

**DYNAMICS OF FOREIGN OPERATION MODES AND THEIR COMBINATIONS:  
INSIGHTS FOR INTERNATIONAL STRATEGIC MANAGEMENT**

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# **DYNAMICS OF FOREIGN OPERATION MODES AND THEIR COMBINATIONS: INSIGHTS FOR INTERNATIONAL STRATEGIC MANAGEMENT**

## **1. INTRODUCTION**

Companies' choice of foreign operation modes (FOM) has been a core subject of international business studies basically from its beginning (Hymer, 1960 [1976]; Root, 1964). A half-century of research has brought us a set of established perspectives on companies' foreign operation mode choices; the most important being the economics based approaches of internalisation and transaction cost theories (Anderson and Gatignon, 1986; Buckley and Casson, 1976; Hennart, 1982), evolutionary and resource based approaches (Andersen, 1997; Kogut and Zander, 1993; Madhok, 1997), institutional approaches (Kostova and Zaheer, 1999; Meyer and Peng, 2005), and process models based on learning and decision behaviour theories (Johanson and Vahlne, 1977, 2009).

The various approaches have been usefully summarized in comprehensive frameworks such as Dunning's (2000) well-known OLI-framework (Ownership-Location-Internalisation) and the eclectic framework proposed by Hill, Hwang and Kim (1990).

Alongside conceptual developments there has also been a surge of empirical studies, especially from the mid-1980s when research templates emerged through the ground-breaking studies by Davidson and McFetridge (1985), Caves and Mehra (1986), Anderson and Coughlan (1987), Gatignon and Anderson (1988), Hennart (1988) and Kogut and Singh (1988); see also Kogut (2001). Several overview articles (Brouthers and Hennart, 2007; Canabal and White, 2008) and meta-analyses (Morschett et al., 2010; Tihanyi et al., 2005; Zhao et al., 2004) have been published recently, indicating that this has become a mature field of research. Well-established research templates and a dearth of innovative contributions

indicate that the field has developed paradigm-like characteristics. Recent research has above all expanded the empirical domains of entry mode studies.<sup>1</sup>

It is uncontroversial to state that this research has been successful in improving our understanding of companies' foreign operation mode choices and their implications, but it has also become increasingly apparent – as is typical of paradigmatic evolution – that potentially important issues remain rather overlooked by international business scholars. First, there has been a focus on the point of entry into specific foreign markets, with a corresponding disregard for what happens after entry.<sup>2</sup> Of course, if firms make few changes and adjustments to their entry modes as times passes on, one could consider this a trivial oversight. However, some studies have shown that mode changes occur with sufficient frequency to merit much closer investigation (Benito, Pedersen and Petersen, 2005; Calof, 1993; Clark, Pugh and Mallory, 1997; Fryges, 2007; Swoboda, Olejnik and Morschett, 2011).

Second, the literature envisages operation mode decision-making as a static rather than dynamic process (Petersen, Welch and Benito, 2010). The issue is not just whether decisions (i.e. the outcomes of a decision-making process) are durable (i.e. are seldom re-considered; see above), but also how the decision-making process itself proceeds. In theory, operation mode choices are made based on considerations regarding how a range of internal and external contingencies are best matched with the particular characteristics (e.g. control, flexibility, costs, etc.) of given modes of operation. However, do decision-makers act according to beliefs based on “perfect” foresight (*a priori* optimization), do they live with their mistakes should match-disparities arise, or do they proceed in gradual, incremental ways

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<sup>1</sup> Initial work tended to focus on entry modes choices made by internationalizing manufacturing firms from the US, UK, and Northern Europe. Research then spread to service firms (e.g. Erramili and Rao, 1993), middle-income countries (e.g. Campa and Guillén, 1999; Pla-Barber, 2001), and emerging markets (e.g. Filatotchev et al., 2007).

<sup>2</sup> Following the established research template, studies have typically used cross-sectional designs. Longitudinal studies are relatively rare, partly because of the difficulties and costs of obtaining reliable data over extended periods of time. Although some (cross-sectional) studies look exclusively at “real” entry modes (i.e. the mode used to enter a country in which a firm has never had operations), *in praxis* many studies take the modes of operations actually used when the studies were conducted, thus lumping entry modes and subsequent modes into the same category.

to pragmatically adjust to changing circumstances? In other words, are operation modes decided or managed, and if the latter, in what ways?

Third, as pointed out by Petersen et al. (2008), the bulk of research has examined the possible effects of a large range of explanatory factors (independent variables) on foreign operation mode choice. An enduring and somewhat surprising characteristic of that research is that the dependent variable itself – foreign operation modes – has barely been discussed. Studies have tended to treat foreign operation modes as choices among a restricted set of well-specified discrete alternatives; the choice between contractual and equity-based types of operation modes (e.g. Anderson and Coughlan, 1987; Davidson and McFetridge, 1985), or that between partly owned and fully owned operations (e.g. Benito, 1996; Gatignon and Anderson, 1988; Hennart, 1991). There is some evidence for a “messier” reality (Benito et al. 2009; Clark et al. 1997; Kedron and Bagchi-Chen, 2011; Petersen and Welch, 2002; Welch et al., 2007), with companies using many different modes at the same time, and even concurrently for the same type of activity in a given location, but the systematic mapping of mode diversity and mode combinations has only just begun (Asmussen, Benito and Petersen, 2009; Benito, Petersen and Welch, 2011; Hashai et al. 2010). Within the broad categories of modes – contractual, exporting and equity – there are many different sub-categories, each important in its own right. For example, contractual modes include licensing, franchising, management contracts, outsourcing and some forms of alliances. Exporting might be handled indirectly, such as via a trading company, or through different types of foreign intermediary arrangements. Equity-based modes range from minority equity alliances to majority or fully-owned foreign subsidiary forms. The combination possibilities are immense, and are used extensively: for example, licensing and equity-based modes are common partners, as are franchising and equity-based modes (Welch et al., 2007).

In this article we take a critical view of the established operation mode literature, with a focus on the themes outlined above. We apply a strategic management approach to foreign operation modes. The strategic management approach to FOMs is far from new. Almost 50 years ago, when Franklin Root introduced FOMs as a key IB-theme (Root, 1964), he basically applied a strategic management approach inasmuch as he provided prescriptions as to how firms could achieve competitive advantage in foreign markets through formulation and implementation of FOM strategies. Since then, however, FOM scholars have mostly subscribed to descriptive and – in particular – predictive approaches.

Descriptive approaches have been applied when a new FOM emerged in the international marketplace and researchers addressed the *how* and *why* questions through in-depth case studies. As an example, international management contracts were described through case studies in a range of industries in the 1980s (Brooke, 1985). Most FOM researchers, however, have focused on the question of *when* firms would prefer one FOM over another. Introduction of new theories – transaction cost theory in the 1980s, the resource-based perspective in the 1990s, and new institutional theory in the 2000s – has driven this penchant for predictive approaches. Since the prime aim has been to test the explanatory power of these theories on FOM choices, the predictive approach could rightly be labelled a theory-testing approach. The theory testing approach inquires about variety in terms of theory-specific factors that may explain simple – often binary – and standardized FOM choices (outcomes). A strategic management approach, in contrast, looks for variety and uniqueness of FOM outcomes since standardized outcomes require a minimum of management discretion and no inimitable capabilities. As such, standardized FOM outcomes can hardly explain sustainable competitive advantage – the very aim of strategic management research.

Our strategic management approach addresses a fundamental FOM management dilemma: the pursuit of operational efficiency through FOM variety that, in turn (and as will be elaborated on later), threatens to trigger excessively high transaction costs. Our discussion of this dilemma will be organized along “the three Cs” of foreign operation mode *choice*, *change*, and *combination*. We start by questioning the enduring myth of static decisions between durable discrete entry modes, and then proceed to look into how the puzzle of mode packages or combinations can be explained once certain commonly held preconceived ideas are discarded. We close with some reflections about the managerial and research implications of broader conceptualisation of foreign operation modes.

## 2. SKETCH OF A MANAGEMENT DILEMMA

FOM *variety* potentially leads to higher operational efficiency than FOM *simplicity*, but variety also implies higher transaction costs – i.e. costs of drafting, (re-)negotiating, enforcing and coordinating multiple FOM contracts. As an example, the operational efficiency (e.g. in terms of scale and scope economies) of licensing succeeded by a production subsidiary is higher in an initially small, but growing foreign market, than is the efficiency of the two modes individually and persistently; but the switch between the two modes is likely to incur take down and set up costs (Benito, Pedersen and Petersen, 1999).<sup>3</sup> However, negotiating an exit option in the licensing contract may curb the “switching costs”. Conversely, an aloof, forced and sudden cancellation of the licensing contract may incur very high transaction costs in the form of high take down costs as well as set up costs associated with the move to an alternative mode or mode combination. Hence, FOM variety in the form of mode switches and mode combinations may differ substantially in terms of transaction costs depending on

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<sup>3</sup> These comprise the costs of taking down existing mode of operation (e.g. severance payments and other outlays involved in the termination or modification of existing contracts) and the costs of setting up a new mode (such as business registration fees, recruitment and training of employees, etc.).

whether they are well-prepared and well-orchestrated – or exercised in an improvised and awkward manner.

The logic is illustrated in Figure 1. The figure depicts the marginal cost (*MC*) and benefit (*MB*) of FOM variety, i.e. the number of modes employed after entry of a given, foreign market. The *MB* curve (*MB* = marginal benefit of one additional FOM) reflects diminishing returns to scale: the *MB* curve has a strong downward slope and moves asymptotically towards zero (the *x*-axis). The marginal cost (*MC*) of adding one more FOM after entry is assumed constant. However, the cost *level* across the added FOMs is assumed to be strongly influenced by MNE managers. Managers’ potential influence on *MC* levels is indicated by including two different horizontal cost lines in the figure:  $MC > MC^*$ . The upper cost line, *MC*, does not intersect with the *MB* curve at any point simply because the potential marginal cost (switching costs, coordination costs, etc.) exceeds the marginal benefit of any additional FOM – even the first, most beneficial. The lower cost line, *MC\**, intersects the *MB* curve at two additional FOMs. Hence, the MNE will be better off by adding one FOM beyond its entry mode and will neither be better or worse off by adding one more FOM (that is, a total of three FOMs). The level of transaction costs in the *MC\** case is significantly lower than in the *MC* case – indicating that the MNE managers in the former case are much better at preparing switches (e.g. by putting in exit options at market entry) and curbing costs of coordinating multiple FOMs. Consequently, a manager in the *MC\** case is closer to achieving the “best of both worlds” in the foreign market: maximum operational efficiency with a minimum of transaction and governance costs.

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Figure 1 about here  
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### 3. TO CHANGE OR NOT TO CHANGE? CHARACTERISTICS, IMPETUS AND BARRIERS

Received theories of foreign operation mode choices (or *entry* mode choices, as these decisions are usually, but often inaccurately, referred to) typically view such decisions as discrete as well as discriminate: that is, at a given decision point (which could be at entry or later) companies choose one among several alternative ways of organising their operations in a foreign market – the mode of operation – and the use of that mode is normally assumed to exclude the concurrent use of other modes.

Some conceptualisations tend to be static; thereby emphasizing the initial point of entry and, if at all, projecting a persistence of the selected mode over the relevant time horizon. Others take a more dynamic approach and accentuate (or at least recognise) the conditions under which changes of foreign operation modes might be expected. Transaction cost theory and the resource-based and institutional approaches have tended to be on the static end of a static-dynamic continuum, whereas internationalisation process theory has been on the other end. Although their key explanatory variables and mechanisms differ,<sup>4</sup> the former approaches have in common a focus on static – but typically long-term – discrete choices, and which consequently may seem to provide limited opportunities for mixing different FOMs.<sup>5</sup>

The dynamic approach offered by internationalisation process theory could perhaps be seen as more “fluid” and hence as more open to mode combinations, and the case study approach favoured by many internationalisation process scholars often produces rich narratives that include descriptions of mode combinations, mixes and packages, but most

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<sup>4</sup> Transaction cost theory focuses on the need to safeguard specific assets against opportunistic actions; resource-based theory emphasizes the appropriation of rents generated by the possession of valuable and unique resources and capabilities; institutional theory emphasizes the (structural and behavioural) adaptation to external demands, regulations, and norms.

<sup>5</sup> However, a distinct contribution is that of Hennart (1993) who argues that mixed methods of organisation are commonplace (i.e. the simultaneous use of rules as well as prices), and that activities (transactions) are seldom carried out in the extreme (caricatures) of either bureaucracies or spot markets. Nevertheless, it must be noted that Hennart’s thesis is that real-life solutions to the organisation-problem – say, the choice of a foreign operation mode – typically involve combinations (“mixes”) of different organisation methods, not that different FOMs are used simultaneously. Hence, his approach is also rooted in a discrete-choice perspective.

studies have actually focused on the transition from one (main) mode to another; for example how an entrant firm's gradual acquisition of foreign market knowledge and/or development of local networks reduce perceived market risk and uncertainty, which in turn could induce a switch from a low risk and commitment mode (e.g. a sales agent) to a high commitment mode (e.g. a wholly-owned sales and marketing subsidiary). Hence, the internationalisation process approach explains why (but not *how*) mode *changes* take place, whereas it is more silent as regards mode *combinations*.

Even though the dynamics of foreign operation modes have been relatively neglected, that is not to say that received theories cannot deal with changes. Benito, Pedersen and Petersen (2005) combine transaction costs and resource-based theories with internationalisation process theory in their study of changes in international sales and distribution channels.<sup>6</sup> They model changes in the way exporters organize such activities in foreign markets as driven by factors that motivate switches as well as factors that work against making switches. The former are called switch motivators while the latter are labelled switch deterrents.

The two types of factors work in opposite directions. Motivators are factors that to some extent reduce the perceived utility of continuing with the current set-up, and which should therefore increase the probability of making change to the current foreign operation mode. Key factors include market growth, company growth, accumulation of market knowledge, disappointing performance, and increasing asset specificity. In contrast, switch deterrents are the set of factors that make it difficult or costly to carry out such changes; these factors have hence also been labelled "switching costs" (Benito et al., 1999).

In their study of Danish exporters, which largely corroborated their model, Benito et al. (2005) found evidence of both within-mode changes (e.g. substituting an intermediary with

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<sup>6</sup> Other studies of mode changes include Calof (1993), Casillas, Moreno and Acedo (2011), Clark et al. (1997), Fryges (2007), and Swoboda et al. (2011).

another) and between-mode changes (e.g. moving from a contractual arrangement with a distributor to in-house operations), but only a limited extent of mode combinations.<sup>7</sup> However, Clark et al. (1997) uncovered a substantial amount of mode combinations, which they called mixed approaches; in a sample of 25 UK firms (that had made a total of 679 foreign operations) they detected 203 mode changes, of which 36 (18%) entailed mode combinations.

#### **4. HOW LARGE A STEP AND HOW MANY? MANAGING THE INTERNALISATION PROCESS**

The concept of internalisation lies at the core of influential theories in international business, with their focus on choice of foreign operation modes (Buckley and Casson, 1976; Hennart, 1982; McManus, 1972; Rugman, 1981); the aim being to use theory to explain the circumstances under which a firm replaces imperfect (or non-existent) external markets by internal coordination (Buckley, 1993). Together with market power explanations (Hymer, 1960/1976; Yamin, 1994) and knowledge-based explanations (Grant, 1996; Kogut and Zander, 1993), internalisation theory offers a paradigm which explains - with a high degree of accuracy under certain assumed conditions - why MNEs choose to exercise tight managerial control over foreign operations rather than work through other firms under contractual or other arrangements. Hence, on a general level internalisation theory can explain the existence of MNEs (Rugman and Verbeke, 2003). By including time-responsive factors that pull in the direction of internalisation, the theory can also predict patterns and directions of the growth of MNEs. However, the theory downplays any meaningful role for management, particularly in the real world dynamic context of constantly evolving foreign market conditions and operations of a MNE (Buckley, 1993).

We argue, however, that internalisation theory could be taken a step further by including managerial judgement considerations in the context of dynamic influences on the

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<sup>7</sup> In their sample of 260 foreign operations, only six involved mixed or dual arrangements. It should be noted, however, that their study was not specifically designed to detect mode combinations. Instead, it aimed at examining the main modes of operation in a key foreign market.

development of foreign operations. The market transaction costs of using outside agents (local operators) are frequently negligible at market entry, but usually increase over time. A key question pertaining to such situations is: what management instruments may ensure persistent concurrence between a changing pressure for internalisation in a foreign market and the *effectuated* internalisation of an MNE in that market?

Internalisation theory basically assigns three roles to MNE management. First, managers need to decide whether the MNE should produce at home and export to the foreign market in question or produce in the foreign market (see e.g. Horst, 1974). Second, the managers face a make-or-buy choice whenever localisation advantages favour production in the foreign market (Dunning, 1980). Third, managers have to decide the timing of internalisation (Buckley and Casson, 1981) in cases where the ‘buy’ choice precedes internalisation<sup>8</sup>.

Seeing market exchange as the ‘default option’, internalisation theorists have first of all focused on the identification and analysis of various market imperfections that may result in internalisation. Since theorists have focused on a market efficiency rather than market power explanation (see e.g. Calvet, 1981), MNE managers have been assigned a ‘neoclassical’ role as omniscient *administrators* of market imperfections – and not *creators* of market imperfections<sup>9</sup>. In this perspective the managerial task in internalisation theory is first of all to *observe* the various relevant – mostly exogenous – choice factors, and only to a limited extent to involve oneself in complex managerial discretion. Exact observation of internalisation-relevant factors (such as market size and degree of asset specificity) unequivocally directs the

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<sup>8</sup> Internalisation theory may include two additional management roles although one may consider these to be at the periphery of the theory, namely (a) the timing of initial export replacement with local production (‘offshoring’), and (b) the specific choice of mode of operation in the case of a ‘buy’ decision (Contractor, 1990; Datta, Herrmann and Rasheed, 2002).

<sup>9</sup> In some models based on internalisation theory, MNE managers are assumed ‘bounded’ and not fully rational (see e.g. Buckley, Casson and Gulamhussen, 2002).

right choice. Furthermore, the choices are relatively simple ones: produce at home or in the foreign market; make-or-buy; when to internalise? Ideally, as depicted in figure 2, there should be a perfect concurrence between the particular *need* for internalisation at a certain point in time – which would be determined by the underlying internalisation drivers – and the *actual* internalisation: that is, firms should respond to a pressure  $P'$  for internalisation by choosing a  $I'$  degree of internalisation, and correspondingly choose  $I''$  for  $P''$ , and  $I'''$  for  $P'''$ .

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Figure 2 about here  
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In the real world, the chosen levels of internalisation may of course differ from the optimal ones, e.g. due to incomplete information, changes in internal and external contingencies, and various impediments (e.g. switching costs) to carrying out changes. Hence, as shown in figure 3, a company might have chosen a level of internalisation, e.g. point A, which is considerably lower than the ideal; or, conversely, chosen a much higher level of internalisation, e.g. point B, than really needed. In case A, the company should further internalise until point A\*, whereas in case B, it should de-internalise until reaching B\*. In figure 3, points C, A\* and B\* indicate optimal choices.

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Figure 3 about here  
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In an ever-changing and complex world it seems unlikely that companies as a rule will have reached the ideal level of internalisation, so there is obviously considerable scope for

management to fine-tune operations in order to try to get as close as possible to the optimal line. Buckley (1993) and Rugman and Verbeke (2003) argue that there is considerable room for developing internalisation theory in a more management-oriented direction.<sup>10</sup> In particular, Buckley stresses the need for theory development incorporating a more important role for management in the following two, closely interrelated issues:

- The theory maintains a rather static view of internalisation – being considered a state rather than a process. Hence, “to incorporate a theory of management, it is essential to move away from a comparison of states to a comparison of processes... Progress can be made by comparisons of the changing balance of the boundary between ‘firm’ and ‘market’ and intermediate states over given time periods” (Buckley, 1993, p. 201).

- There is an oversimplified choice for managers between markets and hierarchies. Hence, “the narrow view that managers simply make ‘buy or build’ decisions ... needs to be extended” (Buckley, 1993, p. 206).

The two issues point in the same direction, namely that internalisation may be a long-term manageable process rather than a time-compressed, binary choice.<sup>11</sup> A pertinent circumstance is when non-hierarchical entry modes enjoy a temporal superiority over hierarchical modes. For example, licensing or joint ventures may be used before wholly-owned production subsidiaries, or independent distributors may precede sales subsidiaries.

When the transition from non-hierarchical to hierarchical foreign operation modes unfolds as a managed and stepwise process, this could suitably be termed *staged internalisation*. The potential pay-off to MNEs of undertaking staged internalisation may be

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<sup>10</sup> This was not to say that the role of management has been totally ignored inasmuch as “strategic behaviour can be identified within the internalisation framework by firms securing exclusive access to key inputs and tying in customers” (Buckley, 1993, p. 206).

<sup>11</sup> Of course, in those situations where no markets – not even contractual ones – exist, internalisation from the outset is the sole foreign entry mode, and it is meaningless to talk about internalisation *processes* (other than post-internalisation processes such as post-acquisition integration processes). Most often, however, non-hierarchical entries (i.e. arm’s length, contractual modes, and shared ownership operations in foreign markets) are feasible alternatives to establishing wholly-owned subsidiaries.

considerable: at any point in time, the ideal outcome for the firm would be when the degree to which a firm has internalised its foreign activities is in perfect balance with the underlying drivers of internalisation. For example, a MNE typically undertakes several different value activities in a given foreign market. Some of the activities in that country may be characterised by a high degree of asset specificity whereas other activities could have low specificity. Due to the considerable scale and scope economies and local market knowledge typically enjoyed by a local, outside agent (e.g. a licensee of the MNE), the entrant MNE may initially choose to only internalise local activities for which a high degree of control is considered to be of utmost importance, such as R&D (Buckley and Hashai, 2005). However, the MNE may internalise more and more value activities in the foreign country as the degree of asset specificity of these activities increases, which typically occurs in small, consecutive steps.

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Figure 4 about here  
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The logic is illustrated in figure 4. It is assumed that the underlying pressure for internalisation (or internalisation advantage) increases monotonically with elapsed time of operations in the foreign market through *inter alia* learning and an increased concern for control. Thus, the *x*-axis indicates elapsed time of operations in the market and the *y*-axis shows the degree to which the foreign market operations are internalised (measured as a continuum from 0-100 %). Exactly where on the *y*-axis does a company choose to operate given the evolving pressure for internalisation as time passes? Figures 5, 6 and 7 illustrate three different scenarios that in terms of the fit between underlying internalisation drivers

(indicated by the dotted line), such as increasing asset specificity, and *effectuated* (i.e. actual) internalisation of operations in a given foreign market.<sup>12</sup>

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Figure 5 about here  
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Figure 5 depicts a scenario of immediate internalisation that, for example, may be justified by excessively high anticipated/potential switching costs (Benito et al., 1999). Such a scenario is typically assumed in the entry mode literature, especially that based on transaction cost economics, as illustrated by the following statement in the much-cited study of foreign distribution by Anderson and Coughlan (1987, 71): “Channel choices, once made, are often difficult to change. Hence, the question of whether to integrate foreign distribution can have a large and lasting impact on the success of a firm's international operations.”

The situation depicted in Figure 5 is one in which internalisation, although economically justified by potential switching costs, actually is ‘premature’ inasmuch as the hierarchical operation mode – the wholly-owned subsidiary (WOS) – in contrast to for example a local, independent licensee – operates below minimum efficient scale during the first years after market entry. Hence, the governance structure is sub-optimal in terms of operational/production costs, although perhaps not with regard to transaction costs (including switching costs). The sub-optimisation in terms of production costs (i.e. sacrificed scale economies) is indicated by the grey area. Figure 6 illustrates a scenario with one shift of governance structure – from a contractual mode (e.g. licensing) to the hierarchical mode (WOS). The shift halves the sub-optimisation (grey) area.<sup>13</sup>

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<sup>12</sup> This material (including the figures) is based on Petersen et al. (2010).

<sup>13</sup> This can be viewed as somewhat simplistic as it is clear that many companies using, for example, licensing employ a range of techniques within licensing arrangements to ensure that a degree of control or internalisation of the licensee is generated (Welch et al., 2007).

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Figure 6 about here  
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The sub-optimisation area is further reduced when the MNE makes two shifts of governance structures/operation modes (see Figure 7). The first shift is from a contractual arrangement to a 50:50 equity joint venture, and later from a joint venture to a sole venture (WOS) – i.e. a hierarchical organisation.

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Altogether, the three scenarios show that the sub-optimisation area diminishes as the number of shifts – or internalisation steps – increases. Of course, a perfect concurrence between the particular *need* for internalisation at a certain point in time – which would be determined by the underlying internalisation drivers – and the *actual* internalisation at that point in time would eliminate the sub-optimisation area completely.

It is also clear that there is a trade-off between – on the one side – production cost savings due to perfect concurrence obtained through frequent internalisation steps, and – on the other side – the additional transaction costs in the form of renegotiation costs. A basic premise of our line of reasoning is that while achieving a perfect fit between the underlying internalisation drivers and the effectuated internalisation may have a high payoff in terms of production efficiency, it also constitutes a major managerial challenge of curbing the transaction costs associated with exercising numerous internalisation steps. Hence,

determining the number of internalisation steps is a managerial challenge that is part of the simplicity-diversity trade-off we outlined earlier (section 2).

## 5. COMBINING MODES

### 5.1. WHY ARE MODES COMBINED?

As noted above, it has become increasingly clear that many companies are engaged in the use of various forms of mode combinations (Benito et al., 2011; Clark et al. 1997), and that they appear to be prepared to institute mode combination additions or deletions if conditions warrant such changes. On the other hand, academic researchers seem to be far more reticent about recognising this reality and its implications for international business theory and strategy

It is not surprising that companies are attracted to the use of mode combinations: they may deliver a range of strategic benefits that managers can readily relate to – such as operational efficiency, flexibility, control, income generation, strengthening of intellectual property protection and as stepping stones to a major change in foreign operation mode.

At a basic level mode combinations provide a significantly wider array of options to companies in how they might go about entering or extending penetration of a given foreign market. Mode combination options go beyond, sometimes well beyond, the mainstream or primary mode that a company might employ in a particular foreign market situation. The universe of mode combination options is immense, especially when added to market location options.<sup>14</sup> Of necessity, managers tend to consider a far more restricted range of options, often

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<sup>14</sup> Following Petersen et al. (2008) and Hashai et al. (2010) the foreign operation mode matrix (i.e. the configuration) of an international firm that operates in  $I$  host markets and has  $J$  identifiable activities in its value chain, can at a given point in time be denoted  $\mathbf{M}=(m_{ij})$ , where  $i=1\dots I$  indexes host markets and  $j=1\dots J$  indexes value chain activities. Each cell in the matrix ( $m_{ij}$ ) may then contain one or multiple operation modes ( $k$ ) under which the given activity is performed in the given host market. Since the number of relevant alternatives in a country is  $k^j$ , even seemingly simple country configurations quickly result in rather large number of alternatives. For example, the extremely simple case of a country  $m_i = \{\text{production, R\&D, sales}\}$ , i.e. 3 activities, which can be done either in-house or outsourced, i.e.  $k = 2$ , gives  $2^3 = 8$  combinations. Adding another mode (e.g. an alliance) results in  $3^3 = 27$  combinations. The number of potential combinations rises exponentially by adding further countries (and/or additional activities) to its portfolio, so a company would quickly face immense

driven by very specific market and/or foreign partner pressures (Larimo, 1987). The availability of mode combination options, assuming managerial recognition, provides greater flexibility to companies in the development of foreign market operations at the outset and beyond – providing an enhanced and broadened ability to adapt as circumstances change. Mode adjustments can be made without necessarily resorting to a potentially disruptive primary mode change. This could vary from fine tuning of existing mode use to important adjustments that flow from the inevitable market and mode learning processes that unfold over time. The JV literature points to the different ways that JV arrangements evolve as the parties build up experience with each other (Becerra, Lunnan and Huemer, 2008; Yan and Gray, 1994; Yan and Zeng, 1999).

Mode additions to the primary JV mode, at any stage, are often made in order to strengthen control over the joint venture – such as by the addition of a licensing or management contract. Control was an important concern for the multinational express delivery company, FedEx, in revising and upgrading its operation in China in 1999. At that stage it was not prepared to commit to a fully-owned operation. It felt that having a Chinese partner was crucial in delivering political and other benefits to its service business, but a 50:50 JV fell short in delivering the control it regarded as also critical. Thus, a management contract was negotiated alongside its 50:50 JV with a Chinese partner: the management contract was seen by FedEx as effectively delivering control of day-to-day operations of the venture (Welch et al., 2007). Licensing arrangements have long been used as a way of seeking to control the use of the licensor's technology, technical and commercial, by foreign partner firms (for example foreign outsourcing contractees), as well as trying to prevent unwanted dissemination. In general, mode combinations can be constructed in such a way as to strengthen intellectual property protection outside formal protection systems (patents,

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combination opportunities: e.g. for two countries,  $27^2 = 729$ ; for three countries,  $27^3 = 19683$ ; for four countries,  $27^4 = 531441$ ; and for five countries  $27^5 = 14348907$ , i.e. more than 14 million combinations.

copyright, etc.). Sales subsidiaries are sometimes used alongside a foreign intermediary in the foreign market as a way of extending control over the foreign sales activity and the intermediary (Petersen et al., 2001). In some instances an additional mode in a package delivers additional returns from a foreign operation, for example in the form of royalty payments under a licensing arrangement that operates alongside foreign direct investment (Welch et al., 2007).

Such mode combination steps may be useful in timing terms as well: rather than seeking to take over the JV partner when not prepared to do so, extended control could be achieved while building towards a move to full subsidiary status. At the same time, adding a mode could be a way of easing the process of ultimate primary mode change – additions to the original mode/s acting as stepping stones (Petersen et al., 2001; see also Petersen et al., 2010). Of course, flexibility would be significantly enhanced when the desired mode option is built into the starting mode arrangement (Petersen et al., 2000). In an overall sense, the availability of mode combination options provides a company with greater strategic control over when and how it develops foreign operations.

Such flexibility is further augmented by the additional possibilities for role variation and adjustment across a mode package: the starting roles performed by modes are not necessarily fixed over time. Companies can and do make mode role changes in response to developments in their external environment or because of modifications in company strategy. Such mode role variation may accompany mode combination changes, but could occur without them. For example, the starting mode arrangement for a company in a foreign market might be a joint venture with exporting from the home market. The starting roles for the two modes could be: the JV acts as a marketing and service base within the foreign market, basically to support the exporting activity; exports assist with home plant utilisation, ensuring economies of scale at the production level. Over time though the operation within the foreign

market may develop in various ways: successful market penetration to the point where production in the foreign market becomes feasible; the relationship with the JV partner advances to a stage characterised by a high level of trust; and management decides that an enhanced facility would be an effective base to service other markets within the same region. Thus, the role of the JV is extended to production and its marketing role expanded. While exports from the home market diminish, they do not disappear as some intermediary products and raw materials are likely to be needed by the JV for some time. Even though the outer shell of the mode package remains unchanged, substantial change within occurs because of the shift in mode roles. In this respect, mode role changes are not dissimilar to within-mode changes in effecting changes without overall mode adjustment (Benito et al., 2009). Taken together, the potential to change mode combinations, mode roles and make within-mode adjustments delivers many mode options short of substantial mode change, enhanced flexibility and the ability to organically stage increased mode commitment within a foreign market.

As the various examples noted illustrate, the path adopted may be in response to circumstances that arise in the foreign market: a mode combination may not be the outcome of a distinct decision at a given point in time. Learning is likely to be a significant component of mode combination adoption or change – reflecting both market learning and mode learning (Barnett and Burgelman, 1996). Rather than being a fixed, carefully structured entity, a mode combination should be viewed as a fluid and adaptable instrument of foreign market penetration.

From an evolutionary perspective, mode combinations reflect various process influences – externally and within a company. Figure 8 shows how a hypothetical company's mode combination might evolve in a foreign market, showing additions and a deletion over time, between the use of primary mode A at  $t_1$  and the switch to primary mode B at  $t_2$ .

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Figure 8 about here  
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## 5.2. BARRIERS TO MODE COMBINATION

Clearly, there are substantial benefits for companies in developing mode packages as a way of penetrating foreign markets. The benefits are seemingly so obvious that it begs the question as to why such arrangements are not the almost automatic default position for companies in devising foreign operation strategies – i.e. instead of what mode, what mode combination should be employed? However, Norwegian data (Benito et al., 2011) indicate that mode combinations fall well short of being the automatic choice in mode strategy. It could be argued that this is because of ignorance: the possibilities are simply not recognised. Other explanations are that managers perceive various barriers to mode combinations, and that the range of possibilities is seen as somewhat overwhelming.

One important form of mode combination barrier or constraint might simply be *mode myopia* or mode ignorance (Welch et al., 2007). Research indicates that companies tend to consider a limited range of mode options in devising foreign operation strategies, let alone the plethora of combination options (Larimo, 1987; Calof, 1993; Petersen et al., 2008). This is understandable given the limited exposure to, or experience that managers have in utilising, all modes and their combination potential.

Faced with so many mode and mode combination options, depending on the extent to which they are perceived, it is not surprising that many managers fall back on those modes they are familiar and comfortable with, and feel confident about using. This may be reinforced by the learning experiences that unfold through mode use. As companies and managers become experienced and adept at using a given set of modes, there is an automatic

tendency to maintain and re-use this strength over time – so-called exploitation learning (March, 1991). It becomes harder to introduce a previously unused mode into an existing mode package: there is comfort and assurance in the known. There are examples of companies using a preferred operation mode over extended periods of internationalisation. The British firm Pilkington internationalised its float glass business over a very long period pre-eminently via the licensing of foreign manufacturers (Taylor 1994). This is despite the fact that the starting mode(s) may have been used without careful analysis in response to an approach by a potential foreign customer, distributor, franchisee or licensee – a common starting point (Welch et al., 2007).

Because of inexperience initially, companies may engage in mode experimentation, but over time, following feedback, engage in a more constrained approach to mode use. In extreme cases, involving what managers regard as highly negative outcomes, the experience can lead to the excision of a particular mode or modes from any consideration. For example, the private US multinational DDI, a provider of human resource services (talent management), entered foreign markets in the 1970s and expanded to 29 countries by 2010 (Warren-Smith, 2010). In its earlier international forays it used a range of operation modes, including wholly-owned subsidiaries, licensing, joint ventures and project operations. By 2010, this range had been substantially reduced: before 1990 licensing and JVs constituted 82% of mode use, but this had declined to 23% by 2010, with JVs dropped altogether because of perceived problems with this form. In contrast, over the same period, wholly-owned subsidiaries had become the dominant form – rising from 12 to 77% of total mode use. The ability to provide consistent services to multinational clients was an important driver of the shift to wholly-owned subsidiaries, along with control of intellectual property. Thus, a company might arrive at a position of considerable *mode inertia* over time (Benito et al., 2009), thereby not seriously canvassing other mode, including combination, options. Of

course, companies could undertake exploratory learning (March, 1991), deliberately researching and expanding mode knowledge, even sending staff to training programs, perhaps sparked by emerging pressures for change in different foreign markets, as most long term internationalisers tend to experience. But, overall there seems to be less evidence of exploratory activities.

*Switching costs* have been noted as a further constraining factor in the preparedness of companies to adopt new mode constructions (Benito et al., 1999). Existing modes are not always readily able to be deleted because of a range of factors – including host government and trade union pressure, and the contractual conditions surrounding a particular mode, for example limiting the ability to exit the arrangement within a stipulated time frame (Petersen et al., 2000). Beyond these constraints there are the set-up costs of adding new modes – not least being learning costs. Fixed costs are typically incurred when adding a new mode – even for a relatively straightforward addition such as a licensing arrangement: i.e. covering the costs of negotiating, writing, and implementing the licence contract. There may also be relationship costs in situations where companies are seeking to add a mode to an existing foreign set-up. Companies sometimes try to add altered arrangements on top of existing foreign distributor connections to advance foreign market penetration – effectively moving to a mode combination basis, sometimes as a deliberate prelude to subsidiary establishment (Petersen et al., 2001). Not surprisingly, foreign intermediaries are prone to resist such moves, and can ensure that their accomplishment is difficult and costly. Mode combination choices, like mode choices in general, are constrained, or compromised, by the realities of the situation and context they are used in, as well as companies' own limitations – of resources, and managerial vision.

Last, but not least, the *cost of coordinating* multiple FOMs may constitute an effective barrier to mode combination. A clear-cut division of responsibilities and roles among a

number of local operators (including the entrant firm) is, in practise, easier said than done. Duplication of tasks and blurred market segmentation may result in inconsistent foreign market servicing, and – in turn – confused customers and dissatisfied operators. Poor coordination and communication may foster scepticism and competition – rather than collaboration – among third-party local operators. From this perspective the entrant firm managers may prefer one FOM at a time.

**6. COMBINING MODES INTO PACKAGES**

Our analysis so far has shown that the array of mode combination options is substantial: there are many different ways in which foreign operation modes can be assembled or packaged in servicing a given foreign market. While a company could be using various modes in a foreign market, they may not necessarily be “combined” i.e. there may be little connection between them in terms of how they are used. The use of multiple modes could be because of geographical or other forms of market segmentation or because they are used in different parts of the value chain (Petersen and Welch, 2002). The Norwegian multinational Norsk Hydro had different divisions active in India in the 1990s, using a range of modes, but there was little coordination of these activities (Tomassen, Welch and Benito, 1998). Similarly, the Australian beer company Foster’s kept their beer and wine operations separate in the US, in part because their wine operations resulted from the acquisition of Beringer, a major US wine company (Speedy, 2007). The organization of its beer operations in the USA illustrates the type of mode arrangement along the value chain that a company may assemble.

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Figure 9 about here  
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Foster's licensed Molson in Canada to brew its beer for the US market, while marketing and distribution were undertaken through a JV with the US company Miller Brewing. When Molson merged with the US brewer Coors, Foster's cancelled its licensing agreement with Molson and signed one with Miller, thus generating a tighter overall mode package. At the same time, all the parts of the value chain in Canada, production, marketing and distribution, continued to be handled through a licensing agreement with the newly formed Molson Coors (Speedy, 2007). Sometimes different modes are used simultaneously in a foreign market for the same type of activity. For example, the Israeli software firm Fundtech performed R&D in the US through a joint venture, a greenfield subsidiary and an acquired subsidiary, while its marketing and customer support services there were conducted through distributors, a joint venture, a greenfield sales office and an acquired subsidiary (Welch et al., 2007). Thus, the fact that multiple modes are used by a company may tell us little about the degree to which they are packaged together or how they are connected in order to achieve foreign market penetration goals. On one end of a connectedness scale we might have two divisions of a company (like Norsk Hydro) that use different modes but their operations (and thereby modes) are not at all integrated or coordinated. At the other extreme is the type of example shown in Figure 10, where modes are tightly connected in a supportive manner around the achievement of a set of goals: in general to ensure success of a company's foreign market involvement. The primary mode is a JV, the main vehicle for achieving foreign market penetration and revenue generation, with associate modes 1-3 in supportive positions, particularly in terms of control.

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Figure 10 about here  
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Competing modes are sometimes used by companies in the same foreign market, even targeting the same segment and market area. This often occurs when a company is seeking to have an alternative marketing channel to its independent foreign intermediary. In a Danish study, 27% of companies retained their independent foreign intermediaries after establishing a subsidiary (Pedersen and Petersen, 1998).

## **7. PROACTIVE MODE COMBINATION STRATEGY**

Mode combinations have been shown to potentially play an important role in achieving a range of companies' foreign market penetration objectives, and therefore should be considered more seriously in the design of international strategy. However, developing a coherent and more deliberative mode combination strategy as part of general international strategy is not a straightforward exercise, as we have alluded to in previous sections. Companies do not have full control over the way that their foreign operations evolve. Managers are unlikely to be aware of the full extent of mode combination options, and changes may occur on the ground in the foreign market without full strategic assessment by a company. Mode strategy is therefore bound to include elements of emergent strategy (Mintzberg and Waters, 1985), for example as opportunities and approaches arise in the foreign market or in the nearby region. Sales to other markets could develop because of general networks maintained by a foreign JV partner. In various ways foreign, not just JV, partners (e.g. including intermediaries, licensees and the like) inevitably influence the way a company's foreign operation strategy evolves – often in subtle ways that are not obvious in the first place. Mode choices may be emergent initially but can become intended (deliberate) over time, even locked-in, as part of a more consistent international mode strategy. Mode inertia is a factor (Benito et al., 2009). There is comfort in continuing to employ those modes, and mode packages, which a company's managers have become knowledgeable about and adept at using in different foreign markets.

Limited evidence indicates that companies make little if any attempt to include mode combinations in the development of international strategies, despite the potential benefits for international operations noted above, and the reality of their sometimes extensive use (Benito et al., 2011). Nevertheless, it is appropriate to ask: in what ways might a more proactive mode combination strategy be developed? Of course, any strategic posture regarding mode combinations cannot be disconnected from general foreign operation mode strategy – covering aspects such as mode choices, mode commitment (resources, etc.), and mode switching over time – in existing and new foreign markets. A first step in strategic development is to simply recognise the role that mode combinations can potentially play in a company's internationalisation. Beyond recognition there may be an issue of adequate knowledge of mode and combination options within a company, or more particularly those designing international strategies. There is likely to be the need for learning about different modes that have not been employed by the company previously, and building competence in a wider range of modes. As Sanchez and Heene (1997) note, competence development is a basic way of widening the range of strategic options available to a firm – of enhancing strategic flexibility. It is difficult for managers to contemplate employing modes they have not used before, have little knowledge of, and lack understanding of as to their potential role: the strategic flexibility provided by mode combinations in the evolution of international operations will only arise if managers are equipped and prepared to use them – in response, at times, to situations where rapid reaction is required. However, the number and complexity of mode combination options, particularly when examined at a disaggregated value chain level, mean that any consideration of feasible combination strategies has to be necessarily limited in scope (Petersen et al. 2008).

Within the context of a company's overall foreign operation mode strategy, key steps in building in a more proactive strategic approach to mode combinations include:

- Establish the current state of mode combination use in different markets.
- Consider the potential for, and benefit of, expanding combinations; as well as potential barriers and how they might be overcome.
- Develop a plan for mode combination use – including how to deal with possible emergent pressures and opportunities; and consider the scope for contractual arrangements with built-in switching options.
- Implementation may require negotiation with foreign partners and expanded mode training for local and foreign staff – as a forerunner to any mode combination actions.

## 8. CONCLUSION

Thinking strategically about foreign operation modes requires moving beyond making a choice for the initial entry into a country. The rethinking about foreign operation modes and how they are used in international business activity has ushered in consideration of the reality of mode combinations as part of mode strategy. We advance theoretical justification for the use of mode combinations. In general, there are strong arguments as to why companies can gain significant benefits from building mode combinations, but mode combinations are as such no panacea. We have also stressed that there are potential barriers to their adoption, and costs in implementing them. Changing modes or mode combinations is not a frictionless exercise. Some companies use mode combinations extensively, while others shy away from them (Benito et al., 2011). It is not surprising that many companies balk at the change process. *Mode learning* may be part of the solution, but it should be recognised that learning-by-doing with respect to already adopted modes may entrench the position of these modes or mode combinations, which is supported by growing confidence in their use. Mode learning may therefore evolve into *mode inertia* that is transferred into new markets (Benito et al. 2009).

Despite such limitations, there are examples of mode combinations being employed successfully, and in creative ways. We suspect that, for many companies, mode combinations are assembled almost unconsciously – that they are not seen as anything unique or unusual, just part of the response to foreign market pressures and opportunities. This certainly seemed to be the case for the Finnish multinational Kone as it penetrated the Japanese market with a more complex mode package over time (Benito et al., 2009). But we know little about how mode combinations are regarded by companies and how they fit into international strategy: our impression is that the strategies we see tend to be emergent strategies.

Clearly, there is need for a substantial effort on empirical research – both in terms of detailed case studies and broad, cross-sectional studies to better understand this phenomenon. We also encourage conceptual development based on a modelling approach, of which Asmussen et al. (2009) is an example. There is also considerable scope for companies to become more knowledgeable about the potential role of mode combinations, and more proactive, and strategic, in their use.

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**Figure 1.** The management choice between FOM simplicity and diversity

**Figure 2.** The ideal degree of internalisation

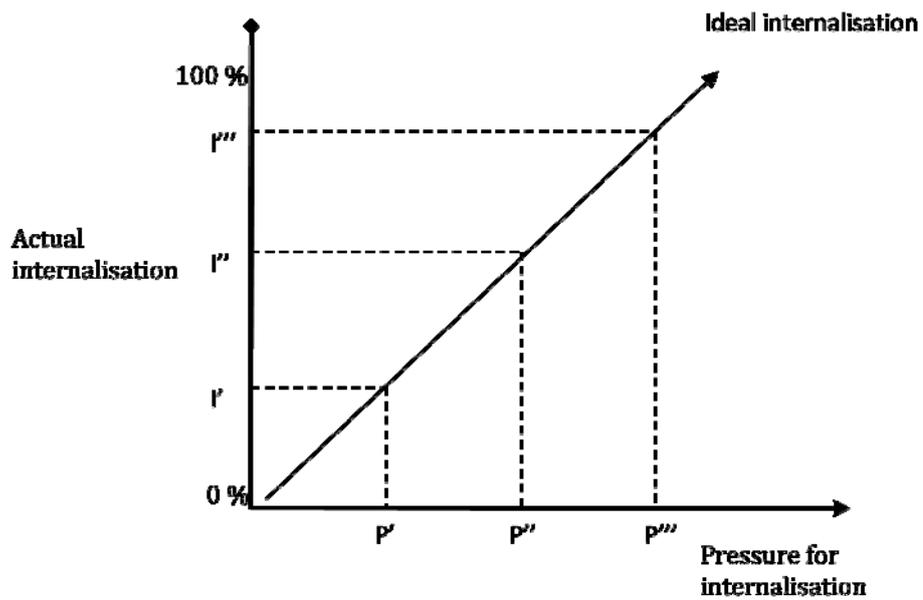


Figure 3. Internalisation decisions

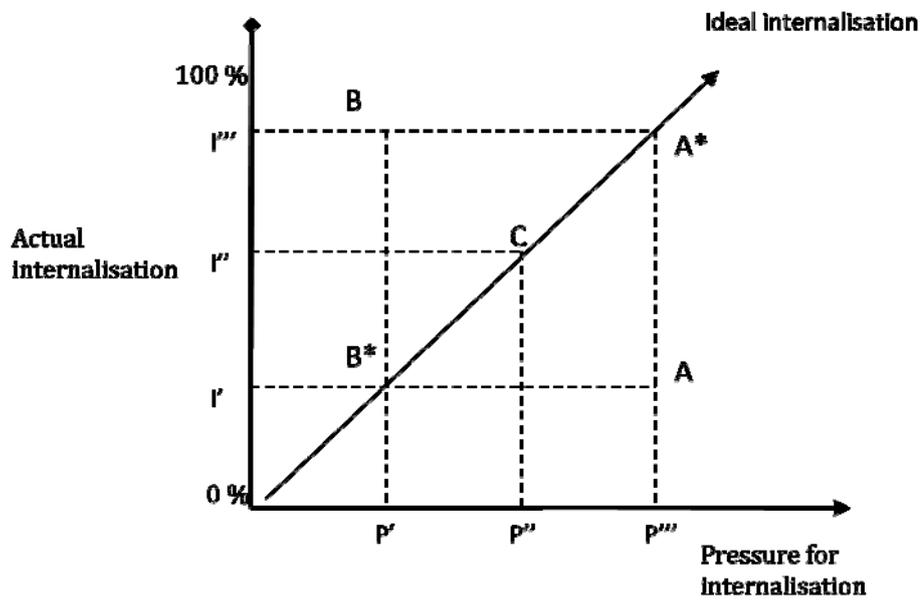
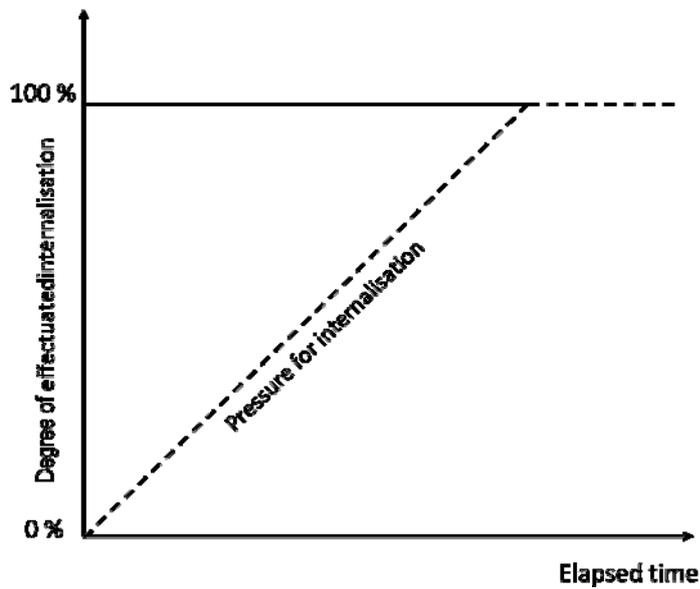
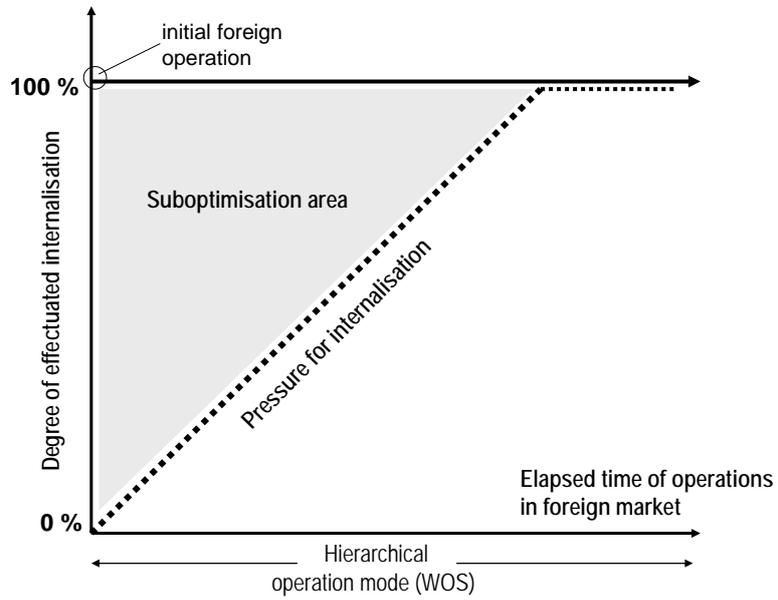


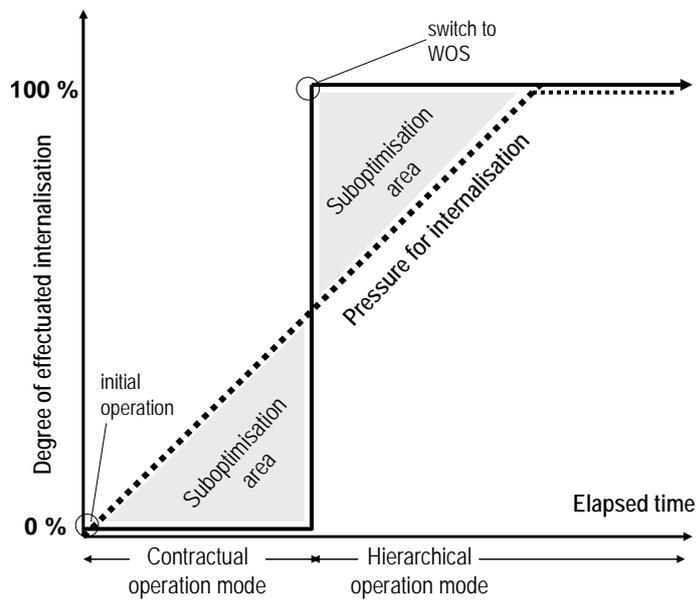
Figure 4. Pressure for internalisation as a function of time



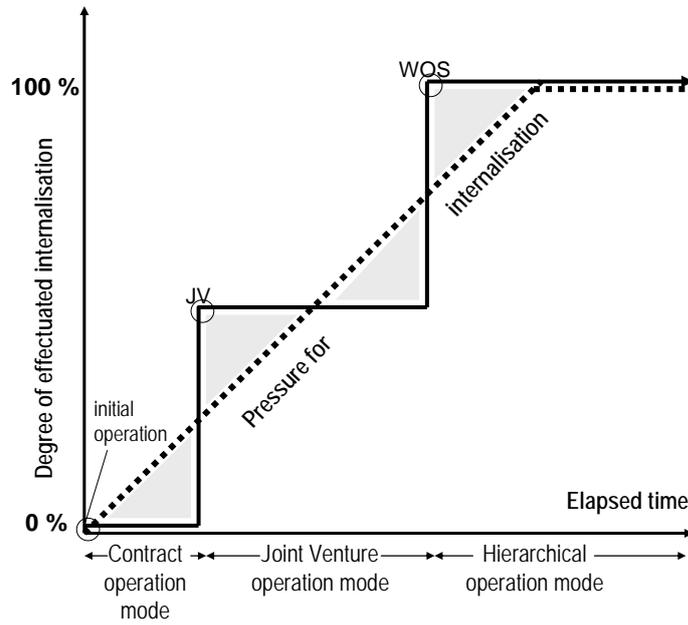
**Figure 5. Immediate full internalisation**



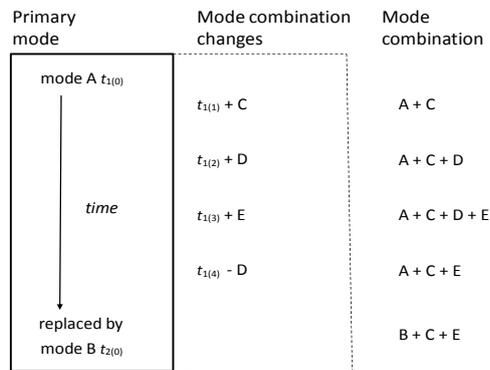
**Figure 6. Internalisation – one step**



**Figure 7. Internalisation – two steps**



**Figure 8: Mode combination evolution**



**Figure 9.** Foster’s beer in US

<b>Production</b>	<b>Marketing and distribution</b>
Pre- 2007: via licensing agreement (with Molson)	JV (with Miller)
2007: licensee change from Molson (Canada) to Miller (US)	2007 - Foster’s + Miller JV: no change

**Figure 10.** Modes packages: an example

<b>Primary Mode: Joint Venture</b>		
<ul style="list-style-type: none"> <li>• market penetration</li> <li>• revenue generation</li> </ul>		
<b>Associate Mode 1: Licensing</b> <ul style="list-style-type: none"> <li>• technology control</li> </ul>	<b>Associate Mode 2: Management Contract</b> <ul style="list-style-type: none"> <li>• management control</li> </ul>	<b>Associate Mode 3: Exporting</b> <ul style="list-style-type: none"> <li>• domestic plant utilisation</li> </ul>

Source: adapted from Petersen and Welch (2002), p.161