# BERTOS MANUFACTURING CORPORATION

## Evaluating Markets to Invest Abroad

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***Abstract:*** *This case deals with the key considerations when planning an international expansion through direct investment in foreign markets. These considerations must be addressed by a finance company seeking to establish foreign subsidiaries to support the international sales of its parent firm, a U.S.-based multinational enterprise (MNE). The company already operates three foreign subsidiaries--in Canada, Mexico (both NAFTA members), and the United Kingdom--but wishes to increase this network further through entry into additional markets. Ten candidate countries are being considered to determine the five most suitable for entry. Hence the need for a rational decision of where to invest.*

**Keywords:** Subsidiaries; multinational enterprise; transnational activities; foreign direct investment; greenfield investment; leveraged institution; wholesale financing; captive finance company; retail installment contract

### 1 Introduction

Victoria Pernarella is a recent university graduate in business administration and a new hire in Bertos Financial Services, Inc., a major finance company in Nashville, Tennessee. After a month long rotational training to gain insights into the company's scope of activities, she was placed in the international department where she has been assigned to work on a project. Bill Pappas, her manager, had asked her to analyze a select number of foreign countries to determine the best prospects for the local establishment of subsidiary finance companies. He went on to clarify that the mode of entry into the foreign markets--acquisition of an existing company or a greenfield investment (from the ground up, that is, from a green field)--was not a primary consideration at this stage. The candidate countries were Argentina, Australia, Brazil, China, France, Netherlands, Russia, Switzerland, Turkey, and Venezuela. With finance companies highly leveraged institutions, the firm was prepared to provide the initial amount of equity capital needed for the establishment of five such institutions. At this stage therefore, the study ought to limit its recommendation to a corresponding number of foreign countries.

With this information at hand, Victoria started reflecting on the approach to use for her analysis. Sensing the need to prove her capabilities by delivering a high quality study for her first company assignment, she thought appropriate to first familiarize herself with the pertinent literature on the international expansion of multinational enterprises (MNE) in general and banks in particular, and then review background information on her employer, and the scope of activities of its financial subsidiary. Hence the sequence of the following sections which address the internationalization process (literature review on the development of MNEs), the modes of bank entry into foreign markets, background of parent company, financial subsidiary and scope of activities, and developing criteria for country recommendation.

## 2 Internationalization Process--A Theoretical Perspective

Recent decades have witnessed the internationalization of operations of many companies around the world, and especially U.S. corporations. Although the extent, form and pattern of their transnational activities vary according to the characteristics of the firms, the products they produce, and the markets in which they operate, they all reflect the dynamics of a changing and increasingly competitive international environment. Of the theories that have sought to explain the transnational activities of enterprises, the eclectic paradigm (Dunning, 1988) enjoys a dominant position. This concept provides a broad framework for the alternate channels of international economic involvement of enterprises and focuses on the parameters that influence individual MNE foreign investment decisions (Buckley and Casson, 1976; Dunning, 1977). Specifically, the eclectic paradigm identifies three important determinants in the transnational activities of firms-- ownership, location and internalization (OLI). The first condition of the OLI configuration states that a firm must possess certain *owner-specific* competitive advantage in its home market that can be transferred abroad if the firm's foreign direct investment (FDI) is to be successful. This advantage must be firm-specific, not easily copied, transferable, and powerful enough to compensate the firm for the potential disadvantages and risks of operating abroad. Certain ownership-specific competitive advantages enjoyed in the home market, such as financial strength and economies of scale, are not necessarily firm-specific because they can be also attained by other firms. Similarly, certain types of technology do not ensure a firm-specific advantage because they can be purchased, licensed or copied. Production and marketing of differentiated products, too, can lose their competitive edge to modified versions of such products promoted by lower pricing and aggressive marketing.

The second strand in the OLI model stands for *location-specific* advantages. That is, the foreign market must possess certain characteristics that will allow the firm to exploit its competitive advantages in that market. Choice of location may be a function of market imperfections or of genuine comparative advantages of particular places. Other important considerations that may influence the locational decision may include a low-cost but productive labor force, unique sources of raw materials, formation of a custom unions or regional trading bloc, defensive investments to counter a firm's competitors, or centers of advanced technology.

The third component of the OLI paradigm is *internalization* and refers to the importance for a firm to safeguard its competitive position by maintaining control of its entire value chain in its industry. This can be accomplished through foreign direct investment rather than licensing or outsourcing. Transferring proprietary information across national boundaries within its own organization would enable a firm to maintain control of its firm-specific competitive advantage. Establishment of wholly-owned subsidiaries abroad reduces the financial agency costs that arise from asymmetric information, lack of trust and the need to monitor foreign partners, vendors, and financial intermediaries. Further, if the parent firm funds the operations of its foreign subsidiaries, self-financing eliminates the need to observe specific debt provisions that would result from local financing. If a multinational firm has access to lower global cost and greater availability of capital why subject its operations to local financial norms or share these important advantages with local joint venture partners, distributors, licensees, and banks that would probably have a higher cost of capital.

Of the three premises of the paradigm described above, the second strand (locational advantage) has been the subject of increased treatise. Although in theory market imperfections and comparative advantage are key considerations in determining the attractiveness of particular locations, in practice firms have been observed to follow a search pattern influenced by behavioral factors. As rational decisions require availability of information and facts, determining where to invest abroad for the first time is significantly more challenging than where to reinvest abroad. The implication is that a firm learns from its operations abroad and what it learns influences subsequent decisions. This premise lies behind two related behavioral theories of foreign direct investment decisions--the *behavioral approach* and *international network theory*. The former, exemplified by the Swedish School of economists (Johansen and Wiedersheim-Paul, 1975; Johansen and Valhne, 1977), sought to explain both the initial and later FDI decisions of a sample of Swedish MNEs based on these firms' scope of international operations over time. The study identified that these firms favored initially countries in "close psychic distance"; that is, they tended to invest first in countries that possessed a similar cultural, legal, and institutional environment to that of Sweden's, e.g., in such countries as Denmark, Finland, Norway, Germany and the United Kingdom. As the firms gained knowledge and experience from their initial operations, they tended to accept greater risks both in terms of the countries' psychic distance and the size of their investments.

The development and growth of Swedish companies over time, contributed to a transformation in the nature of the parent/foreign-subsidiary relationship. The international network theory addresses this transformation by identifying such changes as the evolution of control from centralized to decentralized, nominal authority of the parent firm over the organizational network, foreign subsidiaries competing with each other and with the parent for resource allocations, and political coalitions with competing internal and external networks.

Some authors (Eiteman et al., 2010) view the internationalization of operations as an outgrowth of sequential stages in the development of a firm. They refer to this progression in the scope of business activity as the globalization process and identify three distinct phases. In the *domestic phase*, a company sells its products to local customers, and purchases its manufacturing and service inputs from local vendors. As the company grows to become a visible and viable competitor at home, imperfections in foreign national markets or comparative advantages of particular locations translate into market opportunities and provide the impetus for an expansion strategy. Entry into one or more foreign markets will make the company attain the *international trade phase*. At this stage the company imports its inputs from foreign suppliers and exports its products and services to foreign buyers. In this facet, the firm faces increased challenges of its financial management, over and above the traditional requirements of the domestic-only phase. Exports and imports expose the firm to foreign exchange risk as a result of currency fluctuations in global markets. Moreover, they expose the firm to credit risk management; assessing the credit quality of the foreign buyers and sellers is more formidable than in domestic business. When the firm senses the need to set up foreign sales and service affiliates, manufacture abroad or license foreign firms to produce and service its products, it progresses to the third phase, the *multinational phase*. Many multinational enterprises prefer to invest in wholly owned subsidiaries to maintain effective control of their competitive advantage and any new information generated through research. Ownership of assets and enterprises in foreign countries exposes the firm's FDI to political risk--political events that can undermine the economic viability and performance of the firm in those countries. Political risk can range from seizure of property (expropriation) and ethnic strife to conflict with the objectives of the host government (governance risk) and limitations on the ability to transfer funds out of the host country (blocked funds).

Figure 1 portrays the sequential stages in a firm's international expansion and provides an overview of the globalization process and the FDI decision. For a firm with a competitive advantage in its home market, a typical sequence in its international expansion would be the reach to one or more foreign markets by first using export agents and other intermediaries before engaging in direct dealings with foreign agents and distributors. As the firm learns more about foreign market conditions, payment conventions and financial institutions it feels more confident in establishing its own sales subsidiary, service facilities and distribution system. These moves culminate in foreign direct investments and control of assets abroad. Some of these assets may have been built from the ground up, or acquired through purchase of an existing firm or facility. As the level of physical presence in foreign markets increases so does the size of foreign direct investment.

## 3 Modes of Bank Entry into Foreign Markets

Unlike industrial and manufacturing firms which have expanded internationally along the patterns suggested above (eclectic paradigm and globalization process), financial institutions have entered foreign markets primarily in response to the needs of their business clients. Indeed, this has been the case for commercial banks, the oldest and most dominant institution of the U.S. financial system. The growth of multinational corporations and the accelerating pace of globalization in business activity increased the demand for international financial services and induced the expansion of banks' international operations and presence abroad. Whether proactively (to enhance own growth and profitability) or defensively (to deny a competitor the benefit of the client's business), banks have sought to enter foreign markets early and quickly to gain from the first-mover advantage. The rush of Western banks into Central and Eastern Europe in the 1990s exemplifies the drive to gain this first-mover advantage (Hughes and MacDonald, 2004).

In weighing entry into a foreign market a number of factors must be taken into account, including the bank's resources (both financial and human), projected volume of international business, knowledge of--and experience with--foreign markets, banking structure and regulation in the countries targeted for entry, tax considerations, and customer profile. A key variable in the decision process is the vehicle to be used in the delivery of international services. Major banks around the world have used anyone or a combination of vehicles to structure their international operations. The lowest possible level of presence in a foreign market may be attained through a *correspondent banking relationship*--using a native institution to provide the financial services needed in that market. This approach may be duplicated in one or more countries abroad, as needed, for the processing of international transactions. It entails no investment and hence no exposure to the foreign market. Extension of services may be based on a reciprocal deposit account between the banks or an individual fee per transaction. A *representative office* enables a physical presence in a foreign market. However, it cannot provide traditional banking services; it can only engage in such activities as serving as a liaison and performing marketing function for the parent bank. As it does not constitute a legal entity it has no legal or tax liability. An *agency* may perform more functions than a representative office but cannot perform all banking functions (e.g., in the United States a foreign bank agency may extend local loans but cannot accept local deposits). The principal vehicle used by U.S. banks in the conduct of their activities internationally is the *branch office*. This office is a legal and operational part of the parent bank, backed the full resources of the parent in the performance of the banking functions permitted by the host country. Although it requires a sizable investment it enables the provision of full banking services which the prior vehicles do not. A branch office is subject to two sets of regulation--those of the home country and those of the host country. A *subsidiary* is a separate legal entity organized under the laws, and hence regulated by the authorities, of the host country. It is the second most important vehicle used by commercial banks for the conduct of banking business, and may be established as a new organization or through the purchase of an existing institution. Whatever the approach used in its establishment, a subsidiary offers two important advantages over a branch: it may provide for a wider range of services, and it limits the liability of the parent bank to the amount of its equity investment in that entity. The main disadvantage of a subsidiary is that it must be separately capitalized from the parent bank, which may often entail a greater start up investment than a branch (Rose and Hudgins, 2010).

U.S. finance companies interested to expand their activities internationally take into account many of the same criteria used by banks. In structuring their international operations U.S. finance companies favor the subsidiary organizational form because of the advantages associated with this type of vehicle. Just as in U.S. financial markets, foreign financial subsidiaries are heavy users of debt in financing their operations. Principal sources of borrowed funds include bank credits and issues of debt (e.g., bonds) in capital markets to finance their lending activities in their respective markets (Madura, 2011; Gitman et al., 2010). Finance companies are extremely diversified in their credit granting activities, offering a wide range of loans, leasing plans and long term credit to support capital investment. One of the most important markets for finance companies has been the extension of business-oriented financial services including working capital loans, revolving credit and equipment lease financing.

## 4 Background of Parent Company

Bertos Manufacturing Corporation (BMC) is one of the largest companies of the country in the manufacturing of construction and mining equipment, and engines. BMC draws its origin in a California firm organized in 1890 to manufacture steam-powered tractors for farming. The firm was nominally capitalized and aspired to make inroads in the local market by having its tractors plow California fields. However, soon after the turn of the century, an abandoned manufacturing plant by a failed tractor company in a major manufacturing center in Illinois was instrumental in the relocation of operations in the

Midwest. The location of this center on the Mississippi River made it a prime transportation hub offering important prospects for the young company. Indeed, the move proved a turning point in the development of the company. Domestic sales grew so significantly that by 1911 the factory employed a little over 600 individuals. A natural consequence of the domestic momentum was the firm's entry into foreign markets through tractor exports to Argentina, Mexico, and Canada.

World War II was a company milestone as it created a sharp increase in the demand for tractors to built airfields and other military facilities in strategic sites of the Pacific. However, it was during the post-war construction boom that the company grew at a rapid pace. A series of mergers and acquisitions diversified operations into the current scope of products and contributed to BMC's growth to an industrial company of national and international dimension. A successful export-oriented strategy led to the establishment of a manufacturing venture outside the United States in 1950, which marked the beginning of BMC's development into a multinational corporation.

The company operates in two primary lines of business: machinery and engines. The machinery line of business designs manufactures and sells construction, mining, and forestry machinery, including track and wheel tractors, hydraulic excavators, pipe layers, log loaders, off highway trucks, and related parts. The engines business line designs, manufactures and sells diesel and natural gas engines and gas turbines, which, in addition to their use in the company's own machines and vehicles, provide power for boats, ships and locomotives.

The recent financial crisis (2008) led to the restructuring of operations and renewed management's commitment to fuel efficiency, quality, technology and safety of the company's machinery and engine products. Overall, BMC manufactures some 400 products which are sold both at home and abroad through a network of dealers. The company has a worldwide network of 220 dealers: 63 dealers in the United States and 157 in other countries. To accommodate domestic and international demand for its products and components the company has built 109 plants in different part of the world. Of these, 51 plants are located in the United States and 58 in foreign countries, namely, Australia, Belgium, Brazil, Canada, England, France, Germany, Hungary, India, Indonesia, Italy, Japan, Mexico, the Netherlands, Northern Ireland, the People's Republic of China, Poland, Russia, South Africa and Sweden. The company also licenses or subcontracts the manufacture of BMC-branded clothing, hats, footwear, and other consumer products.

To support higher volumes, growth and new product introductions, BMC's worldwide employment is a little over 100,000, split evenly between the United States and the rest of the world. Consolidated revenue last year amounted to about $45 billion and net profit (after taxes) $3.5 billion (Table 1). More than half of the total revenue was generated outside the United States, while the North American market was the single largest source. A breakdown of revenues by geographic region is provided in Table 2.

Although this performance represents the culmination of an effective international strategy, BMC has been increasingly concerned about its future potential in the global market place. Its board of directors has recognized that although opportunities for future growth exist, international competition may undermine the maximization of consolidated after-tax returns. To offset the effects of such a trend, the board, in its last meeting, decided to explore new avenues for growth. A top prospect was the international expansion of financial services to support the overseas dealer sales of BMC products.

## 5 Financial Subsidiary and Scope of Activities

Following the practice of other industry leaders (e.g., General Electric, Motorola, and Ford Motor Company), BMC established a wholly-owned, and separately incorporated, finance company to perform a dual function--to accommodate the credit needs of the parent but most importantly to finance parent company sales (hence the reference to such a firm as a captive finance company). Established in Nashville, Tennessee, Bertos Financial Services, Inc. (BFSI) promotes the sale of the parent's products and services by engaged in the extension of credit. Specifically, BFSI extends wholesale financing to, and purchases retail installment contracts from, franchised dealers. Also, it offers various forms of insurance to customers and dealers to support the purchase and lease of equipment. Table 3 identifies the location of BFSI offices in the United States and the geographical market covered by each office. The company's domestic network includes 10 regional offices and a wholly-owned subsidiary which engages solely in the financing and leasing of construction and trucking industry equipment on a national scale. Table 3 also identifies BFSI's current presence abroad which is limited to three subsidiaries located in the following countries--Canada and Mexico (both members of the North American Free Trade Agreement), and the United Kingdom.

In its last meeting the BMC board felt that if the spectrum of credit activities pursued at home could be duplicated abroad it would add important impetus in the company's international growth momentum. The board believes that establishment of finance companies in an additional number of select foreign countries would be instrumental in maximizing corporate investment returns. To this end it has requested an in-house study to screen foreign prospects and expressed the interest to review recommendations in its forthcoming meeting. It was under these circumstances that Bill Papas assigned the task for this study to Victoria.

## 6 Developing Criteria for Country Recommendation

To screen the best five prospects among the ten candidate countries for the establishment of subsidiary finance companies, Victoria thought appropriate to develop a set of criteria on which to base her recommendation. Although she could readily identify several key criteria, she felt she should give also due consideration to the rules and regulations governing bank operations in the candidate countries. Granted that the objective was not to set up commercial banks but finance companies; however, the banking regulatory framework provided an indication of the kind of credit and financial environment prevailing in these countries.

Although the focus of her study was the best five foreign prospects, she felt important to defend her recommendation by also addressing the weaknesses of the excluded countries. She realized that this classification was only pertinent under present circumstances and that some of the excluded countries could realize latent opportunities to qualify for entry at a later time.

## 7 Assignment

1. Identify the key criteria and considerations that need to be taken into account in evaluating BFSI entry in the proposed foreign markets.

2. Of the countries under consideration, which five would be most suitable for the immediate establishment of a BFSI subsidiary? Highlight the key issues for each of the selected countries and discuss the reasoning behind your recommendation.

3. Which countries would be unsuitable for a BFSI subsidiary at this time, and what are the basic shortcomings in each case?

**Figure 1** The FDI sequence: foreign presence and foreign direct investment

***Source*:** Eiteman et al (2010), Figure 16.8 © 2010 Pearson Education, Inc. Reproduced by permission of Pearson Education, Inc.

**Table 1** Financial highlights of BMC

| Items | Billions of dollars |
|---|---|
| Total revenues | $44.9 |
| Profit after taxes | 3.5 |
| Assets | 56.1 |
| Stockholders' equity | 8.9 |

*Source:* Authors' analysis

**Table 2** Breakdown of revenues by geographic region

| Region | Billions of dollars | Percent |
|---|---|---|
| North America | $19.7 | 43.88 |
| EAME* | 14.3 | 31.85 |
| Latin America | 4.5 | 10.02 |
| Asia Pacific | 6.4 | 14.25 |
| Total | $ 44.9 | 100.00 |

*Europe, Africa, and the Middle East.
*Source:* Authors' analysis

**Table 3** Bertos Financial Services, Inc.: Operations in the United States and abroad

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**Domestic Offices and Market Area Covered**

Charlotte, North Carolina: Charlotte Area

Tempe, Arizona: Denver Area

Weatogue, Connecticut: Hartford Area

Houston, Texas: Houston Area

Jacksonville, Florida: Jacksonville Area

Rancho Santa Margarita, California: Los Angeles Area

Lenexa, Kansas: Minneapolis Area

Brentwood, Tennessee: Nashville/Indianapolis Area

Peoria, Illinois: Peoria Area

Bellevue, Washington: Seattle Area

Atlanta, Georgia:  U.S. Equipment Financing Inc.

**Subsidiary Companies Abroad**

Canada
Bertos Financial Services, Inc.
Toronto, Ontario

Mexico
Grupo Financiero Bertos Mexico, S.A. de C.V.
Monterrey, Nuevo León

United Kingdom
Bertos Financial Services Limited
Birmingham, West Midlands

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