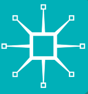

Adriana Calvelli · Chiara Cannavale

# Internationalizing Firms

## International Strategy, Trends and Challenges

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# 3

# Market Entry Strategy

## Introduction

Several authors have dealt with the problem of understanding what factors are most important in evaluating a market. Industrial economists place more emphasis on external factors, recalled in Hymer's theories, in internalization theory, and in institutionalist theory. In Dunning's approach as well, exogenous factors play a key role in choosing the market to invest in if one considers that that the advantages of location are, along with ownership advantages and the benefits of internalization, the essential condition for profitable FDI. Scholars closer to the strategic perspective, influenced by the resource-based approach, instead place greater emphasis on internal factors that, in the Uppsala school's evolutionary approach, become essential to evaluating and increasing the involvement of firms on foreign markets. The contemporary perspective based on strategic management constructs, and therefore the need to combine internal analysis and external analysis and the necessary consistency between these and the market-objective features, does not reduce the importance of exogenous factors in urging internationalization—factors that seem to affect not so much the choice of whether or not to invest in a given

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market, as rather the decision on how to invest and thus how to follow (Calori et al. 2000; Couturier and Sola 2010).

As is often the case, reality is more complex than theory, and companies, in choosing to internationalize, are guided by a mix of motivations arising from the desire to best exploit internal and external factors. Internal motivations include many of the determinants identified in the framework of the previous chapters: the desire to acquire global leadership rather than to protect particular resources, or to exploit particular cognitive resources originating from the cumulative wealth of the enterprises which—by identifying new business opportunities rather than the ability to consolidate their image or reach a global dimension through FDI in a particular marketplace—decide to expand their boundaries. Internal factors therefore reflect the presence of exogenous factors that represent unmatched opportunities for the enterprise (supply voids, access to knowledge or technology resources, reduction of entropy risk, possibility of increasing the efficiency of some value chain activities) in a virtuous circle that sees the interaction between interior and exterior as the element that best represents the reality the enterprise is dealing with.

Internal motivation/external factors also affect the choice of entry mode. While companies often pursue composite goals that simultaneously operate in different ways in different markets, it is possible, seen from the perspective of simplification, to sketch some of the main motivations that drive businesses to move towards a trade that is more international than productive (Saviolo 2008). Compared to the first option, the main reasons lie in the following: the desire to increase sales volumes; the ability to reach a global dimension out of a desire to diversify market risk; the ability to increase profit margins by selling at higher prices; the need to discard stocks of finished products; and the ability to act as first mover on a new market. Compared to the possibility of adopting a pre-emptive strategy, the benefits generally accorded to the first entrant are greater opportunities to raise the loyalty of local clients, the ability to access scarce resources, the ability to leverage resources for higher returns, and the ability to create stable relationships that increase switching costs for local partners.

However, being the first mover exposes the enterprise to a number of disadvantages that need to be carefully evaluated. They are high market exploration costs, bearing costs for problem solving (dealing with foreign

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market analysis and finding the most appropriate solutions), and uncertainty regarding the intensity and conditions of demand (which may delay the timing of the investment). In general, however, empirical evidence shows that, when well designed, the pre-emptive strategy offers businesses a better chance for survival.

The second option, however, is generally linked to the following determinants: the ability to take advantage of work-related benefits, access to particular productive resources, proximity to outlet markets, and access to different cognitive and technological resources. Synthesis, and therefore motivation, can be linked to achieving higher levels of efficiency or to the need for technological learning.

## The Main Steps of International Expansion

The planning of an internationalization strategy is based on an analysis process aimed at identifying target markets, assessing the opportunities and threats that characterize them, and identifying the most appropriate entry mode. It is a complex process that must combine the resources and skills that the company has with the opportunities and threats that characterize the target markets.

Reflecting the strategic management model, the planning process has to proceed through stages, identifying opportunities and threats that characterize the macro environment, and then defining the extent of the forces of the competitive environment that would affect the enterprise's business on that market. The study of the external environment, consistent with resource-based assumptions, goes hand in hand with analysis of the resources and skills that the enterprise has or can acquire to ensure success in the new reference market.

The analysis process is not always simple; on the contrary, the sources that the company has available are often varied and unevenly coherent, especially when the interest concerns emerging or difficult markets. It is in this perspective that management market skills become key: the ability to understand the value of acquired information and to understand what utility (applicability) it has in the specific enterprise is a sine qua non for the strategy's success.

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Foreign market analysis cannot be considered a linear and standardized process: psychological distance, the gap between the home and host market's development levels, language barriers, and the socio-institutional context of the country of destination are all factors that strongly affect the difficulty and intensity of the analysis. It is, however, a fundamental moment in strategic planning even if the choice of internationalization derives from the emergence of spot opportunities for the enterprise. Those who do not acquire adequate knowledge of the target market may not understand the threats they face or even the barriers that can limit the attractiveness of these markets. In many cases, non-planning firms rely on intermediaries who, by pursuing their own goals, do not always serve the business's interests. In even worse situations, companies that do not learn often make the mistake of channelling their products, with negative impact on their brand placement.

This is the experience gained in Germany by many Italian pasta companies that entrusted their products to large local buyers, available mainly online, and also at low prices given the strong economies gained by purchasing the products from the producer; these companies sold pasta in medium-low market segments, in fact undermining the craft production of small Campanian pasta makers, or even the functional value of those making "special" pasta (lower sugar content, organic, etc.).

**Some Evidence in the Italian Pasta Industry**

In 2011, a major German chef wanted to find a quality Campanian pasta to be promoted in Germany and sold through a distribution network of specialty products. Having come to Italy often, the chef was acquainted with some well-known brands in the Gragnano area, which, however, being already established in the distribution channels and therefore known to the German public, would hardly be accepted by consumers as specialty products.

Research then focused on small craft pasta makers, products distributed in Italy through special channels and still not mass-produced. This research led to the identification of some valuable brands from Torre Annunziata and Gragnano; nevertheless, not even in these cases did the deal prove feasible. The problem, in all three cases, concerned neither the product's high and certified quality, nor the quantity or condition of

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the supplies, for which the German distributor was rather flexible. The Campanian enterprises, in theory, ticked every box for success on the German market, but a problem, neither insuperable nor unexpected by pasta enterprises, did not allow negotiations to be concluded: firms that in the past had entrusted the selling of their products in Europe to buyers or trading companies realized that their brand was, in the online food portals quite widespread in Germany, lumped together with significantly lower-quality pasta, in many cases destined exclusively for export, and also of non-Italian origin. Association with these brands and the spread of online products made it impossible to quickly reposition the products.

Businesses also proposed launching a brand new for the German market, but lack of planning and inability to control the market worried potential German partners, which decided not to conclude the deal.

*Source*: Our desk analysis

The literature agrees on the main moments in the strategic analysis process, which essentially concern the following (Hill 1994; Hodgetts et al. 1994):

1. Identification of target countries. This is an exploratory phase in which the company verifies the presence of a potential market for its products abroad. Through exploring opportunities and risks in potential markets, the company identifies its potential reference market. It is a phase of analysis focused on the external environment and intended to check the presence of barriers or risks that could reduce potential cross-border opportunities.
2. Once the set of potential target countries has been defined, the firm will have to decide on the specific area in which to implement its strategy. This requires the company to carefully assess the potential and specific risks of the individual markets and the degree of attractiveness of its business. Macroeconomic analysis will therefore aim at assessing the impact that individual macro-energy forces have on business activities and will be complemented by careful analysis of the competitive environment by identifying competitors (direct, indirect, and potentials), the characteristics of demand, and the contractual strength of

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suppliers. The company considers economic, social, and geographic indicators, which look for and evaluate the type of investment it intends to carry out in the country (simple sale of products, realization of commercial FDI, production relocation processes, etc.). Economic indicators (e.g. GDP, per capita GDP, unemployment rate, and inflation) yield information on the country's current economic phase, consumer buying capacity, low labour costs, the role of the state, and the presence of laws hindering or facilitating investment. Socio-demographic data, on the other hand, elaborate a picture of potential consumer/worker profiles in the country. Although this is only a summary analysis, it can be of use for understanding the stratification of the population, the presence of certain segments of interest to the enterprise (consider products that require particular levels of literacy or that are directed to particular age groups), the level of qualification of labour, and so on. Significant information is also obtained from geographic data: the country's morphology, the presence of transport networks, or, conversely, the lack of infrastructure may make investments in some areas inefficient or, in the case of an export, may require addressing local intermediaries as still takes place today in several republics in the Commonwealth of Independent States.

3. Having narrowed the set of target markets, and before starting the entry process, the enterprise must be able to quantify or at least estimate the major risks that characterize them. It is difficult, in fact, to establish a chronological order between this phase and the previous ones; Simply put, it may be asserted that while at the first moment of analysis the available country risk data and investment risk are considered useful data already narrowing the scope of analysis; but once the potentially more attractive markets are selected, the company will need to deepen the level of risk analysis by identifying the impact that financial variables, as well as political and social ones, may have on their specific business. An initial major assessment concerns the country risk that may have important repercussions on the profitability of the investment, the ability of local debtors to honour their debts, and the company's ability to recover over time the investment that was made. Although risk assessment is generally assigned to specialized institutions, it is useful for management to understand the

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factors underlying country risk, which is one of the basic elements of the analyses carried out by consulting firms and institutions interested in supporting internationalization processes of enterprises. The intensity of country risk as a wider case of counterparty risk is obviously amplified in those countries that do not have regulatory and financial institutions able to protect foreign creditors. Consider, for example, the possibility of a country being exempted from the obligation to comply with contractual clauses, or the hypothesis in which a contract contains clauses in breach of current law that are therefore null and void for local law. Situations of this kind create daily problems for businesses, especially small ones, that export to international markets, and can only be reduced a priori, through adequate analysis of the regulatory system and, hence, through identification of clauses referring to the rules in force or establishing the use of international arbitration (obviously in the signatory countries of the conventions on the subject). Country risk assessment comes on top of the assessment of financial risks associated with internationalization. These risks, in the simplest assessments, are related to exchange rate trends and to the possibility that the presence of economies administered or the impossibility of using some payment instruments will increase exposure to price risks. In any event, the risk assessment does not generally aim at the a priori exclusion of a given market. In order to reduce entropy risk, companies do not aim to exclude some markets to the benefit of others, but, in order to minimize the risks, seek the ways most appropriate for the specific characteristics of individual markets.

4. After the process of analysing and defining the target market, the company goes on to evaluate the most suitable entry mode into the given market. In the first case, the firm will have to decide whether to limit its presence on foreign markets to commercial activities or, on the contrary, to adopt production relocation processes. It is at this stage that the goals the company intends to pursue through internationalization—as well as the resources available to the process—take priority. The greater the involvement of upstream activities, the higher the internationalization risk, and the greater the focus on the choice of ways to ensure an adequate level of efficiency without exposing the

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enterprise to the risk of losing control over important sources of competitive advantage.

Having identified the most appropriate development path to meet the company's specific needs, the country will then have to evaluate the most convenient and appropriate operational solution to achieve the intended objectives. For example, in the case of internationalization, management should assess the possibility of limiting itself to an export activity rather than the design of a franchise network or the creation of a commercial investment; in the latter case, it will have to decide whether to build a new network, acquire a local competitor, or still opt for a strategic partnership. Each solution has potential advantages and criticalities: limited investments often have fewer opportunities to control the sources of competitive advantage and even fewer learning opportunities, which plausibly precludes transition to a more profitable presence on the foreign market.

Generally, the choice between alternative entry modes is carried out by evaluating the following points (Couturier and Sola 2010): potential demand; consistency between demand (or sales conditions) and product; investment of resources; and flexibility.

The presence and magnitude of potential demand does not only affect the choice of whether or not to export to a given market; on the contrary, it can be an essential element in choosing whether or not to make a productive investment, given the possibility that the plant's output is more or less easily located on the foreign market.

The second element concerns the greater or lesser consistency between the product offered and the characteristics of demand (culture, institutional barriers, packaging, certifications). This factor directly affects the choice of direct and indirect exports: if there are too many barriers to the entry of products, especially for smaller companies, the choice of turning to a local intermediary often becomes a compulsory path to take. It may also impact the realization of a productive investment and, more particularly, the choice between managing one's own premises and collaborating with local partners, who will more easily access the information needed to overcome the barriers. Among other things, as has happened to

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Japanese automotive companies and, as is the case in many agri-food sectors, the presence of tariff barriers frequently does not drive companies to the creation of FDI rather than to international trade.

As far as resources are concerned, these are a central element of choice. The term "usable resources" does not exclusively connote those owned by the enterprise, but also those easily acquired—yet also easily integrated into the enterprise. In general, limited resources—but also the desire to reduce the risks resulting from the excessive involvement of resources—drive companies to use collaborative rather than competitive modes.

The willingness to employ resources also depends on the estimation of the gap between desirable and achievable results, also in light of the contractual strength of horizontal and vertical competitors (presence of direct competitors, degree of supply concentration, distributor power, distribution network quality, logistical difficulties, supplier bargaining power, imbalance in the aggregate value chain, etc.). The example outlined earlier in the text clearly clarifies the value of this gap and the impact it may have on future business choices.

Flexibility of choice: as anticipated with regard to the internationalization strategy, the strategic asset must be carefully evaluated in order to avoid a subsequent rethinking of it, which would expose the enterprise to high investment or re-conversion costs. Variety and environmental variability require the enterprise to preserve flexibility as much as possible, and this is even more the case in less advanced markets where sudden political changes, economic and financial shocks, and natural events can quickly change demand conditions and affect the productivity of the supply. It is then necessary, at the same level of control over the strategic importance of activities and the management of key relationships with context stakeholders, for companies to show preference for collaborative, more flexible modes, over competitive modes.

Generally speaking, some empirical analyses have shown that, as a rule, involvement in foreign markets grows along with intensity of demand, the international experience of the enterprise, its size, and the level of economic development of the target country, and that, conversely, it decreases the cultural and political distance between the country of origin and the country of destination (Reddy and Naik 2011).

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### Case X

The German company X is a diversified enterprise which, while an agri-food enterprise at the beginning of the twentieth century, operates today in the following sectors: food, beer and soft drinks, sparkling water; wines and liqueurs, shipments, hotel, and financial services.

The case concerns the food products division and, more specifically, the food service segment focusing on food sales to restaurants, hotels, school canteens, supermarkets, and other retailers. In 2007, the sluggish growth of the domestic market led the company's top executives to implement an internationalization strategy aimed at affirming the HoReCa segment in three main markets—Italy, Poland, and the United Kingdom—already characterized by a good brand affirmation.

Once the target markets were identified, the leadership had to decide on the most appropriate entry modes, based on process planning with regard to some key issues:

1. What are the main factors that could affect the company's success on the market? These included a similar assessment of factors such as market size, demand segmentation, competition structure, and the relationship between the actors in the supply chain.
2. What are the key factors that could drive the enterprise to success? What is the ultimate likelihood of success for a new operator? This question is obviously linked to the previous one but more specifically focuses on assessing the presence of a possible supply void, or any niche in which the operator can be established. It is therefore connected to the consistency between the products offered and the characteristics of demand, as well as the presence of special facilities or, on the contrary, institutional barriers to the entry of new businesses.

Enterprise X has developed three specific analyses to evaluate the most suitable entry mode for each of the three specific markets.

Starting from the United Kingdom, the UK food service market is the largest in Europe and is characterized by the second largest growth rate—at any event the highest rate among the four countries considered (Germany, Italy, Poland, and the United Kingdom). Applying the Compound Annual Growth Rate model, the company estimates an average growth rate of 3% to 4% over the next few years. The Italian market is smaller than that of the United Kingdom but is attractive for its high rate of growth, which should be estimated at around 8%. Lastly, Poland is by far the smallest of the three markets, with a turnover of 2 billion (against 28 billion in Italy and 31 billion in the United Kingdom) and a growth rate

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of under 3%. Growth rate is the most obvious difference between the various markets; food habits—although the specifics of the different cultures present, in fact, some important homogeneities—are linked to the tendency to eat out and have smaller families, as well as to the need to consume quick and easy meals without renouncing food quality. From the point of view of product adaptation, Italy and the United Kingdom, which have a strong propensity towards quality and specialty foods, have the greatest potential, given that within the company's product range, 75% would require no adaptation.

The competition analysis highlights three main categories of players:

1. Food producers Unilever Bestfoods, Nestle, Masterfoods, Danone, McCain Foods, Kraft Foods, HJ Heinz, Cadbury, and Barilla are all considered the main industry players.
2. Other regional companies, for most specialized and limited production product lines.
3. Distributors, and hence wholesalers, which offer a wide range of products and services; Cash and Carry, which mainly supply small restaurants and are threatened by large chains of organized distribution; direct sellers and retailers.

As for direct customers, these are essentially represented by business operators (hotels and restaurants) and institutional operators (school, canteens, hospitals, personal and public administration facilities). Although the structure of the three countries is similar, there is a markedly different level of concentration of competition and contribution by actors to value creation. The majority of this sector is run by a small number of market leaders.

In the United Kingdom, the acquisition of a producer was considered the most appropriate solution. The market's high level of competition required, in fact, choosing a method that would make it possible to enter the market quickly. For the same reasons, greenfield investment was discarded, while the possibility of a partnership with local distributors was not considered optimal given the risk that, thanks to increased knowledge and greater market control, the latter would develop opportunistic attitudes that might eat into the German company's margins.

The acquisition target was found among 60 small- and medium-sized local manufacturing companies. The criteria behind the choice were the range of products offered, the features of the covered segments, the market resources and logistics network, geographic coverage, and the potential for cross-selling with the retail business.

Conversely, in Italy, analysis has led to the choice of a greenfield investment, but gradual and planned, with a reduced sales force to increase over

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time. The choice was justified by the lower intensity of competition, the greater market fragmentation, and the lack of distribution. In Italy, distributors and producers are still relatively small and the market is growing, faster than in other European countries.

Poland had a complex situation: an estimated Compounded Average Growth Rate (CAGR) of less than 3%, but high potential linked to the plausible increase in per capita income. A small number of multinational producers control 50–60% of the market, and several medium-sized wholesalers are undergoing a consolidation process. Finally, in contrast with the other two countries, only 30% of the catalogue was likely to be sold without alteration. The German company therefore opted for a partnership with a well-established regional wholesaler on the Polish market. This option was preferred for a better understanding of Polish market potential over a relatively short period of time and limited strategic risk. An acquisition would have been too risky given the uncertainties of the market and the institutional context.

*Source*: *Our desk analysis*

## Choice of Entry Mode

In implementing an international growth strategy, a company can choose among different modes of strategic action by setting up competitive relationships and collaborative relationships with other market players.

Competitive relationships are essentially the result of the development within the company of all those activities aimed at improving their position on current markets or new outlet markets. Increasing resources and expanding knowledge can be achieved through:

- internal development, implemented through the company's know-how and knowledge deployment (acquisition of technology and technology, recruitment of specialist managers and new staff);
- external development, achieved through the impacts of non-possessed knowledge (technological, market and general management); cases arise from the acquisition of companies that possess complementary or synergistic knowledge, acquisition of suppliers (vertical upstream integration), or business customers, distributors, and downstream

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manufacturers following the implementation cycle in the company (vertical downstream integration);

- collaborative relations coming to fruition in cooperation agreements (or strategic alliances) between companies that, while retaining their decision-making autonomy, decide to cooperate in order to:
  - exploit the cognitive asymmetries of the parties to the agreement through the use of specific technological, market or production complementary knowledge (asymmetric or, as Porter claims, type X alliances);
  - create synergy in the results (synergic alliances or Porter type Y) through the joint operation of partners possessing distinctive competencies

From this standpoint, it is clear that the formulation of a strategy for the development and choice of ways to implement the pursuit of strategic objectives leads not only to the delimitation of the competitive environment in which the company will operate but also, from a systemic point of view, to the creation of a new set of relationships that the enterprise will have to establish with the interlocutors in its environment. Therefore, the decision-making process requires defining the following elements:

– Control over (or ownership of) the resources that the enterprise will invest with new and old actors in its environment in order to pursue the chosen strategy;
– Cooperative relations (strategic alliances) that the company intends to establish with different partners along the value chain corresponding to the strategic choices made;
– Market relationships that place the business in relation to input providers and customers for their output. It is in this relationship that involves the contractual power the company has managed to conquer in its market through behaviour, strategic actions and managerial practices;
– The competition relationships that bring the enterprise into conflict with its present and prospective competitors. These can be both actual or potential competitors.

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Entry choices show different degrees of complexity and can follow two evolutionary paths of business-to-business (transversal) trading or the transfer of productive and oriented resources and technologies, and therefore the acquisition of inputs (non-trade); it should also be noted that the final orientation of the actions taken by the companies, not directly related to the action taken, is always to place their products and services on the outlet markets as much as possible.

From the point of view of internationalization driven by the search for more defensible competitive advantages, companies tend to place their output outside domestic borders, both to increase their growth rate and to gain more strength in their actual competitors and potentials. In this sense, businesses both large and small tend, or should tend, to expand outlets. By expanding the outlet market, the risk of a saturated market is reduced for businesses in the same area, where it is virtually impossible for them to maintain their growth rates.

Vertical integration, as is known, occurs when an enterprise acquires control over an upstream or downstream activity either through internal growth manoeuvres (implementation within know-how and knowledge) or by means of external growth manoeuvres (acquisitions and mergers), with the goal of massively smoothing the efficiency of manufacturing processes and the effectiveness of economic outcomes. Within this scheme, it is clear that integration is a phenomenon that can also cover an internationalization dimension when involving companies operating on different markets. In particular, the integration process offers management the opportunity to diversify the sources of technological, organizational, managerial, and market knowledge, because, as the production/distribution cycle expands, so does the company's knowledge of the technologies used for the production of raw materials and semi-finished products, and of the market for its products.

The integration process can take place through mergers and acquisitions, helping to rebuild businesses and to gain market positions with the speed that simple internal development could not allow. They guarantee the ability to realize all the potential benefits of a combination of activities and capabilities, in ways not allowed by other forms of partnership. In addition to the undisputed advantages offered by acquisitions and mergers, it should not be forgotten that it creates, with external integration, the level of organizational and managerial complexity of companies

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that are in charge of managing new competencies, that is, new professionalism and non-family activities.

Even in an internally integrated way, the greater level of complexity compared to exporting—found in downstream forms that, by requiring the creation of special units finalized for the overseas marketing of the company's products, involve the activation of more expensive coordination mechanisms and greater cognitive needs for access to outlet markets and the success of the initiatives undertaken—is clear.

If new forms of international development have emerged from the uncertainty of overseas operations—given the different types of strategic alliances in our day—the growing spread of increasingly sophisticated knowledge driven by the growth of relationships between transnational actors has created a driving force for the growing complexity of the external environment of enterprises.

The emergence of new modes of non-competitive foreign involvement (alliances), on the other hand, "activate—and do not squeeze—competitive confrontation" (Vaccà 1986) and the organization of externalities, including collaborative strategic modes, poses for the company, in a dynamic perspective, "problems of greater vulnerability and uncertainty, and hence the greater need for organizations to adapt to the environment in which they operate" (Calvelli 1989).

In deciding on the evolutionary paths to follow, choices between modes of competitive development and collaborative modes require management to strike a proper balance between the two alternatives, and the ability to identify the most appropriate institutional structures, in which both competition and cooperation should take place (Teece 1989). The conclusion reached by Teece's analysis places the emphasis on a collaboration that may prove necessary to stimulate competition, especially in fragmented sectors.

## Competitive Entry Modes: Import/Export

For many firms, exporting is the simplest way to enter foreign markets, and consists of selling beyond the company's output boundaries. It is generally a mode associated with other forms of presence on foreign markets, but for small companies, it is often the only form of internationalization

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they implement. Export to foreign jute markets reduces entropy risk and positively affects brand awareness while contributing positively to consolidating corporate image and customer loyalty.

Exporting can take place directly, if the enterprise develops direct contact with the foreign market, involving its own sales personnel or resources that cooperate on a continuous basis with the enterprise, or indirectly, by contacting specialized intermediaries that serve as an interface between enterprise and foreign markets. The second choice, albeit less costly, exposes the company to significant risks and reversion costs that should be carefully evaluated before embarking on such a path.

Small businesses, which do not usually export or do not have a stable flow of exports, generally show interest in operating on foreign markets through indirect exports, leaving other organizations the initiative to sell abroad, while continuing to focus on the home market which remains a priority. Subjects involved as intermediaries that take over the initiative to sell abroad may be of a different type, and the border between one type of broker and the other is not always clear. An essential element in differentiating the services offered, and therefore the appropriateness of turning from one to the other, lies in the intermediary's ability to represent several competing products and to be specialized in product or market. Generally, the following classification is proposed (Calvelli 1998):

– Large buyers operating in the target market or in the region to which it belongs (buyer).
– Importers/distributors operating on a specific reference market.
– International trading companies (trading companies), generally present in multiple markets, usually acquire a number of products from one country's businesses to resell them to several outlet markets. In the most difficult markets they often establish relations with other local intermediaries (distributors or buyers).
– Export consortia; in this case, they are consortia created by the same companies that intend to export and are therefore more inclined to act in the interests of the associated companies. In this case, the risk of opportunism is lower.

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In addition to brokerage firms proper are those that act as multi-firm agents and that specialize in promoting products on foreign markets, starting relations with local distributors, organizing participation in fairs, and procuring trade partners. The main difference between this type of broker and the companies mentioned earlier lies in the fact that the agent does not purchase the products. It is therefore a hybrid form of intermediation that is potentially riskier than the others: the risk of the surplus remains with the enterprise that self-assimilates its learning process by relying on specialized figures in initiating contacts with local distribution and, hence, in the composition of its positioning on foreign markets.

### Some Evidence in the Perfume Industry

The perfume industry is quite fragmented: besides large producers with a very large portfolio of brands, there are medium-sized operators specializing in particular product lines and small operators that cut out successful niches by focusing on particular essences, the organoleptic characteristics of their products, strong references to the territory, or any other elements of differentiation to offset lower brand awareness. In order to gain visibility in retail distribution, the war between trademarks is ruthless. The market is fragmented as well, and being present in a number of outlets sufficient to reach an acceptable volume of business is often expensive for businesses. The choice then becomes that of relying on the support of specialized brokers, trading companies and international distributors that usually operate exclusively in the industry, representing different brands and competitors. The attractiveness of these distributors lies in the possibility, that the manufacturing companies have perceived, of arriving quickly on the shelves of large perfume shops, and thus becoming accessible to consumers. On the other hand, the risk of being in competition with excessively more well-known brands and, therefore, of not achieving concrete results, is definitely high.

An industry analysis has also highlighted that in this sector, the risk of intermediaries' opportunism is particularly high and is manifested through the characteristic behaviours of the industry players. Intermediaries have little interest in engaging in the sale of a specific product (or brand) in the portfolio; on the contrary, they have the luxury of promoting all the brands they represent and targeting simple, fast sales on all markets, thus enabling them to quickly post their turnover and planned margins. It is often the case that the products of the individual company are not adequately represented and that sales proceed according to an inertial mechanism that

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seeks to increase the sales of some particular products and to stop the sales of others.

Intermediaries often only promote the company X product that is useful in completing their offer; in other cases, they promote only some offline and other online products, simply following the spot opportunities that are presented without any planning activity that can raise the same company's standing on foreign markets.

The opportunistic policy of intermediaries and the lack of information on foreign markets has a negative effect on production planning and business inventory management. This in turn brings negative effects on their profit margins, which, in a negative spiral, see a decline over time in the resources to be invested in foreign markets.

*Source*: ***Our desk analysis***

In all forms of indirect export, the risk that the enterprise might miss development opportunities and that, above all, might be unable to recover disadvantageous competitive placements due to the lack of information on sales performance and customer satisfaction is very high. Indirect exports, on the one hand, reduce the risks and costs incurred by the internationalization firm; on the other hand, the intermediary, in fact, carries the knowledge of the local market, which takes on the costs and risks of the operation. In fact, there is a lack of direct contact with customers by the exporting company, and a lack of information on market trends. In addition, as commodity standardization increases, intermediaries tend to generate price competition between the various producers, by threatening the possibility of turning to other suppliers.

In addition, underlying the buyer–buyer relationship is a potential conflict of interest, since the intermediary often tends to act opportunistically by maximizing short-term profits, while the firm, in its approach to foreign markets, should maintain a more stable medium or long-term perspective.

A more strategic approach to foreign market sales is that of direct export, generally used by large companies, although some encouraging signs are now evident among Italian SMEs. The largest exporting company generally connects directly with the foreign distribution system through its own sales force, a stable foreign structure, or single-firm agents. In this case, the enterprise initiates a learning process that expands

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the chances of success, enabling the company to identify new business opportunities or simply to consolidate existing ones. The risk, on the other hand, lies in the possibility of making the company structure excessively rigid, through the immobilization of capital on foreign markets.

Choosing the mode of export—direct or indirect—most suitable for the enterprise depends on a combination of various elements. According to a recurring classification in the literature on the subject, the complexity of the factors influencing the different forms of entry onto the foreign markets may be divided between those inside and those outside the target market. The most important factors are connected to the following:

- The temporal horizon of the choice: If the market entry corresponds to a spot opportunity and concerns the disposal of finished product stocks, it is plausible that the enterprise might opt for indirect exports so that it does not bear the costs and risks associated with a medium- to long-term investment
- The strategic objectives set (growth rates, market shares, profitability): If the goals are considerable and reasonably achievable, the firm will opt for direct exporting, also to prevent the mediator's mistakes from causing damage to image or making it difficult to revise the deal with distribution at a later time;
- The type of product sold, such as specialty products or instrumental goods that generally require a direct export through the creation of their own units abroad;
- The resources available and the knowledge that is part of the cumulative assets of the enterprise: If the company has no knowledge of the landmarks, direct export is risky; on the other hand, the company might agree to postpone the choice of entry and save the time needed to deepen the knowledge of the target market and identify people capable of representing it successfully;
- The strategic positioning of the product that the company intends to achieve: If the positioning responds to a choice of differentiation, direct market control is necessary to avoid image damage or mismanagement of after-sales services;
- Identifying opportunities and threats in the external environment where the company intends to operate: An example of a threat may be

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represented by an overly fragmented distribution system, logistical difficulties or even non-tariff barriers, all of which require the intervention of locals or those at any rate well-placed in the local socio-economic fabric.

Today, most companies acquire goods and components from firms located in different countries. Globalization offers the opportunity to exploit the location advantages for all the activities in the value chain, and importing concerns the search for inputs on foreign markets. Increasing competition requires preserving efficiency, but depending on their strategy, firms are often compelled to look to high quality inputs, and this requires the establishment of good relationships with foreign suppliers. In some cases, firms involve intermediaries in the international purchasing process, but more and more they are learning the advantages of direct relationships. Above all, when imports come from distant countries, characterized by different productive systems and different business cultures, interpersonal relationships are crucial to guarantee the quality of inputs and components. This is particularly true when the logic of international purchasing is not exclusively connected to efficiency, as, for example, in the case of Label Rose.

**The Experience of Label Rose**

The Label Rose brand came into being in 2012, on the strength of the Ammaturo family's three decades of experience in the fashion and retail sector. The style is entrusted to the family's second generation—the young stylist Francesca Ammaturo—and is the result of careful international fashion research.

Francesca earned her diploma at the Naples Artistic Secondary School and a bachelor of arts degree in Germany, and is about to complete her three-year course in the management of international enterprises at Parthenope University of Naples.

The company aims at becoming a European leader in the sector of fast fashion in accessories. Its mission is: "Our corporate culture is to offer a product that is trendy, with good quality at affordable prices, putting our products within everyone's reach." It wants to develop an agents network and a chain of single-brand shops, both directly owned and in franchising, from the low initial investment. The product offers high performance in

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terms of margin. We plan to open 35 points of sale over the next three years, for a total of 45 in Italy and elsewhere in Europe.

Label Rose's business currently consists of selling handbags, luggage, and women's fashion accessories. The term "accessories" is to be understood as the following categories of goods: bijoux, watches, eyewear, scarves, hats, key chains, purses, belts, gloves, and foulards. The commercial approach calls for a network of points of sale, both directly owned and in franchising, and a network of agents retailing to multi-brand shops. It also plans to open an online sales channel in the coming months.

"The collections are produced at high frequency, to ensure quick product rotation. They are designed for a woman attentive to details, who likes to match accessories to apparel and takes care in creating her own look. Label Rose products meet these requirements, providing numerous possibilities for use and a wide range of product categories. In our shops, the consumer can find a vast array of handbags, suitcases, and accessories."

Most of the production takes place in China; in China, the business is centred upon the production of 70% of our goods. This country offers countless opportunities in terms of production, as it allows us to lower the product's unit cost and thus to increase margins, and the increased margin has been crucial to giving our business a boost, and has allowed us to develop the franchising formula.

**Internationalization in China**

At first, Label Rose marketed already imported products, selling them at direct points of sale. "Surely, an important critical area that led us to outsourcing was the fact that our products were not personalized. Consequently, the final customer identified our shops as simple retailers of anonymous products, and therefore, outside of competitive prices, we had no added value in comparison with our competitors. Instead, our objective was to give the brand an identity, and to begin laying the groundwork for forming a company with a sound competitive advantage over its rivals.

The advantage lay precisely in personally designing the products, choosing a range of colours suited to our market, and branding them—making them unique!"

"After a careful market analysis, and an analysis of customer opinions, we decided to make a trip to China with one of the suppliers from whom we purchased goods in Italy, and this marked a decisive step in our company's development."

When we asked Francesca about the challenges and problems faced in China, the first things she mentioned were culture and low quality.

"Chinese culture is quite different from Italy's, and we encountered many problems. Certainly, the most significant one involves quality. In fact, the quality of productions does not match the samples on which the orders are made; as a consequence, the result is a rather low quality that does not

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conform to the standards required by a Western clientele that pays a lot of attention to details. Often, even colours and quantities don't correspond to those ordered, and production types are not respected. Another important point that greatly distinguishes Chinese culture from Italy's is certainly the lack of creativity and style. It is an established fact that they are excellent imitators, but it is very hard for them to make samples from drawings."

While culture is a problem, language is not a barrier. "It didn't create particular problems in terms of work; at any rate, on site we can count on the sound assistance of our intermediary, who also serves as translator. Of course, this does not simplify commercial operations, because it would be far easier to speak with the supplier directly. The only difficulty lies in 'feeling isolated' the moment you set foot in China, since very few people outside airports can speak English or another language."

As regards production, the main problems faced by Label Rose are (1) unqualified human resources, (2) very high staff turnover, (3) low work-orientation also because of the very low salaries, and (4) lack of supervisors who can monitor the workers in their jobs. But high competition encourages them to keep their customers close, and therefore to try to solve all production problems. Label Rose actually has strong and trust-based relationships in China, and the Chinese intermediary is able to find suppliers for any kind of problem.

Another issue is represented by import costs. "Customs duties, transport expenses, and all the accessory costs are a strong barrier to importing, because they significantly impact the goods' unit cost. As a percentage, customs duties represent 10% of the container's total. Transport costs, on the other hand, represent 6–7%, and include the transport of goods from the various factories to the warehouse where it is checked, grouped, and loaded into the container; transport from the warehouse to the port; the cost of the container; transport from the port of Naples to our operative headquarters. The person dealing with all the activities related to grouping the goods, and checking and organizing the containers, also has a cost, representing 5% of a container's total."

Label Rose's logistics strategy is based on monthly deliveries of containers holding a mix of all the goods categories. Their intermediary deals with the entire logistics phase on Chinese territory. Similarly, they have no problems with banks, as they have a line of credit allowing them to be insured by a bank on Chinese soil.

With regard to the international positioning, according to Francesca, one of the main strengths of Label Rose is "the difference in value in comparison with our competitors. For us, it is essential to win the customer's loyalty through our good quality, but at the same time we adopt highly aggressive pricing policies. The objective is to create quick word of mouth between those purchasing the goods and potential new customers."

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"In addition to factors of value, we are seeking to provide a medium-high image both for the products and for the format of the points of sale. Display and packaging are also seen to: these two elements are absolutely not to be underestimated, since the former is an identifier of the brand, while the latter is extremely important because the products we sell are often purchased as gifts. Social media and the website are also given a lot of attention, because we're convinced that a company that wants to stand out in fashion must be very strong on the web as well. A good image allows you to conquer a bigger market share, which therefore is not limited to the middle/lower class, but can reach much of the higher one as well."

While their products have not yet acquired an international presence, they are confident that for the upcoming spring/summer 2019 season they will be able to open new points of sale in Germany. "Germany is above all one of the few European countries—if not the only one—that is seeing continued growth, and we would like to exploit the many growth opportunities offered by the German market, and to use them as a springboard for development beyond domestic borders. Moreover, Germany is a country quite close to me, since I spent my adolescence in a German city."

Label Rose would like to leverage the following potential advantages:

1. The scarcity of established competitors; competitors on a worldwide level can be counted on one hand: Accessorize, Parfois (but their points of sale don't have travel articles), Bijoux Brigitte, and Six (but their core business is costume jewellery).
2. Country of origin effect, given that in Germany, Italian fashion is much loved and appreciated, and they can exploit the *Made in Italy* effect.

Our sector does not suffer a lot from competition, other than from the large apparel brands that have a wide array of accessories at their points of sale; and from Carpisa, which is the leader in the sector of handbags and luggage in Italy. But as I said earlier, our supply portfolio is much broader than that competitor's.

Like any other small, young family firm, Label Rose has to face the generational changeover, but it seems that no problems are on the way. "The generational changeover took place rather naturally—we followed the course of events without rushing things. Day after day, my father has given me more and more trust and independence in my activities in the company. As an aspiring manager, I like being able to supervise anything that takes place in the company, and always to be able to say what's on my mind.

Of course, there is no shortage of disagreements, but most of the time they're constructive, and lead to joint solutions that embrace my father's strong experience on the one hand, and, on the other, my desire to innovate and to apply what I am learning in my university studies."

*Source*: Our interview with Francesca Ammaturo

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When efficiency is the final aim of international purchasing, the situation changes dramatically, and firms do not establish direct relationships with their suppliers. In order to reduce costs and focus on more valuable activities, such as R&D and marketing, firms tend to outsource their operations. Quite often, firms find they care more about costs than about the reliability of the final suppliers, which, above all in East Asia, are often different from the outsourcer: companies make agreements with major components suppliers, and the suppliers outsource this activity again to producers located in cheap markets, without providing any guarantee on labour conditions or organizational processes. This is very dangerous because, as the latest scandals show, companies can have very bad image returns.

**Some Empirical Evidence from the Columns**

A world-well-known German producer of candies came under fire in 2017 for a scandal connected to its Brazilian suppliers. The German company purchased carnauba wax from a Brazilian company that produced the ingredient under slave labour, and was also accused of sourcing its gelatin from producers that maintained cruel conditions for animals.

The news spread the world over, producing a very strong negative effect on the brand image. Although the company immediately tried to limit the effects of the news, promising strong controls on the supply chain and declaring the impossibility of accepting such conditions, boycotting began, forcing the company to make considerable investment in marketing and social initiatives to reposition its brand.

*Source*: Our desk analysis

## The Integration Processes: Foreign Direct Investment

From a historical standpoint, international business development (especially in the United States) was a sequential phase in large firms' evolutionary expansion process. Corporations began to concentrate monetary and knowledge resources in their core business and within the boundaries of the domestic market, and only after having achieved a sustainable and lasting advantage in the home business did they begin vertical integration as a third-step diversification strategy.

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'Vertical integration, as is known, occurs when an enterprise acquires control of an upstream or downstream activity, with the aim of maximizing the efficiency of manufacturing processes and the effectiveness of economic results. Within this scheme, it is clear that integration is a phenomenon that can also cover an internationalization dimension when involving companies operating on different markets. In particular, the integration process offers management the opportunity to diversify the sources of technological, organizational, managerial, and market knowledge, since, as the production/distribution cycle is extended, the company's knowledge of the technologies used for the production of raw materials increases, as does market knowledge for the marketing of materials and products on the target markets.

In economic theory, internationalization by integration finds significant placement within the approaches to transaction costs. Indeed, this phenomenon was originally created by the businesses' objective to control access to raw materials and to minimize their costs, or to more directly control the outlet markets. However, these objectives were not always optimizable through market mechanisms because of the high risks associated with the stipulation and successful outcome of the supply contracts put in place by contractors, or linked to changes in consumer tastes and their lifestyles. In addition, market mechanisms did not allow an effective transfer of knowledge and of scientific and technological know-how, with the effect of stimulating the convenience of internalizing the upstream and downstream production phases in order to achieve greater efficiency and, from this, a more effective entrepreneurial activity.

With regard to the phenomenon of MNCs, the scientific literature has developed numerous interpretative models. In fact, while trying to identify the determinants of foreign direct investment, scholars have not always captured the centrality of firms' strategic choices and core competencies. The debate took place around

- a model of foreign direct investment (FDI) based on internalization theory; and
- the model of international development of the large enterprise, whose theoretical foundations reside in the theory of market power (Hymer 1976).

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In particular, within the explanatory models of the international development of large enterprises, the underlying idea is that, at the initial stages of growth, firms seek to constantly increase their internal market share, through functions and expansion of production capacity, in the hypothesis that increased market power (concentration) increases profits (Cantwell 1989). For this reason, Chandler (1962) stresses the market's dominant and driving role. The author argues that, at a precise historical moment, the phenomenon of firms' growth stemmed from the ability to exploit, through a more efficient use of resources, the opportunities offered by the expanding market thanks to demographic growth on the demand side, and technological progress on the production side.

At present, with increased business management capability and the development of globalization, understood as the interdependence of markets and the ubiquity of competitive advantage, companies have been able to strategically and internationally plan the most suitable organizational configuration for the exploitation of different comparative advantages, as well as the generation of exclusive competitive advantages.

Global-minded business can consider all foreign markets as a single large market, and distribute their value-chain activities on the basis of the comparative advantages of countries, and the opportunities in the host countries, considered of course along with the coordination costs of offshored activities.

In modern businesses, the phenomenon of international development, through upstream and downstream integration processes, has gained more importance. From the point of view of learning, it represents the way in which the enterprise realizes its presence on the learning market, thereby opening cognitive windows in environments with a higher intensity of knowledge.

Acquisitions and mergers, the two ways in which the supplementary process can take place, have a remarkable ability to contribute to the renewal of businesses, helping them gain market positions with a speed that simple internal development would not allow. They guarantee the ability to realize all the potential benefits of a combination of activities and capabilities, in ways not allowed by other forms of partnership.

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**Some Examples of International Acquisition**

Miss Sixty, founded in 1987 by Wicky Hassan and Renato Rossi, has very well-known brands, such as Miss Sixty, Energie, Killah, Murphy&Nye, and RefrigiWear. After the crises beginning in 2009, the group lost revenues, becoming an easy target for Crescent HydePark, which has aimed to exploit Miss Sixty's resources and managerial competencies to relaunch the company on the international market.

*Our elaboration from* Il Messaggero, *22 May 2012*

De Tomaso, an Italian producer of well-known sports cars, was acquired by the Chinese Ideal Team Venture, a carmaker, in 2015. De Tomaso's technical specialties were the main reasons for this international acquisition Kong.

*Our elaboration from* La Gazzetta dello Sport, *28 April 2015*.

Alongside the undoubted benefits of external growth manoeuvres (which is what acquisitions are), we need to consider the potential problems connected with growth. Acquisitions increase organizational–managerial complexity, because they allow entry to new skills and new professional figures, in addition to the challenge of managing unfamiliar activities. For example, in the forms of downstream integration, the acquisition of special units intended for overseas marketing involves activating more onerous coordination mechanisms, and greater cognitive needs for access to outlet markets and for the success of the initiatives undertaken. In addition, managers face the difficulties of creating the necessary osmosis with new entrants in order to establish a unity of purpose within the overall corporate environment—that is to say, in order to find a point of sharing between beliefs and values that may, when the players come from dissimilar cultures, diverge and hence create the conditions for the initiative to fail.

FDIs were seen as the main entry choices for MNCs. The efficiency theories explained in the first chapter show, in fact, given the advantages related to making investment in foreign markets (advantages, however, that bring increasing environmental turbulence and the hyper-competition linked to globalization), FDIs today pose a number of risks that often push businesses to opt for more flexible modes of entry. The majority of FDIs are also referred to as a non-trading entry choice connected to the opportunity to offshore production and upstream activities in order to save costs, but also to the aim of acquiring a global dimension in oligopolistic markets.

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### An International Expansion Through FDI[1]

Ferrero's internationalization strategy has old roots. Founded in 1946, the company saw rapid growth in Italy via its indirect distribution channel. In fact, from the very beginning, the Ferrero family preferred to focus on product research and development. From 1946 to the early 1950s, Ferrero gained market share in national territory, achieving an oligopolistic position. In accordance with the theory of market power (Hymer 1976), domestic surplus profits were invested in the internationalization process.

Ferrero's global success is based on the profitable choice and implementation of competitive strategy. To increase its edge, Ferrero decided to focus on setting its products apart, in accordance with Porter, thus choosing a very precise strategic positioning. All consumers perceive Ferrero as a brand of great quality and tradition, showing great confidence in it and recognizing a premium price in comparison with its competitors. This strategy was adopted by Ferrero in the internationalization process. The prevailing entry mode is FDI and greenfield investment. The company preferred to adopt this entry mode in order to preserve its know-how, by maintaining a very high level of control over resources. In this way, it has used its organizational skills, corporate culture, and production processes as a competitive factor. To implement this strategy, the company has endured high costs in fixed assets—offset, however, by the success of the internationalization processes.

Ferrero's first foreign plant was established in Stadtallendorf, in Hesse, Germany, 150 kilometres from Frankfurt. Ferrero's geographical expansion was to see the opening of a factory in France in 1960, through the creation of a subsidiary called Ferrero France. In both France and in Germany, the logic behind Ferrero's internationalization choices was quite clear: to choose input methods that enhance the competitive advantage and know-how in production, while leaving distribution to local distribution channels. In keeping with this logic, in 1963, the Frankfurt plant was renovated with a new greenfield investment bringing the number of workers to 3500. Meanwhile, Ferrero's products came to reach 80% coverage of the German commercial distribution network. In the second half of the 1960s, eight other European subsidiaries were to be established, bringing Ferrero products to Belgium, Holland, Luxembourg, Denmark, Sweden, Switzerland, and Great Britain. Production was not to be relocated to these countries.

[1] This case study, and in particular the prospective analysis on Malaysia, was elaborated by the students in the master's-level course in international management at Parthenope University of Naples: Antonio Chiaro, Carmine Esposito, Raffaele Gallo, and Vincenzo Valentino. It has been revised and updated by the PhD student Andrea Caporuscio.

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but only marketing and distribution activities. Meanwhile, from the standpoint of research and development, Nutella, the hazelnut cream that would become one of the world's most important products and brands, was created in Italy in 1964. Confirming its international vocation, the brand was modified in 1968 into Kinder (from the German word for "child") and Ferrero.

In 1969, Ferrero's international expansion shifted its horizons to the United States. Given the very different characteristics of the American market, Ferrero decided to enter in a different way, that is first with a sales office, to learn the lay of the land. Then, after finding considerable success, Ferrero implemented continuity with the entry modes used in Europe, that is a greenfield investment. In 1980, in order to coordinate the many subsidiaries present in the world, Ferrero International was founded in Luxembourg. This choice was justified not only by reasons of a strategic/managerial nature: Ferrero turned out to be an importer of Turkish hazelnuts, which have characteristics very similar to Italian ones. Although hazelnuts are a fundamental raw material in the production process, Ferrero has not used upstream vertical integration because its high bargaining power allows it to develop very close synergies with local producers. In 1988, the Belgian and Spanish subsidiaries were established, in addition to a greenfield plant in Aarlon, Belgium. From 2009 to 2012, FDIs were made in Russia, India, and Australia. The year 2012 saw a strategy change, through the acquisition of hazelnut-producing MNCs in Turkey and the Caucasus. Ferrero's success in the American market led the company to set up a new factory in Mexico worth €230 million. The year 2014 saw the acquisition of the Turkish company Oltan, a world leader in hazelnut production. In 2015, Ferrero bought the British company Thorntons.

At the start of 2015, Ferrero had 20 plants in the world. The only major market without an internationalization project was China, and Asia more generally. In May 2015, 400 kilometres from Shanghai, Ferrero opened its first factory in China. With an initial investment of €100 million and 300 workers, Kinder Merendero, Ferrero Rocher, and a few other products were made. With a step-by-step strategy, Ferrero focused on repositioning its products in China, due to the presence of competitors such as Mars China and Mondelez China. Ferrero first chose to enter the high segment of the chocolate market. This strategy allowed it to penetrate with new products, reaching a 20% share in 2017, second only to Mars China with 40% (China Market Research Group). Given the economic importance of China in the global scenario, in 2017, Ferrero decided to invest in Singapore through a greenfield investment in a centre for innovation and development. This centre is located in a district specialized in the development of raw food material for nutrition and consumer health. This investment is consistent

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with the differentiation strategy; the China Market Research Group says that the Swiss chocolate brands have not invested enough in positioning their brands in China, and have therefore suffered from competition by Ferrero and Mars in a high market segment dominated in Europe by such brands as Lindt.

As a further path of expansion in the Asian market, a new greenfield investment, in keeping with the Ferrero strategy, may be imagined in Malaysia. The Ferrero plant in Shanghai produces to a large degree Ferrero Rocher and other Kinder snacks, but not Nutella, which is still exported from Italian factories. For this reason, a new plant making this product in Malaysia may be imagined. The choice of Malaysia is due to reasons relating to macro and micro factors. Indonesia and Malaysia are the world's top-two palm oil producers (World ATLAS statistics by country), and Indonesia is the world's third-largest producer of cocoa. From a geopolitical perspective, Malaysia is a stable parliamentary monarchy, which maintains very close business and economic relations with neighbouring Thailand, Indonesia, and, above all, China. From a commercial standpoint, Malaysia belongs to ASEAN (Association of Southeast Asian Nations: Singapore—Thailand—Malaysia—Brunei—Vietnam—Cambodia—Indonesia—Philippines—Myanmar—Laos), an association of ten nations aimed at promoting the free market without customs duties. The ASEAN+ 3 agreement was later approved, extending the agreement to Japan, China, and South Korea. According to Dunning's eclectic theory, Ferrero can exploit the location-specific advantages and excellent business relationships with China and Indonesia; low raw material costs and a strategic position allowing the costs of transport and product distribution to be minimized; and a potential expanding demand. The ownership advantages concern the brand, the range of products, the technological know-how and the managerial skills. The target market remains the Chinese one, with its growing GDP, that can be reached through Malaysia's most important port, Port Klang. The choice of producing in Malaysia and then exporting the finished product to China is justified by the proximity of the most specialized raw materials and converters.

An acquisition of a plant in Malaysia to reduce implementation time may also be imagined; however, the only two times when Ferrero chose the brownfield investment route involved two companies, Britain's Thorntons and Turkey's Olton, which both boasted high technological standards. In Malaysia, this type of technology is not widespread. In addition, according to the World Bank's 2018 ease of doing business rankings, Malaysia is 8th in the world in energy resources, 4th in the protection of foreign investment, 11th in dealing with construction permits, and 20th in access to credit. For these reasons, Nutella's entry through a greenfield FDI would be more efficient.

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The rationale behind the creation of FDIs is the same referred to for integration: the company grows in size in order to be present on the learning market, so as to reach a global dimension or preserve its competitive position by eliminating competitors from the market. Acquisition is the driving force behind the dimensional development processes of automotive companies; it is a strategy different from that of the Italian-made textiles/clothing industry, where the acquisition of competing firms and brands often responds to the logic of eliminating competitors from the market. In the scheme proposed at the beginning of the chapter, the creation of Wholly Owned Subsidiaries (WOSs) is considered as a different form of integration. The FDI can consist of a greenfield or a brownfield investment, but the point is they maintain strong control over the offshored activity.

Apart from the creation of its own business, FDI can also be achieved through the acquisition of pre-existing shares of companies. In the first case, the transaction is riskier: in the case of capital outlay, the risk is that the investment is not profitable due to lack of demand, inability to hire adequate human resources, delays in building the facility, technical problems related to the structure or to the production system, possible delays in obtaining approvals, licences, and certifications. Investment times grow longer and expose the company to additional risks associated with bureaucracy and the country's regulatory and institutional system (Dikova and Van Witteloostuijn 2007).

Within FDI, participation in the ongoing privatization processes in emerging countries offers interesting opportunities (Cannavale 2008). Several authors have in fact stressed the potential benefits of foreign investors' participation in the privatization processes of large state-owned enterprises (SOEs) and the opportunities arising from the exploitation of the tangible and intangible resources these SOEs possess, as well as the ability to develop, through collaboration with state managers, greater knowledge of the local market, and to overcome the difficulties of lack of information through the relationships investors have with other local operators (Czinkota et al. 2002; Rondinelli and Black 2000; Spicer 2000). New businesses also have the first human resources employed in large SOEs—specialized technicians accustomed to far lower remuneration than those expected for employees with equivalent qualifications in advanced countries (Djarova 1999); international companies therefore

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have the possibility of offshoring knowledge-intensive activities as well as mature technologies, of exploiting the cost-effective benefits of attacking new demands, and of improving their position competitive in advanced markets (Rondinelli and Black 2000; Kedia and Julian 1995).

Collaboration with SOEs and participation in ongoing privatization processes can also be a necessity: in some emerging countries; it still represents the only opportunity to penetrate local markets, because of the extra taxes and bureaucratic difficulties imposed upon wholly owned foreign enterprises (WOFEs). In these same countries, however, investors should value the lack of managerial and marketing knowledge, given the strong protections SOEs had before the start of transition (Czinkota et al. 2002).

Privatization plans and attitudes of local institutions change, however, from country to country. In order for the foreign investor to succeed, the involvement of the foreign enterprise must be perceived by the internal players as a win–win process, that is, as a profitable agreement for all the stakeholders involved foreign affairs, local government, and privatized enterprises. However, the risks associated with such operations must not be neglected: in many countries, there are still strong adversaries to the entry of foreign operators, especially in areas considered strategic for the country's economic development; public opinion, also weary of the sacrifices connected to the economic downturn of the early years of the transition, is in some cases opposed to complete privatization, and this impels local governments to preserve the social content of certain activities (Czinkota et al. 2002; Rondinelli and Black 2000). In these areas, government policies are geared to maintaining strong control over entrepreneurial activities, strong investment is required for the participation of foreign entrepreneurs, and the risk of nationalization is greater.

### Opportunities for Privatization: An Experience in the Household Appliance Industry

The Z Appliances company, later Z, was founded in 1975 by an Italian family company that was one of the leading European manufacturers, occupying a leading position in the world of household appliances for many years.

Starting in the 1980s, the Italian company embarked on its own internationalization strategy, emerging first on the British market, and then on the

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French one. The position on foreign markets has consolidated as a result of the acquisition of quality brand labels, and today Z pursues a dual market policy: on the one hand, it is present on international markets with its own historical brands, on the other hand, it works in a regional perspective, preserving the leadership of the most important acquisitions.

The multibrand policy pursued by the company is characterized in all markets by respecting quality and the pursuit of innovation in Household Appliances; Z was in fact the first company to apply digital technology to home appliances and Internet connections. The strong orientation towards quality is also attested to by the philosophy pursued by the company's leadership, based on such values as product competitiveness, anticipating market requirements, respect for and protection of the environment, worker safety, and timely and transparent communication; all are indicative of the importance attached to external relations.

Concerning the internationalization strategy in Central and Eastern Europe, Z was one of the first European companies to invest in Russia and the former Soviet Union. With the aim of greater productivity and efficiency, the company has consolidated its presence in Russia and the surrounding areas: today it has 10 commercial offices and over 300 service centres in 150 cities in the country, and in 2005 it opened, in the industrial district of Lipetsk, the first logistics pole in Russia, and the industry's largest in Europe. It also has a strong commercial presence in the Balkans and in the other countries of Eastern Europe.

Z home appliances are also present in Turkey and China: in Turkey, since 1994, in the industrial area of Manisa with an establishment dedicated to the production of top-of-the-line refrigerators. The plant produces about 1,000,000 units a year, a figure the company expects to rise to 1.2 million. At present, the Manisa plant employs about 700 people and the number is expected to grow in the coming months. Z Company has launched a pilot project at the Manisa plant to define and implement an innovative occupational health and safety management system (OHSAS 18001).

In China, it has been present since 2005, when it signed a joint venture with Wuxi Little Swan, China's leading washing machine manufacturer. Thanks to the experience of the related Z Progetti, which has built 25 industrial plants in China, Z has gained solid credibility in the country. Z Elettrodomestici used a phased approach, first implementing less complex modes, usually by direct exporting; once more knowledge of the target markets was acquired, it moved on to more complex modes, making provision for direct investment of a productive nature both in Poland and in Russia.

The activities carried out in Central and Eastern Europe contribute 29% to the Group's turnover, which is why Central and Eastern European Countries and the Confederation of Independent States (CIS) are currently, according to the Z Group's Director of Industrial Relations, one of the most important markets for Z Elettrodomestici, especially in light of the local

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development potential. The Group is present with its own representative offices in Bulgaria, the Czech Republic, Romania, and Hungary, as well as in Poland and Russia.

With regard to the activities carried out in the CIS, the director has shown a high degree of satisfaction with the result of the investments made and the potential for market growth, and has pointed out that the success of Z Elettrodomestici in the area is based on long experience amassed in about 20 years of market presence, and the creation of an important network of relationships.

Beginning in the early 1980s, Z Elettrodomestici implemented processes of direct exporting to the Soviet Union for all its products, with the exception of those concerning the cold chain, the transport of which was excessively burdensome; in the same years, Z Progetti was commissioned by the Russian government to build a turnkey facility for S, a state-owned company specialized in the production of refrigerators.

With the start of the transition, the Italian company decided to intensify its presence in the area and exploited the opportunities resulting from the privatization process for offshoring the production of refrigerators: Z thus purchased the majority stake in S for a $120 million investment, becoming the largest investor in Russia for the year 2000. The operation has allowed the Z Group to become the leader in the production and distribution of refrigerators in all the countries of Eastern Europe; Z Elettrodomestici now holds a market share of 36–37%, and, given the success achieved, the company has immediately planned the construction of new investments for the on-site production of washing machines.

In particular, on its own, the acquisition of S accounts for 40% of the Russian refrigerator market, and the company has decided to attack this market exclusively with S and Z branded products, the latter being targeted to the most demanding consumers characterized by greater spending capacity. The investment has allowed the Italian Group to become the leader in a market with a population of 280 million people, similar in size to the European Union, but with a lower penetration and an obsolete product range. Market growth forecasts, estimated at around 10% per year, have been the main determinant of the investment by which the Home Appliances Z aims to transform the Lipetsk plant into a pole of development for the entire region.

The acquisition of S was favoured by the Italian group's certainty as to the quality and productivity levels of the plant, built in accordance with the rules of other European countries; the work, however, was done about 20 years earlier, and some modernization of the facilities and a procedures review was required.

The establishment's operation has been entrusted to the same Russian managers responsible for the activities prior to the privatization process, but local management has been joined, over the years, by Italian task

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forces, established from time to time depending on the goals to be achieved. Responsibilities for industrial relations, however, remain in the hands of the same people, in order to foster stable relations with local stakeholders and to exploit, in the best possible way, the synergies created with local authorities: the director has often been in Russia to study investment opportunities and achievable location benefits, and to discuss the need for better infrastructure with the local government.

Z aims at creating a kind of household appliance district in the Lipetsk region, and it is favoured by the excellent relations the Italian group has with local authorities, which, given the strong impetus given by the Italian company to the area's production fabric, are seeking to encourage S's activity as much as possible: it is precisely for the purpose of reducing logistics costs that the region's government has undertaken to strengthen the transport system and to plan a railway station near the establishment.

The director has stressed that the establishment of such a friendly climate was determined by the long-term perspective of the Italian company operating in the area, in compliance with the safety and environmental standards used in the most environmentally regulated countries. The plants' high quality has also encouraged greater involvement by local managers and employees taking pride in the enterprise, thus developing a greater sense of belonging to the company.

Scaling strategies are a compulsory choice when considering that the Lipetsk plant produces the same amount of goods from the factories located in the South of Italy but with ten times more employees; the group's choice was, however, not to reduce the number of employees immediately, and not to plan layoffs, given the Italian management's awareness that maintaining employment levels was a sine qua non for creating stable, trust-based relationships with local stakeholders. On the other hand, Z Elettrodomestici, by keeping the number of employees stable and offering slightly higher salaries than average, took advantage of the opportunity to keep the best staff while minimizing employee turnover.

The director emphasized how the training of employees was not at all burdensome, as Z Progetti had arranged training courses for the optimal use of the plants at the time of establishment. Upgrading them has made it necessary to upgrade courses, and doing so has not presented particular difficulties.

More complex was the selection of framework and management levels. In the first phase, no change was made; the group's HR manager found that, with S, there were about 80 first- and second-line managers and specialists who, in many cases, had obtained career advancements based more on politics than on merit. The confirmation of all the present management has allowed the group to more deeply examine the issues related to personnel management, and to study solutions suitable for fostering alignment between the managerial skills of local operators and the Italian company's

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standards. The three months after the acquisition were of use to the Italian task force for improving the organizational chart and for better attributing tasks and responsibilities. Evaluation criteria were used for the final selection of potential managers, specialists, and young people.

The evaluation involved a team of psychologists at the University of Lipetsk, who before commencing the activity spent three days comparing notes and getting into sync with the Italian consultant as regards methodology and content, after which they provided each of the candidates with a questionnaire and organized a role play and individual interview for them; the results were translated into Italian by a group of five translators.

The evaluation process has led to the identification of 400 people eligible to be held accountable, some of whom already occupy first- and second-tier assignments, while others had the benefit of age (less than 35 years), alongside 200 graduates.

The Italian consultant's supervision, which has long been used in the group, allowed staff assessment and training to be carried out in accordance with the principles of corporate philosophy, and the group could also take advantage of the first comer's human resource selection. In fact, in 2000, other foreign investors in the area were few, and Household Appliances was the first company to make a long-term investment.

In 2004, the Z inaugurated a new washing plant production facility and in 2005 built a new logistics centre; this allowed the group to become the largest manufacturer of home appliances in Russia, where it ended up controlling 36% of the local market.

Z's industrial base in Russia is therefore composed of two factories—one for refrigerators and one for washing machines—and a logistics pole; local production covers about 70% of the sales and the remainder is imported, mainly from Z's factories in Poland and Italy, with Turkey accounting for a more modest share.

As far as Russia alone is concerned, Z has been present in the country since 1993, the year the first commercial office opened in Moscow. Over the course of a few years after 1993, offices were opened in Russia's largest cities, like St. Petersburg and Vladivostok, as well as in the capitals of some states of the former Soviet Union, such as Ukraine and Kazakhstan. Today, the Russian sales network consists of five representative offices, which allow it to operate in the different time zones, and the logistics centre can handle at least three million pieces a year.

The good prospects for the development of the local market and the geographically close areas are leading the Italian group towards a policy of attraction from other Italian companies: the ability to attract on-site Italian sub-suppliers would not only allow Z to locate the services where the specialists are needed, and thus to streamline the production process, but would also contribute towards further improving relations with local stakeholders, which are hoping for new capital and new knowledge. Such initia-

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tives, however, do not appear to be very successful, because of the low propensity of many Italian entrepreneurs to invest in countries where risk levels are still high.

The new production asset and increasing market share have made Z so attractive that a world leader in home appliances acquired it in 2014.

*Source*: Our desk analysis

## Cooperative Modes

Cooperative modes of internationalization are largely employed today to preserve flexibility and specialization, understood as strategic levers for firms' competitive advantages. They are no more specific than small firms, and MNCs use more and more joint ventures and strategic alliances in all situations where the risks associated with FDI would be too high. Successful cooperation requires managers to be oriented towards learning from their partner and towards sharing their knowledge; they must adapt their competences to the best of their counterparts (Kauser and Shaw 2004). They also have to try to position their skills at higher levels of learning, so that they know not only how to approach and interpret environmental phenomena but also how to seize opportunities in an increasingly changing context, without taking on all the risks. Alliances indeed offer important advantages (Simonin 2004; Meyer et al. 2009): partners share the risks of the investment and can accumulate their knowledge, thus creating synergies between the market and technological knowledge. Costs are limited, and firms can exploit the advantages of the systemic and dynamic relational network. Working together, firms aim to achieve a defensible competitive position on international markets, and are encouraged to develop learning, innovation, and, above all, market creation opportunities that occur where synergies can be exploited (Teubal et al. 1991).

For SMEs, above all, alliances expand the strength of a single business unit, and this expansion allows each component to withstand scientific–technological challenges, massive investment, and competitive risks, which are inaccessible (Vaccà 1990). In this context, the internationalization process is developed not so much by the individual enterprise, but

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by a multiplicity of actors linked to one another, and the level of risk associated with the start-up of an international development process—closely linked to financial, technological, and organizational skills, as well as to information costs—declines. Cooperation also lays the groundwork for reducing uncertainties stemming from entry into non-family or unknown business. The sharing of skills generated through networking seems, in such conditions, to become a more rational solution to the problem.

The process of internationalization of business activities through the development of cooperation agreements is a phenomenon that has been accentuated and distinguished over the last few decades by the intensity and the broad spectrum of the various forms that have developed among businesses. This is why business collaboration can no longer be considered as an intermediate form between hierarchy and market, or as a second-best choice. Not least, they represent an intermediate phase of the internationalization process for the enterprise that evolves from entry to a foreign market through export to direct investment forms, passing through transitional forms, oriented towards agreements with international partners.

In this context, cooperation agreements represent a targeted choice based on and inspired by the structural and competitive characteristics and specificities of the international market, the characteristics of the products and technologies, the capabilities, the organizational structure, and the dimensions of the as well as the conviction that cooperation is a viable way of achieving competitive advantages and benefits in line with the vector of international growth. Therefore, for the enterprise, cooperation agreements are a flexible organizational form for access to markets with broader horizons, new technologies, more convenient supplies, and new outlets to face a competitive clash that has now become increasingly global.

Looking specifically at strategic alliances, these can be connected to marketing-sales and after-sales services, or to production and R&D. R&D alliances allow co-ventures to reduce the risk of exploration of the "new," and may permit the ingenuity of innovative ideas in the event of the presence of capital-bound partner alliances. Alliances can also involve production and productive coalitions, and above all asymmetric alliances,

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offering partners the possibility to increase their knowledge and foster innovation, so as to create a higher barrier to the entry of new competitors. Alliances of this kind, in spite of their complexity, are replacing the simplest, "old" forms of licensing and patents.

Forms of marketing, distribution, and after-sales agreements are often the result of a more complex collaboration than a technical–productive alliance. The aim of this cooperation is to develop synergies among the specific business skills of companies, especially if partners work in local areas characterized by different behaviours and cultures. With regard to the increase in organizational and managerial complexity, which is reflected by the transition from the simplest forms of collaborative typologies to strategic alliances, it should be noted that in trade-oriented forms, current market transactions may include types of offsets or triangular compensation agreements that require complex deals and the long-term involvement of partners in the agreements. It should also be noted that these business cooperation relationships, even in the most complex forms, remain within the scope of typical countertrade transactions; they are resolved in the performance of the obligations deriving from the contracts governing the relationships, which represent the very essence of transactions.

## Countertrade

The simplest forms of business collaboration agreements are those of a contractual nature, in which the relationship between partners remains bound by legally sanctioned rights and obligations. The formal agreement derives from the specific performance provided by the contract that represents the transactional relationship's very reason for being.

Countertrades—in their various forms, such as Barter, Counter-Purchase, buyback, Offset, and Turnkey investments—are often used to enter developing and emerging countries, above all when barriers to international trade exist. In this regard, however, it should be noted that, in the face of high usage of countertrade from major developing countries, by the end of the 1980s, the transformations occurring in Eastern

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Europe and the evolution of many third-country exporters (e.g. Indonesia and Malaysia) have much reduced the use of this tool in favour of monetary payment techniques (Forker 1996).

The factors that contribute to the expansion of the phenomenon are obviously to be sought in the specific situation of each country, such as indebtedness, limited availability of currency, non-convertibility of the local currency, and the need to develop local industries. The main reasons forcing companies to use countertrade in international commerce must be broken down into several categories:

- Market reasons explaining countertrade use in terms of increased sales, consolidation of market shares, entry into new markets, and taking root in regional markets where they had no previous experience;
- Logistical reasons in the sense that countertrade can be used by companies that want to rid themselves of surplus stocks of raw materials and finished products;
- The search, in strongly integrated companies, for constant conditions of convenience in the supply of cheap raw materials against payment in finished products (Lecraw 1989); and
- The attempt to overcome barriers to entry or export in some markets.

The reasons of convenience that may encourage developing countries to use a countertrade may also be based upon:

- Overcoming international price agreements, since the payment of the commodity does not have direct effects on the market price, which is thus not affected by such transactions (Hennart 1990);
- Overcoming trade controls, such as payment of goods against goods, makes it easier to overcome customs controls often imposed on certain types of goods.

However, access to countertrade forms is not risk-free. For Pellicelli (1990), countertrade increases the risks and costs of transactions, as trading requires both longer information gathering times and the presence of specialized brokers. In addition, for that author, the development of

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international exchange would also be hindered, because when a country imposes countertrade trading on the seller, other countries lose market share and are motivated to do likewise: renouncing experiences on foreign markets would reduce the possibility of expanding exports.

Beyond the macro-level disadvantages, for entry into some countries, and especially for currencies that are non-convertible and have difficulty obtaining financial resources, the countertrade represents one of the few easy-to-use modes at lower risk.

There are several types of countertrade, from the simplest, compensated, and contracted, to the most complex, buyback and offset. In general, the logic underlying a countertrade contract provides for an agreement involving the transfer of tangible or intangible assets as a condition for the purchase of goods and services (Pellicelli 1990).

The simplest type of countertrade is offset, considered the most current variant of barter with the introduction of a value, expressed in currency, of the traded goods. It may also include a transferable currency movement (partial offset) by the foreign customer, to partially cover the value of the goods imported by the primary exporter.

The contract, which regulates the reports, shows the characteristics of the goods to be exchanged, the prices, the quantities, and the duration of the transaction, generally short.

Foreign customers (or secondary exporters) are, in general, companies from less developed countries, and since export flows from foreign customers can be divided by the maximum time established in the contract, it is often necessary, as a guarantee for the entire operation, for a trustee bank to intervene in the compensation, with the task of "memorizing" the transactions of exchange between the operators in specific clearing accounts, while highlighting the credit and debit relationships of the parties that arise upon the various deliveries of the goods. The currency in clearing accounts—which are basically accounts opened for the partners in the agreement ("their" accounts) and report the credits and debts that arise whenever an export flow is made from one partner to another—is to be considered soft currency. Generally, the counterpart products are not "familiar" to the primary exporter, which may not have the necessary knowledge for their marketing: in this situation, a commercial intermediary, often a trading company, gets involved in the transaction and sells

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the counterpart products on international markets in order to have the money for the primary exporter while keeping a percentage for itself.

Counter-purchase is the most common form of compensation, especially in Asian countries. In this case as well, the primary exporter agrees to receive, in partial or total payment for its supplies, the goods of the foreign customer, often presented on special lists; however, unlike what happens in barter and compensation in the strict sense, the counter-acquisition involves the drafting of two separate and parallel contracts. The first contract concerns primary export, and all the characteristics of the supply are reported; the second one concerns the commitment of the primary exporter to purchase the partner's products, and establishes only the counter value and the type of goods that must constitute the supply to be counter-bought (or the types indicated in a pre-established list). As a consequence, the foreign client in charge of selling counter products, has a big advantage and can exploit moments when commodity quotations are high to send a smaller amount of goods.

There are various reasons that may encourage an operator in industrialized countries to accept a counter-purchase as condition for its exports; this occurs, for example, in cases where an incorrect programming of the production to be marketed has been carried out; the products are obsolete for their own market, and the counter-purchase is used as the first instrument of entry into markets not easily penetrated through more consolidated methods, such as exports.

The switch originates, generally, when bilateral agreements have been put in place between the countries (Clearing Agreements). The bilateral agreements have a contractual nature and provide for the formulation, for each country that is party to the agreement, of lists of products (or services) exchanged between the parties, valid for a certain period of time. The lists show, for each country, the type of goods accepted in the exchanges, and the total value admitted to the exchange, segmented by single export flow and by maximum value accepted for each flow.

Upon the expiry of the period established in the Clearing Agreements, the uncompensated balance must be paid in a hard currency, and this condition clearly shows that the presence of a bilateral agreement creates the conditions for the entry, in compensatory transactions, of third-country operators.

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The supply of "turnkey" plants, machinery, and equipment of high value: the primary exporter receives in return, in partial or total payment of the supply, the goods obtained from the plant or from the machinery sold by it.

These operations are differentiated from other, more strictly "commercial" compensatory transactions, because they arise from a broader intergovernmental agreement, involve entities of international importance, and entail significant contract values and long-term execution times. There are also quite frequent cases in which the transfer of technologies is accompanied by the establishment of an equity joint-venture between the foreign customer and the primary exporter, aimed at managing the plant and marketing the products obtained from it.

Such agreements are often used in the oil industry, but above all in cooperation with industrializing countries, since the productive coalition is often forced by necessity to obtain legitimization from the local government authority to operate in the host country: the benefit derived from this form of agreement is implicit in the facilitation offered by the host country, which makes these forms of internationalization less expensive than other modes of entry into the local market (Valdani 1991).

The use of countertrades may appear to be of little benefit to companies in advanced countries, and yet it is possible to identify a number of reasons why these companies use various forms of countertrade:

- Market reasons explaining the use of countertrade in terms of increased sales, consolidation of market shares, entry into new markets, and taking root in regional markets where no previous experience has been gained
- Logistical reasons, in the sense that the countertrade can be used by companies wishing to free themselves from the surplus of stocks of raw materials and finished products
- The search, in highly integrated companies, for constant conditions of convenience in the procurement of cheap raw materials against payment in finished products (Lecraw 1989)
- The attempt to overcome entry or export barriers in some markets

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## The Role of the Institutional Context and of Market Commitment in Firms' Entry Choices

While entry choices can have different natures and take on different levels of financial and organizational involvement, they represent a key component of internationalization strategies, and different theoretical and empirical studies have focused on this issue (Shaver 2013). Various scholars, in interpreting this choice, have obtained different results, and empirical evidence is not easy to interpret and revise (Cannavale and Laurenza 2017). This field of research owes its origins to three main backgrounds: economic theories, theories of FDI, and internalization theories. However, the recent trend has been to adopt a more eclectic approach and to involve strategic and behavioural variables as well. The traditional contributions made for entry mode focus on transaction costs theory (Williamson 1985, 1991), on monopolistic advantage theory (Hymer 1976), on internalization theory (Buckley and Casson 1976a, b), and on Dunning's eclectic paradigm (1979). These contributions consider the foreign investment decision as a rational process based on the costs and advantages of outsourcing activities in foreign markets. More recently, contributions have referred to the resource-based perspective (Meyer 2001) and focus on firms' ability to move and to strengthen both internal and external resources and capabilities, which are rare and difficult to imitate or substitute (Barney 1991, 2002). According to this line of thought, the decision to internationalize is based mostly on internal factors, and on the quality and quantity of resources and competencies. However, a strategy is the result of an internal and external analysis: both environmental and firm-specific factors are important in deciding strategic goals, and also in choosing the right way to attain them (Hill and Westbrook 1997). When the strategy is an internationalization strategy, external and internal factors are important for deciding where to invest, and what kind of investment the firm should make. A new input to the interpretation of firms' entry choices derives from application of institutional theory, and from the consideration of cultural values as something affecting international relationships and managerial practices (Brouthers

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2002; Arregle et al. 2006; Brouthers and Brouthers 2001). According to the authors, entry choices are often driven by a combination of transaction cost variables and institutional and cultural characteristics. All operations outside domestic boundaries involve interaction between different systems of cultural and social values; moreover, including cultural variables in international business studies implies that cultural differences between countries increase the costs of firms' entry into host countries, and inhibit the ability of companies to transfer knowledge and skills (Palich and Gomez-Meja 1999).

However, literature on the topic is not thorough, above all because previous studies focus on MNCs, or use the same theoretical framework to explain SMEs' entry choice in foreign markets. SMEs show particular characteristics that can influence entry choices in international markets: the lack of financial resources, and ownership and management features that seem to affect the level of resources committed and the degree of risk SMEs can afford in internationalization process. Furthermore, some studies point out that frameworks developed for MNCs are not always able to explain SMEs' choices, above all in situations of high degree of uncertainty and external pressure (Erramilli and Souza 1995). These studies suggest that the institutional context is suitable for explaining SMEs, because of SMEs' sensitivity to react to external challenges and because of their resource scarcity (Brouthers and Nakos 2004).

Cannavale and Laurenza (2017) contribute to this debate, focusing on two main factors: (a) market commitment, intended as the incremental and sequential commitment of a firm to foreign markets (Millington and Bayliss 1990; Luostarinen and Welch 1990) and (b) the institutional context, which is considered welcome or hostile according to the evaluation of five factors: (1) the extent to which local regulatory influences the activities of foreign firms in the host country (the extent to which the state hinders the development of business); (2) state control (the extent to which the control exercised upon companies distorts competition); (3) restriction on investment (the extent to which investment in the economy are directed by the government); (4) the bureaucracy of local government, protectionism, and fiscal policy; and (5) the cultural barrier meant as closeness to outsiders and unequal treatment of foreigners (the extent to which foreigners are treated unequally compared to local citizens, and cultural boundaries).

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The authors state that, above all for SMEs, entry choices depend on the institutional environment and on market commitment. The institutional environment can represent a limitation on firms' entry choices above all in emerging markets and economies in transition. However, firms' action not only depends on external factors alone but also on the extent of firms' involvement in international activities, and on their previous experiences (market commitment).

Relying on the institutional literature (DiMaggio and Powell 1983; Kostova and Roth 2002; North 1990; Ferreira et al. 2009; Peng et al. 2008; Scott 1995; Amburgey et al. 1996; Oliver 1996; Schwens et al. 2011; Cheng and Yu 2008; Li and Peng 2008; Demirbag et al. 2007; Meyer et al. 2009; McMillan 2008; Delios and Beamish 1999), Cannavale and Laurenza (2017) distinguish the countries covered in the analysis as hostile and welcome. They consider as hostile those countries, which are less open to foreign investments, with demanding and very strict tax regimes. Considering the transitioning markets, these countries are generally high-context cultures, where Westerners are perceived often as culturally distant, and sometimes as a threat (Calza et al. 2009, 2010, 2013). To the contrary, they consider as welcome countries those where the tax regime and the interference of governments are mild, and authorities encourage and attract foreign investment by introducing a number of exemptions and reducing state holdings. Culture does not represent a barrier, and interaction with partners and local stakeholders is much easier because cooperation with foreign company is seen as an opportunity more than as a risk.

To suggest the right entry choice, scholars combine the kind of context with market commitment. Commitment is a broad concept including elements of psychology, attitude, and time (Gundlach et al. 1995). Therefore, market commitment involves not only resources but also the attitude or intent of the decision makers (Lamb and Liesch 2002). Market commitment influences entry choice, because different choices imply different cost levels, risks, and involvement, and require different degrees of knowledge and experience (Bilkey and Tesar 1977). It may concern the inclination to build strategic alliances (Cullen et al. 2000), business-to-business relationships (Zabkar and Makovec Brencic 2004), and cross-border relationships (Styles et al. 2008).

According to the Uppsala School, internationalization is the result of a company's gradual awareness of the opportunities in foreign markets. This

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vision is based on the strategic role of intangible resources and learning: the firm's transition from a limited exploration of international markets to a high degree of international commitment depends on the acquisition of resources (Kuivalainen et al. 2012, p. 448). International experience has a great influence over the decisions on mode of entry. At the start of the internationalization process, companies do not have enough experience, and perceive high uncertainty (Johanson and Vahlne 2009). Following this approach, the authors distinguish high market commitment, understood as the firms' aptitude towards investing resources in foreign markets, from low market commitment, understood as the search for spot opportunities connected mostly to sales performance.

According to the proposed framework, Cannavale and Laurenza (2017) essentially hypothesize that where contexts are hostile and commitment is low, firms try to limit the risks derived from high institutional uncertainty and low experience, and the entry choice is expected to imply low involvement of resources, for example, by indirect export. On the contrary, if contexts are welcome and market commitment is high, firms are inclined to stay in the host market for a long time and to choose a stable and long-term oriented mode, such as FDI. When contexts are hostile but commitment is high, firms can decide to seek first-mover advantages, but the risks encourage them to limit involvement of resources; alliances or joint ventures are the most suitable modes, and there will be partnership. Last but not least, when commitment is low but contexts are welcome, firms can act in a learning perspective, and use the host markets to consolidate their knowledge. Entry choices will be connected to trade opportunities, and firms usually transition from less complex competitive modes, such as direct export, to more complex cooperative modes such as marketing and sales joint ventures.

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# 5

# Key Risks of Internationalization

## The Risks of Internationalization: An Introduction

The planning of an internationalization strategy is based on an analysis process that aims to identify the target markets, assess the opportunities and threats characterizing them, and determine the most suitable mode of entry. This complex process has to combine the resources and competences the company has with the opportunities and threats characterizing the target markets. This is not a linear and standardized process: psychological distance, the gap in development levels between the home and host market, language barriers, and the social/institutional context of the destination country are all factors that strongly impact the analysis's difficulty and intensity. However, it is a fundamental moment in strategic planning, also in the case where the choice to internationalize derives from the emergence of spot opportunities for the company. When players don't acquire adequate knowledge of the target market, they risk failing to grasp the threats existing in them, or the barriers that can limit these markets' attractiveness.

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Identifying target countries cannot occur separately from analysis of the risks and opportunities present in the potential markets; it is a phase of analysis focused on the outside environment and aimed at verifying the presence of barriers or risks that might reduce the opportunities potentially present abroad. From this perspective, it is necessary for the company to carefully assess the specific potentials and risks of the individual markets and the degree of attractiveness of their businesses. Although this assessment cannot be done without analysis of the macroeconomic picture—which allows the company to estimate the impact that the macro-environment's individual forces may have on its activity and profitability—it must also consider soft factors connected with the presence of different beliefs and values that can condition consumers, the work ethic, and the propensity for collaboration with outside players. From economic indicators (e.g. GDP, per capita GDP, unemployment rate, and inflation), the company obtains information on the economic phase in progress in the country, the consumers' buying power, the presence of low-cost labour, the state's role, and the presence of laws hindering or facilitating investment. And from social and demographic data, it gains a picture of the potential profiles of consumers/workers present in the country. This analysis, although summary in nature, may be useful for understanding the stratification of the population, the presence of certain segments of interest for the company (just consider products requiring particular levels of literacy, or that target particular age groups), the level of qualification of labour, and the system of motivations the company can exploit to create a spirit of belonging to the organization and envisage career paths that make the most of human resources.

The company must be able to quantify the chief risks characterizing these elements. To view the phenomenon schematically, it may be stated that the first moment of analysis considers the available country risk data. This may have major repercussions on the profitability of the investment, on the capacity of local debtors to honour their debts and on the company's ability to recoup investment over time, as well as on investment risk, connected not only to the market's economic potential but also to the presence of cultural factors that can negatively influence the company's performance. The company must deepen the level of risk analysis, identifying the impact that financial variables, in addition to political and social ones, can have on their specific business.

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The intensity of country risk, as a broader case of counterpart risk, is obviously amplified in those countries that lack regulatory and financial institutions capable of protecting foreign creditors. Consider, for example, the possibility of a country being exempted from the obligation to comply with contractual clauses, or the hypothesis in which a contract contains clauses in breach of current law that are therefore null and void for local law. Situations of this kind create daily problems for businesses, especially small ones, that export to international markets, and can only be reduced a priori, through adequate analysis of the regulatory system and, hence, through identification of clauses referring to the rules in force or establishing the use of international arbitration (obviously in the signatory countries of the conventions on the subject). Country risk assessment comes on top of the assessment of financial risks associated with internationalization. These risks, in the simplest assessments, are related to exchange rate trends and to the possibility that the presence of administered economies or the impossibility of using some payment instruments will increase exposure to price risks. The size of these risks depends on certain factors connected with the sector the company belongs to and to the sources of competitive advantage, but is generally higher today than in the past due to the growing degree of financialization of the economy, and consequently of companies.

In any event, the risk assessment is not generally aimed at the exclusion of a given market a priori. In fact, to reduce entropy risk, companies do not tend to exclude certain markets to the benefit of others, but to seek—in order to minimize the risks—the ways most suited to the specific characteristics of the individual markets.

## The Financialization of Companies

At the macroeconomic level of the development of the financial activities of international companies, there are multiple determinants of the new role taken on by finance in decision-making choices, and of the birth of new financial instruments in support of both strategic and operative choices.

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The evolution and pervasiveness of the new technologies of information science have expanded the boundaries of competition between companies and among sectors; changes in the competition landscape have required a different response from companies and, from this perspective, have helped develop a new role of corporate finance, seen as a source of competitive advantage for international companies.

Operators in the different capitalist settings now find themselves dealing in different markets and in different securities and currencies, operating in one market in order to invest in another—and developing policies of arbitrage and speculation in stock, bond, and currency prices. In addition, the changed competitive landscape and globalized financial markets have led companies to centralize the operative management of flows in foreign currency, and therefore exchange risk, with the possibility of the hedging and matching of differently oriented positions, and of using such instruments as swaps and options.

Large-sized and corporate enterprises have developed greater knowledge in financial matters and are currently particularly attentive to converting securities in foreign currency, to the differences between domestic and foreign tax systems, and to the interrelationships between transfer prices and taxes, and among transfer price policies, financial profits, and competitive advantages.

It is by no means easy to identify the direction and intensity of the relationship between level of integration of the markets (and especially financial markets), and technological development. It bears observing, however, that since the first introduction of the Reuters display in 1973, there has been a considerable increase in the development of the market integration process that began with the crisis of the Bretton Woods system of fixed exchange rates.

In connection with technological evolution, it bears pointing out that the globalization of markets (of goods, factors, and capital), understood as the strong interaction of markets, in requiring a faster process of companies' adaptation to an articulated and complex environmental setting, has also created new opportunities to be grasped. It has at the same time raised the need for more, and more flexible, financial resources.

In recent decades, every country essentially had a single financial market, in which the different types of instruments circulating in it were exchanged. In this atomistic and highly public law–oriented conception, the operators

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on the financial market were seen as public institutions at the service of private individuals, and not as companies producing services and themselves the object of entrepreneurial initiatives. Therefore, the interaction of financial markets has overturned the atomistic conception, bringing about, on the macroeconomic level, a systemic market vision. Although internally articulated with regard to the operators' behaviours and regulations, this vision should be considered from a unitary perspective with regard to interconnection among the decisions undertaken locally, and in terms of the supranationality nationality of the effects derived from these decisions.

Moreover, considered as a search for the ubiquity of competitive advantage, globalization has resulted in focusing managerial attention on new decision-making problems regarding the location of the business activity, the creation of often captive financial companies, and the acquisition of currency and tax benefits depending on the regulatory differences that exist in the different countries in the matter of inter-company relations and transfer of income.

The fall of the exchange monopoly and of the bank "channelling" of foreign transactions contributed to developing a systemic logic in interpreting financial movements on financial markets. In the common financial space, the competitiveness of financial markets introduced by international unification entails an allocation of capital done with a view to comparative advantages, and thus to arbitrage among the various opportunities that are manifested in the individual markets; competitiveness means that financial exchanges may concentrate in the markets that are most efficient in terms of costs and risks related to the different transnational activities undertaken.

## The Role of the Function of Finance in Internationalized Companies

In this perspective, finance has broadened its field of action, involving a number of different areas/themes within it, such as

– the planning of medium- and long-term financial flows regarding the policies of international investment and the related policies of choosing the sources and types of financing;

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- the choice of criteria for assessing the current and prospective conduct of the activities of international concerns;
- multi-currency treasury management, which is to say the management of cash surplus/deficit generated by financial movements in currencies other than the national one;
- the decision-making choices and the hedging techniques to be adopted to face the risks derived from uncertainty over future variations in financial variables;
- actions aimed at taking advantage of the opportunities derived from the existence of anomalies in financial markets; and
- actions aimed at taking advantage of the opportunities derived from the presence of different tax burdens in the various countries, through suitable policies of transfer prices for goods and services between the parent company and associated companies.

The greater financialization of business activities results in an increase—in both intensity and volume—in the economic and financial risks companies are exposed to. Albeit aware that not all risks can be totally eliminated, it is necessary for companies to learn the effects resulting from exposures to different types of risk.

In the first place, international companies must increasingly acquire a capacity to control market risks, which is to say those risks to which economic operators are exposed as a function of unfavourable variations of the prices of the underlying activities. Market risk, then, is the risk an internationalized company's economic and financial situation is exposed to depending on unfavourable variations in the market prices of financial activities: exchange rates, commodities and securities prices; interest rates.

Secondly, companies that operate above all in emerging countries must acquire an ability to "control" the credit risks linked to the possibility that the other party in a financial operation might not meet the obligation taken on by the deadlines and under the conditions provided for by the contract.

It bears noting here that in cases where there is a high possibility that a defaulting party's crisis situation will spread by "domino effect" to other operators, the company's risk exposure increases: the other party's credit risk enlarges to become systemic risk, which includes the case of country risk.

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Given the growing importance of business finance activities and the repercussions erroneous conjectures may have on the trend in financial variables, the problem is raised of identifying companies' behaviour with regard to the variability of these magnitudes. These magnitudes' impacts on economic and financial equilibria may be verified after the fact, and the likely repercussions estimated beforehand.

In response to expected fluctuations in financial variables, management must seek to act in a timely fashion, concerning itself with limiting or, if possible, nullifying the potential negative economic repercussions connected with their unfavourable trends. Contrariwise, it must also seek to seize the opportunities arising from certain expectations since, with the aid of suitable financial instruments—such as financial arbitrage, repo operations, and more innovative instruments like derivatives—the irregularities present in financial market trends may also present an additional source of increased corporate income. The dichotomy of the results leads, then, to defining exposure to market risk, unlike credit risk, as a "two-way-risk."

Among financial variables, particular attention must be given to the foreign inflationary component (exchange rates); exchange fluctuation generates a dense network of *interrelationships* with retroactive effects leading to variations in the prices of the factors and goods, modified market demand, changes in the levels and structure of interest rates, and imbalances in the companies' economic and financial circuits.

As regards interest rates, uncertainties over their medium/long-term variations have led credit institutions to adopt particular actions to hedge against financial risk, such as cutting down the duration of loans, replacing the fixed-rate system with indexed rates, and reviewing loan conditions more quickly. Moreover, the shorter duration and indexing are also the levers used by the issuers of fixed-rate securities, for the purpose of conquering increasingly large segments of the market of savers.

Fluctuations in the financial variables have an impact on corporate performance that is not homogeneous for all companies in any sector, but varies depending on

– the relevant sector, its structure, and therefore the intensity of competition; and
– the regulations, in the markets of origin, of the productive inputs and of the destination of market outputs.

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The mode of implementation of companies' internationalization strategies can also influence the connections between financial markets and corporate performance, if one considers, for example, that the passage between forms of competition and of collaboration may also bring about supplier/customer agreements aimed at a more equitable division of market risks.

Therefore, it is unthinkable that the management of international companies might let costs and revenues expressed in a foreign currency (with the single currency in Europe, foreign currency refers to non-EU countries) fluctuate freely, and not decide, in response to unfavourable fluctuations, what market risk management policy to implement; this becomes even more important for multinationals, whose branches, often operating in weak-currency markets, may record losses or worsened competitive positions that cannot be linked directly to the parent company's governance policies, or to the branches' decisions concerning the activities included in their sphere of responsibility.

In the case of prices for raw materials, management has developed increasing awareness of the vital role played by the function of procurement; this is in light of the imbalances created following the gradual decentralization of production, and the increased internal variability of the supply markets. In response to price increases, or to expected increases, management streamlines stocks of materials on the one hand, while on the other hand seeking to establish relationships, or types of strategic alliances, with suppliers; the aim is to guarantee the quality of the purchases, to contain price variations within given time frames, and to meet delivery deadlines.

The moment of purchase is a moment of indirect assessment of the company's effectiveness of operation, understood by the customer as the organization's ability to achieve a better trade-off between price and product quality attributes of importance to consumers in accordance with their scale of relative importance; on the other hand, the choices made by consumers in a given segment provide clear proof of the effectiveness of the marketing programmes developed by management in for that particular target market. From the standpoint of marketing actions, price, also considered in its relationship with the quality that may be perceived by the consumer, becomes, for the planner, only one of the decision-

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making variables to be used to modify given market situations to one's own advantage; this means that for a given asset there is what Panati (1987) called the "firmament of prices," a "phantasmagoric kaleidoscope" that disposes the consumer to paying more for a product, not different from others present on the market, but *differentiated* from them in terms of brand or the image that the producing/retailing company has been able to create over time.

"Purchase marketing" activities make it possible to achieve, at the same time, the objectives of lower levels of safety stock, reduced inventory stocking times (obtained by bringing arrival dates closer to the dates of use at the factory), and, in the final analysis, lower pressure on corporate cash flows.

In this regard, the managerial problem that the corporation is called upon to face takes concrete shape in the choice of hedging policy to be implemented or, lacking a hedge, in the orientations to be given to the branches, ensuring the achievement of the strategic objectives pursued both centrally and peripherally.

To respond efficiently and effectively to financial market turbulence, management must, in the first place, learn how to find out the relationships between financial variables and corporate performance. It must then learn how to "make conjectures" on the future trend in these variables, in order not to find itself unprepared to deal with events or, conversely, for to try and exploit opportunities as they arise.

It is in this phase of the company's relationship with its environment that the interrelationships between efficiency and effectiveness in entrepreneurial action are closer and more evident.

## Creation of Supervision Nodes

As stated, coordination difficulties increase considerably in situations of mutual interdependence, that is, where internationalized companies operate with a view to the systemic interconnection of the effects found in the various environments in which the associated companies are located.

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Where there is a complex system of relationships, it may be useful, for more efficient and effective control and governance of the corporation's financial activities, to cut the network of connections between the parent company and decentralized units, and to create "supervision nodes" to be tasked, under the control of the parent company or peripheral unit, with coordinating the associates' activities that fall under their respective spheres of action.

Through the creation of "financial nodes" often located in a market that is particularly attractive in terms of less restrictive policies on controlling the activities of the companies operating in it, geographically disperse multinationals can obtain financial profits by centralizing the management of the associates' financial activities.

One example of a supervision node is that of the reinvoicing centres whose purpose is to centralize, within themselves, procurement for groups of associates, with the consequent economies of cost derived from the increased bargaining power that a centre can obviously have.

It will then be the centre that invoices the associates, depending on the flows of goods sent to them. Generally, invoices are made by the centre in the associates' currency and, in that way, the centre, by centralizing exchange risks within itself, can manage the entire group's multi-currency treasury. By this technique, a more orderly group currency policy is pursued.

Reinvoicing operations have the benefit of avoiding some local resistance to the parent company's strategic choices and offer the possibility of extending compensation mechanisms to operations concluded autonomously by the individual associates with outside customers.

The reinvoicing centre can also pursue transfer price policies, with the term "transfer price" to be understood as the price paid by an associate to the parent company, or to another associate or the reinvoicing centre, for the transfer of raw materials, components, intermediate products, or services.

From the technical standpoint, transfer prices are one of the most complex problems to be solved in the management of multinationals, since if the cost of the transferred products/services could be determined with certainty, in all its components, problems of estimating the transfer prices would not arise. On the other hand, some costs are, by their very

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nature, difficult to divide among the associates (e.g. consider research costs).

The transfer prices to be attributed to the flows of goods transferred from a reinvoicing centre are set basically as a function of the purposes pursued by the centre or the corporation.

Prices may be lower than those charged on the associate's market, when the local competitive situation is rather intense, or when the associate is in a start-up phase and must seek to achieve possible competitive positions as quickly as possible. In this case, the reference price's parameter of reference can be the cost incurred by the centre, which discounts economies of scale, or even a lower price of the procurement cost borne by the centre.

If the centre is unable to bridge the cost/price gap by means of higher transfer prices attributed to other associates, it will suffer fictitious losses, ascribable exclusively to the pursued price policy. The associate so favoured will earn fictitious profits not attributable to the operational conduct of local managers, while the associates in a situation of higher transfer prices of course earn less profit.

Profits are thus transmitted from (favoured) associate to associate, and this is why transfer price policies implemented by corporations often cause intra-organizational conflicts, especially if the peripheral managers are judged (and paid) on the basis of locally earned profits.

In situations where the corporation's policy is centred on a more neutral assessment of the associates' performance, from an equidistant perspective, the criterion followed by the centre may be that of assessing the transferred goods on the basis of the corresponding prices charged on the individual local markets. The formation of fictitious losses or profits can thus be avoided, and it will be the centre that obtains a profit (or, unrealistically, a loss) as a sum of each associate's cost/price gaps.

The transfer price policy also pursue other goals, such as:

– Earning, through higher transfer prices of the goods, low profits where the tax system is more rigorous; conversely, the centre will seek to earn higher profit where the tax system is less rigorous, in this case by transferring lower prices—lower than the transferred goods' cost on the local market;

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– Attenuating the effects of restrictions on movements of capital, dividends, and royalties; reducing the effects of nationalization, should this take place;
– Greater influence not only on taxation but also on duties and, therefore, on the price of raw materials or semi-finished products, when duties are applied to imports on the basis of the value of the products transferred from one country to another.

It is lastly to be pointed out that it is becoming increasingly hard for multinationals to practise transfer price policies, since (Pellicelli 1990)

– the differences among tax systems are continuing to diminish, especially in industrialized countries, and there are therefore fewer incentives to transfer profits from one country to another;
– tax administrations are increasingly attentive and attuned to these procedures that may reduce their tax revenues;
– the assessments of the associates' results may be distorted if the transfer price policy has objectives different from that of calculating actual cost (assessment of the branches' activity).

## Financial Risks and Counterparty Risks

The greater financialization of business activities increases, in intensity and volume, the economic and financial risks to which companies are exposed. While aware that not all risks can be totally eliminated, companies have to learn to recognize the effects derived from exposure to different types of risk.

In the first place, international companies must increasingly acquire an ability to control market risks, which is to say those risks to which economic operators are exposed as a function of unfavourable variations of the prices of the underlying activities. Market risk, therefore, is the risk to which an internationalized company's economic and financial situation is exposed as a function of unfavourable variations of the market prices for financial activities that, excluding the financial variations linked strictly to speculative movements (values of the stock market indices), are

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exchange rates, commodity and security prices, and interest rates. The risks connected to the trend in financial variables are two-way risks: proper financial management must take account of the need to be protected from unfavourable variations, but must also consider the opportunity cost of any hedging; and therefore the possibility that these hedging operations might preclude the ability to exploit any positive variations in these variables. From this perspective, it may be said that financial risks (different cases in which market risk is articulated) cannot be limited: hedging policies allow companies to transform the uncertainty connected to the variation of financial variables into a calculated risk, and thus to limit exposure to the negative effects that may derive from them.

In the second place, companies that operate above all in "difficult" markets must acquire an ability to "control" credit risks, connected with the possibility that the counterparty in a financial operation might fail to meet its obligation by the deadlines and under the conditions provided for by the contract. In this regard, it bears noting that in cases in which there is a high possibility for a defaulting party's crisis situation to spread by "domino effect" to other operators, the company's risk exposure increases: counterparty credit risk expands to become systemic risk. One last case of counterparty risk is country risk, understood as the possibility that a debtor defaults due to causes beyond the individual's control, involving a country's institutional sphere.

Looking specifically at managing financial risks, financial immunization has the purpose of reducing the risks underlying the variability of prices, exchanges, and interest rates. If hedging techniques are systematically adopted for all at-risk operations, the company eliminates, or at least "controls," a "calculated" risk, the riskiness of the negative repercussions on management results caused by fluctuations in financial variables. Over the long term, hedging lowers the likelihood of encountering financial crises, thereby reducing the variance of the company's value (Mayers and Smith 1982; Smith and Stulz 1985). The use of hedging instruments has increased considerably in all financial markets, and the significant development recorded by derivatives is cause to suppose that these instruments have replaced the more traditional forms of hedging (defensive contractual terms, fixed-term contracts, insurance coverage).

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The problem is raised of the determinants that lead companies to cover their financial risks, and that cannot be ascribed to a generic risk aversion which theoretically explains the choices of individuals in a society more than those of institutions and companies.

As Modigliani and Miller taught back in 1958, portfolio theory maintains that corporate hedging cannot benefit the shareholders, because it does not lead to reducing the cost of capital; in fact, since shareholders can diversify their portfolios, the reasons for a company to perform hedging actions in order to safeguard shareholders from financial risks no longer apply.

However, it bears noting that in a traditional perspective and on a macro level, the possibility of reducing risks through portfolio diversification was recognized only for investors that could operate in markets offering a wide array of stocks to invest in. In fact, it was maintained that when shareholders were operating in environments marked by diffuse stockholding, typical of settings dominated by the separation between ownership and control, they could effectively take advantage of diversification opportunities. An efficient and multi-sector financial market could offer a broad choice of stocks to hold, and thus a higher portfolio flexibility depending on the opportunities as they arose on the financial market.

It was also maintained that shareholders could not carry out an efficient diversification of their portfolios when the market concentrated capital in the hands of a majority interested in "controlling" business activity. If on the one hand this kept outside third parties from entering into the decision-making systems, on the other it also limited minority investment choices. Moreover, majority shareholders, in order to make smaller stockholding more stable and also to indirectly control the non-speculative movements of shares on the stock market, had to pursue the primary objective of making the return on the stock investment more stable (at any rate, this is the objective that led to the creation and affirmation of savings shares); the case of hedging done by companies to protect shareholders from financial risks might then be considered from this perspective. However, in the current environmental dynamic, technological development, market integration, and globalization have expanded the boundaries for choices, and broadened opportunities for investment,

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and investors belonging to markets marked by concentrated stockholding can thus also implement policies to diversify their own portfolios.

If the shareholders' interest is not the main determinant leading the company to hedge against financial risks, the incentivizing factors are linked to the possibility that suitable hedging policies and the choice of appropriate hedging instruments can shelter the company from liquidity crisis, and from a strict dependency on contingent factors, thus helping it act with a long-term outlook, with positive effects on maintaining or growing its economic value. This is particularly important in the perspective of an environment subject to changes that not only cannot be controlled, but often cannot be foreseen. On the other hand, the greater environmental complexity has only increased the types of risks and their intensity.

The multiple financial risks that companies operating internationally, both outgoing and incoming, have to face may be summed up as follows (Errunza and Losq 1987):

- Currency risks, related to volatile exchange rates and to the loss of consumers' purchasing power
- Political risks, including the risks of expropriation and nationalization, which present an explicit barrier to capital flows
- Investment risks, correlated with the stage of development achieved by the host country

## Currency Risks

Currency risk, which is to say the risk connected with the variability of exchange rates, produces three important effects for companies:

1. In the first place, an exchange variation impacts the debts owed to and by companies in foreign currency. This risk, defined as transaction risk, is manifested whenever companies grant or receive deferments of payment by or from counterparties situated in different countries. Of course, the risk exists only if the transaction must be settled in a currency other than the home currency, and yields its

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effects when calculating the countervalues in national currency of debts owed or to be collected in foreign currency. In a "direct or indirect" regime, it takes concrete form as follows: for the importer, the possibility that a reduction in the exchange might result in an increase in the euro countervalue of debts owed in foreign currency; for the exporter (seller), the possibility that an increase in the exchange might result in a decrease in the euro countervalue of the debt owed to it in foreign currency. To the contrary, in an "indirect or direct" regime, the importer fears the increase in the exchange rate (a circumstance that would increase the countervalue of the debt expressed in its own reporting currency), and the exporter fears the decline in the exchange rate (which would diminish the countervalue of the debt owed to it in foreign currency).

2. The variation in the exchange rate also impacts the actual countervalue of the financial statement items related to transactions in foreign currency. In the time that passes between the entry and the closure of the financial statements, the exchange might possibly undergo variations such as to modify these entries' relative weight. There is debate in this regard as to the moment in time starting from which exposure to risk begins; this moment would appear to coincide with that in which the order is made (for the purchaser) and the invoice issued (seller), again in currencies other than the home currency. This form of currency risk is defined as translation risk.
3. Lastly, but of no less importance, the exchange variation may impact the company's competitive position in a given market, rendering the investments it has already made less profitable, or its products less attractive. This is more generally defined as economic risk.

The unifying aspect of the different types of exchange risk may be identified by focusing attention on the fundamental effects connected with exchange rate variation, and on the way in which these effects are perceived as management goes forward (Stampacchia 1995). For the author, there are essentially two elemental effects that exchange rate variations can have on the "system" of flows and values in the reporting currency of an international company: the *countervalue effect*, representing the variation of the reporting currency's value as a function of the variation of the exchange; and the *currency flows effect*, representing the varia-

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tions of the flows as a function of the modifications of the overall system of expediencies induced by exchange rate variations.

Emerging from these concepts, and especially from the *currency flows effect*, is the bond of influence that exists between exchange rate fluctuations and the competitive position of companies, when "unfavourable" variations are consolidated over time. Therefore, for efficient governance of transaction risks, it would be appropriate for the manager to seek, at the very moment in which credit or debt positions in currency are taken on, or at a later time (prior, at any rate to the positions' maturity), to effect the relative hedging, if not systematically, at least from a selective perspective. There are many tools available to companies to hedge against transaction risks, and they permit a broad range of alternatives, which may be functional to the managers' financial knowledge and to the nature of the available information.

As for the instruments to hedge against currency risk, a distinction between traditional and innovative is made. The traditional ones are invoicing in reporting currency (generally invoicing is in the seller's currency, but the choice at any rate depends on the parties' contractual power); insurance (highly expensive, and often impracticable for minimum amounts and country); and the establishment of defensive clauses. The most-used defensive clauses are the currency basket (more stable with respect to the individual currency due precisely to the possibility that the revaluations of certain currencies and devaulations of others might offset one another), the establishment of an exchange cap to the exporter's advantage ("direct or indirect" regime), the establishment of an exchange floor to the buyer's advantage ("indirect or direct" regime), and the possibility of establishing an exemption, and thus the possibility of using the established exchange up to a certain threshold.

## Price Risks

In addition to the risks specifically connected to internationalization, consideration should be made, in the area of financial risks, of the volatility of commodity prices, which directly or indirectly impacts companies' production costs and therefore their profit margins. High volatility in the prices of certain raw materials, often originating from countries with

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weak currencies, makes price risk management critical, especially for those companies with considerable risk exposure due to a greater incidence—out of the total of productive inputs—of the factors imported from abroad. The lesser the level of corporate added value, and the higher the replacement costs, the greater the exposure is. The negative repercussions for corporate profitability may be manifested in the form of increased production costs, reduced operating margin, and a lower price competitiveness in comparison with competitors.

With regard to price risks, three types may again be discerned:

1. Transaction risk, linked to the possibility that an increase (decrease) in the commodities' quotations might force the buyer (seller) to pay (collect) an amount greater (less) than that estimated.
2. Replacement risk, linked to the possibility that an increase in prices might shift demand towards replacement products.
3. Economic/competitive risk, related to the possibility that the increase (decrease) in prices might be to the disadvantage of a company but not its competitors that purchased (sold) at more affordable prices.

In this case as well, two categories of hedging instruments may be discerned: real instruments and financial instruments.

As concerns real instruments, mention is to be made of agreements at a fixed price (depending at all times on the parties' contractual strength) and of the use of the technique of speculative inventory (purchasing when prices are lower). This policy, although fruitful, cannot always be used by companies. In the first place, the possibility of using it depends on there being adequate liquidity; in the second place, not all raw materials and semi-finished products can be stocked and, at any rate, stocking depends on having adequate warehouses. Lastly, this policy exposes the company to capital expenditures and the risk of obsolescent and decaying inventories.

## Credit Risk, Country Risk, and System Risk

As already discussed, credit risk expresses the possibility that the counterparty in a financial service might fail to meet its obligation by the deadlines and under the conditions established by contract.

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The assessment of exposure to credit risk includes essentially subjective components, as well as certain parameters of reference for the assessments, such as the time left before the contract expires, and the expected variability of prices, the exchange rate, or interest rates.

The difficulties inherent to measuring credit risk, which grows to the extent in which there are no frequent relationships of exchange with the counterparties, result in entrusting to specialized operators, such as ratings firms, the judgement as to the counterparties' reliability. Often, the assessments expressed by these agencies merely replicate the ratings determined by competitors, thereby accentuating market turbulence; it follows that an error that is made when competitors are "in the right" may create damage greater than the benefits derived from an accurate forecast, in the case in which the competition is "in the wrong" (Masera 1993).

Some financial instruments, such as derivatives, for example, in providing a hedge against market risks, at the same time offer guarantees to protect credit risk. In this way, two orders of benefits are produced: at the microeconomic level, the intermediaries can, with lesser uncertainty, adjust, to the "desired" levels, their exposures to the expected fluctuations of financial variables; at the systemic level, financial transactions that are made do not create new risks, but ensure these risks are distributed more rationally among operators.

For credit risks too, coverage may be gained a priori, by transferring the risk itself to third parties: SACE insures export credits (Ossola Law), provided that the payment deferments granted by the exporter to its debtor exceed a given time frame, equal to eighteen months.[1] It is also possible to protect oneself from credit risks with the known procedural techniques established for documentary credits.

As concerns country risk, it bears noting that the repeated foreign debt crises of the developing countries and the countries of Eastern Europe, and financial integration and liberalization processes, have accentuated the problems related to this risk.

Signs of increased country risk, such as longer delays in making payment, tend to yield economic effects upon the value of the exposures,

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[1] According to the opinion of some entrepreneurs, the bureaucratic problems connected with the excessive required documentation often force the acceptance of solutions requiring deferment times far longer than 18 months.

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even before any concrete manifestation of insolvency, through the depreciation of the credit portfolio recorded on the basis of market quotations (Carcascio 1995).

In comparison with counterparty risk, country risk involves responsibilities that fall within the sphere of government and, moreover, may be realized regardless of the insolvency of the individual counterparty, when the authority's will to repay foreign debt, public or private, ceases. The level of country risk reins in enthusiasm for the international diversification of portfolios, at times also with contained levels of risk, in the consideration that any losses associated with it (nationalizations, prohibition against expatriating capital and profits) may be considerable in size (Solnik and MacLeavey 1991).

Doubts as to a country's political and institutional continuity and the variability of regulations, widespread delays in payments, ethnic conflicts, and internal conflicts are all parameters taken as a reference in evaluating a country's rating. They serve as sentinels of the economic effects that, in terms of probability, will impact the value of the exposures with regard to that country.

Generally, there is a depreciation of the credits owed by countries at risk; the debt-equity-swap mechanism takes place in fact through a drastic reduction of the nominal value of the debts owed to operators in industrialized countries by operators in developing countries.

In recent years, to face country risk, innovative financial instruments have come into being, such as credit derivatives, created in the early 1990s; their purpose is to transfer to a counterparty the credit risk connected with a specific underlying activity (a bond, a bank loan, or a combination of these activities).[2]

[2] Instruments or techniques aimed at obtaining this result already existed, for example, in the form of bond insurance, which did not gain much traction. Another, more widespread, form calls for the creditor to take on short positions in futures, having as their object stocks in the debtor company. This technique in particular allows a profit to be obtained in the case in which the company's insolvency or default reduces the value of its shares, and this profit goes towards offsetting the losses suffered by the creditor. The mechanism, however, has a high basic risk, as the reduction of the shares' value following the insolvency cannot be easily foreseen; moreover, futures contracts for individual stocks are available only for listed companies, whose stock has a high float.

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Credit derivatives consist of an agreement between two parties, through which one party, upon payment of a single or periodic commission, is hedged against the credit risk connected to the activity of reference; the hedge consists of the counterparty's commitment to perform a counter-service, should a specific "credit event" occur, such as insolvency, bankruptcy of the debtor of the underlying activity, or a worsening of its creditworthiness.

The counter-service may consist of a cash payment of an amount predetermined in the agreement, a payment of an amount determined in accordance with the procedural schemes established in the contract (difference between the initial value of the activity of reference and that following the occurrence of the event, pre-established percentage of the credit's recovery value), and the physical delivery of the activity of reference, if this is available.

The most widespread form of credit derivative has been that of the credit swap, in its two main forms: Default Risk Swap and Total Return Swap, which have different structures for the payments established by the agreement (Hart 1995).

Default Risk Swap entails, for the duration of the contract, the periodic exchange between two counterparties of cash flows calculated on a notional capital consisting of the value of the activity of reference: the contracting party that transferred the credit risk (seller) pays to the counterparty, at different agreed-upon dates, a cash flow obtained by applying to the notional capital a rate that takes account of the credit risk connected with the activity of reference (Libor + X basis points). The contracting party that accepts the transfer of the risk (purchaser) pays the counterparty a cash flow by applying to said notional capital a base rate equivalent to the cost of the funds, increased by a spread (Libor + Y basis points).

This payment structure, then, generates a differential cash flow that in fact constitutes the periodic premium borne by the party transferring the credit risk; the level of the premium depends on the size of the risk related to the activity of reference. In the event of the country's insolvency, the seller receives, from the counterparty, repayment of the debt owed to it.

There may also be the case in which the purchaser, generally a bank, issues a bond with a yield equivalent to the country risk for the underlying activity. This bond may be purchased by an institutional investor

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(investment fund, insurance company) in turn interested in increasing the country risk in order to raise the performance of its portfolio, which takes on the burden, in the event of insolvency, of repaying the debt to the seller.

The likelihood of loss by the party accepting the credit risk is a function of the likelihood of the debtor's insolvency, of the leverage factor predetermined by the agency, and of the realizable recovery rate. The statistical data furnished by the leading rating agencies and regarding the elements listed earlier may be used to assess the operation's riskiness.

The Total Return Swap is another possible credit swap structure. In it, the parties, during the contract's lifetime, exchange, in addition to the periodic commission, any revaluations or devaluations of the underlying activity. This means that the periodic cash flows generated by the agreement are not always and exclusively borne by the party transferring the credit risk: the direction and amount of the cash flows also depend on the variations that the value of the activity of reference undergoes between two payment deadlines.

It is clear, then, that one of the crucial elements in the agreement is certainly the determination of the mechanism for assessing the activity underlying the credit swap. If it is a bond that is traded on the market, its market quote can then be used; otherwise, one of the theoretical models developed for this purpose must be employed.

Given the relative complexity characterizing the two types of credit swap illustrated earlier in the text, it is appropriate, upon concluding the agreement, to pay particular attention to the definition of all the contractual elements and, in particular the key terms, such as those connected to the credit event (insolvency, bankruptcy, etc.) and to the consequent structure of the payments. The purpose of this is to avoid objections or defaults based on unclear elements of the contract. The International Swap Dealer Association (ISDA) is also moving in this direction, as it is seeking to formulate a standardized clause able to univocally define the contract terms.

Going on now to analysing the possible concrete uses of these instruments, it must be stressed that their characteristics make them particularly attractive for banking enterprises and, more generally, for financial

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intermediaries, which, following their activities, have always been exposed to credit risk.[3]

Thanks to the use of credit derivatives and of credit swaps in particular, banks can treat credit risk separately from the granted loan, thus achieving greater flexibility in implementing their credit risk management programmes.

Of the most recent players in the credit derivatives market, mention must also be made of industrial and commercial enterprises, at least the larger ones.

## Hedging Policies and Derivative Instruments

Derivative instruments are contracts whose value depends on the trend in the underlying activity. Here, attention will focus on three types of derivative instruments: futures, options, and swaps. The three instruments may have financial activities, currency, or commodities as their underlying activity, and can be used in accordance with more or less speculative perspectives depending on the specific interests pursued by the party signing the contract.

Attention here will focus on derivatives regarding currency (currency options, currency futures, and currency swaps), commodities (commodity options and commodity future), and interest rates (interest rate swap). The logic that is followed will be that of the subscriber (company) using derivatives as hedging instruments, while having at all times to consider, in order to make an appropriate choice of instrument, the speculative potential of each. Moreover, we shall dwell exclusively on the instruments for hedging against exchange risk, typical of companies purchasing and selling from non-EU countries.

The simplest derivative instruments are forward contracts, which involve purchasing or selling a certain quantity of underlying activity at a pre-established maturity, and at a pre-established price (forward price).

[3] Institutional investors have also proven particularly interested in these: as holders of bonds issued by a party that might be insolvent, because the party belongs to a "difficult country," they may wish to separate and, therefore, transfer the credit risk inherent to their position, and thus remain exposed to interest rate risk alone.

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These instruments lock in the price or exchange risk associated with a given transaction, because the subscriber signs a contract today in which the elements are established and cannot be modified. It is an over-the-counter instrument, whose features are negotiated between the company and the financial operator.

However, precisely the fact that prices (or exchanges rates) are fixed, and that, therefore, the subscriber has had no opportunity to take advantage of their favourable variations, leads companies to use other derivative instruments that are more complex and often characterized by higher levels of risk.

## Currency Futures

The futures contract is a bilateral agreement in which one of the parties undertakes to buy or sell a certain fixed quantity of a commodity (commodity future) or of a financial activity (financial future) against a given payment in money, at a certain future date. It is a standardized instrument contracted in a market of its own (futures market). The standardization lies in the fact that the future's base elements (quotation, denomination, mechanism of operation) are pre-established by the Clearing House, the body that serves as a counterparty for all those operating in futures.

These instruments make it possible to take on purchase or sale positions in an activity without being required to have, at the moment of bargaining, the resources needed to meet the assumed obligation.

The positions that may be taken are

– short, equalling a sale of the underlying activities; and
– long, equalling a purchase of the underlying activities.

In addition to quality, type, and price of the commodity or of the financial activity that is the object of trading and the date on which the exchange will take place, the futures contract also includes the place of trading and the possible choices available to the seller for the delivery procedure.

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The elements of the future are as follows:
Position: Long = commitment to purchase; Short = commitment to sell.

- Denomination: fixed for each type of future and underlying activity, indicates the standardized quantity of underlying activity represented by a contract.
- Number of futures to be purchased; depends on the ratio between the capital to be invested and the denomination.
- The quotation, to be monitored daily, is the forward price of the underlying activity in the futures market.
- Nominal value = number of futures for the Denomination.
- Face value = countervalue of the nominal value.
- MI (initial margin) = percentage of VF that operators pay at the moment of signing in order to open the margin account.
- MV (margin of variation) = VF1−Vfo
- Margin call = 75% of the initial margin (MI)

The function of futures revolves around the "marking to the market" mechanism: every day, the subscribers' positions are crossed (pure accounting operation) with opposite positions in order to verify any crediting or debiting of the margin of variation.

Example: Subscription (purchase) of a future, long × short position

1. Purchase (long position) at start of day underlying the start-of-day quotation
2. End-of-day offset with sale (short position) of underlying activity of quotation existing at end of day
3. the next day, the initial long position is reopened at the previous end-of-day quotation and returns to points 1 and 2 until the future's maturity or until the process is interrupted at the will of the operator that subscribed the future, or in the cases in which the operator cannot compensate the margin account.

The objective of those subscribing the future is in fact to earn financial income (margins of variation) and, where applicable, to use it to offset the losses suffered in the real market (commodities) or the currency mar-

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ket (currencies). If the operator initially took a long position, it is offset daily with a short position if the face value increases, and the margin account is credited if the VF increases, and charged if it diminishes. To the contrary, if an operator has initially taken a short position, this is offset with a long position and the margin account is credited if the VF decreases, and is charged if the VF increases.

Based on this mechanism, operators speculating on VF increases will take long positions (to offset short); those speculating on VF decreases will take short positions (to offset long). Specific interest accrues on the sums credited and debited. Should the balance of the margin account fall below 75% of the initial value, the counterparty is required to call the margin, which is to say to bring the margin account's balance in line with the initial margin value. If the operator does not do so, the Clearing House closes the account, compensating the future with a position opposed to the initial one.

Example: dollar/euro currency future

In the currency future, the underlying activity is the foreign currency, and therefore

- the denomination is the standardized quantity of foreign currency drawn from the future (e.g. $100) and
- the quotation is the forward price of the foreign currency.

To simplify bargaining, only the case of a quotation expressed as the forward exchange in force on the European Monetary Union (EMU) market is hypothesized

(e.g. 1 euro = 1, … $ and therefore expressed as 1, … $)

In this way, it will be easy to identify the variation of the quotation and of the face value on which the operator wagers.

Let us consider an example:

Suppose that an Italian exporter is owed a $50,000 debt by US customers, and wishes to cover itself with a future having the following characteristics:

$$T = \$10{,}000$$

$$Q = \$1.27$$

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The exporter fears an increase in the euro/dollar exchange; given that the quotation is expressed as the exchange (N.B. the euro is quoted as "direct or indirect"), the exporter wagers precisely on the increase in Q.

We may calculate the number of futures so yielded as 50,000/10,000 = 5. The exporter thus subscribes five contracts.

Let us use the proportion to calculate VF.

$$€1:\$1.27=VF:VN.$$

Therefore, VF = 50,000 × 1/1.27.

Even without doing the calculation, it may easily be noted that the increase in the quotation would entail a decrease of the VF and, therefore, with these data, the exporter may be covered by taking a short position to offset the long.

In subsequent days, the MV is credited or debited depending on whether the quotation actually increases (decreases of VF) or decreases.

The calculation of VF is at any rate important for calculating the initial margin and margin call.

## Currency Options

Options are contracts with which the right (not obligation) is taken on to purchase (call) or sell (put) a certain quantity of underlying activity (currency or commodities) at a pre-established price or by a pre-established deadline.

Options are defined as European if they may be exercised only at maturity, and as American if they may be exercised until maturity. There are standardized over-the-counter options, but the operating mechanism is the same.

The elements of the option are as follows:

- Strike price (X). This is the pre-established (forward) price at which the subscriber of the call (put) may buy (sell) the underlying activity;
- Premium (Vo), which is the price at which the subscriber may subscribe the option and is always owed by the operator when the contract is signed. It expresses the value of the option.

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Options are referred to as “in the money” if, at the time of subscription, the strike price is lower than the market price. They are referred to as “at the money” if the strike price and market price are the same. Lastly, they are defined as “out of the money” if, at the time of subscription, the strike price is lower than the market price.

In the case of the CURRENCY OPTION, the underlying activity is a foreign currency, and to make calculations of benefit in euros and, therefore, to understand the countervalue in euros of the operations, it is necessary to convert the strike price (which is in practical terms a forward exchange) into euros, and to calculate the countervalue in euros of the spot exchange expected for maturity and of the exchange at maturity.

X = 1/SP, where SP is the strike price
St* = 1/Cpa, where Cpa is the spot exchange expected by the operator for maturity
St = 1/Cps, where Cps is the spot exchange at maturity

CURRENCY OPTION CALL (importer’s hedge):

$$St^* - X - Vo > 0$$

The operator subscribes the call because, according to its expectations, the option will allow it to purchase the foreign currency at a more beneficial exchange (SP>Cpa), and thus to save on the countervalue in euros.

$$St - X > 0$$

The operator removes the premium because the SP is effectively greater than the spot exchange at maturity, and therefore saves on the purchase of foreign currency.

$$St - X - Vo > 0$$

The operator has gained an advantage because it has saved, on the purchase of the foreign currency, an amount greater than the premium it paid.

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CURRENCY OPTION PUT (exporter's hedge)

$$X - St^{*} - Vo > 0$$

The operator subscribes the PUT because, according to its expectations, the option will allow it to exchange the foreign currency in euros (sell currency) at a more beneficial exchange than the market one (SP < Cpa)

$$X - St > 0$$

The operator removes the premium and sells the currency at the strike price (SP < Cps)

$$X - St - Vo > 0$$

The operator has gained an advantage because, with the option, it obtained a remuneration in excess of the premium paid.

## Currency Swaps

These are contracts signed between two parties, through which each party takes on the obligation to make fixed or variable periodic payments. They serve mainly to hedge against interest risk since they make it possible to transform the cost of financing from fixed to variable or the other way around, or to obtain savings on the payment of financial charges by exchanging the rate obtained from one's own credit institution with that received by the counterparty from another credit institution.

They may also serve to hedge against exchange risk.

To hedge against exchange risk, improper use may be made of a currency swap. This entails commitment to a pair of opposing operations on the same notional capital (foreign currency).

In the currency swap, the elements are all known, so operators can make a calculation in advance in order to verify the benefit of the operation.

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With a view to hedging, operators may plausibly choose, as a forward operation, the one that serves as a hedge. The importer will then verify the benefit of making a spot sale and a forward purchase of foreign currency. In this way, it will have, at maturity, the currency it needs to pay foreign suppliers.

The exporter, on the other hand, will verify the benefit of making a spot purchase against a forward sale of foreign currency (sale of foreign currency received from the foreign supplier).

Example 1: Spot sale of dollars and forward purchase of dollars (importer's hedge).

Supposing that the underlying activity is $1, the importer will make the following calculation of benefit, and will make the swap only if the result (R) is greater than zero.

$$R = \frac{1}{Cp} - \frac{1}{Ct} + \text{Interest on euros} - \text{Interest on dollars converted into euros}$$

$$R = \frac{1}{Cp} - \frac{1}{Ct} + Ie - \frac{I\$}{Ct}$$

- Where 1/Cp is the countervalue in euros of $1 calculated at the exchange Cp.
- It expresses the countervalue the importer obtains from the spot sale of $1.
- 1/Ct is the countervalue in euros that the importer pays for the forward purchase of $1.
- Ie is the interest in euros that the importer earns by investing, for the duration of the swap, the euros obtained from the spot sale of 1 dollar.
- I$ /Ct is the countervalue in euros of the interest in dollar that the operator renounces due to having spot-sold the dollar.

From the calculation, it may easily be understood that the operation's benefit depends greatly on the differential between interests, and therefore on the interest rate differential.

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Example 2: Spot purchase of dollars and forward sale of dollars (exporter's hedge).

Example for \$1 negotiated.

$$R = \frac{-1}{Cp} + \frac{1}{Cp} - Ie + \frac{I\$}{Ct},$$

If R > 0, it is beneficial to perform the operation.

In this case as well, the benefit depends greatly on the interest rate differential. In fact, the swap is an improper hedging instrument: to be covered, it is enough to make a forward contract for the forward sale of currency (exporter) or for the forward purchase of currency (importer). Operators choose the currency swap instead of forward precisely to speculate on the interest rate differential.

## Price Risk Hedging and Value Creation: Some Evidence from Jet Fuel

Rising oil prices have led many airlines to hedge prices, considering that, according to estimates by the International Air Transport Association (IATA), fuel is these companies' second largest cost item. Lin and Chang (2009), in a sample of 69 airlines in 32 countries during the period from 1995 to 2005, examined the sources of the hedge premium for jet fuel. These companies are subject to significant risk due to volatility, which allows the sources of added value derived from fuel hedging to be investigated by using the data from global airlines.

The results of the study show that jet fuel price hedging increases the value of airlines throughout the world. In particular, airlines residing in the United States that practise fuel hedging increase their value, while airlines that do not reside in the United States contribute no added value to their enterprises.

Like other industry operators, airlines protect themselves from fuel price risk through hedging. This is a relatively recent practice: before 1985, airlines did not hedge fuel risk, although they were already practicing

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currency hedging. Even today, some airlines are not hedging this risk with financial instruments, but simply pass price increases along to the final customers: this is the case, for example, with Lufthansa and FedEx, which shifted fuel price increases onto the final customers in the cargo sector (Morrell and Swan 2006). However, this solution is difficult to put into practice in passenger transport, given the strong industry competition.

Airlines have the possibility of trading various types of financial instruments useful for hedging both jet fuel and oil. Jet fuel can only be traded OTC (over-the-counter—i.e. outside the regulated markets, with no clearing house), and its liquidity is certainly lower than oil, which can be traded on the regulated markets NYMEX (United States) and IPE (Europe). Generally, contracts do not exceed 12 months, with 80% of contracts not exceeding three. Various types of contracts are used: forward contracts, futures contracts, and derivatives like options, collars, and swap.

Forward contracts are not traded on regulated markets, but directly among counterparties (OTC), which spot fix price and quality of the underlying asset. There is counterparty risk, given the possibility of one of these ending up bankrupt prior to the contract's expiration. The airlines' fuel suppliers, like AirBP, use forward contracts, which are less convenient for speculators (Morrell and Swan 2006).

Futures contracts, on the other hand, are designed both to hedge fuel risk and to provide protection from counterparty risk. The supplier accepts shipping the counterparty a given amount of the underlying asset (in this case, oil) at a given price (the "strike price") on a given future date. In general, the position is in almost all cases reversed upon the contract's expiry, in order to avoid the physical delivery of the underlying asset. According to NYMEX, fewer than 1% of contracts end with the physical shipment of the underlying asset.

Oil futures are traded on two leading regulated markets: NYMEX (New York) and IPE (London). Each futures contract that is signed corresponds to 1000 barrels of petroleum (West Texas Intermediate or Brent Crude Oil). These may be signed every month, up to two years in advance and with a duration of up to three years.

Often, companies in the sector rely on options as well. When exercising the option, the purchaser is in a position analogous to that of futures.

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Call options allow price increase risk to be hedged simply by paying the premium, without requiring an operating margin. This financial instrument can therefore also be used in the event of economic difficulties which, of course, would not permit the purchase of margin instruments.

Jet fuel options are rarely traded, and are OTC. Therefore, there is the risk of both counterparties—a risk from which it is necessary to protect oneself further. On the other hand, Brent gas oil and crude oil options are available, which may be traded on the IPE regulated market.

Lately, airlines have tried a special combination of call and put options, defined as "collar." A call option is purchased for protection against price increases, and at the same time a put option is purchased to protect also against the risk of the market going in the opposite direction.

The premium of the call option will be greater than the put option, and therefore where the call is exercised, the profit lies in the difference between what is collected by exercising the call option and the lost premium on the put option. If the market trends in the reverse, the put option is exercised, in which the earnings will partially hedge the loss paid on the call.

Another financial instrument that can be used is that of swaps. Swaps are customized futures contracts through which airlines lock in the fuel price. The airline purchases a swap at a given strike price for a given quantity of jet fuel per month. The current price is compared every month with the strike price, and where it is higher, the airline receives the added value in comparison with the strike and, conversely, will pay the counterparty the loss on the strike where the price is lower that month.

Turner and Lim (2015) examined four commodities (West Texas Intermediate (WTI), Brent, heating oil, diesel fuel) typically used by airlines to cross-hedge jet fuel.

Airlines have had conflicting results with hedging, and the general feeling on the part of both airline executives and scholars is insecurity regarding the procedures for hedging their own positions on fuel. While some articles have suggested that, due to the shortcomings of an ordinary least squares (OLS), a more advanced model should be used, this study does not draw the same conclusions. Other models, such as ECM and the generalized autoregressive conditional heteroskedasticity (GARCH), generate hedge ratios similar to OLS.

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After the simulations, the results by Turner and Lim (2015) demonstrate that no model clearly and consistently generates a hedge ratio better than the other models. This study shows that airline cross hedges created with futures should use oil as the base product.

Since fuel oil is a refined petroleum product, its price comes close to other fuels. Moreover, with a daily hedge horizon, diesel fuel is inferior to the other three petroleum products, and is less effective for hedging the fuels, regardless of the moment of the contract's expiration, but its performance improves with a weekly hedge horizon. Moreover, airlines that hedge futures would create the most effective hedge by using contracts expiring at three months for fuel oil, but the hedge's effectiveness diminishes as the time to reach the contractual expiration increases.

However, based on the in-sample analyses and the results of the Monte Carlo simulation, also with fuel oil, the hedge's performance is 67% lower for the hedge's effectiveness. Performance improves up to about 71% with a weekly hedge horizon. The results reached by Turner & Lim (2015) might therefore be sensitive to the hedge horizon.

To have a more holistic view of the hedge's performance and of the model's use, the hedge's duration should be carefully examined in future research to associate the frequency of the data with the planned hedge horizon.

An interesting example is that of Delta Airlines (Carter et al. 2006), which maintained high hedge percentages. In particular, at the end of 2002, the company had hedged approximately 65% of its fuel requirement for 2003 but increased its exposure during the period after the 9/11 attacks, believing that the industry crisis would be a short one. At the end of 2003, Delta's long-term debt reached 48% of total assets, against the 27% recorded in 2000, with approximately $1 billion coming due in 2004. During the 2001–2003 period, Delta posted operating losses for nearly $3 billion, even as it made interest payments for $1.9 billion. In February 2004, Delta liquidated the hedge contracts existing on jet fuel to collect $83 million in cash, leaving the airline totally exposed to future price shocks.

The positive link between hedging and value creation is confirmed by the fact that for European airlines, growth in EBIT (earnings before interest and taxes) bears a significant negative correlation with systematic risk (Lee and Hooy 2012). This means that when EBIT grows, the value of $\beta$ must fall.

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