Strategis Partners White Paper

International Business Ventures

How to improve the odds of success

Building Successful International Businesses

For executives planning international business ventures this Paper describes how to improve the odds of success—using the tools of scenario planning and the insights of strategy and organisation economics

INTRODUCTION

In 2006, Kodak's chief executive called for a less "western-centric" approach to doing business in Asia after the US imaging company misread how quickly Chinese consumers would embrace digital technology.

Initially, Kodak had forecast continued growth in sales of traditional film canisters in markets such as China and India. The US Company had hoped this would cushion the impact of losing this highly-profitable business when customers switched more rapidly to digital cameras in Europe and the US. But consumers in China quickly adopted digital photography. In June 2005, Kodak accelerated plans to phase out its traditional film business – in part due to having underestimated the rapid decline of film in China.

Today Kodak is re-framing its world-view, acknowledging that its biggest consumer markets are increasingly a long way from the home base.

International business ventures (IBVs) face many barriers to success, not the least being the "mind-set" barriers that Kodak had to deal with in interpreting consumer responses in different cultures.

If new market entry is a challenge in domestic markets, in foreign markets it is doubly difficult. As a result firms entering markets abroad require new frameworks and capabilities to complement their core resources that drove success in the home market.

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This paper addresses three interrelated questions. Firstly, why is success harder to achieve with international business ventures? Secondly, how can the batting rate be improved? Thirdly, what is the process for building a profitable venture?

WHY IS SUCCESS SO HARD TO ACHIEVE WITH IBVS?

International business involves a different set of "rules of the game"; as a result the "home bias" undermines effective decision making on international ventures; and unavoidably transaction costs are higher in establishing and operating IBVs. Let's look at these in turn.

International business involves a different set of "rules of the game"

The rules of the game are the cultural, legal and regulatory constraints that shape business interactions

The rules of the game are the cultural, legal and regulatory constraints that shape business interactions. Cultural differences include, for example:

- The level of hierarchy accepted in business differs from country to country
- The importance of the individual versus the group in social and business situations differs
- The wide differences in the roles of women in business
- The tolerance for ambiguity; some cultures can cope with change and uncertainty easily, while others demand stability
- Some cultures emphasise perseverance and planning for long term success while other focus on short term results.

International entrants face the disadvantage of "foreignness." Customers tend to discriminate against foreign firms, sometimes formally and other times informally. Fundamentally, trust is lower between partners that are culturally distant.

Failure to recognize these different rules can cost foreign firms dearly, so foreign entrants need to learn new "rules of the game" in host countries to overcome the liability of their non-native status.

The importance of relationships

In countries with a weak legal system strong personal ties (also known as "relational" contracts), serve as viable substitutes for formal legal contracts. The role of relational contracts is to utilize the parties' detailed knowledge of their situation to adapt to new contingencies as they arise.

Strong personal ties between firms not only provide trust and predictability—and consequently low transaction costs—but also facilitate cooperation when facing environmental change. However, strong ties take time and effort to build and are often constrained with limited size that one person or firm could manage, thus reducing the potential transaction opportunities with other firms.

For example, Guanxi or interpersonal relationships is one of the major dynamics of Chinese society. A pervasive part of the Chinese business world for the last few centuries, it binds literally millions of Chinese firms into a social and business web.

Any business in this society, including local firms and foreign investors and marketers, inevitably faces guanxi dynamics. In China's new, fast-paced business environment, guanxi has been more entrenched than ever, heavily influencing Chinese social behaviour and business practice.

The "home bias" undermines rational decision making

There is little doubt that a company's "shared mental models"—cognitive processes employed to make sense of the world—are strongly influenced by the cultural traditions which are forged in the home market.

The Kodak mis-judgement described on page one illustrates that cognitive bias—systematic errors in the way decision makers process information—can wreak havoc on international market success. In Kodak's case what was needed was a judicious, deliberate re-framing of the company's view of the world "outside."

A range of biases come into play

In estimating the key metrics for the international venture—capabilities needed, market size, potential competition, time to launch, market share, revenue and costs—a range of biases come into play, for example:

We are overconfident. We are often blind to the limits of our expertise, and so a manager believes that an outcome is more certain than the facts would suggest. The costs of miscalculation driven by excessive optimism can be large. For every success international venture, at least four will fail.

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We anchor in the status quo. Our tendency is to adjust insufficiently from an initial position in the face of new information. When we are faced with two competing bodies of evidence concerning something important, this tension can cause us to reject or misinterpret one body of evidence in favour of our initial position.

Organisational decision making biases run deep

Organisations tend to favour "safe" projects rather than innovative projects because the evaluation of the former is easier. By their very nature, IBV projects are innovative; in other words:

Risky. There is a high risk of failure, but also prospects for extraordinary pay-offs in international ventures
Uncertain. Many contingencies are difficult to foresee
Long-term. There are often numerous stages of development
Knowledge intensive. The effort and motivation of specific individuals is crucial
Idiosyncratic. The comparability of specific international projects with other projects is low.

In the face of these challenges, long-term commitment to international ventures is paramount. As Mark Twain said, "we should be careful to get out of an experience only the wisdom that is in it—and stop there; lest we be like the cat that sits down on a hot stove lid. She will never sit down on a hot stove lid again—and that is well; but also she will never sit down on a cold one."

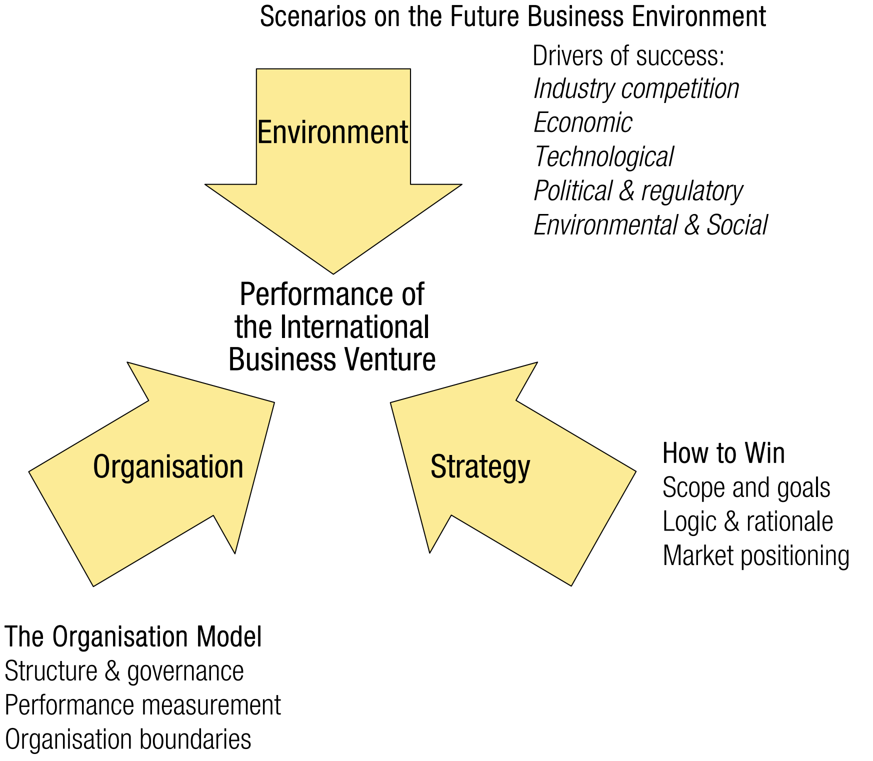
Transaction costs are higher in IBVs

IBV transactions typically face higher costs compared with establishing and running domestic ventures. Firstly, there is the time and effort expended on cross-border business development and relationship building with foreign parties, and the extensive negotiation and contracting costs. Secondly, once an agreement has been reached, monitoring and enforcement costs come into play.

IMPROVING THE SUCCESS RATE OF IBVS

The framework for crafting a successful IBV (Exhibit 1) is based on an understanding of the future business scenarios, the organisational model options, and the strategic rationale on how to win. By achieving an alignment between the business environment and the strategic and organisational choices, the odds of success can be improved.

Exhibit 1 – Building blocks of successful international ventures



Scenarios on the future business environment

Scenarios aim to stretch thinking and question assumptions.

International market developers face profound and persistent uncertainty. The natural inclination of managers is to work from what is known. Scenarios force managers to look at what is not very well-known, and what cannot be controlled. Importantly, they help planners think about the larger picture. They aim to stretch thinking and question assumptions. In so doing they help managers overcome decision making biases, open up new frames of reference, and so lead to more robust strategies.

Scenario planning helps in the construction and testing of IBVs in three ways. Firstly, scenarios provide a framework and process for thinking about change, uncertainty and opportunity that lies in the foreign market. It's an “outside in” approach of understanding the future environment.

Secondly, by educating decision makers about the different ways in which the foreign market might unfold, it can help them to better prepare their venture to respond and adapt. It's possible to challenge conventional wisdom constructively, and enable executives to consider a variety of possible futures. In an uncertain world, strategy is really about creating options and opening up new choices.

Thirdly since the future success of the international venture cannot be predicted with certainty, scenarios help the company adjust course in the light of events. The better the scenarios, the less frequent these surprises will be and the more successful the strategy.

Strategic factors driving success – how to win

A well formulated strategy has several components:

Definition of the goals, and how success is measured. This might be shareholder value maximization, or it might be something more complex involving the interests of different stakeholders. Even when shareholder value is the ultimate objective, the strategic goal might be expressed in more operational (and more motivating) terms; For example "beat the biggest incumbent."

Definition of the scope. This includes a specification of the business that the firm will develop, what products and services it will offer, what customers and market segments it will serve, what activities it will undertake, where it will do these things, and what technology it will use. Most importantly, the scope of the strategy determines what opportunities the firm is *not* going to pursue.

Specification of the firm's competitive advantage. It is an indication of how the firm's offer will lead others to deal with it on terms that allow these to realize its goals.

Strategic rationale. An explicit analysis of why the firm's competitive advantage will actually be realized.

Five strategic factors shown below drive successful foreign market entry:

Five strategic factors drive successful foreign market entry

Size of entry relative to minimum efficient scale. Companies that are closer to minimum efficient scale upon entry are more likely to succeed

Relatedness of the market entered. The more related the new market is to a company's current portfolio of products and services, the greater the chance of success

Complementary assets. Core assets and capabilities are important when entering a new market. However, complementary assets such as marketing and distribution, and business relationships, are often more important than core assets, such as technological know-how.

Industry life cycle stage. Companies entering early in the international market's life cycle have greater chance of success than those entering in the mature phase

Degree of insider understanding. When a high level of "inside" industry knowledge is necessary, incumbents have a major advantage over new entrants.

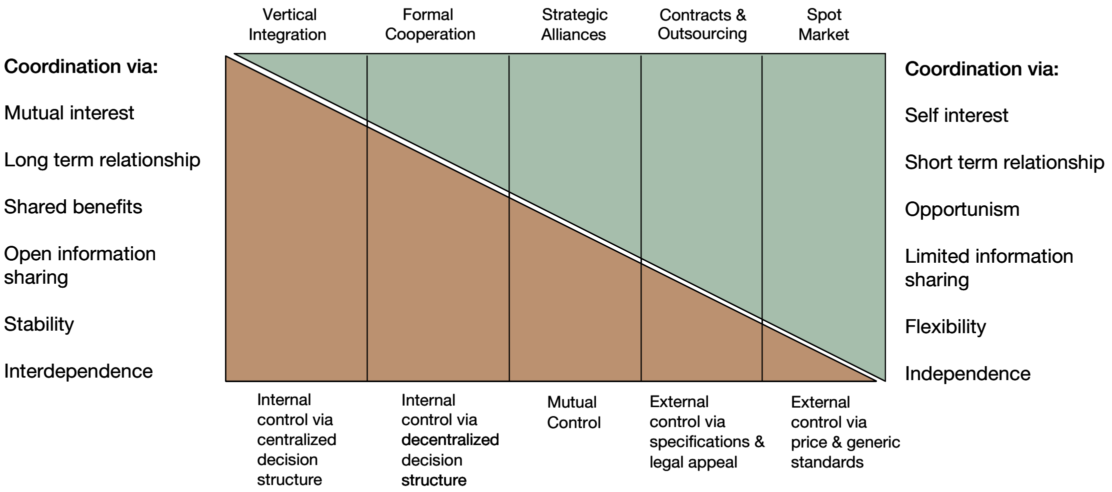
Designing the organisation model for the IBV

In embarking offshore, the nature of the hazards faced in the foreign market should drive the design of the organisation model. For example if uncertainty about market conditions is the critical factor, the organization model should be designed in such a way that it maximizes the company's ability to reduce uncertainty. This might be achieved by an alliance or joint venture to access know-how and information residing in a local company.

In embarking offshore, the nature of the conditions and hazards faced in the foreign market should drive the design of the organisation model

A variety of organisation models are available to govern an international venture (Exhibit 2), each with different means of coordination and control.

Exhibit 2 – There are a range of models of organisation



Choosing between the models of organisation

The choice of models range from a fully integrated organisation, through to arms-length, short-term transactions.

For the vertically integrated organisation, coordination of the venture and its assets is controlled centrally and unilaterally.

Between the two poles of vertical integration and spot markets are hybrid models of organisation. The "formal cooperation" model in Exhibit 2 includes organisational forms such as joint ventures or joint ownership relationships between a foreign and domestic company. The distinguishing feature is the presence of a formal organisation that has an identity distinct from the two owners, and that is designed to be their joint agent in business dealings.

The strategic alliance in Exhibit 2 is a relationship with the following three characteristics: mutuality in objectives, mutuality in controlling decision making processes, and mutuality in sharing risks and benefits.

The next step along the Exhibit 2 continuum, "contracting and outsourcing" is based upon legally enforceable contracts involving establishment of specific and detailed conditions of exchange.

The last form in Exhibit 2 involves arms-length, short-term transactions—where the good or service is generic and identities of buyers / sellers are immaterial to the transaction.

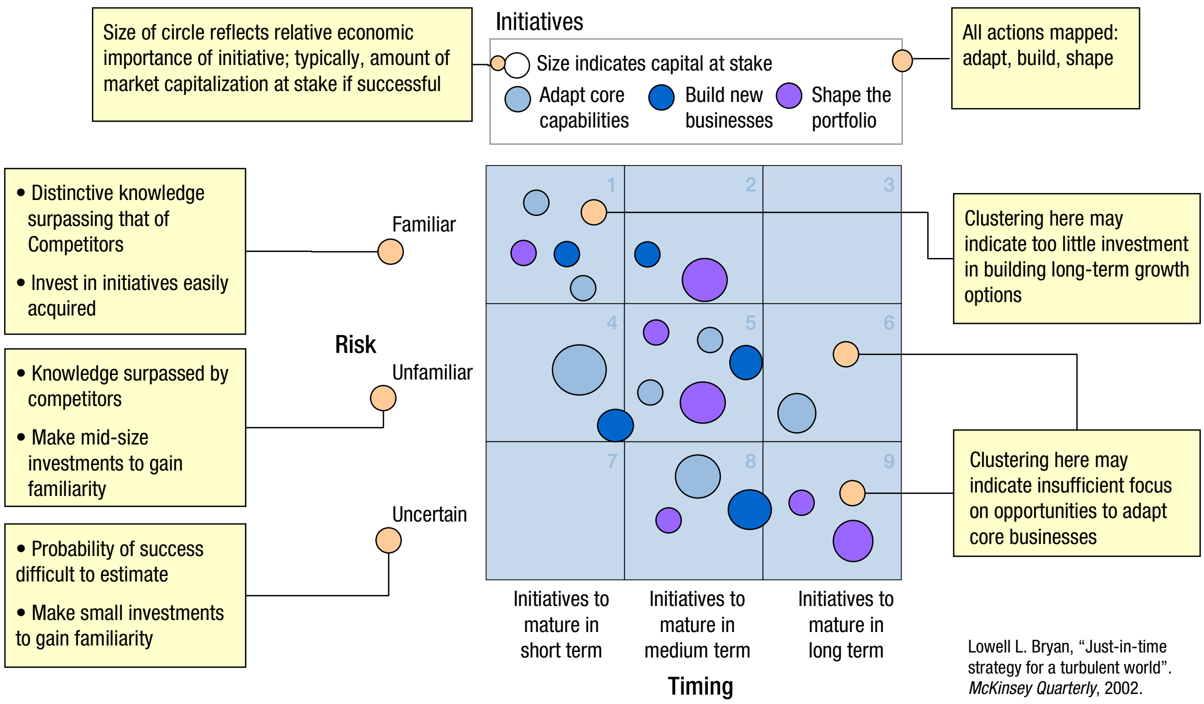
Whereas U.S. firms rely largely on market and hierarchical organisational arrangements in dealing with their suppliers, Japanese firms rely mainly on hybrid forms of governance to manage the high degree of co-specialisation that exists between firms. Some Japanese automakers pay for consultants to work with suppliers to improve production methods. For example, after Honda chose Donnelly Corporation as its sole supplier of mirrors for its U.S.-manufactured cars, Honda sent engineers over the two Donnelly plants, scrutinizing the operations for kinks in the flow. Honda hopes Donnelly will reduce costs about 2% a year, with the two companies splitting the savings.

THE PROCESS FOR DEVELOPING STRATEGY FOR IBVS

At the core of IBV strategy is the development of a "portfolio of initiatives" (Exhibit 3 following). They can include:

- Investments in projects and real options that are robust against the range of scenarios. Decisions include the acquisition or exercise of real options such as options to defer a resource development; options to accelerate the strategy and / or scale up faster in response to better than expected conditions
- New capabilities which are needed, and existing capabilities which need updating
- Initiatives to increase speed of adjustment and flexibility
- Changes in the nature of the dialogue between key stakeholders – customers, investors, policy makers, regulators, and so on
- Formation of new alliances and partnerships.

Exhibit 3 – Designing the portfolio of initiatives



Lowell L. Bryan, "Just-in-time strategy for a turbulent world". *McKinsey Quarterly*, 2002.

Such initiatives may be implemented over different time frames: short term (next two years), medium term (three to five years) and long term (five years and beyond). Exhibit 3 contains a matrix which shows the economics at stake, the risk level of the investments, and the time horizon until each initiative matures.

CONCLUSION

Understanding and managing strategic risks in international ventures has never been more important in this era of globalisation. When advantage lies mostly in the unknown and the uncertain, the ability to sense and learn faster, to correct mistakes, and to embrace uncertainty as a source of advantage, become absolutely essential.

For executives directing international business ventures, the frameworks described in this Paper are valuable aids to build resilience into international initiatives. Within the management team, they can foster openness to new ideas and different perspectives, and can help re-shape core planning assumptions before they become outdated or just plain wrong. Key success factors are uncovered, leading to an enhanced ability to succeed with international business ventures.

About the Author

Jay Horton, Founder of Strategis Partners, is recognised as a leading adviser to companies and Governments on a wide range of strategic business issues, including scenario planning, innovation, value chain strategy and organization.

During his twenty year management consulting career, he has worked with clients in Australia, Canada, Japan, Hong Kong, Indonesia, New Zealand and Singapore.

Jay has played a range of leadership roles:

Partner of PricewaterhouseCoopers, leading their Applied Decision Analysis practice in the Asia-Pacific

Founder and Managing Director of decision consulting firm ORG Pty Limited

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