# Edexcel

# A Level

# Business studies

## (Code: WEC13 01)

## Unit 04-Section 08

## Global markets and business expansion

# 27. Condition that prompt trade

## INTRODUCTION TO THE CONDITIONS THAT PROMPT TRADE

International trade is vital for many economies around the world. It helps to raise living standards and results in higher levels of output, income and employment. However, there are some specific reasons why countries trade with each other.

• Obtaining goods that cannot be produced domestically. Many countries are unable to produce certain goods. This is because they lack the natural resources that enable such production.

• Obtaining goods that can be bought more cheaply from overseas. Some countries can produce certain goods more efficiently than others. This may be because they have cheaper or more abundant resources or because they have become experts through specialisation.

• Excess supplies. Some countries have surplus commodities. In some cases, countries have so much of a resource that they could never use it all themselves.

Although the politics and economics of free trade will never be simple, trade has continued to expand and many consider that we have a **'global consumer culture'** stretching across the world. Regardless, businesses see expanding into international markets as an opportunity to find new resources and markets for their goods, as well as producing their goods and services at a lower cost. This may make more money or extend the life of their products or services.

## PUSH FACTORS

Push factors, such as saturated markets and competition, encourage businesses to seek international opportunities to overcome market weaknesses or lower costs. These factors can be driven by changes in tastes, substitute availability, or new technologies.

**Saturated market**: A saturated market is one where most of the customers who would buy a particular product already have it, so there is limited remaining opportunity for growth in sales.

**Competition**: High competition in the domestic market can force businesses to sell abroad, as competitors may offer similar products at lower prices or higher quality. This can make selling the original product difficult or unprofitable. Businesses may also look to foreign markets, such as Carvajal Oils, which found new markets in Sweden, Norway, and Finland, and developed new products to appeal to foreign customers.

## PULL FACTORS

Pull factors entice firms into new markets. They are the opportunities that businesses can take advantage of when selling into overseas markets. There are many pull factors, and those that are the most important to a firm depend upon the nature of the business and the current state of its home market. However, the following lists many common attractions:

- new or bigger markets
- lower-cost or more secure resources, such as minerals, land or labour
- lower cost of transportation
- technological expertise, including research facilities
- managerial or financial expertise

- organisational skills
- assets, such as brands, patents or other intellectual property.

A firm may be enticed by these factors since they may help it to achieve economies of scale or to spread its risks.

**Increased sales and profitability**: Businesses are increasingly becoming multinational corporations, selling goods and services globally to increase sales revenue and profits. Institutional owners pressure these companies to find new markets, such as emerging economies like India. US companies Walmart and Starbucks are exploring the Indian market, with Walmart India owning 21 B2B wholesale stores and Starbucks aiming to make India one of its top 5 global markets.

**Economies of scale**: Economies of scale occur where increasing the scale of production leads to a lower cost per unit of output. Put simply, increasing size or speed increases efficiency and lowers costs. If a factory were to increase its size, average costs would fall as output rises. The firm could buy supplies in large amounts, usually at a discount. It could use more expensive technology to run its processes with machines and train its workers in increasingly specialist tasks.

**Risk spreading:** Chapter 21 discussed risk and how to reduce it in the context of contingency planning. One way of defining risk is the probability of a bad event happening multiplied by its negative impact.

## IMPROVING COST COMPETITIVENESS BY OFFSHORING AND OUTSOURCING

**Offshoring**: Offshoring involves moving manufacturing or service industries to a location with lower costs. A classic example is the relocation in the 1980s of many call centres from the UK to India, where well-educated workers speaking good English were employed on a lower wage and for longer hours than British workers. Therefore, a firm may offshore in order to:

- reduce costs
- hire workers with particular skills.

Many people oppose offshoring jobs to other countries, fearing damage to a firm's reputation, language or cultural differences, political, economic, technological, or intellectual property risks. Offshoring can increase management costs, reduce efficiency, expose firms to corruption, and potentially be too expensive to continue.

**Outsourcing**: Outsourcing involves moving an entire business function or project to a specialist external provider. For example, many large firms have outsourced their information technology and payroll functions. Others have moved human resources, accounting, supply and logistics, and transportation. In general, a firm might outsource for similar reasons to offshoring:

- to reduce costs
- in order to specialise areas of the business
- to focus on the core competences of the business rather than the support functions
- in order to improve speed, flexibility or quality to comply with rules or regulations.

**Labour productivity**: Firms prioritize labour productivity, which measures the goods and services produced by one hour of labor, influenced by factors such as skills, qualifications, working conditions, technological support, and rules and regulations.

### EXTENDING THE PRODUCT LIFE CYCLE

The concept of the product life cycle was developed in the 1960s to describe the stages in the life of a product, as explained in Chapter 9 in Student Book 1.

These stages again in brief are as follows:

• Development. The product is researched and designed, and a decision made about whether to launch the product.

• Introduction. From the development of an original idea to the launch of the product on the market.

• Growth. When the product takes off and sales increase.

• Maturity. When sales are near their highest but are slowing down.

• Decline. When sales begin to fall.

When a product has reached the decline stage, with falling sales, market **saturation** and a decline in profits, a firm has to decide what to do. They can get that product out of the market altogether or attempt to extend the product life cycle.

**SUBJECT VOCABULARY**

global consumer culture a global culture where social status, values, and activities are centred on the consumption of goods and services
offshoring moving jobs to other countries
outsourcing moving jobs to other organisations
pull factors factors that entice firms into new markets and the opportunities that businesses can take advantage of when selling into overseas markets
push factors factors in the existing market that encourage an organisation to seek international opportunities
risk the probability of a (bad) event happening multiplied by its (negative) impact
saturation (saturated market) the point when most of the customers who want to buy a product already have it, or there is limited remaining opportunity for growth in sales

# 28 Assessment of a country as a market

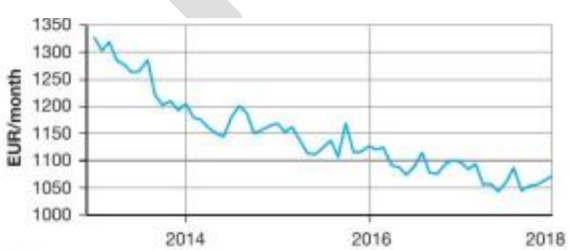
### FACTORS TO CONSIDER

Assessing a country as a market is never easy. You must carry out a huge amount of research to decide whether a place is good for investment. Even then, many companies make a wrong decision. There are some key factors to consider, such as the levels and growth of **disposable income**, ease of doing business, infrastructure, political stability and exchange rates. These are covered in detail below.

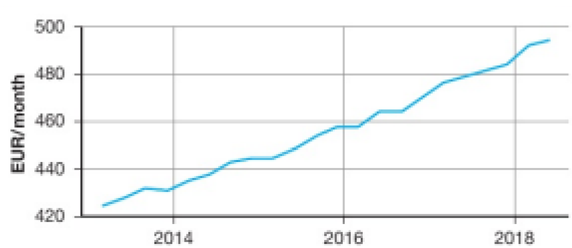
### LEVELS AND GROWTH OF DISPOSABLE INCOME

There may be many reasons why a business might want to sell its goods and services in other countries, as explored in Chapter 27. However, if an enterprise wants to sell to a customer, the customer must have the money with which to buy that good or service. Therefore, it is important for a business to think carefully about whether the consumers in a particular country currently have - and will have in the future sufficient disposable income.

**Disposable income**: Disposable income is the remaining money after taxes and deductions, which can be used for consumption or saving. Understanding the average level of household disposable income compared to other countries is crucial for international trade. A falling disposable income may cause low-income individuals to struggle to pay for a minimum standard of living, while higher-income individuals may reduce expenditure on luxuries, resulting in reduced consumption and market expenditure.




▲ Figure 2 Greece's average monthly salary 2013–18




▲ Figure 3 Germany's disposable income, 2013–18

## EASE OF DOING BUSINESS

When evaluating a potential market, businesses should consider the ease of doing business. Issues with goods entering, setting up premises, or trading activities can lead to delays in sales and increased costs. The World Bank Group publishes a report on country regulations, ranking them based on ease of doing business. New Zealand and Singapore are top-ranked, while Somalia, Eritrea, Venezuela, South Sudan, and Yemen are not.

There are ten indicators produced by the World Bank that track the life cycle of a business from its creation to its end. At each stage, the potential problems are indicated:

1. starting a business (number of procedures, time it takes, cost and minimal capital requirements) 2. dealing with construction permits (number of procedures, time it takes, days and cost)

3. getting electricity (number of procedures, time it takes, days and cost)

4. registering property (number of procedures, time it takes, days and cost)

5. getting credit (strength of legal rights, information required)

6. protecting minority investors

7. paying taxes (payments per year, time, percentage of profit)

8. trading across borders (documents required, time to export/import, cost to export/import)

9. enforcing contracts (number of procedures, time, cost as percentage of claim)

10. resolving insolvency.

## INFRASTRUCTURE

The quality of a country's infrastructure is crucial for businesses to enter new markets. Poor transportation infrastructure in developing countries can increase production and operating costs, leading to lost sales and increased costs. Communication infrastructure is also vital for coordinating production, sales, and distribution electronically. However, electricity shortages and limited internet coverage may hinder these efficiencies.

For example, the Emirate of Dubai has huge oil reserves and a good location. It has used the proceeds from the sale of its oil to further develop its infrastructure, including the following:

- an artificial harbour for ships
- the Jebel Ali Free Trade Zone
- an information technology hub called Dubai Internet City, where businesses such as IBM® pay no tax, and have few currency restrictions and limited regulation
- the Dubai Ideas Oasis to encourage venture capital and new business start-ups
- the Dubai Knowledge Village to improve educational opportunities
- many hotels, tourist attractions and residential complexes to make Dubai an attractive destination for visitors.

## POLITICAL STABILITY

Political decisions and events can have a significant effect on a country's business environment. They can cost investors some or all of the value of their investment.

Therefore, it is important to think carefully about the political situation in a country before investing and to critically assess the potential risks. There are a few obvious issues to check for in the target market:

- the nature of the government and its relationship with business
- the nature of the government and its relationship with major international institutions, such as the United Nations, the World Trade Organization, the International Monetary Fund and the World Bank
- the government's legal orientation and approach to regulation and taxation
- the possible political risks that may emerge in the near future, such as elections, political vacuums, coups, terrorism, human rights issues or protests.

There are also many risks that a business might need to be aware of:

- instability during an election
- increasing authoritarianism
- factions in government, such as when political parties split
- increasing levels of corruption
- external threats (border conflicts, trade disputes, invasion) that may cause internal power changes.

| Country | Rank | Score |
|---|---|---|
| New Zealand | 1 | 89 |
| Demark | 2 | 88 |
| Finland, Norway & Switzerland | 3 | 85 |
| Singapore & Sweden | 6 | 84 |
| Cyprus | 42 | 57 |
| China | 77 | 41 |
| India | 81 | 40 |
| Sri Lanka | 91 | 38 |
| The Maldives | 112 | 33 |
| Egypt and Pakistan | 117 | 32 |
| Kenya and Bangladesh | 143 | 28 |
| Somalia | 180 | 9 |

▲ Table 2 Selected ranks from Transparency International's Corruption Perceptions Index, 2017

Transparency International's Corruption Perceptions Index measures perceived levels of public sector corruption globally. The index ranks 180 countries based on experts and businesspeople's perceptions. The worst score is O, indicating high corruption. Countries with scores approaching 100 are considered clean. In 2017, over two-thirds of countries scored below 50, with an average score of 43.

## Exchange rates

Transparency International's Corruption Perceptions Index measures perceived levels of public sector corruption globally. The index ranks 180 countries based on experts and businesspeople's perceptions. The worst score is O, indicating high corruption. Countries with scores approaching 100 are considered clean. In 2017, over two-thirds of countries scored below 50, with an average score of 43.

Fluctuating exchange rates cause problems for businesses. They create uncertainty because currency movements are unpredictable and can be quite sharp. A business might want to protect itself from adverse movements in the price of currencies. It can do this in many ways, including:

- adjusting prices in the domestic currency
- taking out insurance to protect it from financial loss
- buying and selling currency when prices are favourable
- using financial instruments, such as hedging, to try and hedge against the financial risks.

## APPLICATION OF PORTER'S FIVE FORCES MODEL TO ASSESS MARKETS

In Chapter 4 it was explained how Porter's Five Forces model could be used to analyse the competitiveness of an industry. The model suggests that businesses should consider five different forces when evaluating strategies.

• The bargaining power of suppliers. Suppliers, like any business, want to maximise the profit they make from their customers. The more power a supplier has over its customers, the higher the prices it can charge. This means it can move more profit from the customer to itself. Therefore, limiting the power of suppliers will improve the competitive position of a business.

• The bargaining power of buyers. Suppliers want to charge maximum prices to customers and buyers want to obtain supplies for the lowest price. If buyers or customers have considerable market power, they will be able to beat down prices offered by suppliers.

• The threat of new entrants. If businesses can easily come into an industry and leave it again if profits are low, it becomes difficult for existing businesses in the industry to charge high prices and make high profits. Existing businesses are constantly under the threat that if their profits rise too much this will attract new suppliers into the market who will undercut their prices.

• **Substitutes**. The more substitutes there are for a product, the fiercer the competitive pressure on a business making the product. Equally, a business making a product with few or no substitutes is likely to be able to charge high prices and make high profits.

• Rivalry among existing firms. Rivalry among existing firms in an industry will also determine prices and profits for any single firm. If rivalry is fierce, businesses can reduce that rivalry by forming cartels or engaging in a broad range of anti-competitive practices.

these tend to be large businesses, often funded by the state. A summary of the conclusions drawn by Gentry is shown below:

- competitive rivalry or competition (moderate force
- bargaining power of buyers or customers (strong force)
- bargaining power of suppliers (weak force)
- threat of substitutes or substitution (weak force)
- threat of new entrants or new entry (moderate force).

Based on these conclusions, Gentry will have to develop entry strategies to manage the relative size of the threats discovered by the analysis.

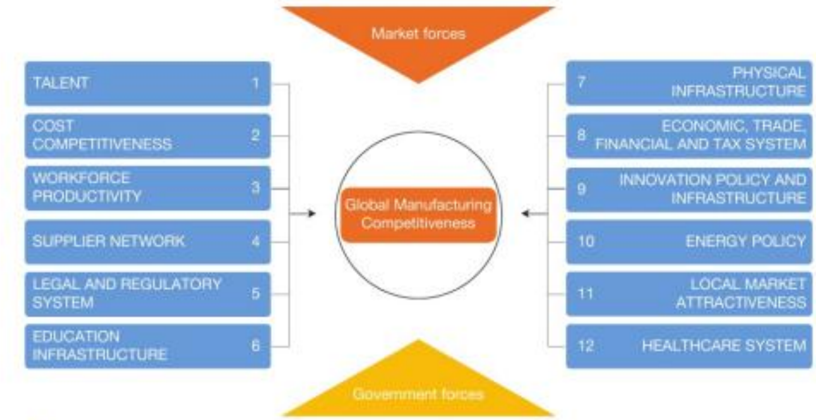
**SUBJECT VOCABULARY**

demonetisation to remove the value of a note or coin so that it is no longer able to be used as money
disposable income the amount of money that a person has left over after they have paid their taxes, national insurance and other deductions

# 29 Assessment of country as a production location

## LOCATING PRODUCTION

When choosing a foreign location for production, businesses must consider factors such as labor costs, productivity, and supplier network. For example, French car manufacturer Renault has factories in Morocco, Slovenia, Turkey, Russia, Romania, and Argentina. China is considered the most competitive nation for manufacturing, with 29% of GDP generated by manufacturing and 93% of exports being manufactured goods. However, by 2020, China is expected to be replaced by the USA.




▲ Figure 1 Global CEO survey: drivers of global manufacturing competitiveness

| Rank | Country | Score |
|---|---|---|
| 1 | USA | 100 |
| 2 | China | 93.5 |
| 3 | Germany | 90.8 |
| 4 | Japan | 78 |
| 5 | India | 77.5 |
| 6 | South Korea | 77 |
| 7 | Mexico | 75.9 |
| 8 | United Kingdom | 73.8 |
| 9 | Taiwan | 72.1 |
| 10 | Canada | 68.1 |
| 11 | Singapore | 67.6 |
| 12 | Vietnam | 65.5 |
| 13 | Malaysia | 62.1 |
| 14 | Egypt | 28.3 |

▲ Table 1 Global manufacturing competitiveness index, 2020 (predicted)

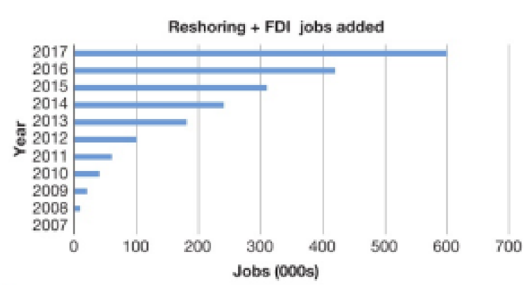
### COSTS OF PRODUCTION

Many businesses locate factories in countries that have low production costs. By keeping costs low, a business may gain a competitive edge in the market. Some of the main production costs, such as labour, energy, raw materials and land, are a lot lower in Asia than in other parts of the world. This is illustrated in the high position of five Asian countries in Table 1.

Low wage costs are often an important factor in attracting businesses. This is particularly true for businesses that employ a large labour force. In 2017, US company, Chembio Diagnostics, said that it would move some of its production to Malaysia after a rise in the minimum wage in New York. According to Sharon Klugewicz, president of Chembio's Americas division, 'We're looking more and more toward automation and moving some of the work to the lower-cost facility in Southeast Asia.'

## SKILLS AND AVAILABILITY OF LABOUR FORCE

A business needs to consider the cost of labour when selecting locations for its production facilities. It also must consider the quality of human capital. A business is not likely to locate a factory to another country only for cheaper labour. A business has to also consider whether the labour force in a country has the skills required to maintain quality standards. Businesses cannot afford the consequences of poor-quality work. In some countries where labour is cheaper, workers might be unskilled and poorly educated.




▲ Figure 2 The trend in reshoring

Fairly recently, a number of businesses have moved production back from east Asia in a process called **reshoring**, which in some cases may be because of poor quality control in east Asian factories.

| Top 10 factors, reshoring + FDI, 2010–17 | | | | | |
|---|---|---|---|---|---|
| Rank | Negative offshore factor | Citings | Rank | Positive domestic factor | Citings |
| 1 | Quality/rework/warranty | 292 | 1 | Government incentives | 527 |
| 2 | Freight cost | 196 | 2 | Proximity to customers/ market | 493 |
| 3 | Total cost | 147 | 3 | Skilled workforce training/ availability | 446 |
| 4 | Delivery | 100 | 4 | Images/brand made in USA | 398 |
| 5 | Inventory | 91 | 5 | Eco-system synergies | 336 |
| 6 | Rising wages | 88 | 6 | Lead time/time to market | 251 |
| 7 | Supply chain interruption risk/ natural disaster risk/political instability | 78 | 7 | Infrastructure | 239 |
| 8 | Intellectual property risk | 64 | 8 | Automation/technology | 211 |
| 9 | Communications | 61 | 9 | Manufacturing/engineering joint innovation (R&D) | 155 |
| 10 | Green considerations | 53 | 10 | Higher productivity | 141 |

▲ Table 3 Top 10 reasons for reshoring in the USA

## INFRASTRUCTURE

When considering a suitable country for a location, the quality of infrastructure is important. In some countries the infrastructure might be poor. For example, in some developing countries where labour might be cheap, the quality of infrastructure might be inadequate to support a large production facility. Any of the following factors might be encountered.

• Roads might be poorly constructed and inadequately maintained. In some countries they may be unsealed. This slows down the transportation of finished goods to customers, and raw materials and components to the site from suppliers. Some areas might be at risk of natural disasters, such as flooding, which may cause a break in the supply of vital components.

• Increasingly, access to a good broadband network is of great importance to businesses when considering locations for production. This is because businesses need rapid and reliable Internet connections to communicate with stakeholders and facilitate e-commerce. Some countries may still be developing their broadband networks, while other networks might be slow and unreliable.

• Some countries may not have modern airports and ports. This might make it difficult for business personnel to travel to and from production facilities and to ship goods out of the country.

• Railway networks may not exist or may not be sufficiently developed. This might be a problem if large or heavy goods need to be transported in large quantities.

• There may be a lack of investment in education. This can affect the quality of human capital and may discourage managers and other senior staff from locating near the site as families moving to the location would desire good-quality schools for their children.

• A lack of commercial services and suppliers may discourage a business from locating in some countries. Businesses may need access to printers, IT support, bankers, insurance providers, advertising agencies, cleaners, maintenance companies and manufacturers of components. Some countries cannot guarantee such facilities.

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## LOCATION IN A TRADING BLOC

Some businesses locate production facilities in certain countries to avoid trade barriers, such as tariffs and quotas. This can be achieved by building a plant inside a trading bloc. This is discussed in detail in Chapter 26. The output of a business located inside a trading bloc will be free from trade barriers when sold to any member of that bloc.

## GOVERNMENT INCENTIVES

Governments may be able to influence the location of business. They are usually keen to attract foreign direct investment (FDI) because of the benefits it brings, such as income and employment. They can do this by providing incentives to businesses to locate their production facilities in their country. Governments may offer financial incentives, such as tax breaks, lower rates of company tax, interest-free loans, cheap land and better rates on business premises.

For example, Bangladesh offers some of the most attractive packages of fiscal, financial and other incentives to foreign entrepreneurs in south Asia. Some examples include:

• Tax Exemptions. New business investments are exempt from tax for between five and seven years (15 years for investment in electric power).

• Duty. All import duties are removed for export- oriented business ventures.

• Income Tax. Double taxation can usually be avoided because Bangladesh benefits from bilateral investment agreements. Exemptions from income tax of up to three years for the expatriate (i.e. living in another country) employees in industries are specified in the relevant schedules of the income tax ordinance.

• Remittances. Capital, profits and dividends can be returned to the investor's own country without penalty.

• Easy exit. Business investors can withdraw their investment either through the decision of an annual or extraordinary general meeting and the money raised can be returned to the investor's own country with authorisation from Bangladesh Bank.

• Ownership. Foreign investors can set up operations r independently or in joint ventures with Bangladeshi partners.

• Other incentives. Six-month multiple entry visas for investors; tax exemptions on royalties or technical know-how fees received by foreign investors; tax exemption on the interest on foreign loans (subject to conditions) and permanent residency (if investing $75000).

Governments can attract businesses by reducing bureaucracy, liberalizing trading laws, investing in education and training, and facilitating free movement of goods and people. Tax regimes are crucial for businesses, with Ireland, Hungary, and Uzbekistan having some of the lowest corporation tax rates globally. In developing countries, such as Kenya, Tanzania, Uganda, and Rwanda, governments offer various financial incentives, such as corporation tax holidays and reductions in standard taxes.

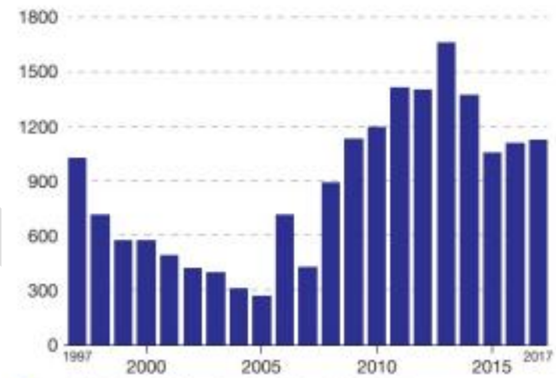
## EASE OF DOING BUSINESS

When choosing a suitable location, the commercial environment is a very important consideration. This is often referred to as the 'ease of doing business'. It is a lot easier to do business in some countries than others. It is important to choose a location where it is easy to do business because trading restrictions and additional costs can be frustrating and expensive for businesses. The ease of doing business may depend on factors like the following:

- the ease with which businesses can be started and closed down
- the efficiency with which contracts are enforced

- the amount of bureaucracy, e.g. the ease with which permits can be obtained for construction projects
- the availability of trade credit
- the efficiency of tax collection
- the ease of resolving insolvency.

Table 4 (Activity 2) shows the Top 10 easiest places in the world to do business in 2017. New Zealand is ranked no. 1, while many of those nations at the bottom of the



▲ Figure 3 Number of kidnappings in Mexico, 1997–2017

## POLITICAL STABILITY

Political instability in countries like Syria, Somalia, and parts of Latin America can make it dangerous for foreign businesses to operate. These countries are also known for high risks of kidnapping, with Latin America being one of the most dangerous. Corruption in political systems can also lead to bribery, which businesses are likely to avoid. Additionally, human rights issues, such as consumer boycotts or shareholder disapproval, can also lead businesses to avoid certain locations.

## NATURAL RESOURCES

Mining and steel industries require large quantities of natural resources, and companies like Rio Tinto and ArcelorMittal often locate near their sources. Mining companies can only operate in locations with proven mineral deposits, while steel producers like ArcelorMittal prefer to be close to mines due to the high cost of transportation for large and heavy materials like iron ore and coal.

## LIKELY RETURN ON INVESTMENT

Businesses looking for locations are likely to consider a number of different options before making their final decision. Many of the factors above are likely to be considered, depending on the nature of the industry in which a business operates. During the decision-making process, SWOT analysis and PESTLE analysis can help to assess the suitability of different locations. Also, quantitative techniques might be used to help make the final location decision. Quantitative techniques can help to evaluate the financial costs and benefits of investing in particular locations.

## QUANTITATIVE METHODS

Chapter 10 discusses evaluating investment projects, comparing two potential sites for a business considering relocation. It uses three investment appraisal methods and assumes no cost savings after five years, assuming no future relocation. The cost savings are not considered after this period.

**Payback method**: The business calculates the payback method for recouping its initial investment. Location A has a $12 million initial cost, $3 million annual savings, and four years of recouped cash flows, while location B has a $15 million initial cost and $5 million annual savings.

**Average rate of return (ARR)**: The average rate of return (ARR) is calculated by dividing the net return per annum by the initial investment. Location A offers a cost saving of $15 million over five years, resulting in a return of $3 million. Location B offers a cost saving of $25 million over five years, making it the preferred location.

**Discounted cash flow:** Discounted cash flow involves reducing the value of future cash flows to show their present value. It's important to note that the value of cash available in the future is worth less today. For example, moving to location A is unprofitable at a 15% discount rate, but moving to location B shows a positive net cash flow, outweighing the initial investment by $1.9 million. However, a higher discount rate would result in negative cash flows, making the move unprofitable.

| | Location A ($ million) | Location B ($ million) |
|---|---|---|
| Initial cost | 12 | 15 |
| **Annual cost savings/increased cash flow** | | |
| Year 1 | 3 | 5 |
| Year 2 | 3 | 5 |
| Year 3 | 3 | 5 |
| Year 4 | 3 | 5 |
| Year 5 | 3 | 5 |

▲ Table 5 Initial costs and cost savings of locations A and B

| | A | B |
|---|---|---|
| Initial cost | 12 | 15 |
| Increased cash flow | 15 | 25 |
| Net cash flow | 3 | 10 |
| Net cash flow per year | 0.6 | 2 |
| ARR (net cash flow per year ÷ initial cost × 100) | 5% | 13.33% |

▲ Table 6 The ARR for locations A and B

| | Location A ($ million) | Location B ($ million) | Discount 15% | Location A ($ million) | Location B ($ million) |
|---|---|---|---|---|---|
| Initial cost | 12 | 15 | 1.00 | 12.0 | 15.0 |
| **Annual cost savings/increased cash flow** | | | | | |
| Year 1 | 3 | 5 | 0.87 | 2.6 | 4.4 |
| Year 2 | 3 | 5 | 0.76 | 2.3 | 3.8 |
| Year 3 | 3 | 5 | 0.66 | 2.0 | 3.3 |
| Year 4 | 3 | 5 | 0.57 | 1.7 | 2.9 |
| Year 5 | 3 | 5 | 0.50 | 1.5 | 2.5 |
| Total cost savings | 15 | 25 | | 10.1 | 16.9 |
| Net cash flow | 3 | 10 | | −1.9 | 1.9 |

▲ Table 7 Initial costs and cost savings of two new locations discounted at 15 per cent

**SUBJECT VOCABULARY**

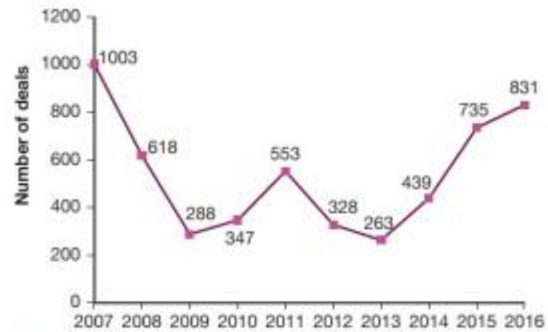
open economy where a country allows the free movement of goods, services, capital and labour into and out of the economy

reshoring bringing production back home after using foreign production facilities for a period of time

# 30. Reasons for global measures, takeovers or joint ventures

## REASONS WHY BUSINESSES JOIN TOGETHER

As discussed in Chapter 22, there are many reasons why a firm might wish to buy or join forces with a foreign company. For example, exporting may not make sense if countries can produce the product or service more cheaply. Arrangements such as licensing or franchising may not make commercial sense.



▲ Figure 1 The number of cross-border M&A deals between 2007 and 2016

- **Licensing**. A firm enters into a licensing contract with another firm to use its brand, intellectual property or to produce its product or service in return for a fee.

- **Franchising**. Franchising involves a long-term co-operative relationship whereby one party, the franchisor, contracts with another, the franchisee, to run its business. McDonald's is a well-known example of a franchise.

Cross-border deals are completed for various reasons, including risk management, market entry, and strategic alliances. Decision-making is influenced by the firms involved, senior managers' personal roles, and factors of confidence or uncertainty. Acquisitions or joint ventures can be strategic, often linked to risk management or a desire to enter new markets.

## SPREADING RISK AND ECONOMIES OF SCALE

**Spreading risk**: During economic downturns (i.e. a fall in the amount of business), even companies with strong balance sheets can face serious difficulties, as outlined in student book 1 chapter 36.

Therefore, it makes sense to try and protect the firm from the consequences of a downturn or crisis by locating in markets where these risks are less likely to occur - or at least less likely to occur at the same time as they occur in the home market.

**Economies of scale**: One of the main motives for mergers and acquisitions is to grow rapidly to a size where costs can be reduced significantly by exploiting economies of scale.

## ENTERING NEW MARKETS AND TRADING BLOCS

Instead of growing organically, businesses can take a shorter route to international growth through mergers and acquisitions.

Equally, firms in established industries may find that the only way that they can grow is through merging with or acquiring firms in other markets. This has been the case in telecoms in some countries where growth has been limited. For example, a number of cross-border mergers have been proposed in Europe.

## ACQUIRING NATIONAL AND INTERNATIONAL BRAND NAMES/PATENTS

A business may want to become a global player in the international market. However, a lack of brand

recognition or the possession of a patent may prevent other businesses from copying its product or producing similar products. By purchasing a business or a product with a strong brand name, it could gain both quickly.

Using mergers, acquisitions and joint ventures is an effective way to gain a strong reputation or to get access to intellectual property. It can have a number of benefits for a business:

- there is likely to be strong brand recognition
- there will be brand loyalty
- it limits competition for the product
- a business will not face the high risk, cost and uncertainty of launching a new product.

It is important to realise how easily a brand can be destroyed if care is not taken post merger to ensure that employee confidence and customer satisfaction are looked after. It may be that the strongest brand is adopted over the weakest one, or some sort of portfolio of brands can be created as part of a differentiation strategy.

literary work or artwork, that the law protects from unauthorised (i.e. without official permission) use by others. This protection occurs through such legal processes as:

- patents for inventions
- **copyrights** for literary works or computer programs
- trademarks for brand names or designs.

Establishing intellectual property can be expensive. It is often easier to gain access to intellectual property by buying it in an acquisition or through a joint-venture agreement.

## SECURING RESOURCES OR SUPPLIES

Firms may often choose to merge with another firm to secure resources or supplies further back in the supply chain. This is known as backward vertical integration (see Chapter 7). A firm may want, or even need, to merge with another firm because:

- the resources used in the creation of its product or service are rare or hard to get. It needs to ensure reliable sourcing
- it needs to ensure that the inputs are of a suitable quality or price.

## MAINTAINING OR INCREASING GLOBAL COMPETITIVENESS

Merging or joining with another firm can provide bigger markets and provide opportunities to make cost savings, by exploiting economies of scale, for example. This could make the firm much more competitive in terms of its **pricing power** over customers and suppliers. If there is a lot of competition in the market, or if a firm is hoping to become a dominant global player, merging or acquiring another firm can be part of a successful strategy.

## REDUCING COMPETITION

An important motive for some cross-border mergers and acquisitions is to reduce competition in the market. For example, if a market is dominated by five large firms and two join together, following the merger there are only four. With less competition, a business might start to dominate the market. There may be possibilities for price increases and there will be less pressure to innovate (i.e. come up with new ideas). In 'Getting started' above, the US aircraft manufacturer Boeing took over a Brazilian rival Embraer. This transaction is likely to reduce competition in the market.

## MAKING USE OF LOCAL KNOWLEDGE

Business partnerships often arise when a company lacks the necessary knowledge and expertise to enter a foreign market. This approach reduces risk by partnering with a company within the new country, as seen in US and

European companies setting up operations in Asian markets like China, Vietnam, and Thailand. This approach highlights the importance businesses place on local businesses when entering new markets.

## GOVERNMENT OR LEGAL REQUIREMENT

Governments in some countries are concerned about foreign businesses dominating domestic markets, potentially threatening local businesses' survival. They insist on firms entering their country in partnership with domestic operators, sharing benefits like income, exports, and employment, and protecting domestic companies.

## ACCESSING SUPPLY CHAINS AND DISTRIBUTION NETWORKS

Another important reason for cross-border business partnerships is for companies to access supply chains and distribution networks. The acquisition of operations in different stages of product is called vertical integration (see Chapter 5). If a business acquires a supply chain, this is called backward vertical integration. In contrast, if a business acquires a distribution network, this is called forward vertical integration.

**Supply chains**: Luxury brands are increasingly purchasing farms to secure control over their supply chain, aiming to maintain quality and reduce uncertainty. This strategy helps companies obtain critical materials and maintain ethical standards by adhering to environmental regulations. For example, Ermenegildo ZegnaR took control of Achill Farm in Australia to protect merino wool. Other companies, like Hermes® and LVMH®, have also acquired live animal suppliers.

**Distribution networks**: Distribution networks are often purchased by manufacturers to ensure outlets for produce, reduce risk, and improve profit margins. In 2018, JAB purchased Dr Pepper Snapple® for $19 billion, the largest soft drinks deal on record, creating a potent competitor for Coca-Cola and PepsiR, who have previously dominated the US soft drinks market.

## SHARING COSTS AND RISKS

Cross-border partnerships involve firms sharing costs and risks of business ventures, particularly in developing unfamiliar markets. This reduces speculation and potential profits, while also minimizing potential losses and potential losses.

In 2017-18, joint ventures were announced between:

- Germany's BMW® and China's Great Wall Motors® to make plug-in electric Minis® for the Chinese market in the future
- Malaysian budget airline AirAsiaR and Hong-Kong- based China Everbright Group®, to set up a new low-cost carrier in China
- SSP Group plc, a leading operator of food and beverage outlets in travel locations worldwide, and Travel Food Services Private Limited (TFS), a leading operator of food and beverage concessions in travel locations in India
- US soft drinks giant Pepsi and Japanese consumer company Suntory Beverage & Food, to expand the sale of soft drinks in South East Asia.

These cross-border joint ventures (and many more) will help the businesses to share the risks and costs of business development in new markets.

### SUBJECT VOCABULARY

**brand recognition** how people identify a brand by its features and attributes
**copyright** a legal right that grants the creator of an original work the sole right to determine and decide whether, and under what conditions, this original work may be used by others
**franchise** a business model in which a business (the franchisor) allows another operator (the franchisee) to trade under their name
**global mergers** where two or more businesses from different countries join together and operate as one
**intellectual property** a product that is a creation of the mind, such as an invention, literary work or artwork, that the law protects from unauthorised use by others. Types include patents, copyrights and trademarks
**joint venture** where two or more businesses co-operate to share the costs and profits from a business venture
**licensing** a contract with another firm to use its intellectual property or to produce its product or service in return for a fee
**pricing power** the effect that a change in a firm's product price has on the quantity demanded of that product

# 31 Global expansion and uncertainty

## GLOBAL EXPANSION

The multinationals benefit most from global expansion. Being multinational can help an enterprise to develop **competitive advantages** that are not available to single- nation companies. Multinational corporations (MNCs) often benefit from the following.

• Global operations can bring much bigger economies of scale.

• Global sourcing can give firms more scope to find the best-quality resources at the right prices.

• Global operations allow companies to get closer to their international customers, both before and after sales.

• MNCs are available to a much bigger range of knowledge and scope for innovation.

• MNCs can diversify risk by engaging in a wider range of business activities.

## GLOBAL UNCERTAINTY

One of the effects of globalisation is an increase in interdependence (i.e. two or more things relying on each other). Some examples of this are outlined below.

• In 2008, the financial crisis led to a world recession. It started in the USA and was caused by irresponsible lending. This had a particular impact on the whole of the USA and much of Europe. Economic growth in many of these countries was flat or negative for several years after.

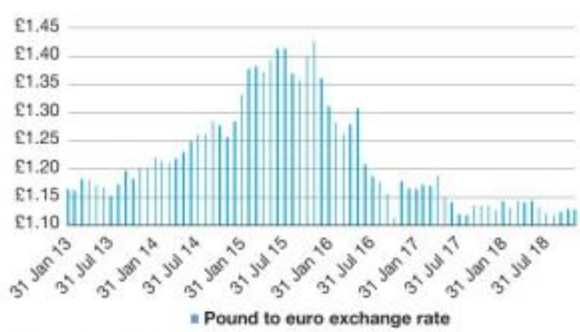
• In 2016, the UK voted to leave the EU. The impact of this is not known yet. According to reports, many believe that trade in the region could suffer and that investment will slow down due to huge uncertainty. In 2018, the threat of a global trade war emerged. This is discussed in 'Getting started' at the beginning of the chapter.

## EFFECT OF EXCHANGE RATE MOVEMENTS ON BUSINESS

One of the factors which can make international trade uncertain is movements in exchange rates. The exchange rate is the price of one currency in terms of another. Like all prices, they can change. When the exchange rate changes businesses that export or import will be affected.

**Appreciation and revaluation:** When a nation's currency gets stronger it is said to appreciate. This means that a unit of one currency can buy more of another currency.

**Depreciation and devaluation**: When a nation's currency gets weaker it is said to depreciate. This means that a unit of one currency buys less of another. This is a **depreciation** of 16 per cent. When the exchange rate is fixed, a government might choose to change the exchange rate so that it is weaker. If this happens, the exchange rate will fall and the currency will be **devalued**.



▲ Figure 2 Pound to euro exchange rate, 2013–17

**Impact of exchange rate appreciation on businesses**: Changes in the exchange rate can have an impact on the demand for exports and imports. This is because when the exchange rate changes, the prices of exports and imports also change.

• **Impact on exporters**. If a UK firm sells goods worth £2 million to a US customer, the dollar price at the original exchange rate is US$3 million (£2 million x US$1.50). When the exchange rate rises, the dollar price of the goods also rises to US$4 million (£2 million x US$2). This means that demand for UK exports is likely to fall because they are now more expensive.

• **Impact on importers**. If another UK firm buys goods worth US$600000 from a US supplier, the price in pounds at the original exchange rate is £400000 (US$600000+ $1.50). When the exchange rate rises, the sterling price to the importer falls to £300000 (US$600000 + US$2). This means that demand for imports is likely to rise because they are cheaper.

• Impact of exchange rate depreciation on businesses: A fall in the exchange rate will have the opposite effect on the demand for exports and imports. Look at what happens when the exchange rate falls from £1 = US$1.50 to £1 = US$1.20.

• Impact on exporters. If a UK firm sells goods worth £2 million to a US customer, the dollar price at the original exchange rate is US$3 million (£2 million x US$1.50). When the exchange rate falls, the dollar price of the goods also falls to US$2.4 million (£2 million US$1.20). This means that demand for UK exports is likely to rise because they are now cheaper.

•Impact on importers. If another UK firm buys goods worth US$600000 from a US supplier, the price in pounds at the original exchange rate is £400000 (US$600 000 US$1.50). When the exchange rate falls, the sterling price to the importer rises to £500000 (US$600000 $1.20). This means that demand for imports is likely to fall

because they are more expensive.

The effects of movements in the exchange rate on exporters and importers are summarised in Table 1.

| Exchange rate | Price of exports | Demand for exports | Price of imports | Demand for imports |
|---|---|---|---|---|
| Rises (appreciation) | Rises | Falls | Falls | Rises |
| Falls (depreciation) | Falls | Rises | Rises | Falls |

▲ Table 1 Summary of the effects of the movements in exchange rates

## THE SIGNIFICANCE OF CHANGES IN THE EXCHANGE RATE ON BUSINESS

**Elasticity of demand**: If there is a depreciation in the value of a currency, the effect it will have on a business and its products depends on price elasticity of demand.

**Significance of the cause of the fluctuation in exchange rate**: If there is an appreciation in a currency because there have been improvements in efficiency and productivity, then businesses will get used to the stronger currency more easily.

**Fixed contracts**: Many businesses use fixed contracts to counter fluctuations in the exchange rate. This means that temporary changes in the exchange rate will have a smaller impact.

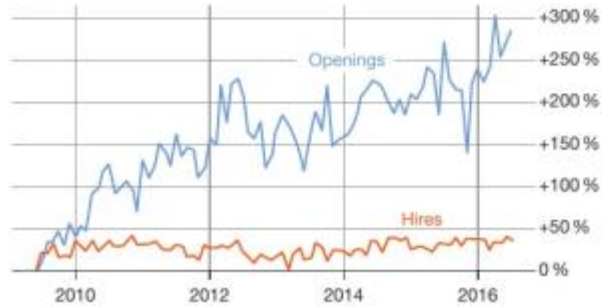
**Economic risk:** Firms trading internationally face risks in exchange rates, including long-term **economic risk,** which is the risk of future cash flows changing due to unexpected fluctuations. This is a significant financial risk as future cash flows form the basis of a business's overall value. The US dollar, the most powerful international currency, plays a significant role in international transactions and is expected to appreciate against most other currencies. Emerging market economies are most likely to feel the impact of any dollar rise, as companies from these regions are more likely to take out loans in dollars. For example, Petrobras, a Brazilian state-owned oil company, is struggling to repay its debt due to falling energy prices.

## SKILLS SHORTAGES AND THEIR IMPACT ON INTERNATIONAL COMPETITIVENESS

Many industries require highly trained engineers, scientists, technicians or professionals to compete. Companies that have long-term access to skilled and low-cost labour have an advantage over their competitors who do not.

In some countries there are serious **skills shortages**. Governments and businesses define skills shortages slightly differently. A government would like to train and educate the country's workforce in the hope that it would make them more competitive relative to other nations.

If businesses are unable to recruit sufficient numbers of skilled workers, their **international competitiveness** can be threatened. The main effects of skills shortages are outlined below.




▲ Figure 3 The rising number of job vacancies in US manufacturing 2009–17

**Higher wages**: When there is a shortage of skilled workers in a specific labour market, the price of labour (wages) is increased. This is a reaction to changes in market forces. Wages are forced up because the supply of labour is restricted.

**Lower quality**: If businesses are unable to attract high-quality skilled workers, it is possible that the quality of output will be negatively affected. This is because firms may be forced to recruit workers who are unqualified or lacking in skills and experience. As a result, the quality of output is likely to be poorer. This could threaten the reputation of the business.

**Lower productivity:** A shortage of skilled labour may result in lower levels of productivity. Lower productivity may be caused by production delays. This is because it takes businesses much longer to recruit skilled labour. In extreme cases, a business may have to stop production altogether if it cannot recruit the required number of skilled workers.

**Loss of business**: If labour shortages continue for a while, there is a danger that a business will lose customers. This is because customers may be kept waiting for their orders. There is a limit to how long customers are prepared to wait. If it is too long, customers are likely to find alternative suppliers. Once a customer is lost to a rival, it is very difficult to tempt them back. In the long term, this could threaten the survival of a business.