Fdi associated strategic theories

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This paper will describe and evaluate Foreign Direct Investment and its associated strategic theories. The paper will begin by defining Foreign Direct Investment and proceed to analyze its tendencies and direction. The paper will also describe another means of international expansion known as licensing and evaluate its related advantages and disadvantages. Foreign Direct Investment may occur horizontally or vertically depending on the industry in which the firm conducts its business; the paper will describe these two areas of investment between foreign firms and it will also evaluate the strategic reasons as to why firms accept the risks and costs Foreign Direct Investment imposes on their businesses.

Foreign Direct Investment

Introduction

For various reasons, over the course of their operations, a firm may decide to invest in a foreign country to set up production facilities or to merchandise their product in the country. This is known as Foreign Direct Investment (FDI) and occurs when a firm or an individual takes a share of 10 percent or more in a foreign business entity. As a consequence, the firm becomes a multinational organization.

There are two main types of FDI; the first one is known as a Greenfield investment and takes place when a firm establishes entirely new facilities in a country other than its own. The second type includes mergers and acquisitions; it involves joining or purchasing an existing foreign firm. The acquisition will be classified as a minority investment when the investor acquires 10-49 percent share of the firm’s stock. However, when a 50-99 percent share of a firm’s stock is purchased, the investment is known as a

majority investment. Finally, a full outright stake occurs when a stake of 100 percent is acquired.

Another form of foreign investment is known as a Foreign Portfolio Investment (FPI). This type of investment differs from FDI as it requires an investment of less than 10 percent in a firm's stock or government bonds; this means that the individual, the firm, or a public body will not acquire any form of ownership.

The Tendency of FDI

Along the years, FDI has been increasing in a relatively fast pace. One of the main reasons for rises in FDI is that a great number of countries in Asia, Eastern Europe and Latin America have been facing considerable economic and political transformations; most of these changes mainly include the globalization of the economy, the removal of many restrictions on FDI, an increase of free market economies and the privatization of many state-owned enterprises. Once countries lose their trade barriers and are more opened to FDI, they consequently become more attractive to foreign investors.

The Direction of FDI

The amount of foreign direct investment carried out over a specific time period (usually a year) is known as the flow of FDI and is characterized as having two different forms. The first form is known as FDI outflow; it consists of FDI flowing out of a country. The second form is known as FDI inflows; it occurs when FDI flows into a country.

Up until the year 2002, the majority of firms situated in advanced countries undertaking FDI would invest in other firms of developed nations. For instance, the United States was one of the most attractive targets for this kind of investments due to its vast demand, wealthy domestic markets, favorable political environment, and its receptive stance to FDI. However, FDI inflows are increasingly prevalent in developing nations. Such countries include India, Vietnam, Brazil, Indonesia, and China due to increasing privatization of state-owned companies, changes in political systems, a growing acceptance of FDI, and an increase of free trade areas, such as NAFTA, and MERCOSUR, among countries.

Licensing

A firm may also expand its business internationally through licensing. As a licensor, the firm will grant permission to foreign licensees to sell its product and use its brand name as well as its trademark legalized under a contractual agreement. A license also entails the licensor benefitting from receiving royalty fees on revenues obtained by the foreign firm or each unit sold. Moreover, the domestic firm (the licensor) can benefit from the agreement because its revenue will increase even though its involvement with the operation process is very little. As well, it will not imply taking the risk of opening a new business in the foreign market as this will be undertaken by the foreign company (the licensee). However, the pure licensing agreement usually does not give to the licensor the full control of its operations abroad which may result in giving the licensee more freedom to operate on its own terms.

Starbucks' FDI Case

Starbucks is internationally known for selling its own premium roasted coffee, espresso-style coffee beverages, coffee accessories, and other products. Moreover, its popularity has given the company the opportunity of having more than 11, 000 stores in the United States and more than 6, 000 stores in 50 different countries.

In the mid 1990s, Starbucks initiated its international business investment in Japan. The primary choice was to license its format, but the company realized that a pure licensing agreement would not give them the full and needed control of its operations. Consequently, Starbucks managed to create a joint venture with a local firm, Sazaby Inc. where each company owned a 50 percent stake of the business.

To make sure the Japanese operations were copying the original standards, Starbucks transferred some of its employees to train and teach the employees of Japan. Consequently, after opening more than 300 stores successfully in the country within a decade, it was clear that investing abroad was a good investment. By the late 1990s Starbucks managed to open more stores in other countries.

In Asia, Starbucks' most common strategy was finding a local operator to license its operations. Yet, Starbucks still insisted on an intensive employee training program and strict specifications to its format and store design.

However, in some cases the licensing arrangements in Asia were not appealing to the coffee company. As a consequence, they managed to convert several initial licensing agreements into joint-venture or fully owned

stores. For example, in Thailand, the primary licensing agreement with Coffee Partners (local Thai company) did not generate success due to the Coffee Partner's difficulties in raising funds from Thai banks to finance the store expansions. As a consequence, Starbucks had to acquire Coffee Partners to be able to accomplish its mission and successfully invest in Thailand.

Horizontal Foreign Direct Investment

Horizontal Foreign Direct Investment occurs when a firm invests in a foreign country in the same industry it operates domestically. FDI includes mergers and acquisitions as well as establishments of wholly new operations. Setting up new operations and acquiring existing firms abroad is very costly compared to exporting. The strategic move also entails the risks associated with differing cultures doing business together which could be avoided through the use of a native sales agent. However, although firms initiating in horizontal FDI may face greater risks and costs than one's who choose to export or license their know-how, there are strategic reasons why horizontal FDI appeals to them. They include:

- Transportation costs
- Market imperfections
- Strategic behavior
- The product life cycle
- Location advantages

Transportation Costs

The first factor, transportation costs, makes FDI the more profitable option over exporting for companies shipping products such as soft beverages or cement as they have a low value-to-weight ratio. The elevated transportation costs linked to these cheaper products for shipping abroad make production in foreign countries (closer to international customers) more appealing. This is however, not always the case for high value-to-weight products as transportation costs do not have a major impact on profits.

Market Imperfections

Marketing imperfections include impediments to exporting and impediments to the sale of know-how. Impediments to exporting causes the flow of goods between countries to encounter friction through the form of government imposed quotas (limits the quantity of a product that can be imported) and tariffs on imported goods. Therefore, the options linked to FDI become more attractive to companies willing to sell their products internationally. Impediments to the sale know-how arise as companies are aware of the possibility that their know-how (their competitive advantage and expertise that allows them to manage assets more efficiently than competing foreign companies) be transmitted to potential competitors abroad. They will also no longer have complete control over manufacturing, marketing and strategy. Moreover, it might not be possible to license all aspects of their know-how. As such, a North American company’s organizational culture including its attitudes, beliefs, values, etc. may not be successfully implemented in a country such as Japan as well as the means by which the company does business, including management.

Strategic Behavior

The third theory explaining the attractiveness of FDI is strategic behavior; it represents a form of strategic rivalry between competing foreign firms. F. T. Knickerbocker further developed this theory proposing a relationship between FDI and " industries composed of a limited number of large firms" known as oligopolistic industries. Since they are very few, the actions of one firm (e. g. lowered prices) can trigger the other firms to mirror their actions in order to retain market share. This principle increases the likelihood of FDI as the entrance of a firm in a foreign country will most likely encourage the rest to follow. If the opposite situation was to occur, the first firm to enter the country could reach a dominant position in the new country. This would result in fewer export opportunities for the firms who arrived later. F. T. Knickerbocker also proposed multipoint competition as a factor increasing horizontal FDI. This phenomenon proposes that competing firms will closely follow each other's moves in order to prevent a rival from becoming the leader in one market and using the profits they have gained to dominate other markets. Although this theory explains to a certain degree a cause in the rise of FDI it does not explain why licensing and exporting are less attractive strategic moves for firms doing business internationally.

Product Life Cycle

The product life cycle theory proposed by Raymond Vernon is another explanation for the rise in FDI that fails to justify its likelihood over exports and licenses. The theory suggests that a firm which has pioneered a product domestically will first carry out foreign direct investment in developed nations when demand is elevated enough to sustain production in those

countries. However, once price competition and pressures arise in the developed nations, production moves to developing countries where costs are slashed due to significantly inexpensive labor wages.

Location Advantages

The last factor influencing a rise in horizontal FDI is proposed by John Dunning. He agreed to the previous factors and theories but added that location-specific advantages also increase the attractiveness of FDI. Furthermore, his theory enables us to better comprehend the direction of FDI. Location-specific advantages can result in a company gaining competitive advantage by combining its assets through FDI with a foreign location that is endowed with particular assets or resources which make setting up production facilities in the region beneficial to the firm. Oil companies for instance benefit from FDI due to location-specific advantages more than they would through licensing as they realize the troubles involved with licensing their know-how. Dunning defines this as eclectic paradigm. Furthermore, many multinational companies benefit from horizontal FDI as foreign countries vary in labor costs and skills. Therefore, production facilities are open abroad where the workforce is most suitable for specific production processes. In California, the Silicon Valley provides a location-specific advantage for firms in the semiconductor and computer industries referred to as externalities; the location has a concentration of intellectual talents and firms gain from one another’s knowledge generation.

Vertical Foreign Direct Investment

Vertical foreign direct investment occurs when a firm directly invests in a foreign firm which differs in respect to its stage in the production process.

For instance a firm such as BP will integrate vertically into a foreign industry to attain oil extractions (input/raw material); this is useful for oil refining which is a production process in the firms’ downstream operations. This is known as backward vertical FDI. The other form of vertical FDI is known as forward vertical FDI. It occurs when a firm such as Volkswagen acquires foreign dealers to sell its outputs. Similarly to horizontal foreign direct investments, this is a costly and risky strategic move. However, (1) strategic behavior and (2) market imperfections provide good explanations for why firms go through such trouble instead of importing raw materials or exporting their outputs abroad.

Strategic Behavior

Strategic behavior can provide the opportunity for a firm that is vertically integrating backwards abroad to gain control over a production process’s source of input, thus providing them with a competitive advantage and possibly creating a barrier to entry to competing firms. Furthermore, a firm such as Volkswagen sees better business opportunities through vertical direct investment in foreign countries as barriers created by existing firms can be avoided; as such, by using company owned dealerships to promote their cars, Volkswagen was able to enter the US auto market more quickly than it would have been able to had it used American dealerships such as GM, Ford or Chrysler.

Market Imperfections

Impediments to the sale know-how as a form of market imperfection decreases the likelihood of a firm licensing it’s know-how to competing firms, instead backwards vertical FDI in a country where there is no efficient

producer to supply the firm's inputs through exports allows the firm to maintain its expertise and competitive advantage while decreasing the chances of competitors becoming too dominant. Finally, the other form of market imperfection for vertical FDI is investment in specialized assets and takes place " when a firm must invest in specialized assets whose values depends on inputs provided by a foreign supplier." These specialized assets are intended for specific tasks and considerably lose their value following the first usage. Therefore, the firm greatly relies on the foreign firm providing its inputs and its investment depends on the price the foreign firm charges for the inputs. Consequently, to avoid drastic increases in the price of the firm's inputs, it will pursue vertical FDI through acquiring the foreign firm providing its inputs. A great example of this is aluminum companies engaging in vertical FDI by acquiring a bauxite mining firm to avoid rising bauxite prices.

Conclusion

This Foreign Direct Investment paper concludes with an understanding of FDI. The paper also reviewed its different forms as well as the strategic reasons increasing the appeal of FDI to firms as opposed to licensing and exporting. The paper further provided explanations for recent rises in FDI and reasons for its increasing presence in developing nations. Finally, with markets becoming more and more interdependent, FDI is becoming a major factor in allowing firms to pierce new markets; it will most likely become a part of standard business practices where firms will invest in foreign firms to benefit from the associated strategies of FDI.