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Liability of foreignness and entry mode choice: Taiwanese firms in Europe

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Abstract

This paper examines the case of Taiwanese firms operating in Europe where linkages to local resources overcome the liability of foreignness. Taiwanese firms have chosen the wholly owned subsidiary (WOS) as the entry mode because the WOS is more effective in establishing and managing local relationships. Both intra-firm and inter-firm linkages are sought. While intra-firm linkages are useful in exploiting firm-specific capabilities, inter-firm linkages are useful in exploring new capabilities. The Taiwanese case demonstrates the importance of building local responsiveness and achieving vertical integration within the firm at the same time.

Keywords: Foreign direct investment; Entry mode; Liability of foreignness; Local responsiveness; Wholly owned subsidiary; Joint venture; Relational asset; Alliance

1. Introduction

Both psychic and geographic distance deter foreign direct investment (FDI) because they increase liability. Psychic distance increases information costs, while geographic distance increases transportation and coordination costs. There are two contradictory arguments regarding how the liability of foreignness should be overcome. One is to overcome the liability by fully exploiting the firm-specific advantages of investors so as to offset the corresponding disadvantages in foreign countries. The other is to overcome the liability by exploring local resources that supplant investor weaknesses. The former argument leads to a preference for wholly owned subsidiaries that are conducive to the exploitation of firm-specific advantage (Dunning, 1988). The latter suggests that joint ventures are preferable since they facilitate linkages to local resources (Hennart, 1988, 1991; Inkpen and Beamish, 1997; Luo, 2002).

This paper presents cases in which wholly owned subsidiaries are preferred even if the exploration of local resources is the main driver of FDI. The key to this choice is local responsiveness. Distance tends to diminish the competitiveness of foreign investors if local subsidiaries always have to draw support from their headquarters. Organizing production in such a way that enhances local responsiveness is important. Although local responsiveness may be available from local partners, it is more desirable to own this capability because ownership allows the subsidiary to capitalize on local market opportunities and also allows the subsidiary to contribute to building the dynamic capability of the multinational firm. We present the case of Taiwanese firms investing in Europe to exemplify this contention.

2. Literature review

The international business literature has assumed that firms operating in foreign countries face extra costs compared to local firms due to unfamiliarity with the local environment (Kindleberger, 1969; Hymer, 1976; Zaheer, 1995). The ability to overcome this foreign liability has become a prerequisite for successful multinational operations (Hymer, 1976; Caves, 1971). It is known as firm-specific

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advantage and covers brand name, technological superiority, managerial expertise, marketing know-how, organizational strength and other intangible assets (Dunning, 1988). Firms that wish to penetrate foreign markets should choose an entry mode that allows them to exploit this firm-specific advantage to the maximum extent possible while controlling for the risks arising from market uncertainty.

Scholars agree that the degree of foreignness affects the choice of entry mode, but the debate on the relationship between entry mode and foreignness in the literature is inconclusive. Some argue that multinational firms are more likely to choose joint ventures over wholly owned subsidiaries in a distant host country because local partners provide resources and connections that allow foreign investors to overcome foreignness. Others argue that wholly owned subsidiaries are preferable in that they minimize transaction costs in dealing with local actors in unfamiliar environments (Dunning, 1988). The debate essentially revolves around the choice between control and resources, which are traditionally viewed as trade-offs in foreign operations (Stopford and Wells, 1972).

The literature on firm-specific advantage in the vein of Hymer (1976) and Caves (1971) emphasizes capability exploitation and highlights the need for multinational firms to compete locally. It views firm-specific advantage as the key to competition and sees the ability to exploit this advantage as essential for success in a foreign country. However, some recent studies have suggested that firm-specific advantages may span firm boundaries and may lie in the networks of relationships in which firms are embedded (Dyer and Singh, 1998). This network-based theory emphasizes capability building and the need for multinational firms to collaborate with local firms when competing locally. Inter-firm collaboration creates a competitive edge by combining and deploying resources in a way that other firms cannot imitate. This line of argument highlights the usefulness of relational assets (Dunning, 2002) and the importance of relationship management in international operations (Holm et al., 1996).

In fact, both capability exploitation and capability building play important roles in the internationalization of multinational firms. Efforts to extract rents from existing capabilities while exploring new resources to create future rent-generating capabilities help multinationals sustain their competitive advantage in global markets (Prahalad and Hamel, 1990). From a dynamic perspective, both aspects have to be taken into account, and therefore, the choice of entry mode should go beyond the relative importance of exploitation and exploration.

As latecomers to FDI, Taiwanese firms tend to adopt an accelerated globalization strategy by mobilizing relational assets to leverage the advantages existing within networks (Chen and Chen, 1998; Mathews, 2002; Li, 2003). Their operations in Europe highlight the management of network relationships and the creation of local linkages that facilitate capability building. They prefer wholly owned subsidiaries over joint ventures even though exploration of local resources is the primary aim of investments.

3. Propositions

The liability of foreignness arises from geographic and psychic distance. Geographical distance gives rise to transportation costs and causes time delays, which tend to diminish the competitiveness of local subsidiaries. Psychic distance refers to the differences in the local markets from the home market in terms of customer needs, distribution channels, market structures, product characteristics, etc. (Grein et al., 2001). These differences prevent multinational firms from fully exploiting their historic strengths.

To overcome these disadvantages, multinational firms have to organize local production in such a way that it nimbly responds to local conditions. Lack of local responsiveness is an intrinsic feature of the liability of foreignness. The more competitive the markets are, the more critical local responsiveness to competition becomes. While a monopoly can afford to respond sluggishly to changing demand, a competitive firm cannot. The importance of local responsiveness also increases with the maturity of the industry. When the industry is so mature that the room for product innovation is limited and further product differentiation is difficult, multinational investors operating in distant foreign markets have to pay close attention to local environments (Powell and DiMaggio, 1991; Rosenzweig and Nohria, 1994). Although it is possible to build local responsiveness jointly with local partners, it does not pay to share this crucial asset with them. Local responsiveness allows the owner of this capability to capitalize on local market opportunities (Luo, 2003) and contributes to the dynamic capability of the multinational firm. Local capability and the strength of the parent company reinforce each other in a virtuous cycle (Birkinshaw et al., 1998). We hence have the following proposition:

Proposition 1 (*Local responsiveness*). *Multinational firms operating in distant foreign countries should invest in building the capability of local responsiveness by themselves rather than by drawing resources from local partners through joint ventures*.

The liability of foreignness literature highlights the costs of doing business in unfamiliar environments as well as the need for multinational companies to acquire knowledge specific to local markets (Davison, 1980; Kogut and Singh, 1988), especially the knowledge that is tacit and complex (Parise and Henderson, 2001). Unfamiliarity also carries with it large uncertainty and environmental hazards, which call for low commitment to distant countries (Johanson and Vahlne, 1977; Gatignon and Anderson, 1988), such as entry by licensing. However, from a relational perspective, direct investment is superior to licensing in facilitating local linkages to aid the dynamic process of capability building. As a direct investment, the wholly owned subsidiary is a superior mode to the joint venture because it reduces transaction costs in dealing with local actors (Dunning, 1988). The establishment of wholly owned subsidiaries also has a positive impact on collaborative linkages with local firms (Castellani and Zanfei, 2002). These collaborative relationships are critical to the competitiveness of multinational firms that are weak in firm-specific assets. They may establish a wholly owned subsidiary in one country to enter collaborative alliances with local firms in other countries. This strategy may be referred to as the "subsidiary-for-alliance" approach, which differs from the traditional "local-for-local" approach where a multinational firm forms a joint venture or assigns an agent in each country to compete with local firms. Using a wholly owned subsidiary as a platform for establishing alliances in the region is superior to forming alliances from the headquarters because the local subsidiary can more effectively manage local relationships by shortening the distance in communication. The more complex the local relationships to be managed become, the more likely it is that wholly owned subsidiaries will be preferred. For example, multi-country operations are more complex than single-country operations and are therefore more suitable for wholly owned subsidiaries. We hence have the following proposition:

Proposition 2 (*Multi-country operations*). *Wholly owned subsidiaries are preferable to joint ventures for multi-country operations compared to single-country operations*.

Because of the difficulties inherent in capability exploitation in geographically and culturally distant countries, multinational firms should invest in distant countries only after substantial capability building has been accomplished. This ensures that the core competence of subsidiaries is powerful enough to overcome the liability of foreignness even after discounting for distance.

But even so, operating in distant markets still carries a high risk of failure and, therefore, it is important to find mechanisms that exploit the core strengths of investors so as to minimize the risk involved. Chang's (1995) study of Japanese multinational firms in the United States, for example, found that they always entered core businesses and those in which they had strong competitive advantages over local firms first in order to reduce the risk of failure. Dunning and Bansal's (1997) comparative study of American and Japanese multinational firms in Europe found that Japanese firms were more concentrated in manufacturing than American firms, a manifestation of their relative strength in this area. Only after Japanese firms succeed in their core business do they diversify into other business ventures. From a relationship–management perspective, companies should enter into local relationships only if they reinforce their core strengths (Burt, 1992). Therefore, investors should first construct alliances that best exploit their core strengths and local partners in these alliances should provide complementary resources that reinforce their core competence. This is particularly important in unfamiliar environments. We hence have the following proposition:

Proposition 3 (*Complementary resources*). *The first local linkages pursued by multinational subsidiaries in host countries are alliances with local partners that provide complementary resources in order to exploit the core strengths of investors*.

Because of the liability of foreignness, it is desirable for foreign investors to envisage strategies that avoid head-on competition with local market leaders that have the upper hand in access to local knowledge and in the ability to mobilize local resources. It is often difficult to ally with market leaders because their product coverage is too comprehensive to find an area for complementarity. In addition, market leaders often take a defensive stance against foreign investors attempting to penetrate their market turf. Therefore, forming alliances with second-tiered players to penetrate niche markets is a more viable strategy. Second-tiered players are also willing to ally with foreign entrants, which provide complementary resources that allow the former to strengthen their competitive edge over the market leaders. Only after the subsidiaries have gained substantial market shares should they take on the market leaders. We hence have the following proposition:

Proposition 4 (*Avoiding market leaders*). *A recommendable strategy at the initial stage of foreign operations is to ally with second-tiered players in distant foreign markets and avoid head-on competition with local market leaders*.

A wholly owned subsidiary has the advantage of reducing transaction costs in managing local relationships, compared with the long-distance management of such relationships from the parent company's headquarters. In other words, local presence reduces the cost of control over local alliances and control is known to be important in enhancing the success rate of strategic alliances (Das and Teng, 2001). Local subsidiaries can form strategic alliances that are short-term by nature because they can afford intense monitoring costs. They can also more effectively evaluate partners in a short span of time and make necessary adjustments. It is plausible that subsidiaries may switch partners from time to time as circumstances change. By contrast, alliances formed without such local subsidiaries tend to be longer-term by nature because they have to be managed from a distance. We hence have the following proposition:

Proposition 5 (*Short-term alliances*). *Compared with alliances formed in the absence of local subsidiaries, FDI allows multinational investors to form shorter-term alliances with local partners*.

The literature argues that the liability of foreignness is most acute in simple, market-seeking, horizontal multinationals, which are multinational units replicating themselves in different countries (Caves, 1982). The liability is high because all subunits depend on the same firm-specific assets and they may even compete with each other. In comparison, vertical multinational enterprises, which divide the value chain geographically to exploit economies of scale or economies of scope, may effectively reduce the degree of foreignness (Ghoshal and Nohria, 1989). Therefore, in host countries that are distant both culturally and geographically from the source countries, multinational investors are likely to establish subsidiaries whose functions are vertically linked to the functions of the units established in other countries. We hence have the following proposition:

Proposition 6 (*Vertical integration*). *Functions of overseas subsidiaries in distant countries are more likely to be vertically integrated with the functions of other subunits of the multinational than horizontally integrated with other multinational units*.

4. Data

In this paper, we study three Taiwanese companies that have invested in Europe. In order to maintain anonymity, let us call them companies A, B and C. All three companies are involved in the electronics industry, and produce personal computer-related products. Their products are typically mature products with slim profit margins. Company A has invested in Telford, UK, Company B in Berlin, Germany, and Company C in Hamburg, Germany. All three operations include manufacturing and sales activities, but manufacturing operations are limited to the simple assembly of semifinished parts shipped from Asia. Sales operations are rather extensive, covering several European countries.

Face-to-face interviews were conducted in 2002 with the three chief executives of the subsidiaries in their offices. Each interview lasted for three hours or so. The interview covered the history of European operations, the motivation behind the FDI, the strategy in Europe and in each regional country covered by the subsidiary, the performance of the subsidiary in terms of sales, profits and market shares, the difficulties encountered in foreign operations, the relationship of the European subsidiary to other units of the organization, the relationship with local partners and competitors, the future perspectives of the subsidiary, and so on. In addition, company profiles and related data were obtained from the company headquarters and the Taiwan Stock Exchange authority. The data included foreign investment records and financial statistics of the companies in recent years. These interviews and company data were combined to examine the propositions listed above. Discussions were focused on the "regional" strategies of the three subsidiaries, and were based on Europe as a whole region, rather than on individual country strategies.

5. Case discussions

5.1. Multi-country operations

Company A's subsidiary in Telford handles sales and service in the UK, Germany, France and Belgium. Products covered in these operations include desktop and notebook computers, monitors, motherboards, personal digital assistants (PDA) and computer peripherals. All products are shipped from China or Taiwan with small fine-tuning or add-ons performed in Telford. The subsidiary also serves as a contract manufacturer in the European market for a major client, Hewlett Packard.

Company B's subsidiary in Berlin sells a single product, computer monitors — both with cathode-ray tubes (CRT) and liquid-crystal-display (LCD) panels. The sales network covers Germany, the Netherlands, the UK, Sweden, Poland, Spain and Italy. This network is supported by a major warehouse in Rotterdam, Netherlands, and 25 service centers throughout Europe. Monitors are made in China, shipped to Rotterdam and distributed by the Berlin office directly to dealers or customers and serviced by 25 service centers.

Company C's subsidiary in Hamburg also sells a single product, computer keyboards. The functions of the subsidiary include warehousing, technical support, logistics and keyboard printing. Additional warehouses have been established in Glasgow in the UK, Bruno in the Czech Republic and Limerick in Ireland. Keyboards are made in Thailand or China, shipped to Hamburg for printing and packaging and then distributed to Eastern and Western Europe, including Russia.

All three subsidiaries were the first investments of their respective parent companies in Europe, and are also the largest investments in Europe so far. They represent the parent companies throughout the entire European region. Before making further investments, the firms mainly entered individual country markets through local distributors. Subsequent investments were made in individual countries as part of an effort to further penetrate the target markets, sometimes taking the form of joint ventures, especially with distributors. Later investments were smaller in terms of capital commitment and employment. It is apparent that initial investments take the form of a wholly-owned subsidiary to ensure absolute control over the management of the multi-country operations and subsequent investments in individual markets may then take the form of joint ventures.

5.2. Complementary resources and short-term alliances

The core competence of Taiwanese firms is their ability to provide products at low cost in a flexible, timely fashion. When they entered Europe, they sought local partners to help them exploit this core competence. Ideal partners are distributors of computer products that sell their own brands or serve do-it-yourself (DIY) customers. These distributors serve diversified customers and lack the operating scale to justify regular OEM contracts with overseas contract manufacturers. Their customers are very cost-conscious and highly demanding regarding product differentiation. These distributors also have poor purchase forecasts and prefer quick delivery when demand rises. Taiwanese firms fit their needs very well. For example, Company B is allied with 70 distributors across 25 European countries. Alliances are managed by European headquarters with assistance from country-specific sales representatives. Another type of distributor that also makes a perfect partner for Taiwanese firms consists of large chain stores that only sell computer products on special occasions. For example, Company C is allied with Aldi of Germany, Carrefour of France and Dixons of the UK, all of which have thousands of stores nationwide. Event sales, such as back-to-school or Christmas sales, require large but unpredictable quantities. They occur occasionally and do not justify long-term contracts with overseas suppliers. Sales last a few weeks and suppliers need to provide a variety of products and back them up with large production capacity in case demand shoots up. Taiwanese subsidiaries in Europe provide a base for negotiating and executing these kinds of contracts. More importantly, they coordinate the work schedules of subsidiaries in China and other Asian countries to deliver low-cost products on time.

5.3. Avoiding market leaders

Local European computer markets are dominated by set makers such as IBM, HP, Apple and Compaq. The strategy of Taiwanese subsidiaries is to ally themselves with smaller local brands to penetrate the clone markets. They also team up with local distributors to sell their own brands to DIY customers. Taiwanese firms are very conscious of avoiding leading brand marketers. In fact, the three companies in this study also serve as contract manufacturers for leading brands in Europe, such as IBM, HP and Siemens, on an OEM basis. To segment the market and avoid head-on competition, the headquarters of the three companies have all set up divisions to deal with OEM business separately from the clone markets. Company C even has a division that exclusively serves IBM. When there is a tender competition between distributors allied with Taiwanese subsidiaries and OEM clients, Taiwanese subsidiaries often instruct distributors to withdraw. However, they are willing to challenge leaders in non-mainstream markets. For example, Company B is very aggressive in competing with Samsung in the clone and DIY markets which Samsung leads. Although OEM sales still account for the majority of the revenues of the three companies in Europe, the clone and DIY markets command higher profit margins. OEM sales allow them to maintain a large production scale, which in turn, provides the cost advantage in clone markets.

5.4. Local responsiveness

To build local responsiveness, subsidiaries need to establish facilities that give rise to product differentiation to meet local consumer demand. Company A has a large assembly line in Telford while companies B and C both have small ones in Germany. The functions of these assembly lines are mainly product modifications and add-ons before shipment. For example, Company C does keyboard printing in Hamburg to accommodate different European languages. Although small in capacity, these production operations involve substantial costs because European wages are significantly higher than those in Taiwan or China. In addition to assembly lines, they also have warehouses to handle shipping and logistics. For example, Company C has four warehouses in Europe. To ensure prompt delivery, they also keep substantial inventories. For example, Company A maintains a two-month inventory of power supplies and computer cases, which are heavy and are therefore transported only by ship. Other computer parts, such as CPUs, motherboards, CD ROMs and hard disks can be shipped by air. With assembly capacity and inventory back-up, Company A can deliver standard desktop computers in two days, and nonstandard products in no more than a week. This makes it very competitive. While the Taiwanese subsidiaries focus resources on creating speedy delivery, after-sales service is handled by alliance partners. On-site service is provided by local distributors or contract service companies with labor costs covered by the Taiwanese subsidiaries.

5.5. Vertical integration

All three Taiwanese subsidiaries are vertically integrated with operations in Taiwan and China. For example, Company A sources most computer parts from Taiwan and China and assembles them in Telford. Some parts are obtained elsewhere, such as CPUs from the United States, memory devices from Japan and hard disks from South Korea. The role of the Telford subsidiary is to negotiate contracts with local distributors, place orders with factories in Taiwan or China (mostly the latter), customize and deliver products, and provide after-sales service. European headquarters have to coordinate the functions of various subsidiaries to ensure effectiveness and efficiency. For coordination, three-way teleconferences are conducted between Taiwan, China and the UK on a daily basis. In addition, an EDI network connects all multinational units. This network of subsidiaries underlines each company's competitiveness. In general, computers are designed in Taiwan, and manufactured in Guangdong Province in China in barebones form (everything except for the CPUs, hard disks and memory). They are then shipped to Telford. The Telford factory adds power supplies and other devices and puts on cabinets before shipping them to distributors. The distributors then configure the computers by inserting

CPUs, hard disks and memory chips as required by customers. The configuration can also be done at the Telford factory if distributors so desire. This operating scheme is very effective for the DIY market and small distributors who sell their own brands.

6. Conclusion

In the three cases examined above, the Taiwanese investors established wholly-owned subsidiaries rather than equity joint ventures to enter distant European markets. According to the existing literature, this should imply that Taiwanese investors are more eager to exploit their firm-specific advantages than explore local resources. In fact, the opposite is true. The main reason why Taiwanese investors have established wholly owned subsidiaries is in order to build local response capability under their own control. Control is important because it enables Taiwanese firms to capitalize on market dynamics in Europe. Local responsiveness is achieved by integrating production vertically within the organization and by managing local relationships in proximity. With production bases in Taiwan and China, European subsidiaries maintain close, reliable links with these manufacturing facilities to ensure that the core strength of low-cost, high-flexibility production capabilities can be transmitted to European markets.

The wholly owned subsidiary is considered superior to the joint venture in the exploration of local resources. Taiwanese investors use subsidiaries as a platform for forming multi-country alliances in the region. Priority local linkages are formed to access location-specific knowledge that complements their core competence. Wholly owned subsidiaries not only allow for a transfer of power from headquarters to take on local uncertainties, but also facilitate alliances with local partners through face-to-face contact. The establishment of local subsidiaries enables local alliances to be managed at low cost, thus making it possible to form short-term cooperative relationships which carry high risks of failure, but which may also bring great opportunities. Without wholly owned subsidiaries, alliances of this nature would not have been possible because Taiwanese firms do not possess firm-specific capabilities powerful enough to forge and manage such alliances over a long distance. This subsidiary-for-alliance approach to market entry is particularly effective when foreign markets are segmented with distinctive consumer tastes, policy environments and market institutions.

The experience of Taiwanese firms in Europe suggests a viable strategy for multinational firms that are weak in their ownership-specific capabilities but are inspired to penetrate distant markets. The strategy consists of three key elements. First, they should exploit their strengths in a proximate and friendly environment so as to enhance their capabilities before embarking on investments in more distant countries. Second, they should invest in the building of local responsiveness to overcome the liability of foreignness, including local facilities and local relationships. Third, a wholly owned subsidiary is a preferable entry mode if investors have to manage a complex web of cross-country relationships to mobilize various kinds of resources for local competition, particularly when many of these relationships are short-term by nature. For the purposes of comparison, future research on cases where joint ventures have succeeded in distant host countries would be interesting.

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