than planned." Why was the failure rate so high? The survey provides the predictable answer: 62% of respondents reported that they had overestimated market potential for their products or services.

A quick analysis of the country along the dimensions of distance might have spared those companies much disappointment. Culturally, China is a long way away from nearly everywhere. First, the many dialects of the Chinese language are notoriously difficult for foreigners to learn, and the local population's foreign-language skills are limited. Second, the well-developed Chinese business culture based on personal connections, often summarized in the term *guanxi*, creates barriers to economic interchange with Westerners who focus on transactions rather than relationships. It can even be argued that Chinese consumers are "home-biased"; market research indicates much less preference for foreign brands over domestic ones than seems to be true in India, for example. In fact, greater China plays a disproportionate role in China's economic relations with the rest of the world.

Administrative barriers are probably even more important. A survey of members of the American Chamber of Commerce in China flagged market-access restrictions, high taxes, and customs duties as the biggest barriers to profitability in China. The level of state involvement in the economy continues to be high, with severe economic strains imposed by loss-making state-owned enterprises and technically insolvent state-owned banks. Corruption, too, is a fairly significant problem. In 2000, Transparency International ranked the country 63rd out of 90, with a rating of one indicating the least perceived corruption. Considerations such as these led Standard & Poor's to assign China a political-risk ranking of five in 2000, with six being the worst possible score.

So, yes, China is a big market, but that is far from the whole story. Distance matters, too, and along many dimensions.

to waterways and the ocean, and topography. Man-made geographic attributes also must be taken into account—most notably, a country's transportation and communications infrastructures.

Obviously, geographic attributes influence the costs of transportation. Products with low value-to-weight or bulk ratios, such as steel and cement, incur particularly high costs as geographic distance increases. Likewise, costs for transporting fragile or perishable products become significant across large distances.

Beyond physical products, intangible goods and services are affected by geographic distance as well. One recent study indicates that cross-border equity flows between two countries fall off significantly as the geographic distance between them rises. This phenomenon clearly cannot be explained by transportation costs—capital, after all, is not a physical good. Instead, the level of information infrastructure (crudely measured by telephone traffic and the number of branches of multinational banks) accounts for much of the effect of physical distance on cross-border equity flows.

Interestingly, companies that find geography a barrier to trade are often expected to switch to direct investment in local plant and equipment as an alternative way to access target markets. But current research suggests that this approach may be flawed: Geographic distance has a dampening effect, overall, on investment flows as well as on trade flows. In short, it is important to keep both information networks and transportation infrastructures in mind when assessing the geographic influences on cross-border economic activity.

Economic Distance The wealth or income of consumers is the most important economic attribute that creates distance between countries, and it has a marked effect on the levels of trade and the types of partners a country trades with. Rich countries, research suggests, engage in relatively more cross-border economic activity relative to their economic size than do their poorer cousins. Most of this activity is with other rich countries, as the positive correlation between per capita GDP and trade flows implies. But poor countries also trade more with rich countries than with other poor ones.

Of course, these patterns mask variations in the effects of economic disparities—in the cost and quality of financial, human, and other resources. Companies that rely on economies of experience, scale, and standardization should focus more on countries that have similar economic profiles. That's because they have to replicate their existing business model to exploit their competitive advantage, which is hard to pull off in a country where customer incomes—not to mention the cost and quality of resources—are very different. Wal-Mart in India, for instance, would be a very different business from Wal-Mart in the United States. But Wal-Mart in Canada is virtually a carbon copy.

In other industries, however, competitive advantage comes from economic arbitrage—the exploitation of cost and price differentials between markets. Companies in industries whose major cost components vary widely across countries—like the garment and footwear industries, where labor costs are important—are particularly likely to target countries with different economic profiles for investment or trade.

Whether they expand abroad for purposes of replication or arbitrage, all companies find that major disparities in supply chains and distribution channels are a significant barrier to business. A recent study concluded that margins on distribution within the United States—the costs of domestic transportation, wholesaling, and retailing—play a bigger role, on average, in erecting barriers to imports into the United States than do international transportation costs and tariffs combined.

More broadly, cross-country complexity and change place a premium on responsiveness and agility, making it hard for cross-border competitors, particularly replicators, to match the performance of locally focused ones because of the added operational complexity. In the home appliance business, for instance, companies like Maytag that concentrate on a limited number of geographies produce far better returns for investors than companies like Electrolux and Whirlpool, whose geographic spread has come at the expense of simplicity and profitability.

A Case Study in Distance

Taking the four dimensions of distance into account can dramatically change a company's assessment of the relative attractiveness of foreign markets. One company that has wrestled with global expansion is Tricon Restaurants International (TRI), the international operating arm of Tricon, which manages the Pizza Hut, Taco Bell, and KFC fast-food chains, and which was spun off from Pepsico in 1997.

When Tricon became an independent company, TRI's operations were far-flung, with restaurants in 27 countries. But the profitability of its markets varied greatly: Two-thirds of revenues and an even higher proportion of profits came from just seven markets. Furthermore, TRI's limited operating cash flow and Tricon's debt service obligations left TRI with less than one-tenth as much money as archrival McDonald's International to invest outside the United States. As a result, in 1998, TRI's president, Pete Bassi, decided to rationalize its global operations by focusing its equity investments in a limited number of markets.

But which markets? The exhibit "Country Portfolio Analysis: A Flawed Approach" provides a portfolio analysis of international markets for the fast-food restaurant business, based on data used by TRI for its strategy discussions. The analysis suggests that the company's top markets in terms of size of opportunity would be the larger bubbles to the center and right of the chart.

Applying the effects of distance, however, changes the map dramatically. Consider the Mexican market. Using the CPA method, Mexico, with a total fast-food consumption of $700 million, is a relatively small market, ranking 16th of 20. When combined with estimates of individual consumer wealth

Industry Sensitivity to Distance

The various types of distance affect different industries in different ways. To estimate industry sensitivity to distance, Rajiv Mallick, a research associate at Harvard Business School, and I regressed trade between every possible pair of countries in the world in each of 70 industries (according to their SIC designations) on each dimension of distance.

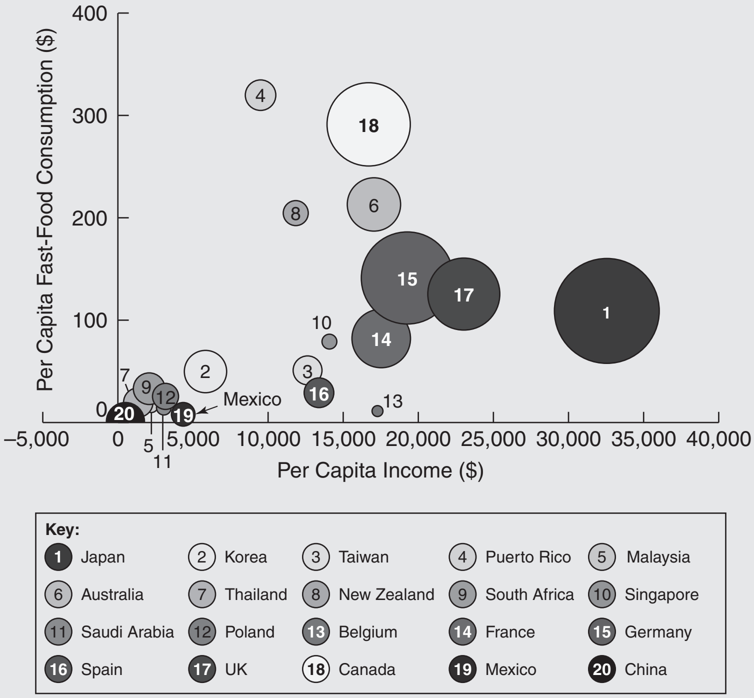
The results confirm the importance of distinguishing between the various components of distance in assessing foreign market opportunities. Electricity, for instance, is highly sensitive to administrative and geographic factors but not at all to cultural factors. The following table lists some of the industries that are more and less sensitive to distance.

CULTURAL DISTANCE Linguistic Ties	**ADMINISTRATIVE DISTANCE Preferential Trading Agreements**	**GEOGRAPHIC DISTANCE Physical Remoteness**	**ECONOMIC DISTANCE Wealth Differences**
More Sensitive			
Meat and meat preparations Cereals and cereal preparations Miscellaneous edible products and preparations Tobacco and tobacco products Office machines and automatic data-processing equipment	Gold, nonmonetary Electricity current Coffee, tea, cocoa, spices Textile fibers Sugar, sugar preparations, and honey	Electricity current Gas, natural and manufactured Paper, paperboard Live animals Sugar, sugar preparations, and honey	*(Economic distance decreases trade)* Nonferrous metals Manufactured fertilizers Meat and meat preparations Iron and steel Pulp and waste paper
Less Sensitive			
Photographic apparatuses, optical goods, watches Road vehicles Cork and wood Metalworking machinery Electricity current	Gas, natural and manufactured Travel goods, handbags Footwear Sanitary, plumbing, heating, and lighting fixtures Furniture and furniture parts	Pulp and waste paper Photographic apparatuses, optical goods, watches Telecommunications and sound-recording apparatuses Coffee, tea, cocoa, spices Gold, nonmonetary	*(Economic distance increases trade)* Coffee, tea, cocoa, spices Animal oils and fats Office machines and automatic data-processing equipment Power-generating machinery and equipment Photographic apparatuses, optical goods, watches

MORE SENSITIVE ←→ LESS SENSITIVE

Exhibit 1a Country Portfolio Analysis (a flawed approach)

Here's how country portfolio analysis (CPA) works. A company's actual and potential markets are plotted on a simple grid, with a measure of per capita income on one axis and some measure of product performance, often penetration rates, on the other. The location of the market on the grid reflects the attractiveness of the market in terms of individual consumer wealth and propensity to consume. The size of the bubble represents the total size of the market in terms of GDP or the absolute consumption of the product or service in question. The bubbles provide a rough estimate of how large the relative revenue opportunities are. This CPA map compares a number of non–U.S. markets for fast-food restaurants.



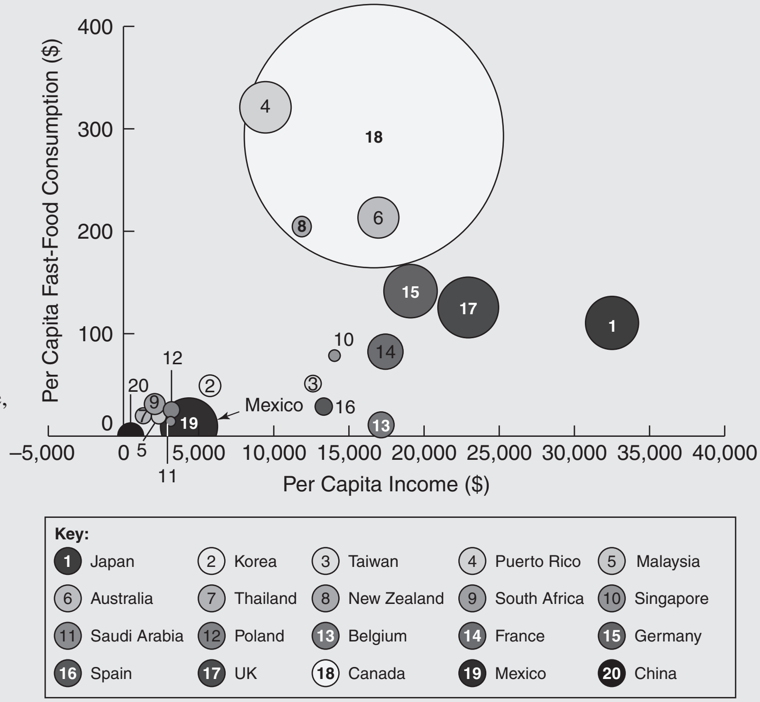
and per capita consumption, this ranking would imply that TRI should dispose of its investments there. But the exhibit "Country Portfolio Analysis: Adjusted for Distance" tells a different story. When the fast-food consumption numbers for each country are adjusted for their geographic distance from Dallas, TRI's home base, Mexico's consumption decreases less than any other country's, as you might expect, given Mexico's proximity to Dallas. Based on just this readjustment, Mexico leaps to sixth place in terms of market opportunity.

Further adjusting the numbers for a common land border and for membership in a trade agreement with the United States pushes Mexico's ranking all the way up to second, after Canada. Not all the adjustments are positive: adjusting for a common language—not a characteristic of Mexico—pushes Mexico into a tie for second place with the United Kingdom. Additional adjustments could also be made, but the overall message is plain. Once distance is taken into account, the size of the market opportunity in Mexico looks very different. If TRI had used the CPA approach and neglected distance, the company's planners might well have ended up abandoning a core market. Instead, they concluded, in Bassi's words, that "Mexico is one of TRI's top two or three priorities."

Factoring in the industry effects of distance is only a first step. A full analysis should consider how a company's own characteristics operate to increase or reduce distance from foreign markets. Companies with a large cadre of cosmopolitan managers, for instance, will be less affected by cultural differences than companies whose managers are all from the home country. In TRI's case, consideration of company-specific features made

Exhibit 1b Country Portfolio Analysis (adjusted for distance)

Taking distance into account dramatically changes estimates of market opportunities. In this chart, each of the fast-food markets has been adjusted for a number of distance attributes, based on the estimates by Frankel and Rose. The relative sizes of the bubbles are now very different. For example, Mexico, which was less than one-tenth the size of the largest international markets, Japan and Germany, ends up as the second largest opportunity. Clearly, the CPA approach paints an incomplete picture, unless it is adjusted for distance.



Mexico even more attractive. The company already owned more than four-fifths of its Mexican outlets and had a 38% share of the local market, well ahead of McDonald's.

Consideration of the interaction of company-specific features and distance is beyond the scope of this article. But whether the analysis is at the industry or company level, the message is the same: Managers must always be conscious of distance—in all its dimensions. The CAGE distance framework is intended to help managers meet that challenge. While it is necessarily subjective, it represents an important complement to the tools used by most companies seeking to build or rationalize their country market portfolios. Technology may indeed be making the world a smaller place, but it is not eliminating the very real—and often very high—costs of distance.

Reading 1-3 The Tortuous Evolution of the Multinational Corporation

Howard V. Perlmutter

Four senior executives of the world's largest firms with extensive holdings outside the home country speak:

Company A: "We are a multinational firm. We distribute our products in about 100 countries. We manufacture in over 17 countries and do research and development in three countries. We look at all new investment projects—both domestic and overseas—using exactly the same criteria."

Company B: "We are a multinational firm. Only 1% of the personnel in our affiliate companies are non-nationals. Most of these are U.S. executives on temporary assignments. In all major markets, the affiliate's managing director is of the local nationality."

Company C: "We are a multinational firm. Our product division executives have worldwide profit responsibility. As our organizational chart shows, the United States is just one region on a par with Europe, Latin America, Africa, etc., in each product division."

Company D (non-American): "We are a multinational firm. We have at least 18 nationalities represented at our headquarters. Most senior executives speak at least two languages. About 30% of our staff at headquarters are foreigners."

While a claim to multinationality based on their years of experience and the significant proportion of sales generated overseas is justified in each of these four companies, a more penetrating analysis changes the image.

The executive from Company A tells us that most of the key posts in Company A's subsidiaries are held by home-country nationals. Whenever replacements for these men are sought, it is the practice, if not the policy, to "look next to you at the head office" and "pick someone (usually a home-country national) you know and trust."

The executive from Company B does not hide the fact that there are very few non-Americans in the key posts at headquarters. The few who are there are "so Americanized" that their foreign nationality literally has no meaning. His explanation for this paucity of non-Americans seems reasonable enough: "You can't find good foreigners who are willing to live in the United States, where our headquarters is located. American executives are more mobile. In addition, Americans have the drive and initiative we like. In fact, the European nationals would prefer to report to an American rather than to some other European."

The executive from Company C goes on to explain that the worldwide product division concept is rather difficult to implement. The senior executives in charge of these divisions have little overseas experience. They have been promoted from domestic posts and tend to view foreign consumer needs "as really basically the same as ours." Also, product division executives tend to focus on the domestic market because the domestic market is larger and generates more revenue than the fragmented European markets. The rewards are for global performance, but the strategy is to focus on domestic. His colleagues say "one pays attention to what one understands—and our senior executives simply do not understand what happens overseas

Trained as an engineer and a psychologist, Howard V. Perlmutter spent eight years at M.I.T.'s Center for International Studies and five years at the Institut pour l'Etude des Methodes de Direction de l'Enterprise (IMEDE) in Lausanne, Switzerland. His main interests are in the theory and practice of institution building, particularly the international corporation. He has recently been appointed Director for Research and Development of Worldwide Institutions in association with the Management Science Center at the University of Pennsylvania, as well as a member of the faculty at the Wharton School.

and really do not trust foreign executives in key positions here or overseas."

The executive from the European Company D begins by explaining that since the voting shareholders must by law come from the home country, the home country's interest must be given careful consideration. In the final analysis he insists: "We are proud of our nationality; we shouldn't be ashamed of it." He cites examples of the previous reluctance of headquarters to use home-country ideas overseas, to their detriment, especially in their U.S. subsidiary. "Our country produces good executives, who tend to stay with us a long time. It is harder to keep executives from the United States."

A Rose by Any Other Name . . .

Why quibble about how multinational a firm is? To these executives, apparently being multinational is prestigious. They know that multinational firms tend to be regarded as more progressive, dynamic, geared to the future than provincial companies which avoid foreign frontiers and their attendant risks and opportunities.

It is natural that these senior executives would want to justify the multinationality of their enterprise, even if they use different yardsticks: ownership criteria, organizational structure, nationality of senior executives, percent of investment overseas, etc.

Two hypotheses seem to be forming in the minds of executives from international firms that make the extent of their firm's multinationality of real interest. The first hypothesis is that the degree of multinationality of an enterprise is positively related to the firm's long-term viability. The "multinational" category makes sense for executives if it means a quality of decision making which leads to survival, growth and profitability in our evolving world economy.

The second hypothesis stems from the proposition that the multinational corporation is a new kind of institution—a new type of industrial social architecture particularly suitable for the latter third of the twentieth century. This type of institution could make a valuable contribution to world order and conceivably exercise a constructive impact on the nation-state. Some executives want to understand how to create an institution whose presence is considered legitimate and valuable in each nation-state. They want to prove that the greater the degree of multinationality of a firm, the greater its total constructive impact will be on host and home nation-states as well as other institutions. Since multinational firms may produce a significant proportion of the world's GNP, both hypotheses justify a more precise analysis of the varieties and degrees of multinationality.[1] However, the confirming evidence is limited.

State of Mind

Part of the difficulty in defining the degree of multinationality comes from the variety of parameters along which a firm doing business overseas can be described. The examples from the four companies argue that (1) no single criterion of multinationality such as ownership or the number of nationals overseas is sufficient, and that (2) external and quantifiable measures such as the percentage of investment overseas or the distribution of equity by nationality are useful but not enough. The more one penetrates into the living reality of an international firm, the more one finds it is necessary to give serious weight to the way executives think about doing business around the world. The orientation toward "foreign people, ideas, resources," in headquarters and subsidiaries, and in host and home environments, becomes crucial in estimating the multinationality of a firm. To be sure, such external indices as the proportion of nationals in different countries holding equity and the number of foreign nationals who have reached top positions, including president, are good indices of multinationality. But one can still behave with a home-country orientation despite foreign shareholders, and one can have a few home-country nationals overseas but still pick

[1] H. V. Perlmutter, "Super-Giant Firms in the Future," *Wharton Quarterly,* Winter 1968.

those local executives who are home-country oriented or who are provincial and chauvinistic. The attitudes men hold are clearly more relevant than their passports.

Three primary attitudes among international executives toward building a multinational enterprise are identifiable. These attitudes can be inferred from the assumptions upon which key product, functional and geographical decisions were made.

These states of mind or attitudes may be described as ethnocentric (or home-country oriented), polycentric (or host-country oriented) and geocentric (or world-oriented).[2] While they never appear in pure form, they are clearly distinguishable. There is some degree of ethnocentricity, polycentricity or geocentricity in all firms, but management's analysis does not usually correlate with public pronouncements about the firm's multinationality.

Home-Country Attitudes

The ethnocentric attitude can be found in companies of any nationality with extensive overseas holdings. The attitude, revealed in executive actions and experienced by foreign subsidiary managers, is: "We, the home nationals of X company, are superior to, more trustworthy and more reliable than any foreigners in headquarters or subsidiaries. We will be willing to build facilities in your country if you acknowledge our inherent superiority and accept our methods and conditions for doing the job."

Of course, such attitudes are never so crudely expressed, but they often determine how a certain type of "multinational" firm is designed. Table 1 illustrates how ethnocentric attitudes are expressed in determining the managerial process at home and overseas. For example, the ethnocentric executive is more apt to say: "Let us manufacture the simple products overseas. Those foreign nationals are not yet ready or reliable. We should manufacture the complex products in our country and keep the secrets among our trusted home-country nationals."

In a firm where ethnocentric attitudes prevailed, the performance criteria for men and products are "home-made." "We have found that a salesman should make 12 calls per day in Hoboken, New Jersey (the headquarters location), and therefore we apply these criteria everywhere in the world. The salesman in Brazzaville is naturally lazy, unmotivated. He shows little drive because he makes only two calls per day (despite the Congolese salesman's explanation that it takes time to reach customers by boat)."

Ethnocentric attitudes are revealed in the communication process where "advice," "counsel," and directives flow from headquarters to the subsidiary in a steady stream, bearing this message: "This works at home; therefore, it must work in your country."

Executives in both headquarters and affiliates express the national identity of the firm by associating the company with the nationality of the headquarters: this is "a Swedish company," "a Swiss company," "an American company," depending on the location of headquarters. "You have to accept the fact that the only way to reach a senior post in our firm," an English executive in a U.S. firm said, "is to take out an American passport."

Crucial to the ethnocentric concept is the current policy that men of the home nationality are recruited and trained for key positions everywhere in the world. Foreigners feel like "second-class" citizens.

There is no international firm today whose executives will say that ethnocentrism is absent in their company. In the firms whose multinational investment began a decade ago, one is more likely to hear, "We are still in a transitional stage from our ethnocentric era. The traces are still around! But we are making progress."

Host-Country Orientation

Polycentric firms are those which, by experience or by the inclination of a top executive (usually one of the founders), begin with the assumption

[2] H. V. Perlmutter, "Three Conceptions of a World Enterprise," *Revue Economique et Sociale,* May 1965.

Table 1 Three Types of Headquarters Orientation toward Subsidiaries in an International Enterprise

Organization Design	Ethnocentric	Polycentric	Geocentric
Complexity of organization	Complex in home country, simple in subsidiaries	Varied and independent	Increasingly complex and interdependent
Authority; decision making	High in headquarters	Relatively low in headquarters	Aim for a collaborative approach between headquarters and subsidiaries
Evaluation and control	Home standards applied for persons and performance	Determined locally	Find standards which are universal and local
Rewards and punishments; incentives	High in headquarters, low in subsidiaries	Wide variation; can be high or low rewards for subsidiary performance	International and local executives rewarded for reaching local and worldwide objectives
Communication; information flow	High volume to subsidiaries; orders, commands, advice	Little to and from headquarters; little between subsidiaries	Both ways and between subsidiaries; heads of subsidiaries part of management team
Identification	Nationality of owner	Nationality of host country	Truly international company but identifying with national interests
Perpetuation (recruiting, staffing, development)	Recruit and develop people of home country for key positions everywhere in the world	Develop people of local nationality for key positions in their own country	Develop best men everywhere in the world for key positions everywhere in the world

that host-country cultures are different and that foreigners are difficult to understand. Local people know what is best for them, and the part of the firm which is located in the host country should be as "local in identity" as possible. The senior executives at headquarters believe that their multinational enterprise can be held together by good financial controls. A polycentric firm, literally, is a loosely connected group with quasi-independent subsidiaries as centers—more akin to a confederation.

European multinational firms tend to follow this pattern, using a top local executive who is strong and trustworthy, of the "right" family and who has an intimate understanding of the workings of the host government. This policy seems to have worked until the advent of the Common Market.

Executives in the headquarters of such a company are apt to say: "Let the Romans do it their way. We really don't understand what is going on there, but we have to have confidence in them. As long as they earn a profit, we want to remain in the background." They assume that since people are different in each country, standards for performance, incentives and training methods must be different. Local environmental factors are given greater weight (see Table 1).

Many executives mistakenly equate polycentrism with multinationalism. This is evidenced in the legalistic definition of a multinational enterprise as a cluster of corporations of diverse nationality joined together by ties of common ownership. It is no accident that many senior executives in headquarters take pride in the absence of non-nationals in their subsidiaries, especially people from the head office. The implication is clearly that each subsidiary is a distinct national entity, since it is incorporated in a different sovereign state. Lonely senior executives in the subsidiaries of polycentric companies complain that: "The home office never tells us anything."

Polycentrism is not the ultimate form of multinationalism. It is a landmark on a highway. Polycentrism is encouraged by local marketing managers who contend that: "Headquarters will never understand us, our people, our consumer needs, our laws, our distribution, etc. . . ."

Headquarters takes pride in the fact that few outsiders know that the firm is foreign-owned. "We want to be a good local company. How many Americans know that Shell and Lever Brothers are foreign-owned?"

But the polycentric personnel policy is also revealed in the fact that no local manager can seriously aspire to a senior position at headquarters. "You know the French are so provincial; it is better to keep them in France. Uproot them and you are in trouble," a senior executive says to justify the paucity of non-Americans at headquarters.

One consequence (and perhaps cause) of polycentrism is a virulent ethnocentrism among the country managers.

A World-Oriented Concept

The third attitude which is beginning to emerge at an accelerating rate is geocentrism. Senior executives with this orientation do not equate superiority with nationality. Within legal and political limits, they seek the best men, regardless of nationality, to solve the company's problems anywhere in the world. The senior executives attempt to build an organization in which the subsidiary is not only a good citizen of the host nation but is a leading exporter from this nation in the international community and contributes such benefits as (1) an increasing supply of hard currency, (2) new skills and (3) a knowledge of advanced technology. Geocentrism is summed up in a Unilever board chairman's statement of objectives: "We want to Unileverize our Indians and Indianize our Unileverans."

The ultimate goal of geocentrism is a worldwide approach in both headquarters and subsidiaries. The firm's subsidiaries are thus neither satellites nor independent city states, but parts of a whole whose focus is on worldwide objectives as well as local objectives, each part making its unique contribution with its unique competence. Geocentrism is expressed by function, product and geography. The question asked in headquarters and the subsidiaries is: "Where in the world shall we raise money, build our plant, conduct R&D, get and launch new ideas to serve our present and future customers?"

This conception of geocentrism involves a collaborative effort between subsidiaries and headquarters to establish universal standards and permissible local variations, to make key allocational decisions on new products, new plants, new laboratories. The international management team includes the affiliate heads.

Subsidiary managers must ask: "Where in the world can I get the help to serve my customers best in this country?" "Where in the world can I export products developed in this country—products which meet worldwide standards as opposed to purely local standards?"

Geocentrism, furthermore, requires a reward system for subsidiary managers which motivates them to work for worldwide objectives, not just to defend country objectives. In firms where geocentrism prevails, it is not uncommon to hear a subsidiary manager say, "While I am paid to defend our interests in this country and to get the best resources for this affiliate, I must still ask myself the question 'Where in the world (instead of where in my country) should we build this plant?'" This approach is still rare today.

In contrast to the ethnocentric and polycentric patterns, communication is encouraged among subsidiaries in geocentric-oriented firms. "It is your duty to help us solve problems anywhere in the world," one chief executive continually reminds the heads of his company's affiliates. (See Table 1.)

The geocentric firm identifies with local company needs. "We aim not to be just a good local company but the best local company in terms of the quality of management and the worldwide (not local) standards we establish in domestic and export production." "If we were only as good as local companies, we would deserve to be nationalized."

The geocentric personnel policy is based on the belief that we should bring in the best man in the world regardless of his nationality. His passport should not be the criterion for promotion.

The EPG Profile

Executives can draw their firm's profile in ethnocentric (E), polycentric (P) and geocentric (G) dimensions. They are called EPG profiles. The degree of ethnocentrism, polycentrism and geocentrism by product, function and geography can be established. Typically R&D often turns out to be more geocentric (truth is universal, perhaps) and less ethnocentric than finance. Financial managers are likely to see their decisions as ethnocentric. The marketing function is more polycentric, particularly in the advanced economies and in the larger affiliate markets.

The tendency toward ethnocentrism in relations with subsidiaries in the developing countries is marked. Polycentric attitudes develop in consumer goods divisions, and ethnocentrism appears to be greater in industrial product divisions. The agreement is almost unanimous in both U.S.- and European-based international firms that their companies are at various stages on a route toward geocentrism but none has reached this state of affairs. Their executives would agree, however, that:

1. A description of their firms as multinational obscures more than it illuminates the state of affairs;
2. The EPG mix, once defined, is a more precise way to describe the point they have reached;
3. The present profile is not static but a landmark along a difficult road to genuine geocentrism;
4. There are forces both to change and to maintain the present attitudinal "mix," some of which are under their control.

Forces Toward and Against

What are the forces that determine the EPG mix of a firm? "You must think of the struggle toward functioning as a worldwide firm as just a beginning—a few steps forward and a step backward," a chief executive puts it. "It is a painful process, and every firm is different."

Executives of some of the world's largest multinational firms have been able to identify a series of external and internal factors that contribute to or hinder the growth of geocentric attitudes and decisions. Table 2 summarizes the factors most frequently mentioned by over 500 executives from at least 17 countries and 20 firms.

From the external environmental side, the growing world markets, the increase in availability of managerial and technological know-how in different countries, global competition and international customers' advances in telecommunications, regional political and economic communities are positive factors, as is the host country's desire to increase its balance-of-payments surplus through the location of export-oriented subsidiaries of international firms within its borders.

In different firms, senior executives see in various degrees these positive factors toward geocentrism: top management's increasing desire to use human and material resources optimally, the observed lowering of morale after decades of ethnocentric practices, the evidence of waste and duplication under polycentric thinking, the increased awareness and respect for good men of other than the home nationality, and, most importantly, top management's own commitment to building a geocentric firm as evidenced in policies, practices and procedures.

The obstacles toward geocentrism from the environment stem largely from the rising political and economic nationalism in the world today, the suspicions of political leaders of the aims and increasing

Table 2 International Executives' View of Forces and Obstacles towards Geocentrism in Their Firms

Forces towards Geocentrism		*Obstacles towards Geocentrism*	
Environmental	**Intra-Organizational**	**Environmental**	**Intra-Organizational**
1. Technological and managerial know-how increasing in availability in different countries	1. Desire to use human versus material resources optimally	1. Economic nationalism in host and home countries	1. Management inexperience in overseas markets
2. International customers	2. Observed lowering of morale in affiliates of an ethnocentric company	2. Political nationalism in host and home countries	2. Nation-centered reward and punishment structure
3. Local customers' demand for best product at fair price	3. Evidence of waste and duplication in polycentrism	3. Military secrecy associated with research in home country	3. Mutual distrust between home-country people and foreign executives
4. Host country's desire to increase balance of payments	4. Increasing awareness and respect for good people of other than home nationality	4. Distrust of big international firms by host-country political leaders	4. Resistance to letting foreigners into the power structure
5. Growing world markets	5. Risk diversification in having a worldwide production and distribution system	5. Lack of international monetary system	5. Anticipated costs and risks of geocentrism
6. Global competition among international firms for scarce human and material resources	6. Need for recruitment of good people on a worldwide basis	6. Growing differences between the rich and poor countries	6. Nationalistic tendencies in staff
7. Major advances in integration of international transport and telecommunications	7. Need for worldwide information system	7. Host-country belief that home countries get disproportionate benefits of international firms' profits	7. Increasing immobility of staff
8. Regional supranational economic and political communities	8. Worldwide appeal products	8. Home-country political leaders' attempts to control firm's policy	8. Linguistic problems and different cultural backgrounds
	9. Senior management's long-term commitment to geocentrism as related to survival and growth		9. Centralization tendencies in headquarters

power of the multinational firm. On the internal side, the obstacles cited most frequently in U.S.-based multinational firms were management's inexperience in overseas markets, mutual distrust between home-country people and foreign executives, the resistance to participation by foreigners in the power structure at headquarters, the increasing difficulty of getting good men overseas to move, nationalistic tendencies in staff, and linguistic and other communication difficulties of a cultural nature.

Any given firm is seen as moving toward geocentrism at a rate determined by its capacities to build on the positive internal factors over which it has control and to change the negative internal factors which are controllable. In some firms the geocentric goal is openly discussed among executives of different nationalities and from different subsidiaries as well as headquarters. There is a consequent improvement in the climate of trust and acceptance of each other's views.

Programs are instituted to assure greater experience in foreign markets, task forces of executives are upgraded, and international careers for executives of all nationalities are being designed.

But the seriousness of the obstacles cannot be underestimated. A world of rising nationalism is hardly a precondition for geocentrism; and overcoming distrust of foreigners even within one's own firm is not accomplished in a short span of time. The route to pervasive geocentric thinking is long and tortuous.

Costs, Risks, Payoffs

What conclusions will executives from multinational firms draw from the balance sheet of advantages and disadvantages of maintaining one's present state of ethnocentrism, polycentrism or geocentrism? Not too surprisingly, the costs and risks of ethnocentrism are seen to out-balance the payoffs in the long run. The costs of ethnocentrism are ineffective planning because of a lack of good feedback, the departure of the best men in the subsidiaries, fewer innovations, and an inability to build a high calibre local organization. The risks are political and social repercussions and a less flexible response to local changes.

The payoffs of ethnocentrism are real enough in the short term, they say. Organization is simpler. There is a higher rate of communication of knowhow from headquarters to new markets. There is more control over appointments to senior posts in subsidiaries.

Polycentrism's costs are waste due to duplication, to decisions to make products for local use but which could be universal, and to inefficient use of home-country experience. The risks include an excessive regard for local traditions and local growth at the expense of global growth. The main advantages are an intense exploitation of local markets, better sales since local management is often better informed, more local initiative for new products, more host-government support, and good local managers with high morale.

Geocentrism's costs are largely related to communication and travel expenses, educational costs at all levels, time spent in decision making because consensus seeking among more people is required, and an international headquarters bureaucracy. Risks include those due to too wide a distribution of power, personnel problems and those of reentry of international executives. The payoffs are a more powerful total company throughout, a better quality of products and service, worldwide utilization of best resources, improvement of local company management, a greater sense of commitment to worldwide objectives, and last, but not least, more profit.

Jacques Maisonrouge, the French-born president of IBM World Trade, understands the geocentric concept and its benefits. He wrote recently:

> "The first step to a geocentric organization is when a corporation, faced with the choice of whether to grow and expand or decline, realizes the need to mobilize its resources on a world scale. It will sooner or later have to face the issue that the home country does not have a monopoly of either men or ideas. . . .
>
> "I strongly believe that the future belongs to geocentric companies. . . . What is of fundamental importance is the attitude of the company's top management. If it is dedicated to 'geocentrism,' good international management will be possible. If not, the

best men of different nations will soon understand that they do not belong to the 'race des seigneurs' and will leave the business."[3]

Geocentrism is not inevitable in any given firm. Some companies have experienced a "regression" to ethnocentrism after trying a long period of polycentrism, of letting subsidiaries do it "their way." The local directors built little empires and did not train successors from their own country. Headquarters had to send home-country nationals to take over. A period of home-country thinking took over.

There appears to be evidence of a need for evolutionary movement from ethnocentrism to polycentrism to geocentrism. The polycentric stage is likened to an adolescent protest period during which subsidiary managers gain their confidence as equals by fighting headquarters and proving "their manhood," after a long period of being under headquarters' ethnocentric thumb.

"It is hard to move from a period of headquarters domination to a worldwide management team quickly. A period of letting affiliates make mistakes may be necessary," said one executive.

Window Dressing

In the rush toward appearing geocentric, many U.S. firms have found it necessary to emphasize progress by appointing one or two non-nationals to senior posts—even on occasion to headquarters. The foreigner is often effectively counteracted by the number of nationals around him, and his influence is really small. Tokenism does have some positive effects, but it does not mean geocentrism has arrived.

Window dressing is also a temptation. Here an attempt is made to demonstrate influence by appointing a number of incompetent "foreigners" to key positions. The results are not impressive for either the individuals or the company.

Too often what is called "the multinational view" is really a screen for ethnocentrism. Foreign affiliate managers must, in order to succeed, take on the traits and behavior of the ruling nationality. In short, in a U.S.-owned firm the foreigner must "Americanize"—not only in attitude but in dress and speech—in order to be accepted.

Tokenism and window dressing are transitional episodes where aspirations toward multinationalism outstrip present attitudes and resources. The fault does not lie only with the enterprise. The human demands of ethnocentrism are great.

A Geocentric Man—?

The geocentric enterprise depends on having an adequate supply of men who are geocentrically oriented. It would be a mistake to underestimate the human stresses which a geocentric career creates. Moving where the company needs an executive involves major adjustments for families, wives and children. The sacrifices are often great and, for some families, outweigh the rewards forthcoming—at least in personal terms. Many executives find it difficult to learn new languages and overcome their cultural superiority complexes, national pride and discomfort with foreigners. Furthermore, international careers can be hazardous when ethnocentrism prevails at headquarters. "It is easy to get lost in the world of the subsidiaries and to be 'out of sight, out of mind' when promotions come up at headquarters," as one executive expressed it following a visit to headquarters after five years overseas. To his disappointment, he knew few senior executives. And fewer knew him!

The economic rewards, the challenge of new countries, the personal and professional development that comes from working in a variety of countries and cultures are surely incentives, but companies have not solved by any means the human costs of international mobility to executives and their families.

A firm's multinationality may be judged by the pervasiveness with which executives think geocentrically—by function, marketing, finance, production, R&D, etc., by product division and by country. The takeoff to geocentrism may begin with executives in one function, say marketing, seeking to find a truly worldwide product line. Only when this worldwide attitude extends throughout the

[3] Jacques Maisonrouge, "The Education of International Managers," *Quarterly Journal of AIESEC International*, February 1967.

firm, in headquarters and subsidiaries, can executives feel that it is becoming genuinely geocentric.

But no single yardstick, such as the number of foreign nationals in key positions, is sufficient to establish a firm's multinationality. The multinational firm's route to geocentrism is still long because political and economic nationalism is on the rise, and, more importantly, since within the firm ethnocentrism and polycentrism are not easy to overcome. Building trust between persons of different nationality is a central obstacle. Indeed, if we are to judge men, as Paul Weiss put it, "by the kind of world they are trying to build," the senior executives engaged in building the geocentric enterprise could well be the most important social architects of the last third of the twentieth century. For the institution they are trying to erect promises a greater universal sharing of wealth and a consequent control of the explosive centrifugal tendencies of our evolving world community.

The geocentric enterprise offers an institutional and supranational framework which could conceivably make war less likely, on the assumption that bombing customers, suppliers and employees is in nobody's interest. The difficulty of the task is thus matched by its worthwhileness. A clearer image of the features of genuine geocentricity is thus indispensable both as a guideline and as an inviting prospect.