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Teaching Note - Entry Strategies into China: A Case Study of Three Benelux Technology Firms

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Abstract. In this case study, three technology-based companies from the Benelux area are introduced, with different sizes, ages, and backgrounds (Philips, SMS-Timing, and Trebu Technology). The companies have used different entry strategies into the Chinese market, ranging from exporting goods and services to setting up joint ventures with Chinese partner firms and setting up wholly-owned subsidiaries in China. The case study presents the experiences of the three companies with these different modes of internationalisation in the Chinese market. Advantages and disadvantages of each mode are discussed in light of the different characteristics of the three companies. The purpose of the case is to improve understanding of doing business on the Chinese market. This case can be widely used for MBA and undergraduate students in the studies of international strategy, entrepreneurship, and cultural management. Teaching notes and analysis are provided for students as well as for instructors. Among other things, the teaching notes discuss the experiences and choices of the three firms regarding their internationalisation modes in light of the theoretical OLI (Ownership - Location - Internalisation) framework.

Keywords: China, internationalisation strategies, OLI framework.

Case Synopsis

The increasingly open business environment and the rapidly changing demographics with rising income levels have made China an attractive market for Western firms. The Chinese market has endless possibilities, but it is also one of the most difficult markets to successfully deal with (Zhang, 2013). This case discusses the different internationalisation modes of three Benelux technology firms with different sizes, ages, and backgrounds – Philips, SMS-Timing and Trebu Technology. The three firms have had different historical experiences with China as they were making efforts to optimise their internationalisation strategies while finding ways to overcome institutional hurdles.

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Teaching Objectives

After discussing the case, students should be able to understand a list of challenges related to dealing with the Chinese market, in addition to understanding the explicit advantage of China as one of the largest (if not the largest) markets in the world. Students need to be able to use strategic thinking to deal with various barriers and challenges including institutional, legal, political, and cultural challenges.

Target Audience

This case is suitable for postgraduate students in strategic management and international business courses. It can also be used in executive education for any Western company that is looking to expand into China.

Teaching Plan

1. What implications do the laws and regulations of the Chinese government have for companies desiring to develop their Chinese market?

First, although the Chinese economy has developed fast in the past decades, it still lacks consistent regulations towards foreign investment and foreign business in China. This is one of the most critical institutional barriers for innovation-based firms to operate in China. Since small companies do not have sufficient capital and experience to deal with disputes, lack of clear legal know-how has more significant impact on them than on any larger firm. China's current laws and regulations on breaching a contract that involves international cooperation are imperfect and a Chinese firm might break a contract without taking a factual legal consequence. This has put small and medium-sized foreign companies into a very disadvantageous position. To summarise, the contract-based institutional environment is less binding for Chinese domestic firms than for foreign firms, creating an uneven playing field. This is the primary challenge that foreign firms have to face in China.

Second, due to the preferential treatment by the Chinese government, large companies in China enjoy an advantage and tend to monopolise the market (Zhu, Wittmann & Peng, 2012). The internationalisation mode of large Benelux firms tends to evolve with China's policies. When China introduces new policies (such as the 'Belt and Road' Initiative – BRI), large multinationals will express their support and give positive responses. For example, Philips's internationalisation mode tends to change with and adjust to new policies being introduced in China. Its CEO Frans van Houten expressed his enthusiasm for BRI and said that the BRI is consistent with Philips' vision (FCCC, 2018).

However, the influence of policies is not so clear for SMEs like SMS-Timing and Trebu. In China, policies are the first signal to predict economic endeavour. Bigger companies tend to hear about new policies relatively early and are able to adjust their behaviour. However, for foreign SMEs, it is much more difficult to

receive the early signals, neither for them to digest nor to take advantage of the policy. SMEs' limitation in hearing, understanding, and using (new) policies is significant, and increases the chance to be squeezed out by Chinese local firms. Even with BRI's call to strengthen the collaboration between two sides of the world, foreign SMEs, without sufficient understanding of China, would not be able to easily survive there.

2. How does firm size affect a foreign company's expansion mode in the Chinese market?

Small firms like Trebu Technology and SMS-Timing chose a relatively simple expansion method, whereas Philips expands in a more aggressive way, using an early-bird advantage. Due to their small size, the obstacles SMS-Timing and Trebu faced were quite consistent. Without sufficient capital, it's challenging to adopt aggressive modes of internationalisation, such as international mergers and acquisitions or setting up wholly-owned subsidiaries. Other modes that don't need a large amount of investment are more feasible to them, such as exports. Meanwhile, without a known brand or building a brand intensively, small companies are less likely to access required resources, which makes the adaptation to local circumstances more difficult. In contrast, big players like Philips have more resources and support systems to accelerate expansion. Philips decided to invest in China in the late 1980s when it was already a global company. This is very much related to its early-mover strategy.

Unfair competition is a significant challenge for SMS-Timing and Trebu's development in China as the current Chinese business environment continues to favour big and local firms (Paik, 2020). Such an unfair environment hinders the development of foreign SMEs in the Chinese market. A big firm will always earn more credit than SMEs to win a deal or bid in China. This is not only due to preferences from stakeholders such as the (local) government but also preferences from local consumers who are more prone to believe the rule of thumb that "bigger is better".

3. Use the OLI model to provide firms with constructive advice on their internationalisation mode

There are three key factors playing important roles on the path of internationalisation, which are Dunning's OLI (Ownership – Location – Internalisation) advantages (Dunning, 1980). The first factor is ownership advantages (OA), which addresses the question of why some firms can go abroad while others can't. OA mainly refers to competitive advantage via the ownership of unique intangible assets such as branding, copyright, trademark or patent rights, or the use and management of internally-available skills. Ownership advantage also often involves possession of technology and capital. Large, capital-intensive firms also enjoy an ownership advantage in that they are able to exploit economies of large-scale production (Dunning, 1980).

The second one is locational advantage, which addresses the question of where a firm chooses to locate in its expansion. Firms choose to invest abroad mainly by means of two formats: vertical foreign direct investment (vertical FDI) and horizontal FDI. Vertical FDI provides the advantage of cost effectiveness that allows firms to have lower transactional cost or production cost in host countries (e.g. cheap labour); while horizontal FDI prefers to have plants abroad for easy access to the foreign (product) market. Vertical FDI is usually for North-South investment, with evolution in recent years of South-South investment flows emerging as well.[2] The horizontal type of investment flow is more developed from originally North-North investment flows towards South-North investments emerging more recently as well.

The third factor is the internalisation advantage, which addresses why some activities are carried on within firms and others through arms-length transactions. Higher internalisation advantage is associated with higher firms' inherent flexibility and capability to produce and market through its internal subsidies. By keeping production in-house rather than to outsource it, firms avoid market imperfections that may be present in certain host countries such as weak property rights, opaque government regulation, high import tariffs (in case of export), etc.

Taking it into a general case, the decision tree can be interpreted as follows (Business-to-you.com, 2016):

- If a firm does not have ownership advantage, it is better to remain in the domestic market.
- If a firm has ownership advantage, while it does not have locational advantage, it is better to keep its production at home and export.
- If a firm has ownership advantage and locational advantage, but no internalisation advantage, it is better to focus on licencing.
- If a firm has all three advantages, it is better to go for a FDI (either as a wholly-owned subsidiary or a joint venture).

Regarding the first step in the above decision tree, firms need to assess whether they have unique ownership of certain assets that gives them a competitive advantage over foreign rivals, i.e. firms need to assess whether they have an *ownership advantage*. If this is not the case, it makes no sense to enter the foreign market, as the liabilities of doing business on the foreign market (such as cultural, language and institutional differences) will outweigh the benefits.

Regarding the second step, if the firm does have unique competitive advantage so that there will be demand for the firm's product or service from the

2. In this terminology, the "North" stands for rich, developed countries and the "South" for poor, developing countries (Sen, 2009).

considered host country, but there are no *locational advantages* of producing abroad, then the firm should produce at home and export. Such locational advantages may involve the availability of cheap labour or raw materials, a low tax regime, or more generally, any beneficial production-related circumstance in the host country that is not available in the home country.

If both ownership and locational advantages are present, the firm may consider moving production to the host country. There is then still a choice between keeping the production in-house or outsource it to local parties in the host country. Reasons for outsourcing can be that local firms can produce in a better or cheaper way, or have more local market knowledge (Business-to-you.com, 2016). However, the firm may also keep the foreign production in-house by means of foreign direct investment, i.e. by setting up a wholly-owned subsidiary or partly-owned subsidiary (joint venture). Although such investment requires more capital, it allows the firm to internalise its capital, technology, management skills, and other assets, i.e. the firm is able to exploit *internalisation advantages* (Dunning, 1980). This is important in host countries with a weak institutional environment, where the 'rules of the game' are either opaque or subject to arbitrary interpretations. In-house production may be particularly relevant for technology firms as it will allow them to avoid their unique technological knowledge spilling over to local companies in the host country (imitation).

However, if such internalisation advantages are less clear, then firms with ownership and locational advantages may consider outsourcing their production to local firms by means of licensing, as the decision tree indicates. With licensing, a permit is given to a foreign company that can sell the product in the host country. This may be particularly attractive to smaller, non-technology firms. The benefit will be that less capital is required for this mode of internationalisation while the risk of imitation of technology by local licensing partner firms will also be small in such cases. The disadvantage will be a greater dependence on local partners plus that profits have to be shared with the licensing partner (the licensee). By and large, the advantages and disadvantages of licensing also apply to setting up a joint venture (JV) with a local partner firm, the difference being that with a JV, ownership (and hence control) of the subsidiary firm is shared with the foreign partner firm.

4. Using the OLI Framework to discuss the success and failure of the three companies

Table 1 provides an overview of the three OLI advantages that each of the three firms has or does not have. In the column "Feasible mode", the internationalisation mode predicted by the OLI framework (see above) is indicated. Finally, the last column shows the mode actually chosen by the various firms.

Table 1. Comparison between the theoretical entry mode and actual mode of the 3 firms

		Advantages				
		Ownership	Locational	Internalisation	Feasible mode	Actual mode
Philips	Expansion Phase 1	Yes	No	No	Export	Export
	Expansion Phase 2	Yes	Yes	Yes	Wholly-Owned Subsidiary	Wholly-Owned Subsidiary
Trebu	Expansion Phase 1	Yes	No	No	Export	Export
	Expansion Phase 2	Yes	Yes	Yes	Joint Venture	Joint Venture
SMS-Timing		Yes	Yes	Yes	JV or Wholly-Owned Subsidiary	Export

Philips' actual entry mode is consistent with the theoretically recommended model. In the first expansion phase, Philips was a small family business without any locational or internalisation advantage, so Philips focused on an export-only approach. In the second expansion phase, Philips grew in size and became a listed company; it further developed its ownership advantage while the firm was also able to develop locational advantages, both by expanding their consumer base (horizontal FDI) and by integrating local labourers in the production process (vertical FDI). The bigger presence in the Chinese market allowed to benefit from internalisation advantages as well. As in this second phase, all three OLI advantages were present, and the stronger resource base of Philips (compared to the early years) allowed for considerable investment, the creation of wholly-owned subsidiaries was the most efficient mode of internationalisation.

Trebu Technology faces almost the same situation as Philips in the expansion phase 1. Trebu began as a small family business with technological advantages. It chose to export to China. In the expansion phase 2, it has developed its locational advantage in China, allowing Trebu to consider establishing a joint venture. Trebu first established a joint venture and returned to export-only after several failures (What is the reason? Leave it for students to discuss). Institutional barriers caused by cultural differences and inadequate laws and regulations in the Chinese market impact small family businesses like Trebu greatly.

Since 2017, SMS-Timing is no longer a family business after a private investor acquired 50% of its shares. Given its OLI advantages, the theory suggests that SMS-Timing would choose to establish a joint venture company or a wholly-owned subsidiary in the Chinese market. However, SMS-Timing has always chosen the export mode, due to its risk-averse tendency. Therefore, even if the firm's background conditions allow the firm to invest in the Chinese market, it does not opt for a radical expansion model.

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