CHAPTER - 2

Modes of International Business

Learning Objectives

- *Describes the different modes of entry*
- *Explains the trade mode*
- *Understanding of the transfer mode in international business*
- *Foreign direct investment*
- *Foreign portfolio investment*

In international business, private enterprises and the government have to decide how to carry out their business, such as what mode of operation to be used. The choice of mode for operation is important as different firms prefer different levels of involvement in international business. If a firm is in favour of least involvement, it is only trade that may suffice the purpose. On the contrary, if a firm is in favour of maximum involvement in international business, investment mode will be most suitable. Even if a company is capable of making investment, the host country environment may not be congenial for making investment. So a firm may go for different entry modes in different countries. Sometimes companies choose exporting as a entry mode in a region but gradually may set up a joint venture in the host country.

2.1 DETERMINANTS OF ENTRY MODE

There are three modes of entry in international business. These are as follows:

a) Trade mode
b) Transfer mode
c) Investment mode

2.1.1 Trade Mode

In this type of operation, the products are produced within the domestic territory and then exported to other countries, where there is a market for the products. Thus, this type of method involves marketing, i.e. exporting and importing of the products. Importing is to buy goods and services from another country.

Manufacturing companies can either directly export their goods or indirectly through another company. In direct export, a company takes full responsibility for making its products available in the international market, by selling directly to the end-users usually through their own distributing agents. When the exporting company does not possess the necessary infrastructure to involve itself in direct exporting, indirect exporting takes place. It takes place when the exporting company sells its products to intermediaries, who in turn sell the same products to the end-users in the target market. This prevents the manufacturer from directly facing the environment. For example, earlier Pearson Publication sold its book in India on collaboration with PHI-Prentice-Hall of India. Now PHI is a separate publishing company.

2.2.1 Service Exports and Imports

Many developing nations like India is more involved in service exports. Nowadays with advancement of technology, it is easier to export services to distant lands through various modes of communication. Like, physical goods, even in case of export of services, there is an inflow of foreign currency and outflow of services or expertise and in import of services, there is inflow of services, technological or management know-how and outflow of domestic currency. There are four different types of services depending on their mode of provision. Mode 1: is called cross-border supply, where neither the buyer nor the seller is mobile. Call centres, business outsourcing, and knowledge outsourcing jobs are few examples. Mode 2: is called consumption abroad, where the buyer is mobile and seller is immobile. Tourism, medical tourism are the examples for this type of services. Mode 3: In this mode seller is mobile like courier services, international logistics company. Mode 4: In this mode both the service provider as well as the user are mobile.

World trade in services has taken a big leap forward with service exports growing at a very high rate in recent years. There are factors both on demand and supply side that have contributed to the growth of the service. The contribution of technology in telecommunication has extensively lessened the distance between two countries. Internet, cell phones, videoconferencing are helping people to work from anywhere in the world for any one in any place in the world. In world trade, the services which were earlier in-house are now getting highly specialized and are splintering off to outside business firms possessing the required expertise. Compositionwise India's service exports generally consist of business services, tourist services, computer software services.

India as a developing country has a competitive strength in service sector because of huge number of skilled labour. The most ambitious area is that of software, research and development in biotechnology, marketing, medical and management.

The Hindu Business Line

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MTR Foods to revamp distribution network, expand presence

MTR Foods on Friday outlined a new perspective of its diversified business which seeks to consolidate its presence in northern and western parts of the country and revamp distribution network. It plans to increase marketing spend and double turnover to ₹ 500 crore within two years. The Bangalore-based company, acquired by the Norwegian major Orkla ASA in 2007, has begun to outsource vermicelli from a manufacturer based in Mathura recently and is poised to double the capacity of its spices unit in Bangalore with an outlay of ₹ 15 crore.

The Chief Executive Officer of MTR Foods, Mr Sanjay Sharma, said the company has a significant presence in Karnataka and Andhra Pradesh, with the South accounting for about 70 per cent of the total business. "With the restructuring of distribution network, we expect other parts of the country to contribute about 40 per cent to the overall business," he said. Addressing a press conference, Mr Sharma said south Indian food is no longer South Indian. There is opportunity to grow the instant mix and ready-to-eat categories, which currently contribute to about 25 per cent and 10 per cent of the total business respectively.

"We spend 14 per cent of the revenues on advertisements and promotions. During the current year we expect to double this spend, largely aimed at new markets," he said.

"Exports account for about 10 per cent of the total business. This is mainly to the US and the UK. We are yet to market them in the European Union. To export to the EU, we need to change the production lines to conform to EU norms. Once the spice plant is ready by December, we will look at exporting to the Scandinavian countries," he said.

"Currently, spices/masalas contribute to 35 per cent of the business, instant mix 25-26 per cent, vermicelli 14 per cent, ready-to-eat 10 per cent and the rest is from ice creams, papads, etc. There is more capacity in the existing nine plants based in Bangalore. These are being upgraded and revamped," he said.

Source: http://www.thehindubusinessline.com/2010/06/05/stories/2010060550890500.htm

Intangible property is classified as :

(a) Patents, inventions, formulas, processes, designs, patterns
(b) Copyrights for literary, musical or artistic compositions
(c) Trademarks, trade names, brand names
(d) Franchises, licenses, contracts
(e) Methods, programmes, procedures, systems

2.3.2 Franchising

Franchising is a specialized form of licensing, where the franchiser not only sells the use of intangible property but also operationally assists the business on a continuing basis, such as through sales promotion and training. The franchisee makes use of intellectual property rights, viz. trademark, copyrights and business know-how, managerial assistance and geographic exclusivity, or of specific set of procedures of the franchiser for creating the product. There are two types of franchising, the direct and indirect form. In direct franchising, the franchiser frames policy, monitors and directly directs the activities in each host country from its home country base. In indirect franchising there is a subfranchiser, who directs the activities in each host country and the original franchiser frames the policy and monitors.

The benefits of franchising is quite similar to licensing, this is also less risky than foreign direct investment. Though franchising is not cost free, but still the amount of investment required is comparatively less than other modes of international business. Franchising needs policing and supervising the activities of the franchisee in order to maintain its brand image. Besides, this property right protection is essential when the franchiser takes step to safeguard its ownership advantage.

Differences:

Franchising	**Licensing**
It encompasses transfer of total business function.	It concerns just one part of business including transfer of right to manufacture or distribution of a single product or process.
It gives a company greater control over the sale of the product in the market.	Comparatively lesser control over the sale of the product.
It is more common in service industry.	It is more common to manufacturing industry.
The policy formulation and monitoring is essential.	The policy formulation and monitoring is not required.
Cost incurred is more.	Cost incurred is less.

2.4 INVESTMENT MODE

In this mode of Foreign Direct Investment, there is inflow of capital from abroad in the form of private investment. This is vital for the growth of a developing economy, especially in the initial stages of its economic development.

The importance of foreign capital is:

1. Sustaining a high level of investment: Since the underdeveloped countries want to industrialize themselves within a short period of time, it becomes necessary to raise the level of national investment substantially. And in turn, this requires a high level of savings which is comparatively less in developing countries. So to fill up the gap between investment and savings, foreign capital is required.

2. Technological gap: The technology is backward in developing countries compared to developed countries. Thus, technical assistance helps to fill up the technological gap through the following ways like,

   (i) Provision of expert services.
   (ii) Training of the personnel of the underdeveloped countries.
   (iii) Helping the establishment of new or development of existing, educational research and training institutes.

3. Exploitation of natural resources: A number of developing countries possess huge mineral resources which await exploitation. But they do not possess the required technical skill to make use of those resources.

4. Undertaking the initial risk: Developing countries lack entrepreneurial skills which creates obstacles in the progress of industrialization. Whereas, foreign investors take the risk of investment in the host countries and also provide the much needed impetus to the process of industrialization.

5. Development of basic infrastructure: The domestic capital of the developing countries is often too less for the development of infrastructure. Thus, they require foreign capital to undertake this risk.

6. The foreign exchange gap: The developing countries in their initial phase of development depend more on the imports. Thus, imports are generally higher than exports and balance of payment is adverse. This creates a gap between the earnings and expenditure of foreign exchange has to be filled up through foreign capital.

2.4.1 Foreign Direct Investment

Exports can increase the sales but it has some limitations like when the product is differentiated one depending upon various consumption patterns in different markets, economies of scale cannot be achieved. FDI is a better alternative than exports because the products with dissimilar features are produced in different countries in order to meet the specific demand of the consumers. FDI plays an extraordinary and growing role in global business. It can provide a firm with new markets and marketing channels, cheaper production facilities, access to new technology, logic distract that capital should flow from the relatively less profitable developing country.

Other Location Advantage: These include the technological status of the country, brand name and goodwill employed by the local firms, openness of the economy, trade and macro-policies pursued by the government and intellectual property protection granted by the government.

Cost-effective: Many MNCs set up their units in the developing nations because of availability of cheap labour and natural resources. This gives them a cost advantage compared to units in their own country.

Characteristics of multinational companies are given below:

MNCs are multi-purpose, multi-product, multi-process, multinational composite enterprises. The important characteristics are mentioned below:

Giant Size: The assets and sales of MNCs run into billions of dollars and they also make supernormal profits. The gross sales of General Motors and Ford was greater than the GDP of 6 developing countries—Brazil, China, Mexico, India, Republic of Korea, Indonesia in 1994. Exxon is about the same size as the economy of Pakistan and larger than Peru's. No size, however big, is perceived to be sufficient.

International Operations: In such a corporation, control resides in the hands of a single institution. But its interests and operations sprawl across national boundaries. An MNC operates through parent corporations in the home country. If it is a branch, it acts for the parent corporations without any local capital or management assistance. If it is subsidiary, the majority control is still exercised by the foreign parent company although it is incorporated in the home country.

Oligopolistic Structure: The giant size, merger and takeover makes it oligopolistic in character in due course.

Collective Transfer of Resources: An MNC facilitates a multilateral transfer of resources. Usually, the transfer takes place in the form of a package which includes technical know-how, equipment and machinery, raw materials, finished product, managerial services, and so on. MNCs are composed of a complex of widely varied modern technology ranging from production and marketing to management and finance.

2.4.2 Importance of Foreign Direct Investment

Capital Formation: Private foreign investment goes directly into capital formation and thus it constitutes a net addition to investible resources in the recipient country which in turn helps in pushing up the rate of growth of the economy. The investment leads to link to local companies, increased productivity, improved efficiency and capital formation.

Advancement of Technology: The sophisticated and modern technologies are not available in the host country. But with the FDI inflow, the host country can get improved technology and more importantly ongoing access to continued research and development programmes of the investing country. Besides, it also promotes growth of human skill. For example, research and development services of Philips in Bangalore.

Improvement in the Balance of Payment: FDI helps improve the balance of payment of the host country. The inflow of investment is credited to the capital account. At the same time, current account improves because FDI helps further in import substitution or export promotion. The host country is able to produce those items that were imported earlier. FDI is able to augment export because the foreign investors bring in the knowledge of exporting mechanics and of foreign markets. They bring in improved technology to produce goods of international standard with lower cost. Another way, the more capital inflow a country receives, the more it can import and more it can run a trade deficit. The capacity to run a trade deficit is especially important for developing countries because they typically have more goods and services available for their use than they produce themselves. The ability to use these additional resources helps them achieve their growth objectives. For example, China had been a large net receiver of FDI; it also had been running a trade surplus.

Diversification: MNCs command technology and skills required for diversification of the industrial base and for the creation of backward and forward linkages. The MNC bring pollution-free technologies, which are of better standards.

Employment Generation: Classical economists assumed that production factors were at full employment consequently, a movement of any of these factors abroad would result in an increase in output abroad and a decrease at home. Even if these assumptions were realistic, the gains in the host country may be greater or less than the losses in the home country.

2.4.3 Disadvantages of FDI to the Host Country

Special Concessions to the Foreign Investors: The governments of the developing countries have to provide special facilities and concessions to the foreign investors to attract them. They may include tax concessions, provision of subsidized inputs, financial assistance, freedom to remit profits in foreign exchange despite tight foreign exchange, etc. If the country is facing an adverse balance of payments position and an acute foreign exchange crisis, finding foreign exchange sufficient for the remittance of profits might pose a serious problem.

Payment of Dividends and Royalty: A large amount of money flows out of the recipient country in terms of payment of dividends, royalty and technical fees to the foreign investors.

Technology: Technology transfer is not so easy because of its cost, updating and technical support. The satisfaction expressed on technology transfer is partly misconceived also on account of the fact that MNCs which generally command a

Amalgamation: In this form two firms merge by losing their own identity and form a new firm that represents the interest of both the companies.

2.4.4 Motives for FDI

There are basically three reasons of why a company choose setting up operations abroad though risk is more involved. They are: (a) To expand their sales, (b) To acquire resources, (c) To minimize competitive risk.

Expand Sales: When companies find there is potential market abroad where they would expand. The product which he supplies in domestic territory may be produced in surplus and it needs a market to sell the products. Initially, the company may broaden its horizon by exporting but due to the reasons like transportation cost, trade restrictions, comparative costs, product alterations, the company would like to directly invest in the country.

Transportation cost: Sometimes cost of transportation to cost of production becomes higher because of availability of resources like raw materials and labour may be cheap in the host country.

Product alterations: Companies that need to alter their products substantially for different foreign markets benefit less by economies of scale. The more the product has to be altered for the foreign market, the production will shift abroad from the domestic market.

Trade restrictions: Removing trade restrictions among a group of countries also may attract direct investment possibly because the expanded market may justify scale economies and the output from a new location can be feasibly exported.

Comparative costs: A company may successfully compete from a production location within its home country. This success may be due to cost, which depends on its prices and the productivity of the individual production factors, the size of the company's operation, the cost of transporting finished goods and any regulations of production. All these conditions are never static; they keep on changing.

To Acquire Resources: A company engages in international business to acquire goods or services from abroad. If the raw materials for production of products are available in different countries, then the companies will need a tight relationship to ensure that production and marketing continue to flow. One way is to gain a voice in the management of one or more of the foreign operations by investing in it. Recently most of the companies are moving towards the developing countries for investment because of their heavy dependence on the emerging economies for raw materials. Some companies produce different components of their product line in different parts of the world to take advantage of low labour costs, capital and raw materials. For example, General Electric uses Mexico as a base for the manufacture and assembly of labour intensive portions of its aircraft engine components. The companies may establish a presence in a country in order to improve its access to knowledge like what is happening in the capital market of

U.S. which can affect other worldwide capital occurrence. The governments of host countries usually, restrict import and to often attract foreign foreign investors offer tax concessions, subsidies which affect the comparative cost of production.

Risk Minimization Objectives: When the companies diversify sales from their domestic territory, the companies feel free from risk involved in its domestic market. The companies may produce goods which are consumed as intermediate products by the companies which are also placed in different countries. Suppose a steel company of "A" country sells its product to another company which produces cars in "B" country. In such case the company may shift its production site after analyzing the cost of factors of production. Even the companies sometimes decide to invest not on earning gains but rather what it could lose by not entering the field. Sometimes a company may invest in a foreign competitor's home market to prevent the competitor from using the high profits it makes in that market to invest and compete elsewhere.

In this chapter, a brief profile of a Indian based company working on health care sector is given. In future, it is predicted that the demand in health care and pharma sector will increase in developing nation like India and China.

L.N. MEDICARE SERVICES

The company incorporated on 29th May 2000, trading in medical and surgical disposable products and equipment of various companies.

The Company Regd. Office :- J-36, Laxmi Nagar, Delhi-110092. The Company is promoted by **Mr. Swarup Dutta**, who is B.E. and is the proprietor of the company.

Authorized Distributors

The Company is authorized distributor for the following companies:

1. 3M India Ltd.
2. Diagnostix India.
3. IVALON Surgical products (USA)
4. INVOTEC International (USA)
5. Steril Help International
6. PORTEX (UK)
7. SCHILLER India

Institutions

The company supplies the medical and surgical products to the following institutions:

1. St. Stephens Hospital.
2. Sant Parmanand Hospital
3. IHL
4. Dr. BSA Hospital (Delhi Govt.)

- Portfolio investment consists of equity holdings by the non-residents in the recipient by non-residents in the recipient country's joint stock companies and creditor's capital from either official sources or private sources.
- Foreign Direct Investment is the direct investment in a host country in the form of equity holdings more than 10% or voting power in an incorporated enterprise.

ACTIVITY

1. Collect the data for the amount of FDI and FII flow in India since 1991. Then see the GDP growth in India since 1991 and try to find out the relation between the FDI and GDP growth rate and FII and GDP growth rate.
2. Differentiate between the trade mode and transfer mode of business in International Business with examples.
3. Differentiate between licensing and franchising with examples.
4. "FDI is more risky than exporting". Justify the statement.
5. Why does a company move to Direct Investment from exporting?
6. "FII is more volatile than FDI". Justify the statement.
7. Write an explanatory note on Merger and Acquisitions with examples.

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