Recent studies of subcontracting and competitiveness have emphasized the importance of outsourcing: moving functions or activities out of an organization. Outsourcing is often more efficient, except in the case of the firm’s core competences, which are considered central to its success. Thus the issue is whether an organization should perform certain functions itself (‘make’) or source (‘buy’) these activities from outside. If LSEs outsource an increasing number of value chain functions this provides business opportunities for SMEs as subcontractors to LSEs (main contractors).
Chapter 13  International sourcing decisions and the role of the subsupplier

A subcontractor can be defined as a person or a firm that agrees to provide semi-finished products or services needed by another party (main contractor) to perform another contract to which the subcontractor is not a party. According to this definition, the characteristics of subcontractors that distinguish them from other SMEs are as follows:

- Subcontractors’ products are usually part of the end product, not the complete end product itself.
- Subcontractors do not have direct contact with the end customers, because the main contractor is usually responsible to the customer.

The position of subcontractors in the vertical production chain is shown in Figure 13.1.

In the OEM contract (where OEM stands for original equipment manufacturer), the contractor is called the OEM or ‘sourcer’, whereas the parts suppliers are regarded as ‘manufacturers’ of OEM products (= subcontractors = subsuppliers). Typically the OEM contracts are different from other buyer–seller relationships because the OEMs (contractors) often have much stronger bargaining power than the subcontractors. However, in a partner-based buyer–seller relationship the power balance will be more equal. There are cases where a subcontractor improved its bargaining position and went on to become a major force in the market (Cho and Chu, 1994).

The structure of the remainder of this chapter is shown in Figure 13.2.

13.2 Reasons for international sourcing

More and more international firms are buying their parts, semi-finished components and other supplies from international subcontractors. Creating competitiveness through the subcontractor is based on the understanding that the supplier can be essential to the buyer (contractor) for a number of reasons.
Market entry strategies

Concentration on in-house core competences
A contractor wishes to concentrate management time and effort on those core business activities that make the best use of in-house skills and resources. There may also be special difficulties in obtaining suitably skilled labour in-house.

Lower product/production costs
In this respect there are two underlying reasons for outsourcing:

1 Economies of scale. In many cases the subcontractor produces similar components for other customers, and by use of the experience curve the subcontractor can obtain lower production costs per unit.

2 Lower wage costs. The labour costs involved in the domestic country can make the in-house operation uneconomic and motivate international sourcing. For example, 80 per cent of the labour cost of clothing manufacture is in the sewing stage. Short production runs of different sizes of clothes permit only a low degree of mechanization. Moreover, adjusting the tooling for each run is relatively labour intensive (Hibbert, 1993). Therefore a large part of labour-intensive clothing production is moved to low-wage countries in eastern Europe and the Far East.

General cost efficiency
If a firm plans to be more cost efficient than its competitors it has to minimize the total costs towards the end (ultimate) customer. Figure 13.3 shows a model of the different cost elements, from the basic price of materials to the ultimate customer cost.

Each element of the supply chain is a potential candidate for outsourcing. Quality costs, inventory costs (not explicitly mentioned in Figure 13.3) and buyer–supplier transaction costs are examples of costs that should be included in every calculation. However, some of these costs are difficult to estimate and are consequently easily overlooked when evaluating a subcontractor.
Chapter 13  International sourcing decisions and the role of the subsupplier

For example, the quality of a subcontractor’s product or service is essential to the buyer’s quality. However, it is not only a question of the quality of the product or service. The quality of the delivery processes also has a major impact on the buyer’s performance. Uncertainties, as far as lead times are concerned, have an impact on the buyer’s inventory investments and cost efficiency, and they may cause delays in the buyer’s own delivery processes. Thus the buyer’s own delivery times towards the end customers are determined by the subcontractors and their delivery. Another important fact is that the cost of components and parts is to a large extent already determined at the design stage. Thus, close cooperation between buyer and seller at this stage can give rise to considerable cost advantages in production and distribution.

**Increased potential for innovation**

Ideas for innovation can be generated by the subcontractor due to its more in-depth understanding of the component. New ideas can also be transferred from other customers of the subcontractor.

**Fluctuating demand**

If the main contractor is confronted with fluctuating demand levels, external uncertainty and short product life cycles, it may transfer some risk and stock management to the subcontractor, leading to better cost and budget control.
Finally, it should be mentioned that, when buying from international sources, fluctuations in exchange rates become particularly important, especially when there is a lag from the time the contract is signed to when payment is made. When the currency in the country of the main contractor is very strong against a particular country this can be an incentive for the main contractor to buy from this country.

In summary, price is a very important reason for (international) outsourcing, but the main contractors increasingly regard cooperation with critical subcontractors as advantageous to the buying firm’s competitiveness and profitability.

### 13.3 A typology of subcontracting

Traditionally, a subcontractor has been defined as a firm carrying out day-to-day production based on the specifications of another firm (the main contractor). The variety of subcontracting relationships that are appearing indicates a need for a more differentiated typology.

Figure 13.4 displays a typology of subcontractors based on differences in the contractor–subcontractor relationship. The typology displays the interplay between the degree of coordination needed and the complexity of the tasks to be solved.

- **Standard subcontracting.** Economies of scale often operate in the global market with standardized products, in which case no adaptation to specific customers is needed.
- **Simple subcontracting.** Information exchange is simple since the contractor specifies criteria for contribution. The contractor’s in-house capacity is often a major competitor.
- **Expanded subcontracting.** There is some mutual specialization between the two parties and exit costs are higher for both parties. Therefore single sourcing (one supplier for a product/component) may replace multisourcing (more suppliers for a product/component).

![Figure 13.4 Typology of subcontracting](Image)

Source: adapted from Blenker and Christensen, 1994.
Chapter 13  International sourcing decisions and the role of the subsupplier

- **Strategic development subcontracting.** This is very important to the contractor. Subcontractors possess a critical competence of value to the contractor. They are involved in the contractor's long-term planning, and activities are coordinated by dialogue.
- **Partnership-based subcontracting.** This is a relationship based on a strong mutual strategic value and dependency. The subcontractor is highly involved in the R&D activities of the contractor.

There is a certain overlap between the different types of subcontractor and in a specific relationship it can be very difficult to place a subcontractor in a certain typology. Depending primarily on the task complexity, a main contractor may have both standard subcontractors and partnership-based subcontractors. Also a subcontractor may play more than one role in Figure 13.4, but only one at a time.

### 13.4 Buyer-seller interaction

Traditionally, subcontracting has been defined as the production activities that one firm carries out on the day-to-day specification of another firm. Outsourced activities increasingly include R&D, design and other functions in the value chain. Thus what starts with simple transactions (so-called episodes) may, if repeated over time, evolve into a relationship between buyer and seller.

Interaction theory was developed by the Swedes but spread into France, the United Kingdom, Italy and Germany when a group of like-minded researchers formed what became known as the IMP Group, basing their research on the interaction model (Figure 13.5).

---

**Figure 13.5 The buyer–seller interaction**

The interaction model has four basic elements:

1. The interaction process, which expresses the exchanges between the two organizations along with their progress and evolution throughout time.
2. The participants in the interaction process, meaning the characteristics of the supplier and the customer involved in the interaction process.
3. The atmosphere affecting and being affected by the interaction.
4. The environment within which interaction takes place.

**Interaction process**

The interaction process can be analysed in both a short-term and a long-term perspective. Over time the relationship is developed by a sequence of episodes and events that tends to institutionalize or destabilize it, depending on the evaluations made by the two firms in the interaction. These episodes may vary in terms of types of exchange: commercial transactions, periods of crisis caused by delivery, price disputes, new product development stages, etc.

Through social exchange with the supplier the customer attempts to reduce decision-making uncertainty. Over time and with mutual adaptation a relationship-specific mode of operation emerges and may act as a 'shock absorber' in case of crisis. This mode of operation can take the form of special procedures, mutual developments, communication style between individuals, and more or less implicit rules. These rules are modified through past exchanges and form the framework for future exchanges.

**Interacting parties**

The participants' characteristics strongly influence the way they interact. Three analytical perspectives of buyer and seller, at different levels, may be taken into account.

1. **The social system perspective**
   Dimensions such as culture – languages, values and practices – and the operating modes of the firm influence the distance between actors that will limit or encourage collaboration.

2. **The organizational perspective**
   The relationship between buyer and seller is influenced by three organizational dimensions:
   1. The characteristics of each firm's technology (i.e. products and production technology) strongly influence the nature of the interaction between the two organizations.
   2. The complexity of products sold, for example, conditions the very nature and the density of the interaction between supplier and customer.
   3. Relationship characteristics: a supplier can choose to develop a stable relationship with a customer, or the supplier can regard the relationship as a pure transaction-based exchange where the supplier typically makes 'one-shot' business with a customer purely to increase sales volume and with no further involvement.

3. **The individual perspective**
   The individuals' characteristics, their objectives and their experience will influence the way social exchanges and social contacts take place, and subsequently the development of supplier–customer interaction.
Chapter 13  International sourcing decisions and the role of the subsupplier

Atmosphere of the relationship

The atmosphere is the ‘climate’ that has developed between the two firms. This atmosphere can be described in terms of power–dependence, cooperation–conflict and trust–opportunism, and in terms of understanding and social distance. The atmosphere concept is central to the understanding of the supplier–customer relationship. In the case of key account management, atmosphere plays a particularly important role. As buyer and seller approach each other the marketing exchanges are changing from single transactions to a relationship. The further characteristics of these two situations are described in Table 13.1 and Figure 13.6.

### Table 13.1 Marketing exchange understanding

<table>
<thead>
<tr>
<th></th>
<th>Transaction</th>
<th>Relationship</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Objective</strong></td>
<td>To make a sale (sale is end result and measure of success). Customer needs satisfaction (customer buys values).</td>
<td>To create a customer (sale is beginning of relationship). Customer integration (interactive value generation).</td>
</tr>
<tr>
<td><strong>Customer understanding</strong></td>
<td>Anonymous customer. Independent buyer and seller.</td>
<td>Well-known customer. Interdependent buyer and seller.</td>
</tr>
<tr>
<td><strong>Marketers’ task and performance criteria</strong></td>
<td>Assessment on the basis of products and prices. Focus on gaining new customers.</td>
<td>Assessment on the basis of problem-solving competence. Focus on value enhancing of existing customers.</td>
</tr>
<tr>
<td><strong>Core aspects of exchange</strong></td>
<td>Focus on products. Sale as a conquest. Discrete event. Monologue to aggregated broad customer segments.</td>
<td>Focus on service. Sale as an agreement. Continuing process. Individualized dialogue.</td>
</tr>
</tbody>
</table>


### Figure 13.6 Market exchange understanding

Interaction environment

Supplier–customer relationships evolve in a general macroenvironment that can influence their very nature. The following analytical dimensions are traditionally considered: political and economic context, cultural and social context, market structure, market internationalization and market dynamism (growth, innovation rate).

13.5 Development of a relationship

A relationship between two firms begins, grows and develops – or fails – in ways similar to relationships between people. The development of a relationship has been mapped out in a five-phase model: awareness, exploration, expansion, commitment and dissolution. The five phases are shown in Figure 13.7.

Figure 13.7 shows, the initial psychic distance 1 between a buyer and a seller (both from different countries and cultures) and it is influenced by the psychological characteristics of the buyer and the seller, the firm’s organizational culture, and the national and industry culture to which the firm belongs. Figure 13.7 also shows that the initial psychic distance 1 at the beginning of the relationship is reduced to physical distance 2 through the interaction process of the two partners. However, relationships do not always last forever. The partners may ‘move from each other’ and the psychic may increase to distance 3. If the problems in the relationship are not solved, it may result in a ‘divorce’.

Within such a framework one might easily characterize a marketing relationship as a marriage between a seller and a buyer (the dissolution phase being a ‘divorce’). The use of the marriage metaphor emphasizes the complexity as well as some affective determinants of the quality of the relationship. Dwyer et al. (1987) call the first phase in a relationship awareness, which means that the partners recognize each other as potential partners. In other words, in their model the decisions made about cooperating and choosing the partner are combined. Both types of decision making can exist at the beginning of cooperation, but it is difficult to state any definite chronological order between them.

In SMEs it is likely that the decision-making process is reactive, in the way that the SME probably first realizes the existence of a potential partner (maybe ‘love at first sight’) and then decides to cooperate. The selection process may, however, be better if companies look for three key criteria (Kanter, 1994):

1 **Self-analysis.** Relationships get off to a good start when partners know themselves and their industry, when they have assessed changing industry conditions and decided to seek an alliance. It also helps if executives have experience in evaluating potential partners. They will not be easily attracted by the first good-looking prospect that comes along.

2 **Chemistry.** To highlight the personal side of business relationships is not to deny the importance of sound financial and strategic analysis. But successful relations often depend on the creation and maintenance of a comfortable personal relationship between senior executives. This will include personal and social interests. Signs of managers’ interests, commitment and respect are especially important in high-context countries. In China, as well as in Chinese-dominated businesses throughout Asia, the top manager of the western company should show honour and respect to the potential partner’s decision by investing his or her personal time.

3 **Compatibility.** The courtship period tests compatibility on broad historical, philosophical and strategic grounds: common experiences, values and principles, and
Chapter 13  International sourcing decisions and the role of the subsupplier

hopes for the future. While analysts examine financial viability, managers can assess the less tangible aspects of compatibility. What starts out as personal rapport, philosophical and strategic compatibility, and shared vision between two companies’ top executives must eventually be institutionalized and made public (‘getting engaged’). Other stakeholders get involved, and the relationship begins to become depersonalized. But success in the engagement phase of a new alliance still depends on maintaining a careful balance between the personal and the institutional.

In Figure 13.7’s exploration phase trial purchases may take place and the exchange outcomes provide a test of the other’s ability and willingness to deliver satisfaction.

Figure 13.7 The five-phase relationship model

[Diagram showing the five phases of the relationship model: Awareness, Exploration, Expansion, Commitment, Dissolution.]

- **Psychic distance 1:**
  - Seller:
    - Relationship phases:
      - 1 Awareness
      - 2 Exploration
      - 3 Expansion
      - 4 Commitment
      - 5 Dissolution
  - Buyer:
    - Phase characteristics:
      - 1 No interaction. Unilateral considerations of potential partners.
      - 2 Interaction between the parties occurs. A gradual increase in dependence reflects probing and testing. Termination of this fragile association is simple.
      - 3 One party has made a successful request for adjustment. Both parties are satisfied with some customization involved. Additional benefits from products, services or terms are sought from the current partner rather than from an alternative partner.
      - 4 Some means of sustaining the relationship result: contracts, shared ownership, social ties. Inputs are significant and consistent. Partners adapt and resolve disputes internally.
      - 5 Possible termination of the relationship. It can make assets dedicated to the relationship obsolete.

Subprocesses for deepening dependence:
- Attraction
- Communication and bargaining
- Expectations development
- Norm development
- Power and justice

Seller’s and buyer’s increasing dependence on each other

Physical distance 2

The ‘marriage metaphor’:
- Shared values and decision-making structures
- Joint investment in the relationship

‘Divorce’?
In addition, electronic data interchange can be used to reduce the costly paperwork associated with purchase orders, production schedule releases, invoices and so on.

At the end of the exploration phase it is time to ‘meet the family’. The relations between a handful of leaders from the two firms must be supplemented with approval, formal or informal, by other people in the firms and by stake holders. Each partner has other outside relationships that may need to approve the new relationship.

When a party (as is the case in the expansion phase) fulfils perceived exchange obligations in an exemplary fashion, the party’s attractiveness to the other increases. Hence motivation to maintain the relationship increases, especially because high-level outcomes reduce the number of alternatives that an exchange partner might use as a replacement.

The romance of courtship quickly gives way to day-to-day reality as the partners begin to live together (‘setting up house’). In the commitment phase the two partners can achieve a level of satisfaction from the exchange process that actually precludes other primary exchange partners (suppliers) that could provide similar benefits. The buyer has not ceased attending other alternative suppliers, but maintains awareness of alternatives without constant and frequent testing.

During the description of the relationship development, the possibility of a withdrawal has been implicit. The dissolution phase may be caused by the following problems:

- Operational and cultural differences emerge after collaboration is under way. They often come as a surprise to those who created the alliance. Differences in authority, reporting and decision-making styles become noticeable at this stage.
- People in other positions may not experience the same attraction as the chief executives. The executives spend a lot of time together both informally and formally. Other employees have not been in touch with one another, however, and in some cases have to be pushed to work with their overseas counterparts.
- Employees at other levels in the organization may be less visionary and cosmopolitan than top managers and less experienced in working with people from different cultures. They may lack knowledge of the strategic context in which the relationship makes sense and see only the operational ways in which it does not.
- People just one or two tiers from the top might oppose the relationship and fight to undermine it. This is especially true in organizations that have strong independent business units.
- Termination of personal relationships, because managers leave their positions in the companies, is a potential danger to the partnership.

Firms have to be aware of these potential problems before they go into a relationship, because only in that way can they take action to prevent the dissolution phase. By jointly analysing the extent and importance of the attenuating factors, the partners will become more aware of the reasons for continuing the relationship, in spite of the trouble they are already in. Moreover, this awareness increases the parties’ willingness to engage in restorative actions, thus trying to save the relationship from dissolution (Tähtinen and Vaaland, 2006)

### 13.6 Reverse marketing: from seller to buyer initiative

Reverse marketing describes how purchasing actively identifies potential subcontractors and offers suitable partners a proposal for long-term cooperation. Similar terms are proactive procurement and buyer initiative (Ottesen, 1995). In recent years
Chapter 13  International sourcing decisions and the role of the subsupplier

Figure 13.8 Supplier development strategies

<table>
<thead>
<tr>
<th>Existing suppliers</th>
<th>New activities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intensify current activities</td>
<td>Develop and add new activities</td>
</tr>
<tr>
<td>Replace existing suppliers</td>
<td>Add suppliers: secure deliveries</td>
</tr>
<tr>
<td>New potential suppliers</td>
<td>Develop new activities not covered by existing suppliers</td>
</tr>
</tbody>
</table>

The buyer–seller relationship has changed considerably. The traditional relationship, in which a seller takes the initiative by offering a product, is increasingly being replaced by one in which the buyer actively searches for a supplier that is able to fulfil its needs. Today, many changes are taking place in the utilization of the purchasing function:

- Reduction in the number of subcontractors.
- Shorter product life cycles, which increase the pressure to reduce the time to market (just in time).
- Upgraded demands on subcontractors (zero defects). In addition, firms are demanding that their suppliers become certified. Those that do not comply may be removed from the approved supplier list.
- Purchasing that no longer just serves the purpose of getting lower prices. The traditional arm’s-length relationships are increasingly being replaced by long-term partnerships with mutual trust, interdependence and mutual benefits.

Implementing a reverse marketing strategy starts with fundamental market research and with an evaluation of reverse marketing options (i.e. possible suppliers). Before choosing suppliers the firm may include both present and potential suppliers in the analysis as well as current and desired activities (Figure 13.8).

Based on this analysis the firm may select a number of suitable partners as suppliers and rank them in order of preference.

13.7 Internationalization of subcontractors

In Chapter 3 the internationalization process was described as a learning process (the Uppsala school). Generally speaking it is something that can be described as a gradual internationalization. According to this view the international development of the firm is accompanied by an accumulation of knowledge in the hands of management and by growing capabilities and propensities to manage international affairs. The main consequence of this way of thinking is that firms tend to increase their commitment towards foreign markets as their experience grows. The number of adherents to this theory has grown, but there has also been much criticism of it.

The main problem with the model is that it seems to suggest the presence of a deterministic and mechanistic path that firms implementing their internationalization strategy must follow. Sometimes it happens that firms leapfrog one or more stages in
the establishment chain; at other times firms stop their internationalization altogether (Welch and Luostarinen, 1988).

Concerning internationalization among contractors and subcontractors, there is a central difference. The internationalization of subcontractors is closely related to their customers. The concept of subcontractor indicates that the strategies of such a firm, including its internationalization strategy, cannot be seen in isolation from the strategies of its partner, the contractor. Therefore the internationalization of subcontractors may show irregular paths, such as leapfrogging.

Andersen et al. (1995) introduce four basic routes of internationalization (note that sometimes there is an overlap between the different routes, e.g. between routes 2 and 3).

**Route 1: Following domestic customers**

If a contractor is internationalizing and establishing a production unit in a foreign market some subcontractors (standard or simple in Figure 13.4) may be replaced with local suppliers, because they might be able to offer the standard components at cheaper prices. However, subcontractors in the upper part of Figure 13.4 and with a strategic value to the contractor will be maintained if they commit themselves to foreign direct investment: claims for direct delivery to the foreign production unit or claims for after-sales service on delivered components may result in the establishment of a local sales and/or production subsidiary by the subcontractor. In most cases such a direct foreign investment related directly to a specific contractor is based on a guarantee of procurement over some years (until the payback period has passed).

When the furniture chain IKEA established itself in the North American market it took along some strategically important Scandinavian subcontractors, some of which also established subsidiaries in North America. Other examples are the Japanese car manufacturers that established production units in the United States and pulled along a lot of Japanese subcontractors to establish subsidiaries there. This route is similar to the 'late starters' in the model of Johanson and Mattson (1988) in Figure 3.6.

**Route 2: Internationalization through the supply chain of an multinational corporation**

Deliveries to one division of a multinational corporation may lead to deliveries to other divisions, or to parts of its network. One case is when mergers and acquisitions take place between firms, and create new business opportunities for dynamic subcontractors.

The strategic alliance between the French car manufacturer Renault and the Swedish Volvo is one example, where Swedish subcontractors have become involved in the subcontracting system of Renault, and French subcontractors have opportunities to get into the subcontracting system of Volvo (Christensen and Lindmark, 1993).

**Route 3: Internationalization in cooperation with domestic or foreign system suppliers**

In collaboration with other specialized subcontractors, system suppliers may be involved in international system supplies by taking over the management of whole supplies of subsystems (see Figure 13.9).

Systems supplies result in the development of a new layer of subcontractors (second-tier subcontractors). Through the interaction between a system supplier and a domestic main contractor the system supplier can get access to the network of a
global contractor (the dotted line in Figure 13.9) because of the network/contract between the contractor and the global contractor. For example, a Japanese car seat supplier supplies the Japanese Toyota factory (domestic main contractor). This can eventually give the supplier access to other Toyota factories around the world (global contractors) and their global networks.

In many cases the collaboration between the subcontractors will be characterized by exchange of tacit, not easily transferable, knowledge. The reason for this is that the complete subsystem is frequently based on several fields of competence, which have to be coordinated by use of tacit knowledge and communication. In the case of the Japanese car seat supplier, the system supplier should have a tight relationship with the subcontractors (suppliers of leather head rests, etc.) in order to adapt the car seat to the individual car models. (See also Exhibit 13.1.)

**Route 4: Independent internationalization**

The need to gain economies of scale in production forces the standard contractor, in particular, to use the route of independent internationalization. In other cases it cannot be recommended that small subcontractors follow the independent route. The barriers of independent internationalization are too high for small firms with limited resources. For these firms, route 3 (collaboration with other subcontractors) seems to be a more realistic way to internationalize.

**Exhibit 13.1** An example of Japanese network sourcing: the Mazda seat-sourcing case

Mazda adopts a policy of splitting its seat purchases between two suppliers, Delta Kogyo and the Toyo Seat Company. The present division is approximately 60 per cent to Delta and 40 per cent to Toyo. Each of these companies is responsible for different models of seats. Note that each individual item, such as a seat for the Mazda 626, is single sourced for the product life cycle of typically three to five years, but seat production in general is, in effect, dual sourced.

Both Delta Kogyo and the Toyo Seat Company are informally assured of a certain percentage of the Mazda seat business at any one time. This percentage is approximately one-third of the total Mazda seat purchases. Thus
Part III  Market entry strategies

Project export (turnkey contracts)

This chapter has dealt mainly with sourcing (subcontracting) in the industrial market. Although marketing of subsupplies to international projects has a number of similarities with subsupplies in the industrial market in general, it also has the characteristics of the special marketing situation in the project market: for example, the long and often very bureaucratic selection of subsuppliers for ad hoc supplies.

The subsupplier market in project export, however, is also very internationalized, and the main part of marketing should be conducted in those centres or countries where the main contractor is domiciled. For example, London is the domicile of a number of building contracting businesses, which work in those countries that used to be in the British Empire.

Project export is a very complex international activity, involving many market players. The preconditions for project export are a technology gap between the exporting and importing countries and that the exporter possesses the specific product and technology know-how that is being demanded in the importing country.

Exhibit 13.1 continued

each firm has an assured long-term share of Mazda’s seat business. Indeed, when asked about the length of relationship that Mazda has with its suppliers, Mr Nakamichi of Mazda’s marketing division noted that relationships with all suppliers, whether they are affiliates, subcontractors or common part suppliers, were established for an ‘indefinite’ period of time. In addition, the last third of the seat business was available to whichever of the suppliers had performed the best over the life cycle of previous car models.

The two seat makers rely on Mazda for a very high percentage of their business. In the case of Delta Kogyo, Mazda business represents around two-thirds of its total sales. In addition, both suppliers are members of Mazda’s keiretsu (network) and hence come into direct contact with each other on a regular basis. Additionally, since they are direct competitors for only a third of Mazda’s seat business, there is a significant degree of openness between the two firms. This openness in some instances takes the form of cooperation in solving mutual or individual problems, because the other seat supplier is often in a better position to give advice than Mazda itself.

However, competition for the remaining third of the Mazda seat business is very intense, since both firms know that they have only one chance to gain the orders for a new car model every three to five years. The most interesting aspect of this competition is that it is based primarily on performance since the last contract was awarded. The areas of competition include design abilities, management strength, cost-reduction progress, quality record and, perhaps surprisingly, the amount of assistance that the supplier has given to its direct competitor either within the auspices of the keiretsu or on separate occasions. Thus either firm can obtain new business as long as the other does not fall below 33 per cent of Mazda’s total seat purchases. A situation has been created in which there is creative tension between cooperation and competition.

Indeed, when one of the suppliers approaches the lower limit of its 33 per cent supply Mazda typically uses its own engineers, and possibly those of the supply competitor, to help the weaker supplier in terms of a joint value analysis/value engineering programme. Because neither supplier wants to be forced into this situation both will work diligently to avoid this fate – and at the same time to enhance their own competitiveness.

Mazda is careful to ensure that neither supplier is forced into a situation of unprofitability, since this would obviously mean that Mazda would suffer in the long term. This is not to say that either supplier is allowed to make excessive profits. Indeed profit as a percentage of sales is roughly equalized throughout the supply network, including the Mazda organization itself. During recessionary periods Mazda and its network of suppliers would make no more than about 2 per cent profit on sales. Thus members of the supply network stand or fall together, increasing the shared bonds and the willingness to help any member of the network.


Exhibit 13.1 continued

Project export
Combination of hardware (e.g. buildings and infrastructure) and software (technology and project know-how), e.g. in the form of a factory for ice cream production.
Chapter 13  International sourcing decisions and the role of the subsupplier

Project export involves supplies or deliveries that contain a combination of hardware and software. When the delivery is concluded it will constitute an integrated system that is able to produce the products and/or the services, which the buyer requires. An example of this type of project is the construction of a dairy in a developing country.

**Hardware** is the blanket term for the tangible, material or physical contribution of the project supply. Hardware is composed of buildings, machines, inventory, transport equipment, etc., and is specified in the quotation and contract between buyer and seller in the form of drawings, unit lists, descriptions and so on.

**Software** is the blanket term for the intangible contributions in a project supply. Software includes know-how and service. There are three types of know-how:

1. *technology know-how*, comprising product, process and hardware know-how;
2. *project know-how*, comprising project management, assembly and environmental know-how;
3. *management know-how*, which in general terms involves tactical and operational management, and specifically includes marketing and administrative systems.

Service includes advisory services and assistance in connection with various applications and approvals (environmental approval, financing of the project, planning permission, etc.).

The marketing of projects is different from the marketing of products in the following respects:

- Decision of purchase, apart from local business interests, often involves decision processes in national and international development organizations. This implies the participation of a large number of people and a heavily bureaucratic system.
- The product is designed and created during the negotiation process, where the requirements are put forward.
- It often takes years from the disclosure of needs to the purchase decision being taken. Therefore total marketing costs are very large.
- When the project is taken over by the project buyer, the buyer–seller relations cease. However, by cultivating these relations before, during and after the project, a 'sleeping' relationship can be woken again in connection with a new project (Hadjikhani, 1996).

Financing a project is a key problem for the seller as well as the buyer. The project’s size and the time used for planning and implementation result in financial demands that make it necessary to use external sources of finance. In this connection the following main segments can be distinguished. The segments arise from differences in the source of financing for the projects:

- Projects where *multilateral organizations*, such as the World Bank or regional development banks, are a primary source of finance.
- Projects where *bilateral organizations* are a primary or essential source of finance.
- Projects where a *government institution* acts as buyer. This was normal in the command economies, where government companies acted as buyers. However, it can also be found in liberal economies: for example, in connection with the development of social infrastructure or the building of a bridge.
- Projects where a *private person or firm* acts as buyer, as when Unilever builds a factory in Vietnam for the production of ice cream.

For large-scale projects, like a new airport, there may be many partners forming a consortium, where we will have the concept of a 'leader firm', but each partner would undertake financing, organization, supervision and/or construction etc., of a part of the project on the basis of their specific expertise.
Part III  Market entry strategies

Organizing export projects involves establishing an interaction between different firms from the West on the one side, and firms and authorities typically from developing countries on the other. Creating or adapting an organization that is able to function under these conditions is a precondition of project marketing.

13.9 Summary

This chapter has analysed the buyer–seller relationship from different angles in the internationalized environment. The advantages and disadvantages for the contractor and subcontractor of going into a relationship are summarized in Table 13.2.

The project export situation differs from the ‘normal’ buyer–seller relationship in the following ways:

- The buying decision process often involves national and international development organizations. This often results in very bureaucratic selection of subcontractors.
- Financing of the project is a key problem.

Table 13.2 Advantages and disadvantages of buyer–seller relationships for contractor and subcontractor

<table>
<thead>
<tr>
<th>Contractor (buyer)</th>
<th>Subcontractor (seller)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td><strong>Disadvantages</strong></td>
</tr>
<tr>
<td>The contractor is flexible by not investing in manufacturing facilities.</td>
<td>The availability of suitable manufacturers (subcontractors) cannot be assumed.</td>
</tr>
<tr>
<td>The subcontractor can source the products more cheaply (because of e.g. cheaper labour costs) than by own production.</td>
<td>Outsourcing tends to be relatively less stable than in-house operations.</td>
</tr>
<tr>
<td>The contractor can concentrate on in-house core competences.</td>
<td>The contractor has less control over the activities of the subcontractor.</td>
</tr>
<tr>
<td>Complement of the contractor’s product range.</td>
<td>Subcontractors can develop into competitors.</td>
</tr>
<tr>
<td>New ideas for product innovation can be carried over from the subcontractor.</td>
<td>Quality problems of outsourced products can harm the business of the contractor.</td>
</tr>
<tr>
<td>Access to new export markets because of the internationalization of the contractor (especially relevant for the so-called late starters).</td>
<td>Assistance to the subcontractor may increase the costs of the whole operation.</td>
</tr>
<tr>
<td>Exploits scale economies (lower cost per unit) through better capacity utilization.</td>
<td>Risk of becoming dependent on the contractor because of expanding production capacity and concurrent overseas expansion of sales and marketing activities in order to meet the demands of the contractor.</td>
</tr>
<tr>
<td>Learns product technology of the contractor.</td>
<td></td>
</tr>
<tr>
<td>Learns marketing practices of the contractor.</td>
<td></td>
</tr>
</tbody>
</table>

CASE STUDY 13.1

LM Glasfiber A/S: Following its customers’ international expansion in the wind turbine industry

LM Glasfiber A/S is the world’s leading supplier of rotor blades for wind turbines. Its headquarters are located in Lunderskov, Denmark and it has 14 manufacturing bases in ten Danish towns, with more than 1,700 employees in modern production areas covering some 100,000 m². The company is internationally represented, with manufacturing facilities and sales offices in
Germany, the Netherlands, Spain, the United States, India and China. Its customers are thus guaranteed prompt and punctual delivery with a high level of service worldwide.

LM Glasfiber’s establishment in India is explained and illustrated in Figure 13.10. Typically, rotor blades represent approximately 20 per cent of a wind turbine’s value (excluding mounting, installation etc.).

Figure 13.10 shows the phases that LM Glasfiber (as subsupplier) went through in order to globalize via the buyers’/wind turbine manufacturers’ network, especially Micon’s network.

The 1 in the figure indicates that LM Glasfiber has very large deliveries of rotor blades to the Danish network of wind turbine manufacturers (‘domestic contracts’), the largest being NEG Micon (in 1999), Vestas (wind systems), Bonus (energy), and Nordex. Even though the total Danish network covers more than 50 per cent of the world market for wind turbines it should be remembered that competition between the companies in the international market is very keen. Having exceeding close relations with and deliveries to the Danish Wind Turbine Manufacturers’ Association, LM Glasfiber also cooperates very closely with the research environment within wind turbine technology by way of relations with the Ris National Laboratory.
This example is based on LM Glasfiber’s relations with Micon in the mid 1990s – at the time the second-biggest wind turbine manufacturer in the world (Micon merged with Vestas in May, 2004). As regards subsuppliers Micon’s strategy has been to outsource the biggest part of its rotor blade production. However, Micon has always aimed at having an adequate share of internal subsuppliers of rotor blades, in order for the company to have the necessary technological preparedness compared to competitors and external subsuppliers. This flexible sourcing concept is an essential precondition for Micon’s continued globalization process.

The ② shows Micon’s establishment of a sales and manufacturing company in India at the beginning of the 1990s. India is an attractive market for wind turbines, as India’s power supply is poor, especially in the countryside. The Indian government has therefore supported the mounting of wind turbines that can contribute to stabilizing the power supply (often in cooperation with foreign development aid organizations).

LM Glasfiber realized that it had to start manufacturing rotor blades in India to continue being one of India’s subsupplies. The ③ shows the 1994 establishment of LM Glasfiber India Ltd. – a joint venture between LM Glasfiber A/S, the Industrialization Fund for Developing Countries, and the Indian wind turbine manufacturer NEPC. The ④ therefore shows the local deliveries of rotor blades and the back-up service that LM Glasfiber India can provide by being a local company. As a consequence of the partnership with NEPC, LM Glasfiber has now (via the local joint venture) gained access to NEPC’s network, which includes several markets in Asia. Finally the ⑤ shows that LM Glasfiber has been able to use its relationship with NEPC as a ‘springboard’ to other markets in Asia.

At the start of 2007 LM Glasfiber has ‘convinced’ three or four of its major suppliers to follow it to India. Consequently, these subsuppliers have also established local production in order to be close to their major customer, LM Glasfiber.

Questions
1 Are there any threats to LM Glasfiber’s strategy in following its key customer abroad?
2 How does this case relate to the network model in Chapter 3?

Lear Corporation (www.lear.com) is one of the ten largest independent automotive suppliers in the world. The company is also the leading supplier of automotive interior systems in the global automotive interior market and the third largest supplier in the global automotive electrical distribution systems market. In 2006 Lear employed approximately 115,000 people worldwide, including about 29,000 in the United States and Canada, 40,000 in Mexico and Central America, 33,000 in Europe and 13,000 in other regions of the world.

The company has established in-house capabilities in three segments of the automotive interior market: seating systems; electronic and electrical; and interior products. The company is the largest supplier in the global seat systems market (with total net sales in 2005 of $17.1 billion). In North America it is one of the two largest suppliers in each of the other principal automotive interior markets, with the exception of the instrument panels market, in which it is the fourth largest. The company is also one of the leading global suppliers of automotive electrical distribution systems.

Lear’s objective is to strengthen and expand its position as a leading automotive supplier to the global automotive industry by focusing on customer needs. Lear supplies total solutions to major automotive manufacturers around the world, including General Motors, Ford, DaimlerChrysler, BMW, PSA, Volkswagen, Fiat, Renault-Nissan, Hyundai, Mazda, Subaru and Toyota. In order to realize substantial cost savings and improved product quality and consistency, automotive manufacturers are requiring their suppliers to manufacture products in multiple geographic markets. In recent years, Lear has expanded its operations significantly
Lear’s automotive customers face continuing competitive pressures to improve quality and functionality at a lower cost and to reduce time to market and capital needs. These trends have resulted in automotive manufacturers seeking fewer independent suppliers to provide automotive interior systems and components. The company believes that the criteria for selection of automotive interior systems suppliers are cost, quality, technology, delivery and service. A worldwide presence is necessary to satisfy these criteria.

Lear emphasizes the development of strong relationships with its customers by focusing on customer service, quality and costs, aiming to turn customers into partners. It believes that strong relationships with its customers allow it to identify business opportunities and anticipate the needs of customers in the early stages of vehicle design. Working closely with customers in the early stages of designing and engineering automotive interior systems gives Lear a competitive advantage in securing new business with existing customers or in securing completely new customers.

In the local manufacturing process (e.g. at the seating facilities) Lear generally uses just-in-time manufacturing techniques, and products are delivered to the automotive manufacturers on a just-in-time basis. These facilities are typically located near customers’ manufacturing and assembly sites. Seating facilities utilize a variety of methods whereby foam and fabric are affixed to an underlying seat frame. Raw materials used in seat systems, including steel, aluminium and foam chemicals, are generally available and obtained from multiple suppliers under various types of supply agreements. Leather, fabric and certain components are also purchased from multiple suppliers under various types of supply agreements. The majority of steel purchases are comprised of engineered parts that are integrated into a seat system, such as seat frames, mechanisms and mechanical components. Lear is increasingly using long-term, fixed-price supply agreements to purchase key components from its suppliers. The company generally retains the right to terminate these agreements if its supplier does not remain competitive in terms of cost, quality, delivery, technology or customer support.

One example of a growth market, China

The Chinese automotive market is expanding rapidly, with an estimated 5 million units produced in 2005. Lear seeks to partner with automotive manufacturers in China through joint venture arrangements and is well-positioned to take advantage of China’s emerging growth. Currently the company has 12 joint ventures in China, where the majority of its production is for the local market. In addition, Lear has established two wholly-owned subsidiaries in China to supply seats to the joint venture between First Automobile Works Group and Volkswagen and that between Shanghai Automotive Industry Corp. and General Motors Corporation. Lear also sees opportunities for growth with customers in Korea, India and elsewhere in Asia.

Questions

1. Draw a figure showing the total supply chain (Figure 13.1) for Lear’s seat systems?
2. How can Lear Corporation be characterized as a subsupplier?
3. Describe the relationships that the company has with its customers.
4. How would you consider the international competitiveness of the company compared with its Japanese customers?
Questions for discussion

1. What are the reasons for the increasing level of outsourcing to international subcontractors?
2. Describe the typology of subcontractors based on the differences in the contractor/subcontractor relationship.
3. Explain the shift from seller to buyer initiative in subcontracting.
4. Explain the main differences between the US and the Japanese subsupplier systems.
5. How are project exports/turnkey projects different from general subcontracting in the industrial market?
6. Project export is often characterized by a complex and time-consuming decision-making process. What are the marketing implications of this for the potential subcontractor?

References


Chapter 13  International sourcing decisions and the role of the subsupplier


At the beginning of 2007 Ingvar Kamprad, founder of the Swedish furniture retailing giant IKEA, is concerned ‘his’ firm may be growing too quickly. He used to be in favour of rapid expansion, but he has now become worried that the firm may be forced to close stores in the event of a sustained economic downturn.

Although IKEA is one of Sweden’s best-known exports, it has not in a strict legal sense been Swedish since the early 1980s. The store has made its name by supplying Scandinavian designs at Asian prices. It has managed its international expansion without stumbling. Indeed, its brand – which stands for clean, green and attractive design and value for money – is as potent today as it has been at any time in more than 50 years in business.

The parent of all IKEA companies – the operator of 207 of the 235 worldwide IKEA stores – is Ingka Holding, a private Dutch-registered company. Ingka Holding (which is named after the first and last name of the founder) belongs entirely to Stichting Ingka Foundation. This is a Dutch-registered, tax-exempt, non-profit-making legal entity, which was given the shares of Ingvar Kamprad in 1982. Stichtingen, or foundations, are the most common form of not-for-profit organisation in the Netherlands; tens of thousands of them are registered.

Most Dutch stichtingen are tiny, but if Stichting Ingka Foundation were listed it would be one of the Netherlands’ ten largest companies by market value. Its main asset is the Ingka Holding group, which is conservatively financed and highly profitable.

Valuing the Ingka Holding Group is awkward, because IKEA has no direct competitors that operate globally. Shares in Target, a large, successful chain of stores in the United States that makes a fifth of its sales from home furnishings, are priced at 20 times the store’s latest full-year earnings. Using that price/earnings ratio, the Ingka Holding Group is worth €28 billion ($36 billion).

Now Ingvar Kamprad has heard that the top management of the IKEA Group plans to make a further international expansion, into South America, because of the growth opportunities there. Kamprad is very sceptical about these plans and his personal assistant has asked you, as an international marketing specialist, to get an expert opinion about the plans . . .

IKEA – the story
IKEA Svenska AB, founded in 1943, is the world’s largest furniture retailer and specializes in stylish but inexpensive Scandinavian designed furniture.

Brief timeline
1943 The founder of IKEA, Ingvar Kamprad from Agunnaryd, Sweden, registers the name IKEA. The name was formed from the founder’s initials (IK) plus the first letters of Elmtaryd and Agunnaryd, the farm and village where he grew up.
1950 Furniture enters the IKEA product range for the first time.
1951 The first IKEA catalogue is published.
1953 The first IKEA furniture showroom is opened in Älmhult, Sweden, to better display the products’ quality.
1955 IKEA begins to design its own furniture.
1956 IKEA introduces self-assembly furniture in flat packs.
1958 The first IKEA store opens in Älmhult, Sweden.
1963 The second IKEA store is opened in Oslo, Norway.
Case III.1  IKEA

1965  The IKEA Stockholm store opens. The self-service, open warehouse is introduced.
1969  The first IKEA store in Denmark opens.
1973  The first store outside Scandinavia is opened in Spreitenbach, Switzerland.
1974  The first IKEA store opens in Germany, in Munich.
1975  The first IKEA store in Australia.
1976  The first IKEA store in Canada.
1977  The first IKEA store in Austria.
1978  The first IKEA store in Singapore.
1979  The first IKEA store in the Netherlands.
1980  The first IKEA store in the Canary Islands.
1981  The first IKEA stores in France and Iceland.
1983  The first IKEA store in Saudi Arabia.
1984  The first IKEA stores in Belgium and Kuwait.
1985  The first IKEA store in the United States.
1987  The first IKEA stores in the United Kingdom and Hong Kong.
1989  The first IKEA store in Italy.
1990  The first IKEA stores in Hungary and Poland.
1991  The first IKEA stores in the Czech Republic and the United Arab Emirates.
1992  The first IKEA stores in Mallorca and Slovakia.
1994  The first IKEA store in Taiwan.
1996  The first IKEA stores in Finland, Malaysia and mainland Spain.
1997  IKEA appears on the Internet with the World Wide Living Room website.
1998  The first IKEA store in mainland China.
2000  First IKEA store opens in Russia (Moscow).
2001  First stores in Israel (Netanya) and Greece (Thessaloniki).
2004  First stores in Portugal (Lisbon).
2005  First stores in Turkey (Istanbul).
2006  First stores in Ireland (Dublin).
2007  First stores in Romania (Bucharest).

About corporate IKEA
IKEA has grown into the world’s largest furniture retailer, with 237 stores in 35 countries (2007) and a workforce of some 90,000 people since its first outlet opened in Älmhult in 1958. The firm is noted for its rapid international expansion and has recently set up stores in Eastern Europe and Russia.

IKEA’s success in the retail industry can be attributed to its vast experience in the retail market, product differentiation and cost leadership. The company is one of the world’s most successful multinational retailing firms, operating as a global organization, with its unique concept that its furniture is sold in kits that are assembled by the customer at home.

The firm, which remains in private ownership, racked up sales of nearly €15 billion in 2002.

There are about 12,000 products in the total IKEA product range. Each store carries a selection of these 12,000 products depending on store size. The core range is the same worldwide.

IKEA accounts for just 5 per cent to 10 per cent of the furniture market in each country in which it operates. More important is that the awareness of the IKEA brand is much bigger than the size of the company because IKEA is far more than a furniture merchant. It sells a Scandinavian lifestyle that customers around the world embrace.

The IKEA business idea is to offer a wide range of home furnishing items of good design and function, excellent quality and durability, at prices so low that the majority of people can afford them. The company targets the customer who is looking for value and is willing to do a little bit of work serving themselves, transporting the items home and assembling the furniture. The typical IKEA customer is a young low- to middle-income family.

As mentioned, IKEA’s retailing, is based on a franchise system. Inter IKEA Systems B.V., located in Delft (the Netherlands), is the owner and franchisor of the IKEA concept. The IKEA Group is a private group of companies owned by a charitable foundation in the Netherlands. It is active in developing, purchasing, distributing and selling IKEA products. The IKEA experience is more than just products, however, it is a retail concept. For the concept to work all aspects must be in place. IKEA products are therefore sold only in IKEA stores franchised by Inter IKEA Systems B.V. However, most of the global product policy (including product development) and the global marketing is centralized to the Swedish part of the company, IKEA of Sweden.

Product development
The team behind each product consists of designers, product developers and purchasers who get together to discuss design, materials and suitable suppliers. Everyone contributes with their specialist knowledge. Purchasers, for example, use their contacts with suppliers all over the world via IKEA Trading Service Offices. Who can make this product of the best quality for the right price at the right time? Products are often developed in close cooperation with suppliers and often only one supplier is appointed to supply all the stores around the world.
Part III Market entry strategies

IKEA does not have its own manufacturing facilities but uses subcontracted manufacturers all over the world. In order to keep costs low, IKEA shoppers are pro-sumers – half producers and half consumers. In other words, they have to assemble the products themselves. To facilitate shopping, IKEA provides catalogues, tape measures, shopping lists and an internet website to help the consumer with fitting the furniture into the room. Car roof racks are available for purchase at cost and IKEA pick-up vans/mini-trucks are available to rent. IKEA’s success is based on the relatively simple idea of keeping the cost between manufacturers and customers down. Costs are kept under control starting at the design level of the value-added chain. IKEA also keeps costs down by packing items compactly in flat standardized packaging and stacking them as high as possible to reduce storage space during and after distribution.

Effective marketing through catalogues is what usually attracts the customer first; what keeps customers coming back is good service. IKEA believes that a strong in-stock position, in which the most popular style and design trends are correctly anticipated, is crucial to keep customers satisfied. For that IKEA depends on leading-edge technology and the company has developed its own global distribution network. By utilizing control points in the distribution cycle the firm is able to insure timely delivery of products to retail stores all over the world.

IKEA thinks that consumer tastes are merging globally. To take one example, IKEA, which has been exporting the ‘streamlined and contemporary Scandinavian style’ to the United States since 1985, found several opportunities to export US style to Europe, as Europeans picked up on some US furnishing concepts. To respond to this new demand IKEA now markets ‘American-style’ furnishings in Europe.

Bureaucracy is fought at all levels in the organization. Kamprad believes that simplicity and common sense should characterize planning and strategic direction. In addition, the culture emphasizes efficiency and low cost, which is not to be achieved at the expense of quality or service. Symbolic policies, such as only flying economy class and stay at economical hotels, employing young executives and sponsoring university programmes, have been integrated into the corporate culture and have further inspired the spirit of entrepreneurship in the organization. For instance, all design teams enjoy complete autonomy in their work, but are expected to design new and appealing products regularly. IKEA has improved its value chain by a cooperative focus on suppliers and customers. The firm emphasizes centralized control and standardization of the product mix.

In order to maintain cost leadership in the market, internal production efficiencies must be greater than those of competitors. Under IKEA’s global strategy suppliers are usually located in low-cost nations, with close proximity to raw materials and reliable access to distribution channels. These suppliers produce highly standardized products intended for the global market, which size provides the firm with the opportunity to take advantage of economies of scale. IKEA’s role is not only to globally integrate operations and centrally design products, but also to find an effective combination of low cost, standardization, technology and quality.

In the case of IKEA, a standardized product strategy does not mean complete cultural insensitivity. The company is, rather, responding to globally emerging consumer tastes and preferences. Retail outlets all over the world carry the basic product range, which is universally accepted, but also place great emphasis on the product lines that appeal to local customer preferences.

IKEA has modified the value chain approach by integrating the customer into the process and introducing a two-way value system between customers, suppliers and IKEA’s headquarters. In this global sourcing strategy the customer is a supplier of time, labour, information, knowledge and transport. On the other hand, the suppliers are customers, receiving technical assistance from IKEA’s corporate technical headquarters through various business services. The company wants customers to understand that their role is not to consume value, but rather to create it.

IKEA’s role in the value chain is to mobilize suppliers and customers to help them further add value to the system. Customers are clearly informed in the catalogues of what the firm’s business systems provide, and what they are expected to add to the final process.

In order to furnish the customer with good quality products at a low cost, the firm must be able to find suppliers that can deliver high-quality items at low cost per unit. The company’s headquarters provides carefully selected suppliers with technical assistance, leased equipment and the necessary skills needed to produce high-quality items. This long-term supplier relationship not only produces superior products, but also adds internal value to the suppliers. In addition, this value chain modification differentiates IKEA from its competitors.

Directly linked to its mission statement, IKEA has built its cost leadership position on these processes. It furnishes the customer with a quality product with components derived from all over the world utilizing multi-level competitive advantages, low cost logistics, and large simple retail outlets in suburban areas. Furthermore, cost leadership has been effectively incorporated into the organization’s culture through symbols.
and efficient processes. In return for high sales volumes IKEA accepts low profit margins. In addition, IKEA’s marketing emphasis on budget prices and good value clearly communicates cost leadership to customers. IKEA’s strategy demonstrates that the perception that cost leadership equals poor quality in products and services is incorrect. High quality is associated with input and process variables. Cost reduction, on the other hand, does not mean reducing the quality of these variables, but rather doing things better, and more efficiently. Cost leadership is a part of the management process and culture.

From this discussion it is possible to conclude that IKEA effectively aligns its cost leadership platform, focusing on the needs of its target market segment. Differentiation, as indicated in the modification of the value chain, also focuses on this particular segment.

**The internationalization of IKEA**

IKEA has applied a conservative policy to internationalization. As a general rule, the firm does not enter a new potential market by opening a retail outlet. Instead, a supplier link with the host nation is established. This is a strategic, risk-reducing approach in which local suppliers can provide valuable input on political and legal, cultural, financial and other issues that provide opportunities and/or threats to the IKEA concept. In the 1970s and 1980s IKEA concentrated its international expansion in Europe and in North America mainly through company-owned subsidiaries. On the other hand, over the past 20 years franchising has been extensively utilized in expanding to other areas of the world.

**Expansion by franchising**

IKEA approaches unknown, relatively small and high risk markets by franchising. Franchises are granted by Inter IKEA Systems B.V. as part of a detailed international expansion plan. Serious applicants are carefully researched and evaluated and franchises are granted only to companies and/or individuals with strong financial backing and a proven record in retail. Franchisees have to carry basic items, but have the freedom to design the rest of the product mix to fit local market needs. The basic core items number approximately 12,000 simple and functional products. The centralized head office is actively involved in the selection processes and provides advice. In addition, all products have to be purchased from IKEA’s product lines. In order to maintain service, quality and logistic standards, individual franchisees are periodically audited and compared to overall corporate performance. Extensive training and operational support is provided from headquarters. All franchisees pay franchise fees to IKEA Holdings. All catalogues and promotional advertising is the responsibility of headquarters. Franchising has been used as a vehicle for the company’s generic focus strategy.

**Balance of autonomy and strategic direction**

As IKEA continues to expand overseas the significance of centralized strategic direction will increase. Naturally rapid internationalization will trigger a range of challenges imposed on the headquarters, such as the following:

- The complexity of the logistics system will increase.
- It will be more difficult to respond to national needs and cultural sensitivity issues.
- Franchisees may demand more control over operations.
- Emerging demographic trends will force the organization to broaden its focus strategy to respond to varying nation-level consumer groups.

With all these challenges emerging it might be very difficult to maintain a central organizational structure. The best way to meet these challenges is to find the proper balance between country level autonomy and centralized intervention. With reference to IKEA’s long-term relationship and control over its suppliers in exchange for quality assurance, technology transfers and economies of scale factors may trigger potential suppliers to integrate forward and produce competitive products for IKEA’s local competitors. With logistics complications and long lead times IKEA is forced to maintain high control levels over its suppliers. For instance, if the supplier responsible for the screws component to a table cannot deliver on time, the supplier of the table-top has to adapt its production to the new scenario. Without IKEA’s centralized logistics system this example could lead to severe store shortages, leading to losses in sales.

**The Brazilian market for furniture**

According to the Brazilian Association of Furniture Manufacturers (ABIMOVEL), the Brazilian furniture market was estimated at approximately $3.6 billion in 2000, of which about $111 million were imports. The market can be broken down into three main categories: residential (60 per cent), office (25 per cent), and institutional organizations, such as schools, hospitals and hotels (15 per cent).

Brazil has 4.6 million hectares of planted forests, almost all of which is located in the south of the country. Wood from such forests is mainly used in the production of furniture, pulp and paper. The main furniture production centres, as well as the most important markets, are also located in southern Brazil.
The production of particleboard, which was 494,000 m$^3$ in 1990, jumped to 1.3 million m$^3$ in 1998, an annual growth rate of 13 per cent. This pattern is expected to continue in the near future. Approximately 80 per cent of Brazil’s particleboard production is consumed by the furniture sector. A smaller volume is marketed by resellers and destined for small furniture manufacturers.

As the Brazilian furniture market continues to reap more and more of its profits from exports, production is increasingly tailored to satisfy market niches that demand differentiated products. To meet this need the Brazilian industry is investing more in design and development, although investments are smaller in comparison to investments made in the United States, Italy and Germany. Brazil is also importing state-of-the-art equipment to address quality issues mandated by foreign markets, e.g. the US, Italian and German ones. Today the segment requires import of equipment such as wood-drying machinery, finishing machinery and tools.

According to the Brazilian Furniture Association there are approximately 13,500 Brazilian furniture manufacturers, most of which are small. These firms are typically family-owned companies whose capital is exclusively Brazilian. Historically, the greater proportion of Brazilian manufacturers have been concentrated in areas of large population density in southern Brazil.

The process of trade liberalization initiated in 1990 introduced significant changes in Brazil’s trade regime, resulting in a more open and competitive economy.

The Brazilian economy was deeply affected by the crises in the Asian and Russian markets. As a consequence the currency suffered deeply from the devaluation in January 1999. Brazilian imports of furniture were also seriously affected by this devaluation, and the industry is currently suffering from the unfavourable (for Brazilians) real-dollar exchange rate.

US exports of furniture to Brazil reached $43 million in 2000 (39 per cent of total Brazilian furniture imports) and are expected to decrease to $36 million in 2001. US exports to Brazil were particularly strong in the area of seats, new-design office furniture, and high-end, high-value-added residential furniture. Market analysts estimate that in the next three to four years imports of institutional furniture, such as that used in hospitals and hotels, will increase considerably, mainly imports from the United States.

**Imports**

Brazilian furniture imports totalled $111 million in 2000, and decreased to $96 million in 2001. This represents 3 per cent of the total furniture market in Brazil. The USA holds 39 per cent of the imported furniture market, followed by Germany with 36 per cent, Italy with 10 per cent, and other countries with 15 per cent.

**End-user analysis**

Different industry segments, such as automotive, aviation and furniture (residential, commercial and institutional) make up the Brazilian market. Each of those areas has its own purchasing approach. For example, the automotive industry may import directly from its headquarters and, in the case of the furniture industry, the end user might be an importer or a store chain.

It is important to mention that there are no major distributor chains in Brazil. Most furniture imports are made through direct importers and, in a smaller proportion, local manufacturers wishing to complement their product line.

High-end furniture and mattresses are commonly imported into Brazil by direct importers or furniture stores. Interior decorators and architects are also considered decision makers, since they are the ones who recommend brands and styles to their final clients.

**Import climate**

Brazil has a tariff-based import system and has simplified the process for obtaining import licences. Import tariffs are levied ad valorem on the CIF value of the imports. Import tax (IPI – See below) for furniture varies from 5–15 per cent.

The industrial products tax (IPI) is a federal tax levied on most domestic and imported manufactured products. It is assessed at the point of sale by the manufacturer or processor in the case of domestically produced goods, and at the point of customs clearance in the case of imports. The tax rate varies by product and is based on the product’s CIF value plus duties.

Interest rates in Brazil are high (estimated at 18.3 per cent per year in June 2001) and discourage demand for bank loans. The few sources of funds available for long-term financing are provided by the National Bank for Economic and Social Development (BNDES), through leasing operations and by foreign government export agencies.

**Distribution and business practices**

Major end users of furniture will only purchase from well-known and reliable suppliers. Although large end users may import directly from foreign suppliers, they are always concerned with after-sales service. Technical assistance and availability of replacement parts are considered important factors in the purchasing decision. In some segments, such as commercial and institutional, this factor may determine from whom the end user will purchase. A physical presence in the market, either through an agent or a manufacturing plant, increases the end user’s trust in the supplier’s commitment to this market and facilitates the sale.
The retail scene in Brazil
For many years the popular wisdom in Brazil was that shopping malls were only for rich people. The 1984 opening of Center Norte mall in São Paulo changed all that. It is strategically placed next to a subway and a bus terminal. Proximity to mass transit is essential, since many low-income consumers do not own cars. Center Norte was followed by other shopping malls in other cities, such as Rio de Janeiro and Belo Horizonte.

Economic instability, difficulties in obtaining financing at reasonable interest rates and customs barriers for certain imports have slowed down the entry of foreign retailers to Brazil. Among the international chains that have been attracted by Brazil’s 80 million consumers are JC Penney, Zara and the Dutch chain C&A, that leads the fashion sector in Brazil. International franchisors such as Benetton, Lacoste, Hugo Boss, Polo Ralph Lauren and McDonald’s operate in Brazilian shopping centres, some on a large scale.

Those who have set up shops in Brazil have varied results directly related to their ability to adapt to local conditions. Sears, for example, had extremely negative results, due to the centralization of decision making in Chicago. Similarly, Zara tried to bring to Brazil its European management policy and market approach and is now facing poor financial results. The contrast is the excellent performance of C&A, whose policies and procedures were defined in Brazil for the local market. JC Penney acquired a local chain (Renner) and accelerated its expansion with good results (ICSC Worldwide Commission, 2000).


Questions
1 Until now IKEA international marketing strategy has been tightly and centrally controlled by corporate headquarters. However, high local pressures emerging due to demographic and cultural differences might force the local IKEA shops to take strategic initiatives to respond to local market needs. In this connection discuss the regional headquarters and transnational organization (presented in Chapter 12) as hierarchical ‘entry mode’ alternatives to the very centralized strategy emanating from IKEA’s headquarters.

2 IKEA has not yet explored joint venture and strategic alliances strategies. Evaluate the pros and cons regarding these two entry strategies versus the traditional IKEA entry mode of franchising.

3 Should IKEA penetrate the South American market by establishing a shop in Brazil?

4 In the light of the political and economic situation in South America, outline the sourcing concept that should be implemented in the South American market.
Chief executive officer of Autoliv Inc., Lars Westerberg, is in the middle of a board of directors’ meeting in Stockholm in September 2006, discussing how it is possible to further globalize Autoliv. He takes out a situation report for the business area of air bags. As there are a couple of new members on the board Lars takes the opportunity to give a broader introduction to the business area than he usually does. The following is Lars Westerberg’s status report.

Situation report for the business area of air bags

Business concept
Autoliv Inc., which is a Fortune 500 company, is the world’s largest automotive safety supplier with sales to all the leading car manufacturers in the world. Autoliv’s shares are listed on the New York Stock Exchange and on the Stockholm Stock Exchange. The company develops, markets and manufactures airbags, seat belts, safety electronics, steering wheels, anti-whiplash systems, seat components and child seats. Autoliv has 80 subsidiaries (production plants) and joint ventures in 30 vehicle-producing countries, with over 40,000 employees. In addition, Autoliv has technical centres in nine countries with 20 crash test tracks – more than any other automotive safety supplier.

Autoliv aims to develop, manufacture and market systems and components worldwide for personal safety in automobiles. This includes the mitigation of injuries to automobile occupants and pedestrians and the avoidance of accidents. In this aspect, Autoliv wants to be the systems supplier and the development partner to car producers that satisfy all the needs in the area of personal safety. To fulfil its business concept Autoliv has strong product lines:

- frontal and side-impact airbags (including all key components such as inflators with initiators, textile cushions, electronics with sensors and software, steel and plastic parts);
- seat belts (including all key components such as webbing, retractors and buckles);
- seat belt features (including pretensioners, load limiters, height adjusters and belt grabbers);
- seat SubSystems (including anti-whiplash systems);
- steering wheels (including integrated driver airbags);
- roll-over protection (including sensors, pretensioners and airbag curtains).

In 2006 the penetration rate of curtain airbags in new cars was 50 per cent in Europe, 35 per cent in North America, 20 per cent in Japan and 10 per cent in the rest of the world.

The following concentrates on the business area of air bags.

Production strategy
Autoliv has final assembly of restraint systems, located close to major customers’ plants for just-in-time supply (see Figure 1). Most of the component production (textiles and stamped metal components, etc.) has been outsourced during the past five years.

Since major automobile manufacturers are continuously expanding production into more countries, it is also Autoliv’s strategy to have manufacturing capacity where the major vehicle manufacturers have or are likely to set up production facilities. As a consequence Autoliv has more plants for automotive safety products in more countries than any other supplier.
The product: the air bag

Even the best belt designs cannot prevent all head and chest injuries in serious head-on crashes. This is where air bags help, by creating an energy-absorbing cushion between an occupant’s upper body and the steering wheel, instrument panel or windshield. Independent research has shown that driver deaths in head-on crashes are about 20 per cent lower in cars with frontal air bags than in similar cars with belts only. In all kinds of crash deaths are down by about 15 per cent over and above lives already being saved by belts.

Although air bags may seem complicated they are in fact relatively simple. In moderate and severe head-on crashes sensors signal inflators to fill the bags with harmless gas. The bags fill in a fraction of a second and begin deflating the instant they cushion people, but in the United States a few occupants have died of broken necks. Peak inflation is in less than 1/20th of a second, faster than the blink of an eye. The speed and force of air bag inflation may occasionally cause injuries, mostly minor abrasions or bruises, but in the United States some occupants have died of broken necks caused by air bags that inflated with great force. Those at the greatest risk of injury caused by an air bag are those who drive or ride unbelted, small children, short or obese adults, and certain disabled people.

Injury risk from the bag itself can be reduced by choosing a driving or passenger position that does not put your face or chest close to the steering wheel or instrument panel. The combination of seat belt and air bag provides maximum protection in all kinds of crash.

Together with Volvo Autoliv has also developed the first side air bags to protect drivers and front-seat passengers in side-impact crashes. These bags are typically smaller than frontal air bags and they inflate more quickly. Volvo was the first manufacturer to offer side air bags in its 850 model in 1994. Volvo’s bag is mounted on the outside of driver and front-seat passenger seat backs. Since 1996 side bags have been standard in all Volvo models.

The history of air bags goes back to the early 1950s. The product idea was patented in 1951 by Walter Linderer from Munich. It was in the United States, however, that the concept came into existence, driven by the North Americans’ reluctance to use seat belts and hindered by the car manufacturers, which initially ridiculed the idea. In 1981 only 2,636 air bag systems were produced.

However, in late 1989 automatic restraint systems became compulsory in all passenger cars in the United States on the driver’s side and, while this included automatically fastening seat belts, it seemed that the air bag had at last arrived. By 1992, 10 million air-bag-equipped cars had been delivered to the United States. In 1993 came the requirement that all new light vehicles of model year 1999 produced in the United States had to be fitted with frontal air bags for the driver and the front-seat occupant. The next stage will be the compulsory fitting of air bags to both the driver and front passenger sides.

Autoliv introduced its first air bag system in 1990. It was designed to meet US requirements, where not all states have laws on wearing seat belts. The air bag therefore had to be relatively large. Autoliv has developed a special system (the Eurobag system) for markets where wearing a seat belt is compulsory. In this system the air bags have less volume (but they are still effective) and therefore the price can be kept at a lower level than some of the competitors. In the Eurobag system the air bags are 30–45 litres on the driver’s side and 60–100 litres on the passenger’s side. Furthermore, the Eurobag system is lighter and less bulky.

An air bag system consists of an electronic control unit and an air bag module. The electronic control unit contains (among other things) a sensor, while the module essentially consists of a gas generator, a nylon bag and a cover for the steering wheel centre or the instrument panel, depending on where the air bag module is placed. Autoliv typically supplies entire systems adapted to individual car models.

Organization

In France, Germany, Spain, Sweden, the United Kingdom and the United States, local management is regionally responsible for Autoliv’s operations in countries other than their own. As a result the main customers have the advantage of dealing with Autoliv both in their home market and when they have or are going to establish production in other markets. Together with two regional coordination offices this organization contributes to low corporate overheads and short response times for the customers. (Autoliv’s global headquarters has only 40 employees.) Autoliv’s business directors and their organizations coordinate all activities with major customers on a global basis.

The world market for air bags

With its successful growth strategy, Autoliv has become the global leader in the $20 billion automobile occupant restraint market. Airbags account for just over 50 per cent of that market, seat belts for almost 30 per cent and electronics for nearly 20 per cent.

The global steering wheel market, which Autoliv entered in 1995 to promote the integration of driver air bags into steering wheels, amounts to over $1.5 billion.

The world market for air bags was an area of spectacular growth during the 1990s. In 2005 the number of frontal air bag units was almost 125 million and the number of side-impact air bags nearly 50 million.
In the United States frontal air bags – both on the driver and the passenger side – are compulsory under federal law in all new light vehicles sold after 1 September 1998. The US market for frontal air bags therefore fluctuates with the car production cycle, but sales of side air bags are now about to take off. Their penetration rate was less than 20 per cent among new US light vehicles in 2001. Both Ford and General Motors have announced aggressive plans for curtain side air bags such as Autoliv’s Inflatable Curtain. In addition, new regulations in the United States will require vehicle manufacturers to phase in more valuable ‘advanced air bags’ during a three-year period starting on 1 September 2003.

In Europe, Autoliv estimates that more or less all new vehicles have dual airbags. Installations of side impact air bags began in 1994, but in 2001 two-thirds of all new vehicles in Europe had such systems for chest protection. In addition, 25 per cent had a separate side impact air bag for head protection (such as the inflatable curtain).

In Japan, where development started later than in Europe, penetration rates for frontal air bags are nearly as high as in Europe, while the penetration rate for side air bags is clearly below the level in Europe.

In the rest of the world, penetration rates vary greatly from country to country, but the average is still less than 50 per cent for both driver and passenger air bags (see Table 1). Installations of side air bags has just started.

The potential market for side air bags is difficult to assess. This is because side impact air bags will be optional accessories in many cars – at least initially – until the car producers have had time to evaluate the reaction from the market.

Autoliv estimates that it currently has approximately one-third of the global market for car occupant restraint products and that it has a somewhat larger global market share for air bags than for seat belts. For side air bags, which were invented by Autoliv and introduced in 1994, Autoliv’s global market share is still more than 40 per cent (see also Table 2). For other recent safety improvements, such as seat belt pretensioners and load limiters, Autoliv’s global market position is strong.

In North America, Autoliv estimates that in 2001 it accounted for a little less than one-third the air bag products market and the same for the seat belt market compared with just over 10 per cent in 1999. (Autoliv did not sell seat belts in the United

---

### Table 1 The world market for frontal air bags, 2005

<table>
<thead>
<tr>
<th>Region</th>
<th>Production of light vehicles (millions)</th>
<th>Percentage of vehicles equipped with air bags (dual air bags, both driver and passenger)</th>
<th>Total market for frontal air bags (driver + passenger) (millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Europe</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>East</td>
<td>6</td>
<td>100% with dual bags</td>
<td>44</td>
</tr>
<tr>
<td>West</td>
<td>16</td>
<td>100% with dual bags</td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>18</td>
<td></td>
<td>36</td>
</tr>
<tr>
<td>Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>11</td>
<td>70% with driver’s air bag</td>
<td>34</td>
</tr>
<tr>
<td>China</td>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>South Korea</td>
<td>4</td>
<td>50% with dual air bags</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>10</td>
<td>50% with driver’s air bag</td>
<td>11</td>
</tr>
<tr>
<td>South Asia</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>60</td>
<td></td>
<td>125</td>
</tr>
</tbody>
</table>

Case III.2  Autoliv Air Bags

States until 1993.) Autoliv made its big entry into the North American market in 1996 when it acquired Morton Automotive Safety Products, which at that time was North America’s largest air bag producer. The air bag business has given Autoliv an opportunity to expand its seat belt business now as complete systems sourcing takes place. In 2000 Autoliv acquired the North American seat belt business of NSK. Autoliv’s market share for seat belts also increased as a result of new contracts, and the increasing number of new United States vehicles with seat belt pretensioners. Steering wheel sales in the United States commenced in 1998. Based on orders received so far, Autoliv expects its steering wheel market share to approach 10 per cent in just a couple of years.

In Europe, Autoliv estimates its market share to be about 50 per cent with a somewhat higher market share for seat belts than for air bags. The market share for steering wheels is approximately 15 per cent. In Asia, Autoliv’s market share is not more than approximately 10 per cent for frontal air bags.

In Japan, Autoliv has a strong position in the air bag inflator market and rapidly growing sales of air bag modules. Local assembly of air bag modules began in 1998. In 2000 Autoliv acquired the second largest Japanese steering wheel company with a market share exceeding 20 per cent, and 40 per cent of NSK’s Asian seat belt operations with the option to acquire the remaining shares in two steps in 2002 and 2003. Including NSK’s sales, Autoliv accounts for approximately a fifth of the Japanese seat belt market.

In other countries, such as Argentina, Australia, China, India, Malaysia, New Zealand, South Africa and Turkey, where Autoliv established production early, the company has achieved strong market positions in several places.

Competitors

In the late 1990s the number of major suppliers of occupant restraint systems was reduced from nine to four. As a result of the consolidation among producers of light vehicles the new entities that have been formed require suppliers to be cost efficient and have the capability to deliver the same products to all the companies’ plants worldwide.
Part III  Market entry strategies

Table 4 Three years of economic development at Autoliv Inc.

<table>
<thead>
<tr>
<th>Key figures</th>
<th>2005</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales ($million)</td>
<td>6,205</td>
<td>6,144</td>
<td>5,301</td>
</tr>
<tr>
<td>Pre-tax profit ($million)</td>
<td>293</td>
<td>326</td>
<td>268</td>
</tr>
</tbody>
</table>

sales. Of the 2005 total sales in Table 4, Europe accounts for 54 per cent, North America 26 per cent, Japan 9 per cent and the rest of the world 11 per cent.

The total number of employees (whole Autoliv Group, including subsidiaries) in December 2005 was about 40,000.

With this positive news Lars Westerberg finishes his presentation of Autoliv’s position in the air bags market. He would like a discussion of the following, to which you are asked to contribute.

Questions

1. Describe Autoliv’s role as a subsupplier for large auto manufacturers in a market that is characterized by consolidation.
2. Which car manufacturer should Autoliv target to strengthen its global competitive position?
3. What strategic alternative does Autoliv have to strengthen its competitive position outside Europe?
Back in 1997 the CEO of IMAX, Richard L. Gelfond, was a bit sceptical about building a story with Hollywood movie stars into the big screen format. At that time his answer to the criticism of IMAX® films’ missing story was: ‘It is too expensive and risky for us to put all our eggs in one basket and hire a major movie star.’

However, in 2003 new technological achievements have made it possible to show, for example, *Matrix Reloaded* on the huge screen format. This is not just the projection of the standard theatrical print on an IMAX screen—the film will undergo the patented IMAX DMR (digital re-mastering) process, which enhances the quality of the image and soundtrack to the huge IMAX 15/70 format. The same has happened to *Apollo 13*, featuring Oscar®-winning actor Tom Hanks.

So though IMAX have been through financial tough times the company now seems to be looking towards a brighter future.

**The IMAX Corporation**

The IMAX Corporation is involved in a wide variety of out-of-home entertainment business activities. It designs and manufactures projection and sound systems for giant-screen theatres based on a patented technology. The IMAX Corporation is the world’s largest producer and distributor of films for giant-screen theatres.

The IMAX Corporation, together with its wholly-owned subsidiaries, is one of the world’s leading entertainment technology companies whose principal activities are the following:

- the design, manufacture, marketing and leasing of proprietary projection and sound systems for IMAX theatres principally owned and operated by institutional and commercial customers in more than 36 countries (1 September 2003);
- the development, production, digital re-mastering, post-production and distribution of certain films shown in the IMAX theatre network;
- the operation of certain IMAX theatres located primarily in the United States and Canada; and
- the provision of other services to the IMAX theatre network including designing and manufacturing IMAX camera equipment for rental to film-makers and providing ongoing maintenance services for the IMAX projection and sound systems.

The IMAX theatre network is the most extensive large-format network in the world, with 239 theatres operating in more than 36 countries. Of these, 115 are in institutional locations and 102 in commercial locations. While IMAX’s roots are in the institutional market, it believes that the commercial market is potentially larger. To increase the demand for IMAX theatre systems, it is currently working to position the network as a new window for Hollywood event films. To this end IMAX has both developed a technology that allows standard 35 mm movies to be converted to its format and is also working to build strong relationships with Hollywood studios and commercial exhibition companies.

IMAX theatre systems combine advanced, high-resolution projection systems, sound systems and screens as much as eight storeys high (approximately 80 feet) that extend to the edge of a viewer’s peripheral vision to create the audio-visual experience. As a result audiences feel as if they are a part of the on-screen action in a way that is more intense and exciting than in traditional theatres. In addition, IMAX’s 3D theatre systems combine the same projection and sound systems and up to eight storey screens with 3D images that further increase the audience’s feeling of immersion.
Part III Market entry strategies

in the film. IMAX believes that its network of 3D theatres is the largest out-of-home, 3D distribution network in the world.

History
The IMAX system has its roots in EXPO ’67 in Montreal, Canada, where multiscreen films were the hit at the fair. A small group of Canadian film-makers/entrepreneurs (Graeme Ferguson, Roman Kroitor and Robert Kerr), who had made some of those popular films, decided to design a new system using a single powerful projector rather than the cumbersome multiple projectors used at that time. The result was the IMAX motion picture projection system, which would revolutionize giant-screen theatre. As the IMAX screen is about ten times the size of a conventional movie screen, picture quality has to be very good. The camera required is also much bigger than a conventional movie camera, but for anyone with film experience it is not hard to learn to use.

The much acclaimed Fires of Kuwait was nominated for an Academy Award in the Feature Documentary category in 1993. Since the premiere in 1970 more than 700 million people have enjoyed the IMAX® Experience™.

In 1977, IMAX was awarded the sole Oscar® for Scientific and Technical Achievement by the Academy of Motion Picture Arts and Sciences. The award recognized IMAX’s innovation in creating the world’s best film capture and projection system as well as IMAX’s acceptance as part of the entertainment mainstream.

IMAX Ridefilm: entry and departure
Historically, another part of the corporation was the IMAX® Simulation Ride System, which combined giant-screen technology with aspects of an amusement park ride.

One of Ridefilm Corporation’s new state-of-the-art projects became reality in 1993. Back to the Future – The Ride, directed by Douglas Trumbull, premiered in June at Universal Studios, Hollywood. This high-tech attraction was considered by entertainment industry experts to be the paradigm for the film experience of the future. The Ridefilm concept consisted of 18-person projection rooms in which the seats are equipped with seat belts and move with the action on the screen. The film is projected on a 180-degree screen, with digital surround sound.

IMAX never succeeded in becoming profitable in the ridefilm business. One of the reasons for that might be that it never reached the critical mass of about 100 cinemas needed in order to support the three or four ridefilms that must be made each year to make the business profitable. In fiscal 1999 IMAX was forced to write off Ridefilm’s assets, resulting in a charge of $13.6 million.

IMAX’s business today
Generally speaking IMAX does not own its theatres, but leases its projection and sound systems and licenses the use of its trade marks. IMAX derives revenue principally from theatre system lease agreements, maintenance agreements, film production agreements and distribution of films.

In 2002, Imax introduced a technology that can convert live-action 35mm films to its 15/70-format at a modest incremental cost, while meeting IMAX’s high standards of image and sound quality. IMAX believes that this proprietary system, known as IMAX DMR (Digital Re-Mastering), has positioned IMAX theatres as a new release window or distribution platform, for Hollywood biggest event films. As of 31 December 2005, IMAX, along with its studio partners, had released 11 IMAX DMR films. In 2005, IMAX released four films converted through the IMAX DMR process contemporaneous with the releases of the films to conventional 35mm theatres, rereleased one IMAX DMR film that had previously been released in 2004, and released one film made specifically for IMAX theatres.

In March 2003, IMAX introduced IMAX MPX, a new theatre projection system designed specifically for use by commercial multiplex operators. The IMAX MPX system, which is highly automated, was designed to reduce the capital and operating costs required to run an IMAX theatre while still offering consumers the image and sound quality of the trademarked experience viewers derive from IMAX theatres known as ‘The IMAX Experience’. During 2005, IMAX signed agreements for 31 MPX theatre systems from North American and international commercial theatre exhibitors.

Theatre system leases
IMAX’s system leases generally have 10–20-year initial terms and are typically renewable by the customer for one or more additional ten-year terms. As part of the lease agreement IMAX advises the customer on theatre design and custom assemblies and supervises the installation of the system; provides training in using the equipment to theatre personnel; and for a separate fee provides ongoing maintenance of the system. Prospective theatre owners are responsible for providing the location, the design and construction of the building, the installation of the system and any other necessary improvements. Under the terms of the typical lease agreement the title to all theatre system equipment
Case III.3  IMAX Corporation

IMAX Corporation (including the projection screen, the projector and the sound system) remains IMAX’s. IMAX has the right to remove the equipment for non-payment or other defaults by the customer. The contracts are generally not cancellable by the customer unless IMAX fails to perform its obligations. The contracts are generally denominated in US dollars, except in Canada and Japan, where contracts are generally denominated in Canadian dollars and Japanese yen, respectively.

The typical lease agreement provides for three major sources of revenue: (i) initial rental fees, (ii) ongoing additional rental payments and (iii) ongoing maintenance fees. Rental payments and maintenance fees are generally received over the life of the contract and are usually adjusted annually based on changes in the local consumer price index. The terms of each lease agreement vary according to the system technology provided and the geographic location of the customer.

**IMAX films**

IMAX produces films that are financed internally and through third parties. With respect to the latter, IMAX generally receives a film production fee in exchange for producing the films and is appointed the exclusive distributor of the film. When IMAX produces films it typically hires production talent and specialists on a project-by-project basis, allowing IMAX to retain creative and quality control without the burden of significant ongoing overhead expenses. Typically the ownership rights to films produced for third parties are held by the film sponsors, the film investors and IMAX.

IMAX is a significant distributor of 15/70 format films, with distribution rights to more of these films than any competing distributor. IMAX generally distributes films that it produces and it has acquired distribution rights to films produced by independent producers. As a distributor, IMAX generally receives a percentage of box office receipts.

**International marketing**

IMAX markets its theatre systems through a direct sales force and marketing staff located in offices in Canada, the United States, Europe, China and Japan. In addition, IMAX has agreements with consultants, business brokers and real estate professionals to find potential customers and theatre sites for IMAX on a commission basis.

IMAX has experienced an increase in the number of commercial theatre and international signings since 1995. The commercial theatre segment of IMAX’s network is now its largest, with a total of 120 theatres opened. As at 31 December 2002, 38.0 per cent of all theatres are outside North America. IMAX’s institutional customers include science and natural history museums, zoos, aquaria and other educational and cultural centres. IMAX also leases its systems to theme parks, tourist destination sites, fairs and expositions. See Table 1 for an outline of IMAX’s operations by area.

For information on revenue breakdown by geographic area see Table 2 (revenue by geographic area is based on the location of the theatre).

Table 2 also shows that IMAX has been in a positive financial development during the last three years. No one customer represents more than 3 per cent of IMAX’s installed base of theatres. IMAX has no dependence upon a single customer, or a few customers, the loss of any one or more of which would have a material adverse effect on IMAX.

As of 31 December 2005 IMAX had 376 employees, excluding hourly employees at company-owned and operated theatres.

**IMAX enters the Chinese market**

The first IMAX projection system in a theatre in China was installed in December 2001 and 13 additional IMAX theatre systems are scheduled to be installed in China by 2008. China is now IMAX’s second largest and fastest growing market. However, the geopolitical instability of the region comprising China, Taiwan, North Korea and South Korea could result in some economic risks.

### Table 1 IMAX Breakdown of installations by geographic segment as at 31 December 2005

<table>
<thead>
<tr>
<th>Geographic Segment</th>
<th>2005 Installed base</th>
<th>2004 Installed base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>22</td>
<td>24</td>
</tr>
<tr>
<td>United States</td>
<td>134</td>
<td>125</td>
</tr>
<tr>
<td>Europe</td>
<td>47</td>
<td>46</td>
</tr>
<tr>
<td>Japan</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Rest of World</td>
<td>49</td>
<td>39</td>
</tr>
<tr>
<td>Total</td>
<td>266</td>
<td>248</td>
</tr>
</tbody>
</table>

### Table 2 IMAX Revenue by geographic area

<table>
<thead>
<tr>
<th>Geographic Segment</th>
<th>2005 Revenue and net income ($1,000)</th>
<th>2004 Revenue and net income ($1,000)</th>
<th>2003 Revenue and net income ($1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>7,027</td>
<td>9,616</td>
<td>5,224</td>
</tr>
<tr>
<td>United States</td>
<td>73,711</td>
<td>68,411</td>
<td>66,808</td>
</tr>
<tr>
<td>Europe</td>
<td>26,700</td>
<td>26,144</td>
<td>26,805</td>
</tr>
<tr>
<td>Asia</td>
<td>22,024</td>
<td>18,789</td>
<td>9,989</td>
</tr>
<tr>
<td>Rest of world</td>
<td>15,468</td>
<td>13,040</td>
<td>10,434</td>
</tr>
<tr>
<td>Total</td>
<td>144,930</td>
<td>135,980</td>
<td>119,260</td>
</tr>
<tr>
<td>Net income</td>
<td>16,598</td>
<td>10,244</td>
<td>231</td>
</tr>
</tbody>
</table>

---

**Table 1 IMAX Breakdown of installations by geographic segment as at 31 December 2005**

<table>
<thead>
<tr>
<th>Geographic Segment</th>
<th>2005 Installed base</th>
<th>2004 Installed base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>22</td>
<td>24</td>
</tr>
<tr>
<td>United States</td>
<td>134</td>
<td>125</td>
</tr>
<tr>
<td>Europe</td>
<td>47</td>
<td>46</td>
</tr>
<tr>
<td>Japan</td>
<td>14</td>
<td>14</td>
</tr>
<tr>
<td>Rest of World</td>
<td>49</td>
<td>39</td>
</tr>
<tr>
<td>Total</td>
<td>266</td>
<td>248</td>
</tr>
</tbody>
</table>

**Table 2 IMAX Revenue by geographic area**

<table>
<thead>
<tr>
<th>Geographic Segment</th>
<th>2005 Revenue and net income ($1,000)</th>
<th>2004 Revenue and net income ($1,000)</th>
<th>2003 Revenue and net income ($1,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Canada</td>
<td>7,027</td>
<td>9,616</td>
<td>5,224</td>
</tr>
<tr>
<td>United States</td>
<td>73,711</td>
<td>68,411</td>
<td>66,808</td>
</tr>
<tr>
<td>Europe</td>
<td>26,700</td>
<td>26,144</td>
<td>26,805</td>
</tr>
<tr>
<td>Asia</td>
<td>22,024</td>
<td>18,789</td>
<td>9,989</td>
</tr>
<tr>
<td>Rest of world</td>
<td>15,468</td>
<td>13,040</td>
<td>10,434</td>
</tr>
<tr>
<td>Total</td>
<td>144,930</td>
<td>135,980</td>
<td>119,260</td>
</tr>
<tr>
<td>Net income</td>
<td>16,598</td>
<td>10,244</td>
<td>231</td>
</tr>
</tbody>
</table>
Competition in the industry

The out-of-home entertainment industry is very competitive, and IMAX faces a number of challenges. IMAX competes with other large-format film projection system manufacturers as well as, indirectly, conventional motion picture exhibitors.

IMAX competes with a number of manufacturers of large-format film projection systems, most of which utilize smaller film formats, including eight-perforation film frame, 70 mm and ten-perforation film frame, 70 mm formats, which IMAX believes deliver an image that is inferior to the IMAX experience. As already mentioned, the IMAX theatre network and the number of 15/70 format films to which IMAX has distribution rights are substantially larger than those of its competitors, and IMAX DMR films are available exclusively to the IMAX network. IMAX’s customers generally consider a number of criteria when selecting a large-format theatre, including quality, reputation, brand name recognition, type of system, features, price and service. IMAX believes that its competitive strengths include the value of the IMAX® brand name, the quality and historic up-time of IMAX cinema systems, the number and quality of 15/70 format films that it distributes, the quality of the sound system in the IMAX theater, the potential availability of Hollywood event films to IMAX cinemas through IMAX DMR technology and the level of IMAX’s service and maintenance efforts. Nearly all of the best performing large-format theatres in the world are IMAX’s.

In addition to existing competitors, IMAX may also face competition in the future from companies in the entertainment industry with new technologies and/or substantially greater capital resources. IMAX faces competition from a number of alternative motion picture distribution channels such as home video, pay-per-view, video-on-demand, DVD, and syndicated and broadcast television. IMAX competes for the public’s leisure time and disposable income with other forms of entertainment, including sporting events, concerts, live theatre and restaurants.

Furthermore, the out-of-home entertainment industry in general is undergoing significant changes. Primarily due to technological developments and changing consumer tastes, numerous companies are developing, and are expected to continue to develop, new entertainment products for the out-of-home entertainment industry, which may compete directly with IMAX’s products.

The motion picture exhibition industry is in the early stages of conversion from film-based media to electronic based media. IMAX is similarly in the very early stages of developing a digital projection system that can be utilized in IMAX theatres. Such risks could include the need for Imax to raise additional capital to finance remanufacturing of theatre systems and associated conversion costs, which capital may not be available to IMAX on attractive terms.

The commercial success of IMAX’s products is ultimately dependent on consumer preferences. The out-of-home entertainment industry in general continues to go through significant changes, primarily due to technological developments and changing consumer tastes. Numerous companies are developing new entertainment products for the out-of-home entertainment industry and there are no guarantees that some of these new products will not be competitive with, superior to or more cost effective than IMAX’s products.


Questions

1. Discuss the statement back in 1997: ‘It is too expensive and risky for us to put all our eggs in one basket and hire a major movie star.’
2 What are the main reasons for the failure of Imax Ridefilm?

3 Can IMAX's core competences be transferred to the marketing of high volume commercial products? Which types of product could these be?

4 What are possibilities of growing the IMAX business with the new IMAX MPX system combined with their new IMAX DMR technology, which enables Hollywood studios to digitally remaster their films into IMAX’s 15/70?
Heineken/Al Ahram Beverages Co. is eyeing the growing Islamic market with an ambitious plan to use its vast distribution network for a line of non-alcoholic, fruit-flavoured beers. As a first step Heineken, one of the world’s largest brewers, paid $287 million in October 2002 to buy Al Ahram Beverages Co. (ABC) of Cairo, the biggest financial deal in Egypt’s history. Al Ahram uses a special brewing process that yields no alcohol, thus allowing its malt beverages to be certified fit for consumption by Muslims, whose religion prohibits drinking alcohol.

Background
Modern Egyptian beer-brewing officially began 100 years ago. On 15 May 1897 the Crown Brewery Company (ABC’s oldest forerunner) registered itself in the Kingdom of Belgium – home of the well-known Stella Artois beer – to start operations in Alexandria. Two years later a different group of entrepreneurs from Brussels and Antwerp opened a brewery in Cairo, which came to be known as Pyramids Brewery. In July 1953 the Cairo brewery became known as Al Ahram (the pyramids) Beer Company.

Ten years later all companies traded on the Cairo and Alexandria stock exchanges were either nationalized or sequestered. Al Ahram Beer Company was first sequestered in 1961, then nationalized in 1963 when it was forcibly merged with the Crown Brewery Company of Alexandria.

This was the beginning of a state-run economy. Although contracts with the West slowed to a trickle and revenues were drying up under new public sector financial systems, Al Ahram Beer Company kept brewing beer and introducing new products including the Stella Export brand in 1967, created for foreign tastes.

Beginning in the 1970s the population of Egypt began to explode, and tourism became increasingly important. Demand for Stella beer grew with the crowds, foreigners and Egyptians alike, despite a rise in anti-secular sentiment throughout the Nile Valley.

In an attempt to counter these social trends and appease general sentiment Al Ahram Beverages (the company’s new name as of May 1985) diversified its production line and launched several non-alcoholic drinks including the non-alcoholic beer Birell, and Fayrouz, a malt-based apple/lemon-flavoured beverage. These new drinks complemented Stella beer in an increasingly diverse and competitive market. The introduction of two more soft drinks, Yusfino (mandarin) in 1993 and Citrino (lemon–lime) in 1994 further varied the company’s innovative product line.

Alcoholic drinks in Egypt
The alcoholic beverages market in Egypt, despite the large growth in values and volumes across all sectors and improvements in the quality of products available, is still characterized by unsatisfied demand. Unlike most other consumer markets, there are severe restrictions that thwart the development of this market in Egypt. Egypt is a Muslim country, with 85 per cent of the population practising Muslims. Islam condemns alcohol consumption and considers it a very serious sin. Even the Christian population, influenced by the general Islamic atmosphere, considers drinking alcohol a very bad habit, although they are not bound by religious law regarding consumption.

Shari’aa Law prohibits the manufacture and sale of alcoholic beverages or even being in the same physical space as those drinking alcohol. A regular drinker in
Egypt is seen as untrustworthy and particularly weak in terms of their desires. Hence, despite the significant number of drinkers, consumption usually takes place outside the family except in rare cases. Parents who drink tend not to drink in front of their children and children would consider it disrespectful to drink in front of their parents. So there is a great deal of discretion, sometimes amounting to secrecy, surrounding the buying and drinking of alcohol in Egypt.

Discretion is paramount when retailing alcohol. Most off-trade outlets operate in large open shopping malls or areas where the police are present. In fact some stores have police outside the front doors. This caution is due to the tension that flares up between Islamic groups and the government, the former tending to target such outlets as expressions of western influence on Egyptian society. Discretion is also used in order to avoid offending the large number of Egyptian Muslims who do not want to see alcohol being sold.

Retailers in more remote areas do not have access to the same level of security as their urban counterparts and tend to be very discrete about selling alcoholic beverages. These outlets usually sell such products only to known customers. If the owner does not know the person asking for alcohol, for example, they will deny that alcohol is sold in the store. This is because Islamic groups are known to attack shops selling alcohol.

The Egyptian government places its legitimacy on being a Muslim state, which derives its legislation from the Shariaa. However, it has never tried to prohibit the drinking of alcohol as it is a very lucrative business and has been a cash cow for the government. Duties on imports of alcoholic beverages are very high, at 300 per cent for beer and 3,000 per cent for wine and other spirits, making it almost impossible for someone to pay this duty. The tourism sector, however, which accounts for more than 30 per cent of national foreign currency earnings, is the main reason behind the government’s attitude and the overall social compromise regarding alcoholic beverages.

It is believed that Egypt’s competitiveness in terms of tourism would be harmed if alcohol was banned. Thus the state imposes these very high duties to prevent locals from buying alcoholic drinks, reserving them almost exclusively for tourists, who have access to duty free quotas of alcoholic beverages. The local population is denied access to such privileges, and this encourages black market trading, as high demand from those who do drink far outstrips supply. Current supply is hampered by limited local production and the limited supply of alcohol from duty free shops, and as such this market has huge gaps that have yet to be filled. As a result it certainly represents an opportunity for new players.

Dominant position in beer and wine
Local production has always dominated beer and wine sales in Egypt. The presence of prohibitive tariffs mean that off-trade purchases of such items are rather small compared to on-trade sales in tourist compounds and high-class restaurants. The general trend has been towards the monopoly of these particular products. In February 2001 ABC bought its only rival in beer and wine sales, El-Gouna Beverages Co., which accounted for 15 per cent and 40 per cent of beer and wine sales respectively. Thus ABC became the main producer of beer and wine in Egypt, accounting for around 98 per cent and 60 per cent of local production respectively.

ABC has an absolute monopoly of wine and beer sales in the absence of local rivals. The state also helps prevent foreign competitors from gaining a foothold as it imposes extremely high import duties on alcoholic drinks. Hence beer and wine account for the largest proportion of the total alcoholic beverages market in both volume and value terms. In addition, Egyptian consumers prefer low-alcohol percentage beverages to very high percentage products. This makes them preferable due to Egypt’s very hot climate. In volume terms, beer accounted for 96 per cent of the total market while wine accounted for 3.3 per cent. The rest was mainly accounted for by spirits, as neither flavoured alcoholic drinks or cider/perry demonstrated significant sales. Sales of these products were limited to the extent that they remained negligible.

Market expansion potential
Led by ABC’s monopoly, the market is expanding rapidly. Fuelled by the boom in tourism, which is growing by 11 per cent per annum on average, the market has a renewable source of consumers with high purchasing power. Most tourists drink alcohol in Egypt and they tend to drink rather heavily while on holiday. The year 2001 saw rapid development in this market. New products are being launched, and expansion of production facilities has also been rapid in response to the high unsatisfied demand. Expansion of outlets has also been increasing.

Over the past three years more than 150 outlets were opened or reopened by ABC. The company also operates a telesales system, which provides consumers with the discretion and convenience necessary in image-conscious Egypt, where many people do not want others to know that they are buying alcoholic beverages. The introduction of telesales has greatly boosted sales.

Beer sales are expected to grow by an average approaching 24 per cent per annum over the forecast period, while wine is expected to see average annual growth of more than 33 per cent. This will mainly occur as a result of growth in production, as demand is still
higher than the production capacity of the single company in this business. Foreign imports have no chance of penetrating the market due to the duties imposed on them, which place their products beyond the reach of Egyptian consumers.

**ABC also dominates distribution**

Retail outlets are undeveloped in Egypt. The majority are very old, owned by either Coptic or Greek families who have lived in Egypt for a long time. ABC is the only company to have really developed a sophisticated distribution network of specialized off-licence shops in Egypt. In fact ABC distribution network has been so successful that it accounted for the majority of off-trade sales over 2000–01. ABC expanded its outlets after privatization in late 1997 to reach a total of 150 outlets by 2001. Outlets are present throughout the country but are still restricted to the big cities. Their locations are well planned and the shops themselves are remarkably clean, unlike the old specialist shops, which tend to be very dusty and unpleasant.

**Legal restriction on sales**

Egyptian law is rather tough on drinking in general. It is a violation of the law to drink in public, and it is also illegal to be drunk in public. However, the police in Egypt are rather lax in the application of these laws with regard to the wealthy, and certainly do not apply them to tourists. Lower classes are usually the target of these laws.

**Al Ahram Beverages Co.**

ABC’s Pilsener beer brand Stella is almost synonymous with beer in Egypt. With a volume of 620,000 hectolitres of non-alcoholic malt beverages, particularly the promising malt-based drink Fayrouz, ABC is also the market leader in this segment. In addition ABC has wineries producing the brands Gianaclis and Obélisque that account for 85 per cent of domestic consumption. The market share of the spirits division is around 35 per cent while its soft drinks operations have a market share of 3 per cent. In 2001 ABC derived 52 per cent of its sales from beer, 29 per cent from non-alcoholic malt beverages, 11 per cent from spirits and wine and 8 per cent from soft drinks. Total net turnover in 2001 amounted to $105 million, operating profit to $30.8 million and net profit to $22.8 million. ABC employs 3,860 people.

**Heineken acquires Al Ahram Beverages Co.**

It is no secret that the local Egyptian economy is thirsty for foreign investment. Now, the biggest private sector acquisition in national history could be the thrust that stokes western investors’ interest in Egypt, which has been badly on the wane of late.

On 25 September 2002 Netherlands-based brewer Heineken bought up Al Ahram Beverages Co., whose shareholders agreed to sell 98 per cent of the local company at the $14 share price offered by the Dutch giant. This brings the total acquisition price to $280 million.

**Heineken**

Heineken has the widest global presence of all the international brewing groups, operating in over 170 countries and employing 40,000 people. In 2001 Heineken brewed a total of 105 million hectolitres of beer at over 110 breweries in more than 60 countries. In 2002 Heineken reached a turnover of approximately €10.3 billion. The net profits were €800 million.

The company’s main international brands are Heineken and Amstel. Amstel holds strong positions in a number of European and African markets and is as a rule positioned as a mainstream beer. In the United States Amstel Light profits from its good taste and the success of the light beer segment, which makes up more than 44 per cent of the US beer market.

In order to remain one of the top global brewers, Heineken focuses on a combined portfolio of local brands and international brands, first their flagship Heineken, but also Amstel and speciality beers such as Desperados and Murphy’s. This combination has enabled Heineken to achieve strong market positions and an efficient cost structure in many countries.

Heineken’s overall beer market share in the European Union is 14 per cent, in Europe 12 per cent, and globally it is 6 per cent.

**Heineken’s growth strategy in the Middle East**

ABC had long been considered the darling of the Egyptian privatization drive – a shining example of an uncompetitive, state-owned dinosaur turned into a star in the private sector.
Ahmed Zayat’s Luxor Group bought 75 per cent of ABC in February 1997. While maintaining the well-known Stella as its flagship label, the new management also introduced new brand names, delving deeply into the non-alcoholic beverage market with heavy promotion of Fayrouz.

Four years after privatization ABC bought out its only local competitor, Gouna Beverages, previously owned by Samih Sawiris’ Orascom Projects & Touristic Development. From that point Ahmed Zayat’s beverage empire held a 95 per cent market share in Egypt, while pushing rapidly into the Gulf countries on the basis of its growing non-alcoholic range.

Heineken was obviously impressed by ABC’s near domination of the Egyptian market within five years: ‘We believe this is a very good brewery with excellent management, and well equipped,’ Heineken spokesman Albert Holtzappel was quoted as saying in an Oxford Business Group bulletin, adding, ‘We think that the Egyptian beer market in the long term will be attractive.’

Heineken is hardly new to Egypt. The Dutch brewer owned part of ABC before it was nationalized in 1963. For Heineken the deal is part of a larger strategy – to secure a dominant market share in the Mediterranean region and Africa.

A different kind of investor
Regional political frictions have led many foreign investors to avoid pumping money into the Middle East market altogether. This is not the case for Heineken.

Since the outbreak of the second Palestinian intifada in October 2000 and the attacks of 11 September 2001, the Middle East has been hit hard, with foreign investors pulling out of the region ‘in droves’. ABC was – as were most Egyptian companies – badly bruised by these events, with its stock price falling below its 1997 Initial Public Offering (IPO) price.

Major multinational brewers, for their part, began to recognize the potential of a well-run beverage monopoly in a market of 65 million – within striking range of Africa and the Middle East. Heineken, along with Belgian Interbrew and South African Breweries, expressed interest in ABC.

ABC officials do not anticipate drastic changes to the company’s local operations as a result of the takeover. ABC products, they assured, would continue to be marketed under their existing, regionally recognized brand names. ABC’s 3,860 employees, meanwhile, will keep their jobs, according to ABC’s corporate communications director Hala Al-Khatib.

Still, Egypt’s opposition press, notoriously distrustful of the privatization process and of foreign investment, were satisfied with the deal. The newspaper Al-Neba Al-Watany went so far as to suggest that Ahmed Zayat should buy other loss-making Egyptian companies and reform them, too.

Questions
1. In what circumstances would acquisitions be an advantage to Heineken, compared to ‘greenfield’ investments (use Chapter 12 as a starting point)?
2. Will Heineken’s acquisition of ABC help with selling more alcoholic and non-alcoholic beverages in Egypt and in other international markets?
3. Is Heineken’s acquisition a good strategic move from Heineken’s viewpoint?
4. If you were a consultant for Budweiser would you also recommend Budweiser to select acquisition as a main ‘entry mode’ in the Middle East? If not, which entry mode would you recommend?