

CORPORATE STRATEGY CONSIDERATION
OF THE PHASE-OUT JOINT VENTURE AS A FORM OF
DIRECT FOREIGN PRIVATE INVESTMENT

by

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B.Sc., University of Alberta
(1960)

SUBMITTED IN PARTIAL FULFILLMENT

OF THE REQUIREMENTS FOR THE

DEGREE OF MASTER OF

SCIENCE

at the

MASSACHUSETTS INSTITUTE OF

TECHNOLOGY

June, 1972

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Alfred P. Sloan School of Management, May 4, 1972

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ABSTRACT

This thesis takes a look at the phase-out joint venture as a form of direct foreign private investment from the viewpoint of corporate strategy. The phase-out joint venture principle is defined as the establishment of international joint ventures in which the foreign and host country partners agree from the outset to three phases for their joint venture: a) phasing in, b) operation/control, c) programmed phase-out of the foreign partner. The phase-out agreement does not mean a complete divestiture for the foreign partner, but a lessening of his equity position. At the start, the foreign partner would usually have an equity position greater than 50% and, after meeting the phase-out requirement, would usually have an equity position less than 50%.

This topic is of increasing interest due to the worldwide trend to increased nationalistic behavior. The international entrepreneur is faced with increasing restrictions on foreign investment in the majority of countries, with phase-out in a few and, depending on the country and the industry, with expropriation in the extreme case.

In order to find out what strategies are being formulated to cope with the increasingly nationalistic foreign investment environment, information has been gathered from published articles, from interviews with executives of various government organizations and private companies, and from the case studies of three companies. The phase-out principle has been used as a reference because it represents an extreme case for the international entrepreneur and in determining how it is and will be handled should give an indication of what can be expected from the foreign investment environment in the future.

General conclusions are that while the international entrepreneur will continue to maximize his opportunities, and therefore tend to shy away from phase-out requirements, each case will be studied on its own merits. As the field becomes increasingly restricted, or if a particular market looks especially attractive, as in the case of Japan, the investor will probably "learn to live with nationalism".

Thesis Supervisor: Richard D. Robinson
Title: Senior Lecturer

ACKNOWLEDGMENTS

I would like to express my appreciate to Dr. Richard D. Robinson (thesis supervisor) and Mr. Richard S. Morse, Senior Lecturer, for their interest, patience and counsel throughout this thesis. I would also like to thank the executives of the various government organizations and private companies who provided me with opinions and other valuable material for my research.

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PREFACE

The research for this topic has been approached from the point of view of a potential entrepreneur (developer) who is interested in the possibility of investing overseas and would therefore like an overview of the field for reference purposes.

The author's interest in this general area comes from having been a foreign-based employee for a number of years of a company which, after many years of successful operation in a certain country, has recently been forced into negotiating a phase-out arrangement for the local subsidiary.

The rising tide of nationalism which led to the above situation appears to be part of a world-wide phenomenon and leads to such questions as: "Is it possible to live with increasing nationalism and the increased restrictions being placed on foreign investment?", "What future is there for the international entrepreneur?", "What are the present conditions and world-wide trends in restrictions on foreign investment?", "What is the attitude of business and how are companies adapting?", etc.

Time has been a limiting factor in trying to treat a topic of this scope in any great depth. The author's strategy has been to combine information obtained from articles found in library research with reports and opinions obtained in interviews with executives of certain

selected government organizations and private companies, university professors, and other researchers in the foreign investment area. It is quite probable that there are a number of articles of pertinent information in the library and not discovered by the author due to his lack of time or diligence.

The author has been surprised to find how difficult it is to unearth published information of the world-wide overview variety. This is apparently due to the complexity of world economics and the individual treatment given each country's investment laws and seems to be confirmed by the large multinational firms which have their areas experts but very few who can talk in world-wide overview terms. It is mainly for this reason that some sub-topics, which could merit thesis treatment themselves, are treated in a very superficial manner.

The topic with its broad (almost unstructured) coverage was chosen by the author for his own education and to satisfy his own curiosity; if the reader finds anything of value, then this is a bonus.

CHAPTER 1
INTRODUCTION

Intent of the Thesis

The main purpose of this study is to take a look at the approach to strategy formulation for direct foreign private investment decisions-- and especially those involving joint ventures. Much has been said about rising nationalism and its effect on a given country's investment laws. Studies have shown the national and firm characteristics which might indicate the propensity of a nation to expropriate and the vulnerability of an investment to be expropriated.¹ In those countries considered most restrictive, the trend appears to be to require joint or mixed ventures,² and in extreme cases to a programmed phase-out of the foreign investor.³

Although Meeker's thesis showed that businessmen tend to shy away from a commitment to the fade-out principle, they apparently are able to

¹TRUITT, John Frederick. "Expropriation of Private Foreign Investment: A Framework to Consider The Post World War II Experience of British And American Investors". Unpublished Ph.D. dissertation, Indiana University, 1969.

²MEYER, Juan Miguel. "Mixed Ventures Between International Corporations and Government Institutions: The Venezuelan Case". Unpublished Master of Science (Management) thesis, Massachusetts Institute of Technology, 1970.

³MEEKER, Guy Bentley. "The Feasibility Of The Fade-Out Joint Venture Principle As A Form Of Direct U.S. Private Investment In Latin America (An Empirical Study)". Unpublished M.B.A. thesis, George Washington University, 1970.

learn to live with increased investment restrictions.¹

Statement of The Research Questions

This thesis is an investigation of corporate strategy applied to direct foreign private investment decisions, and especially those involving joint ventures. The main questions to be answered are;

1. Do companies that are doing business in several countries notice a definite general trend to increased restrictions on direct foreign private investment, and if so what strategies are being developed to cope with this?
2. Is it possible to learn to live with increasing nationalism resulting in greatly increased restrictions on investment?
3. Is the fade-out joint venture principle viable and does its inclusion in the laws of the Phillipines and the Andean Pact Decision 24 represent a trend?

Scope of The Study

The study looks first at a general model (structure) used for corporate strategy formulation and then applies this to the foreign environment. A combination of library research and interviews has been used to gather information on some of the ingredients thought necessary for a decision. Interviews with three companies provide case material to help answer the questions. These companies were chosen specifically because

¹--"Nationalisation: Living With It," Economist (June 6, 1970).

--"Mexico Takes a Piece Of The Action," Fortune Magazine (December, 1971) 59.

they each have operations in Mexico (increased restrictions), Phillipines (phase-out requirement), Europe (Common Market), Venezuela (Ancom country), and Canada (rising nationalism); also each of these companies has experience with joint ventures (although not of the required-phase-out variety..).

CHAPTER 2

GENERAL MODEL FOR BUSINESS STRATEGY FORMULATION

Business strategy, a relatively new and complex business concept, consists of a set of management guidelines which specify the firm's product-market position, the directions in which the firm seeks to grow and change, the competitive tools it will employ, the means by which it will enter new markets, the manner in which it will configure its resources, the strengths it will seek to exploit and conversely, the weaknesses it will seek to avoid. Strategy is a concept of the firm's business which provides a unifying theme for all of its activities.¹

Since the middle fifties, a significant trend in business firms has been towards explicit and formal formulation of their strategies. One of the main reasons for this has been the need to anticipate increasing rates of change, to take advantage of new opportunities and timely action in avoiding threats to the firm. Corporate strategy is the first and major step towards such ability.²

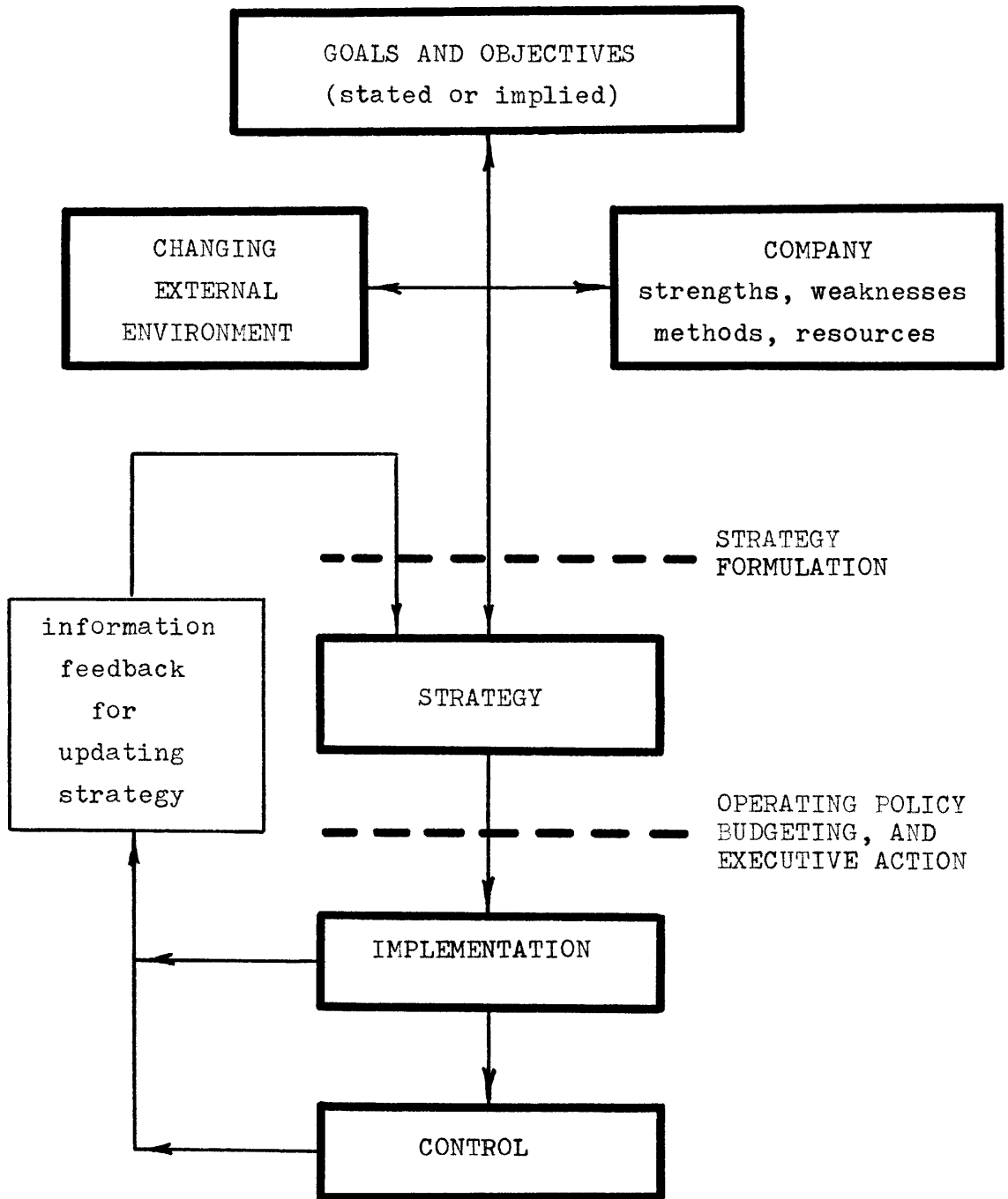
A simple and very useful framework which can be used when formulating a company's business strategy is shown on the following page.³

¹ANSOFF, H. Igor. Business Strategy. Middlesex, England: Penguin Books, 1969.

²ANSOFF, H. Igor. Corporate Strategy. New York: McGraw-Hill, 1965.

³Developed by M.I.T.'s Professor Edward H. Bowman in his course, Corporate Strategy, Policy and Planning.

STRATEGY FORMULATION FRAMEWORK



The framework is a reminder that a company's business strategy is formulated taking into consideration its goals, its environment, and its own strengths, weaknesses, methods, and the resources it has at its disposal. This strategy is then implemented and controlled. The feedback of information on results from the implementation and control process is then re-compared with the company's goals, the changing environment, and the changing strengths and weaknesses of the company in order to determine what strategy shifts are necessary. It can be seen from this that strategy formulation is a dynamic process.

An examination of the way different enterprises carry out the same activity--whether that activity is manufacturing, marketing, procurement of supplies, finance, or administration--has as much value as a study of how a single firm carries out all these activities.¹

In the following chapters the business strategy framework concept is applied to the activity of direct foreign private investment strategy formulation. The chapters on political trend environment and joint venture are not meant to be an exhaustive study in themselves, but only an attempt to provide a framework which will facilitate a comparison of the cases. The changing environment is taken to mean more the changing political environment seen as a trend in rising nationalism, and further, that this rising nationalism is the principal reason for the increasing trend

¹CHANDLER, Alfred D., Jr. Strategy And Structure: Chapters in The History Of The American Industrial Enterprise. Cambridge: M.I.T. Press, 1962.

in joint ventures and,¹ in extreme cases, leads to the phase-out requirement. It is assumed that these trends will lead to strategy shifts which can be compared in the cases.

¹FRIEDMAN, Wolfgang G.; and BEGUIN, Jean-Pierre. Joint International Business Ventures in Developing Countries. Columbia University Press, 1971.

CHAPTER 3

POLITICAL TRENDS IN THE FOREIGN INVESTMENT ENVIRONMENT

The main purpose of this chapter, as mentioned previously, is to provide some background information on present international trends in the foreign investment environment in order to;

- a) give some indication of the variety of external environment conditions which always face the international business strategist.
- b) provide a framework of reference for comparison of the cases.

Each of the companies selected for case study is doing business in each of the country-group areas. The chapter is not meant to be an exhaustive study in itself, but is only an attempt to provide the required environmental reference.

Country-Group Areas

a) Africa and Middle East

Apart from Africa and the Middle East's problems of extremely low level of development, the greatest uncertainties appear to be political.¹

Worth mentioning are;

- the continuing Arab-Israeli conflict.
- the focus on the Middle East as a theater for East-West military and diplomatic rivalry.
- the heightened tribal divisions in several countries.
- increased nationalism as typified by Uganda's 60% take-over of business.

¹I.L.&T. Report on Africa and Middle East, Business International, December, 1970.

--the divisions among the "black" African countries themselves over the future of southern Africa's black majorities.

The welcome of African and Middle Eastern governments to foreign investors ranges from almost outright hostility to real enthusiasm. The climate for foreign investors has been clouded recently by the threat of nationalization, particularly in the extractive industries. Moves to nationalize, in part or completely, have taken place in Sierra Leone, Uganda, and Zambia, among others. The pressure for participation with local investors, including state agencies, appears to be growing.¹

b) Asia

In comparison with other parts of the less developed world (e.g., Latin America and Africa), Asian countries are currently enjoying a greater degree of political stability.² Although major uncertainties appear to continue to concern the future of Vietnam, Laos, Cambodia and Pakistan, there is more short-term political stability in the Phillipines, Indonesia, Japan, Australia and to some degree, India. Mainland China remains a question mark. Hong Kong is very open.³

Asia has some of the largest and some of the fastest growing countries of the world, and it has tremendous growth potential. Japan is decidedly the major market in the region. Also, Japan's importance outside

¹I.L.&T. Report on Africa and Middle East, Business International, December, 1970.

²I.L.&T. Report on Asia, Business International, January, 1971.

³Ibid.

its borders will continue to grow making Japanese-based firms major competitors to other companies, worldwide. On the whole, foreign investment is welcome as a necessary ingredient for national--and regional--economic development. Most countries offer foreign investors incentives. There is, however, considerable sensitivity to economic dominance and in most countries foreigners are encouraged or obliged to include local equity in their ventures.¹ In the Phillipines, for example, this can take the form of a required phase-out for the foreign-controlled firm after a specified number of years.² The major problem countries for foreign investors are India, where the government generally makes doing business more difficult than it is worth, and Japan, which is only now liberalizing some of its very comprehensive controls on income capital.³

c) Europe

Europe's move towards unity continues, but progress has been confined almost entirely to the economic sphere, with a strong sense of national identity blocking real progress toward political unity. Europe is divided into two trade blocks--the European Economic Community (EEC) or Common Market, and the European Free Trade Association (EFTA). Attempts to build a bridge between the two have not been successful.⁴

¹I.L.&T. Report on Asia, Business International, January, 1971

²from the report "Summary and Text of Phillipines Investment Act" in the U.S. Dept. of Commerce Overseas Reports, OBR 68-7, February, 1968.

³I.L.&T. Report on Asia, Ibid., January, 1971.

⁴I.L.&T. Report on Europe, Business International, January, 1971.

The Common Market comprises Belgium, France, Germany, Italy, Luxembourg, and the Netherlands, with two associates, Greece and Turkey. The primary aim has been to form a customs union with later political integration and a truly integrated market allowing a free flow of goods and capital and free establishment of persons.

The European Free Trade Association is very different from the E.E.C. With eight full members (Austria, Denmark, Iceland, Norway, Portugal, Sweden, Switzerland, and the U.K.) and one associate member (Finland), it has established a free-trade area rather than a customs union. A free trade area is one in which the members do not impose tariffs on each others goods but continue to levy their own individual tariffs on goods originating in non-member countries. EFTA was originally created to facilitate the eventual entry of its members into the Common Market, an aim it has not forsaken. Denmark, Norway, the U.K., and Ireland will probably be the first to join.

European integration has been most successful in the areas of business and finance.¹ In the past few years a genuine European capital market has emerged, in which dozens of firms, regardless of nationality, have been able to raise substantial amounts of medium and long-term funds. Moreover European firms in increasing numbers are entering into arrangements to pool their manufacturing or distribution forces across borders, or trade blocs, although such agreements continue to be outnumbered by

¹I.L.&T. Report on Europe, Business International, January, 1971.

mergers and regroupings within country frontiers.¹

d) Latin America

Companies approaching a strategy formulation for new investment or expansion in one of the Latin American countries today must evaluate the prospect on two separate dimensions: the local market situation with the general environmental conditions affecting the potential demand for the firm's own products, as well as the implications of Latin America's evolution toward economic integration. The eventual goal of integration in Latin America is a Latin American Common Market (LACM) embracing all the countries south of the Rio Grande--a total of some 270 million people, with current GNP of approximately \$110 billion. It now appears that the transition toward an eventual common market will not begin before the later '70s and will still be far from completion in 1985.²

As in Europe, the integration movement is presently revolving around two trade groupings: the Central American Common Market (CACM) and the Latin American Free Trade Association (LAFTA). CACM includes Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, with Panama expected to join eventually. LAFTA includes Argentina, Bolivia, Brazil, Chile, Columbia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. Inside of LAFTA is an important subgroup, called the Andean Common Market or Ancom, which came into effect in 1969 and includes Bolivia, Chile, Columbia, Ecuador, and Peru (Venezuela decided at the last minute to stay

¹I.L.&T. Report on Europe, Business International, January, 1971.

²I.L.&T. Report on Latin America, Business International, March, 1971.

out of this group). In 1967 the so-called Andean bloc--including Venezuela--agreed on the basic outlines of a subregional common market designed to accelerate their integration within the broader context of LAFTA and LACM. Ancom has set certain time schedules for itself on various steps it is to take and, to date, has met all of the important deadlines. The very nationalistic attitude that the group has taken toward foreign investment in its rules on harmonized treatment of foreign capital set very difficult conditions for the foreign investor. The rules call for the dismantling of foreign majority positions according to a "fade-out" formula whereby local participation must be at least 51% of equity by the fade-out deadline. The fade-out period is 15 years in Chile, Colombia, and Peru, and 20 in Bolivia and Ecuador.¹ Only national (80% or more locally owned), mixed (at least 51% locally owned), and fading-out companies (in the process of selling amounts according to a set Ancom calendar) will be issued the certificates of origin needed to take advantage of preferential relationships in Ancom. Once CACM has consolidated its own integration, it is expected to become associated with LAFTA thus completing the continental solidarity within which the advance toward an eventual Latin American Common Market will continue.²

e) Canada

Canada has had, generally speaking, almost no restrictions on most

¹I.L.&T. Report on Latin America, Business International, March, 1971.

²I.L.&T. Report on Latin America, Ibid., March, 1971.

investments, making it one of the freest areas in the world, including the U.S. The extent of foreign control of Canadian industry is unique among the industrialized nations of the world.¹ Although foreign investment is generally welcomed, and in fact is eagerly sought for slow growth regions, Canadians are caught up in a new wave of economic nationalism.²

There is now more pressure for a degree of Canadian ownership, specialization (in manufacturing) for domestic and export markets, active R & D operations, and Canadian management. In Quebec there is also pressure to make French the working language in business. Canadians are less concerned about Japanese or West European investment than U.S. investment, and some even welcome investment from these areas to broaden foreign ownership.³ There are restrictions on certain sensitive sectors, particularly insurance, banking, loan and savings companies, etc. Generally speaking, no non-resident may own more than 10% individually or 25% of the outstanding shares of such a company in total by all non-residents. This

¹WATKINS, Melville H. "Foreign Ownership and the Structure of Canadian Industry", a task force report prepared for the Canadian Privy Council, 1968. Among the issues raised are the following;

- a) benefits and costs of the multinational corporation.
- b) availability of information about foreign-controlled corporations.
- c) concentration of market power and restrictive trade practices by foreign-controlled firms.
- d) performance and efficiency of foreign-controlled firms.
- e) extraterritoriality.
- f) Canadian participation.

²I.L.&T. Report on Canada, Business International, February, 1971.

³I.L.&T. Report on Canada, Ibid., February, 1971.

applies to new ventures or take-overs. Existing situations are excluded. Restrictions are applied by both the Federal Government and lately also the Provincial Governments with a tendency to give preferential tax treatment to companies which have a minimum of 25% Canadian ownership.

f) United States

In its attitude toward foreign investment, the United States is also one of the freest areas in the world. Foreign investments are actively sought, both by the federal and state governments.¹ The U.S. Dept. of Commerce administers an "Invest in the USA" program to provide information and other help to attract foreign investors and put them in touch with appropriate business and government offices. Among the states more aggressively seeking foreign-owned plants are: Alaska, Arkansas, California, Georgia, Illinois, Indiana, Kentucky, Michigan, New York, Ohio, Pennsylvania, South Carolina, Tennessee, and Virginia. However, there is opposition to foreign investment in some areas deriving from local public attitudes. Joint ventures with and acquisitions of U.S. firms are most frequent, but many wholly owned affiliates have been established.²

¹I.L.&T. Report on U.S., Business International, September, 1970.

²I.L.&T. Report on U.S., Ibid., September, 1970.

CHAPTER 4

JOINT VENTURE STRATEGY CONSIDERATION

The purpose of this chapter is to identify some of the strategies and methods utilized by the international business strategist when considering joint-venture opportunities. The chapter is not meant to be an exhaustive study in itself, but only an attempt to provide a reference around which to question the companies interviewed for the cases. In order to provide a broad reference, topics are considered from each of the three phases in the life of a joint venture: a) phasing in, b) operation/control, c) phasing out.

A. Phasing In

1. Analyzing Foreign Investment Climates

It is possible to divide what companies actually do in analyzing foreign investment climates into four basic types: a) go-no-go; b) premium for risk; c) range of estimates; d) risk analysis. Most companies at present take one of the first two approaches, but the latter two are more sophisticated and indicative of the direction in which many companies are moving.¹ There are some companies that use a mixture of various parts of these approaches.

a) Go-No-Go; rejection or acceptance of a particular country based on an examination of one or two characteristics (i.e., rapid inflation), with usually no further serious study given to the investment climate.

¹STOBAUGH, Robert B., Jr. "How To Analyze Foreign Investment Climates" Harvard Business Review, (Sept/Oct, 1969), 100-108. (from a study of 40 international companies).

This approach has an advantage in reducing the amount of investigation to be done in looking for a foreign investment opportunity, but also has the major disadvantage of passing over very good investment opportunities by rejecting them in the first screening.

b) Premium For Risk; a scale is developed for rating countries according to their perceived investment climates. Higher rates of return on investment are then demanded from proposed projects in countries with "poor" investment climates than from comparable projects in countries with "good" investment climates. Specific cutoff points on ROI are usually assigned for the different countries. Difficulties with this approach are; the various elements of the investment climate often have different effects for different projects, it is difficult to assign proper weights for each category of investment climate. The "premium-for-risk" technique is used by approximately 80% of U.S.-based international firms,¹ primarily because of its simplicity and because of perceived difficulties in making accurate estimates about the future in foreign countries.

c) Range of Estimates; a best estimate is made of what the values will be for the various factors that will affect the project's profitability. The crucial variables are identified, best estimates made of what these variables will be at different times in the future, and a resultant estimate of cash flow obtained. The estimates of the crucial factors are then varied in order to determine the sensitivity of the cash flow to

¹STOBAUGH, Robert B., Jr. "How To Analyze Foreign Investment Climates" Harvard Business Review, (Sept/Oct, 1969), 100-108

changes in each factor. By selecting the factors having the greatest effect on project profitability and varying them, it is possible to estimate a likely range within which the resulting cash flow will be. Relatively stable factors are: income tax rates, depreciation allowance rates, availability of loans in terms of quantity and cost, tariff rates, presence of exchange controls. The two main problems in using the "range-of-estimates" approach are; a) it is necessary to be on the lookout for variables that change in the opposite direction and thereby tend to offset one another; b) indiscriminate use of all the pessimistic estimates of variables in any one case.

d) Risk Analysis; This approach uses probability theory to make an estimate of the probable outcomes of various events. One of the problems of investment analysis is that individual managers often have a different risk preference from that decreed by company policy.

Numbers can reflect some judgment but not all, and in the final analysis executive judgment is needed in making the investment decision.

2. Locating The Local Partner

Regardless of the type of business, all investors, whether foreign or local, take a partner into a joint venture for the purpose of gaining from that partner some skill or resource that they lack...it might be that the presence of the local partner is justified simply because...restrictions in the host country are based on the assumption that 100% foreign ownership is undesirable.....¹

Local partners are always the key to success in joint ventures abroad. One has to select a foreign (i.e., local)

¹BIVENS, Karen K.; and LOVELL, Enid B. Joint Ventures With Foreign Partners, International Survey of Business Opinion And Experience. National Industrial Conference Board, New York, 1966, p. 15.

partner rather in the same way as a bride. The normal financial and personnel checks cover some of the ground, but the final assessment is always dependent upon subjective considerations.....¹

Three major decisions can be distinguished in connection with joint ventures:

- a) The decision to invest, in particular, to invest in a given host country.
- b) The decision to invest through the joint venture form.
- c) The decision to associate with a specific partner.²

From the point of view of a foreign investor, one can group the possible reasons for which a specific associate may be selected into six categories:³

- 1) Forced: Cases in which the choice is effectively forced upon the foreign investor either because of explicit host government direction or indirectly because the associate preempts an exclusive license.
- 2) Facilities: Convenience to the foreign partner of local facilities under the control of the associate. Among these would be a site or plant, marketing or distributive facilities, or a strong market position; cases in which the associate was already in the same line of business as that of the proposed joint venture.
- 3) Resources: Convenience of local sources of managerial and technical personnel, materials, components, or local capital which can be contributed by the associate.
- 4) Status: Status and capability of the associate in dealing with local authorities and public relations. This subset would also include status defined in terms of general financial and business soundness and standing.

¹TOMLINSON, James W. C., from an unpublished study of the U.S. joint ventures in India, Pakistan, and Iran. 1965.

²TOMLINSON, James W. C., The Joint Venture Process In International Business: India and Pakistan. Cambridge: M.I.T. Press, 1970.

³Ibid.

- 5) Past: Favorable past association with the associate when the latter had been an agent, licensee, major customer, or partner in a previous joint venture. The category includes special cases in which there might have been strong personal contacts between individuals in the foreign and local parent companies, possibly even individuals common to both.
- 6) Identity: Cases in which a partner would be chosen chiefly to obtain local identity, often through association with a potential "sleeping partner".

The services of an investment bank can be very useful to the international entrepreneur when going into an area for the first time. The investment bank will aid in locating the local partner, give advice on local business and legal problems, help conduct negotiations, and put together a package of financing, including the obtaining of new equity capital.

3. Capital Sources

There are essentially nine decisions facing the international entrepreneur which determine his firm's financial strategy.¹

1. Where the profits are to be taken (location of profit centers).
2. By what routes profits are to move to the profit centers.
3. Where the investment decisions are to be made (location of investment centers).
4. The type of financing to be used.
5. What the substance of the investment is to be.
6. The source of financing.
7. What legal instrumentality is to be used.
8. How assets are to be made secure.
9. How the value of assets is to be maintained.

With the availability of both domestic and foreign financing, an international business has a wider range of types of financing from which

¹ROBINSON, Richard D. International Management. New York: Holt, Rinehart and Winston, 1967.

to choose than does the purely domestic. All international financing falls within three principal alternative categories:¹

self financing vs external financing,
debt financing vs equity financing,
local vs foreign financing.

There are many variations of international financing techniques available to the international entrepreneur, and the larger corporations doing business in many countries have probably used them all. Because techniques which are common practice in one country may be illegal in another, it is not possible to establish a unified global financial strategy common to all operations. Each country has to be considered not only a special case, but also a changing one. Differences in cost of the financing techniques are mainly due to the location of risk. Because the investment may take the form of cash, capital equipment, depreciated machinery inventories, services, or intangibles, the international entrepreneur has the problem of valuation of assets for the purpose of capitalization in the foreign enterprise. Important sources of cross-border equity financing include the following;

- a) commercial banks
- b) investment banks
- c) the World Bank group
- d) regional development banks

a) Commercial Banks Of all the sources for external financing international operations, the commercial banks are the most important.² The

¹F.F.O. Report on Techniques For Financing, Business International, December, 1971.

²F.F.O. Report on Cross Border Financing, Business International, October, 1971.

rapid growth in the international facilities and know-how of the world's major commercial banks in the last decade has been very useful for companies trading and investing on a worldwide scale. Motivated by the fact that more and more of their customers are multinational in character and that their banking needs must be met on a global basis, banks in the U.S., Canada, Europe, and even in Japan and other areas of the Far East have rapidly expanded their international facilities and services. Commercial banks are those banks which accept deposits, supply short-term credit and trade financing, make collections, etc. These banks, as a rule, can be classified as those having deposits or assets of \$2 billion or more and offering a wide range of international financing services. Included among their activities are: increased and refined syndication for large financing; international cash management; financial counseling; a variety of lending techniques from short- to long-term maturities, in various currencies, with funds available in a number of different geographic locations.

U.S. banks have expanded their international financing facilities through Edge Act Corporations--corporations chartered under the Edge Act--and agreement corporations, which have similar status. These are special domestic subsidiaries that can provide a wide variety of financing services to international business. Along or with partners they can grant loans abroad, finance exports and third-country trade, and invest in

equity of foreign corporations.¹

Banks are now grouping together to form ad hoc consortia, with up to 30 members, to complete a single, or repeated, large transaction. The first multibank to be established, Midland and International Banks, located in London and set up in 1964, is typical of these banks in having parents from several countries: Midland Bank (UK), Toronto-Dominion Bank (Canada), the Commercial Bank of Australia, and the Standard Bank (Anglo-African). Many commercial banks have affiliated themselves with a wide range of foreign institutions and are providing services through them extending from simple overdrafts and accounts receivable financing to investment banking, services which they might not provide at home.

b) Investment Banks They are the intermediaries between those seeking to invest long-term funds (e.g., pension and trust funds, insurance companies, organizations, and private investors) and those needing such funds for worldwide operations. Their strength is their creative ability in finance planning, their knowledge of the market and of the type of securities the market is looking for, and their international contacts established through long experience in arranging placements and managing syndicates. The international contacts are increasingly being extended by the establishment of new offices abroad, mergers, and the taking of equity

¹in interviews with First National City Overseas Investment Corporation and the First National Bank of Boston, bank officials indicated that this is becoming an increasingly important and attractive form of the banks' foreign activities. First National City O.I.C. indicated that their equity investments have taken the form of 50% congeneric and 50% venture capital, while First National Bank of Boston indicates that their equity investments have been mainly congeneric.

positions in foreign financial institutions, including both commercial and investment banks. In the process of change the traditional distinction between "commercial" and "investment" banks has been blurred. While the actual functions of the investment banker can be fairly clearly differentiated from those of the commercial banker, it is more difficult to make a separation between commercial banks and investment banks. In many countries, banks offer both types of services; in others there are an increasing number of affiliations between the two types of institution. The range of investment banking services offered international companies include the following;¹

- a) public flotation of bonds,
- b) private placement of bonds,
- c) arranging equity financing,
- d) supporting a secondary or after-market for securities,
- e) brokering, and
- f) assisting in mergers, acquisitions, and reorganizations.

c) The World Bank Group The largest and most important source of international development financing is the World Bank group, whose lending and investment activities serve the capital requirements, particularly for financing infrastructure projects, of developing countries. The group consists of three financial institutions: International Bank for Reconstruction and Development (BRD, World Bank), which makes loans at near-conventional terms to countries for projects of high economic priority; International Development Association (IDA), which makes loans on "soft" or concessionary terms to countries that might otherwise not be able to obtain funds; and International Finance Corp (IFC), which finances

¹F.F.O. Report on Investment Banks, Business International, December, 1971.

(through loans and equity participations) various projects in the private sector. The international entrepreneur (especially manufacturers and suppliers that engage in international trade) may benefit from the World Bank group's activities in the following ways:¹

1. as suppliers to projects for which the group disburses billions of dollars on behalf of borrowers in developing countries.
2. as potential borrowers from the 38 development finance institutions that the group has assisted financially and technically.
3. as prospective users of the Bank's center for arbitration of disputes arising between foreign private investors and the governments of host countries.
4. as beneficiaries of the improved business climate resulting from general and specific group activities in developing countries, e.g., better infrastructure, improved economic management, reliable inventories of economic resources, etc.
5. as receivers of IFC financing for joint projects with local business in developing countries that are members.

d) Regional Development Banks All development banks are basically similar.² They provide funds--often a substantial percentage of project cost--for the financing of manufacturing, mining, and agricultural projects that are considered of importance to the economic development of the market. In most cases repayment terms are over a 5-15 year period and interest rates are favorable. Often several years of grace are allowed. In a number of cases the development banks also provide equity financing; in some they insist upon it. A good many of the development banks are also useful to international companies as underwriters and guarantors of other loans. A large percentage have both local and foreign currencies

¹F.F.O. Report on the World Bank Group, Business International, December, 1971.

²F.F.O. Report on Regional Development Banks, Business International, March, 1971.

available, the foreign funds being lent to them by the World Bank, the International Finance Corp, and individual governments. Development banks also provide other services. They are almost always good sources of information about their area. More important, they act as a catalyst for the raising of funds from local, regional, or international institutions.

The regional banks are usually owned by a long list of participating governments, although privately owned regional development banks are becoming more common. The banks tend to work more closely with the World Bank and its affiliates than with the local governments. The regional banks are generally much larger than the country development institutions. Banks in one area (e.g. Europe) might have funds available for lending in other areas (e.g. Africa or Middle East) because of special trade and economic ties. The regional banks grouped by geographical area are as follows;

a) Africa

1. The African Development Bank (government)
2. The East African Development Bank (government)
3. Societe Internationale Financiere pour l'Investissement et le Developpement en Afrique (Sifida) (private)

b) Middle East and North Africa

1. The Arab Development Bank (government, not yet in business)
2. The Kuwait Fund for Arab Economic Development (government)
3. Arab Fund for Economic and Social Development (government)

c) Asia

1. The Asian Development Bank (government)
2. The Private Investment Company for Asia (private)

d) Europe

1. The European Investment Bank (government)
2. European Coal and Steel Community (government)
3. The European Social Fund (government)
4. The European Development Fund (government)

e) Latin America

1. The Inter-American Development Bank (government)
2. Adela Investment Company (private)-----¹
3. The Andean Development Corporation (government)

B. Operation/Control

1. Organizational Structure

The successful implementation of strategy requires that the general manager shape to the peculiar needs of his strategy the formal structure of his organization, its informal relationships, and the processes of motivation and control which provide incentives and measure results.²

The successful firm will be structured so that both external and internal

¹from the Adela Investment Company 1971 annual report and from an interview with Vice-president, Robert L. Ross it was learned that;

1. The Adela Investment Company is an international private investment firm dedicated to the economic development of Latin America by strengthening private enterprise through capital, entrepreneurial, and technical services.
2. Among the company's approximately 240 shareholders are some of the leading industrial and financial companies of Europe, North America, Japan, and Latin America.
3. Adela seeks to expand the application of modern technology and management practices within Latin America. It also conducts business itself through three major operating subsidiaries; Adela Compania de Inversiones, and investment subsidiary; Adela International Financing Co., a financing subsidiary chartered in Panama; Adelatec Technical and Management Services.
4. Adela is very flexible in the financing facilities it offers and the selection of projects to assist. There are no basic criteria to qualify for an Adela investment or loan, except that the project must be feasible and potentially profitable. Adela prefers to invest in conjunction with other financial institutions and, if possible, local investors. The equity split is usually one-third Adela, one-third international company, one-third local partner.

²LEARNED, Edmund P.; CHRISTENSEN, C. Roland; ANDREWS, Kenneth R.; and GUTH, William D. Business Policy. "The Accomplishment of Purpose: Organizational Structure and Relationships", p. 573, Illinois: Richard D. Irwin Inc., 1969.

problems are given appropriate and continuous attention.¹ Control may be defined as the relationships and devices designed to assure that strategy (or policy) decisions are made by designated authority and that tactical (or operating) decisions conform to the selected strategies.² Due to geographical separation, there is a tendency for each individual international operation to become isolated from the rest of the firm. The organizational structure must assure:

- a) optimum location of tactical decision making authority,
- b) efficient exchange of information for optimum synergy,
- c) means of reporting and evaluating both individual and overall performance,
- d) maintenance of overall control of strategy formulation and its implementation,
- e) a reference framework for management training and development of key personnel.

The single-line diagrams on the following page show some of the forms of organizational structure used by international firms.

2. Protection of Foreign Assets

Establishing a strategy for protecting the firm's assets against other than normally insurable risks is of prime importance to the international entrepreneur. Three types of international environmental phenomena may effect current and/or fixed assets:³

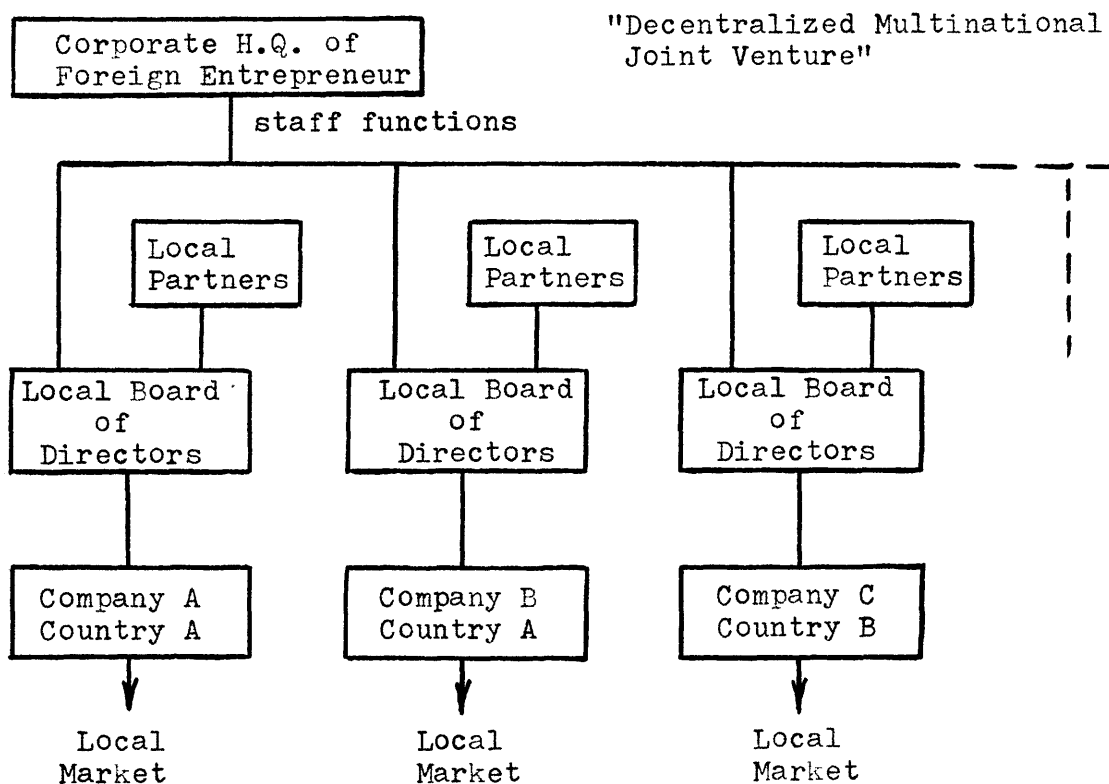
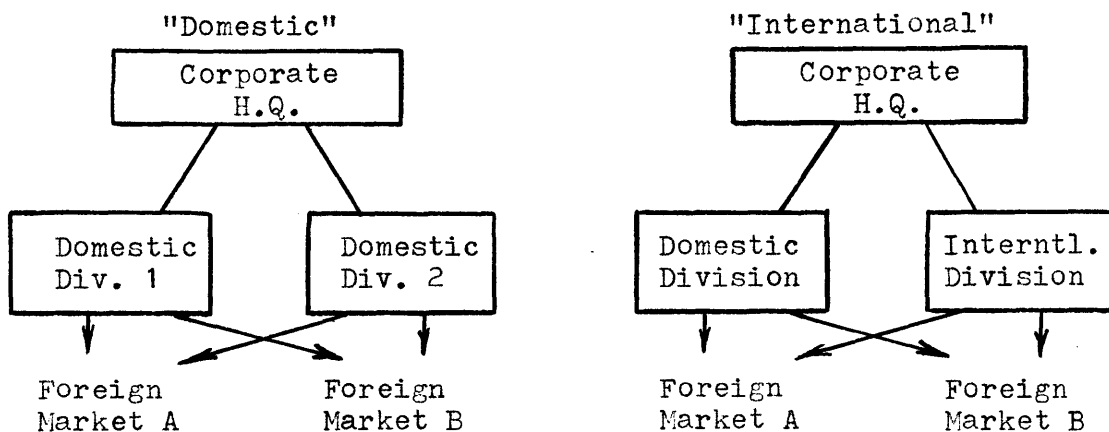
- a) changes in foreign government policy,
- b) price inflation in foreign localities,
- c) host country or lending-country balance-of-payments problems resulting in the loss in dollar value of assets and profitability

¹ANSOFF, H. Igor. Business Strategy. Middlesex, England: Penguin Books, 1969.

²ROBINSON, Richard D. International Management. New York: Holt, Rinehart and Winston, 1967.

³F.F.O. Report on Investment Guarantees, Business International, April, 1971.

ORGANIZATIONAL STRUCTURE



of the affiliate and/or restrictions on the movement of funds.

a) Protection Against Changes In Foreign Government Policy

Separate from the problem of protecting foreign assets from currency risks and the ravages of inflation is the protection of foreign investments from inherent political risks. Australia, Canada,¹ Denmark, France, Germany, Japan, the Netherlands, Norway, Sweden, and the U.S. each have programs to protect the investments made by their firms in less developed countries. The rising tide of nationalism in less developed countries (LDCs) and the continuous tightening of exchange controls that restrict the transfer and convertibility of earnings and royalties, the transfer of proceeds from disinvestment, and often the repayment of loans have increased the need of international companies to seek protection of their assets against political risks. For U.S.-based companies roughly one-third of the total annual investment flow to the LDCs in 1971 was insured

¹Canada's Export Development Corp (EDC) will insure investors against a) war, riot, insurrection; b) expropriation and confiscation; c) any action of the government of the host country, other than b, that deprives the investor of any rights in, or in connection with, the investment; d) restrictions on the transfer of money or on the removal of property from the host country. To be eligible the foreign investment must be more than 50%-owned by a Canadian company, and it must provide economic advantages to Canada.

under the U.S. political risk insurance program.¹

The World Bank has created a facility for protection of foreign investments by sponsoring the Convention on the Settlement of Investment Disputes between States Nationals of Other States. The convention does not provide investment guarantees, but an apparatus for settling a dispute between an investor from one state and the government of the host country. Settlements are made via arbitration and conciliation.

b) Protection Against Price Inflation in Foreign Localities

The international entrepreneur doing business in a given environment

¹The U.S. Government, through the Overseas Private Investment Corp (OPIC), offers eligible U.S. investors protection for their investments abroad under two programs:

1) Investment Insurance Risk Program: Insurance against the specific political risks of inconvertibility into dollars of profits, royalties, fees, and other income, as well as the original capital investment; further insurance against loss due to expropriation, nationalization, or confiscation by the foreign government, and losses from damage to and destruction of tangible property as the result of war, revolution, and insurrection. Insurance is normally only issued to investments in nations that have signed a bilateral agreement with the U.S. The investors must be: a) U.S. citizens regardless of residence; b) essentially businesses which are more than 50% owned by U.S. citizens. Fees range from 0.3% to 0.6% annually of the amount covered.

2) Extended Risk Program: Guarantees against losses from all causes, including commercial losses, except for fraud or misrepresentation for which the party seeking payments is responsible and risks that are normally coverable with ordinary commercial insurance. A distinction is made between the role of the "investor" and that of the "borrower" or "sponsor". The investor, the beneficiary of the guarantee, is usually a U.S. bank, insurance company, Edge Act Corp, or other financial institution (but also a U.S. parent company lending to its foreign affiliate). The sponsor actually puts the project together, contracts the potential lenders, applies for the guarantee in favor of the lender, and carries out the project. Up to 50% of long-term loans and interest may be covered, and up to 50% of equity investments. The cost of the all-risk policy is a flat 1.75% annually of the covered portion of the investment.

where there is a high rate of inflation will notice some of the following developments;¹

1. A general crimp in credit availability may ensue, usually coupled with substantially higher credit costs,
2. accounts receivable may build up and collection periods lengthen,
3. the government may impose price controls on some or all industries,
4. firms may receive illusory profits because depreciation and amortization schedules are based on outdated costs,
5. exporting forms will find their products less competitive in world markets,
6. labor costs will require constant attention.

Against these developments, the two inter-related operational objectives confronting the local subsidiary are;

- 1) defend the real value of existing assets,
- 2) protect the profit-making ability of the company.

General strategy guidelines are as follows;

- 1) For Defending The Real Value of Existing Assets
 - a) keep current assets at the lowest possible level
 - b) limit accounts receivable by such inducements as discounts for prompt payment and general collection pressures.
 - c) invest excess cash quickly in assets that tend to appreciate in value in line with price increases, e.g., land, etc.
 - d) discount receivables and customers' drafts with local financial institutions, and channel the resulting cash into less exposed assets.
 - e) maximize locally denominated debt funds.

¹F.F.O. Report on Financing in Inflationary Markets, Business International, October, 1970.

- f) in general, establish solid relationships with many different banks by splitting company deposits and other financial business among them. This increases total bank credit available.
 - g) establish overdraft lines
 - h) consider issuing promissory notes, as such issuances by firms in good standing are a favored instrument for raising local working capital in many markets.
 - i) borrow, if possible, from other firms in the same country that have excess funds available for short-term investment.
 - j) negotiate extended payback terms with suppliers.
 - k) stretch financial resources by delaying payment of taxes, social security, and pension fund contributions, and the like.
2. For Protecting The Profit-Making Ability of the Company:¹ there are three basic tools; cost control, an appropriate pricing policy, and flexible product management.
- a) cost control:
 - 1. where local borrowings are available at relatively low cost, invest heavily in inventories and supply materials.
 - 2. revalue the affiliate's fixed assets to represent more realistically their replacement value, whenever legally possible.
 - b) appropriate pricing policy:
 - 1. keep sales prices in step with or ahead of inflation
 - 2. refrain from giving price guarantees for future delivery.
 - 3. maintain tight control over raw material inputs, goods in process, and finished products so that prices reflect replacement cost rather than original cost.
 - c) flexible product management:
 - 1. from a corporate perspective, consider re-arranging component input patterns.
 - 2. adapt production processes to minimize the use of inflationary inputs.
 - 3. modify the product mix of the corporation.

¹F.F.O. Report on Financing in Inflationary Markets, Business International, October, 1970.

c) Protection Against Host Country or Lending Country Balance-of-Payments Problems Resulting In The Loss In Dollar Value of Assets and Profitability of the Affiliate and/or Restrictions on the Movement of Funds

An effective asset-protection policy for subsidiaries involves forecasting the probabilities of occurrence and magnitude of parity changes (or imposition of exchange controls), measuring the exposure comparing the potential loss with the cost of protection, and using the available defensive measures before they become too costly. Evaluating the foreign exchange exposure of a given company at any given time primarily involves segregating the assets and liabilities of the balance sheet so as to reveal the net amount of assets that are subject to a loss in value in the event of currency deterioration. An asset-protection policy must be planned and implemented well in advance of the events it is attempting to guard against. Some international firms have found it valuable to devise categories of defensive measures according to timing;¹

1. long-term defensive measures (forthcoming 6 to 12 months)
2. short-term defensive measures (less than 6 months)
3. contingency measures (when changes have occurred).

1. Long-Term Defensive Measures

- a) minimize local currency current assets--whose dollar value would diminish by the amount of devaluation--as well as minimize foreign indebtedness, whose local currency cost to the affiliate would increase by the same percentage as the devaluation.
- b) maximize local-currency current liabilities (e.g. accounts payable, local bank credits, suppliers' credits, customers' deposits, and other short-term debt), as well as increase local currency long-term liabilities, whose dollar cost will diminish after a devaluation.

¹F.F.O. Report on Protecting Foreign Assets, Business International, November, 1970.

2. Short-Term Defensive Measures:¹

- a) Hedge net exposed assets by purchasing forward dollars or other desired stable convertible currency on the foreign exchange market.
- b) reduce the parent company or head office investment of hard currency and borrow locally for all purposes.
- c) use currency or credit swaps in those instances when local financing cannot be arranged.
- d) maximize and speed up remittances of dividends and profits to the parent firm, in the form of provisional dividends or profits if necessary.
- e) convert local currency and make advance remittances abroad in the form of hard currency for loans, deposits on purchases.

3. Contingency Measures: (when changes have occurred)

For moving funds from the host country:

- a) consider changing accounting procedures (e.g. revalue fixed assets) where permitted.
- b) purchase government bonds issued by the host country which are convertible at maturity into the home currency of the purchaser.
- c) for those countries with public companies listed on the local exchange, as well as on foreign stock exchanges, it may be permissible to purchase stock locally and then sell it on the foreign exchange for hard currency.
- d) where dividend remittances are restricted, the affiliate may be able to remit funds in other forms such as payments for sufficiently documented contractual licensing agreements for the transfer of technical know-how.
- e) raise the transfer price on goods sold to the affiliate by the parent company.
- f) make a currency swap with another international firm's local affiliate in return for an equivalent hard currency transfer by the other company's international headquarters to the lender's parent firm.

¹ F.F.O. Report on Protecting Foreign Assets, Business International, November, 1970.

For protecting and maintaining profitability:

- a) Internally, the surplus funds can be invested in capital equipment or inventory.
- b) Externally, several types of local portfolio investments should be considered.

C. Phasing Out

The international entrepreneur is likely to be faced sometime with either the complete divestiture or the partial phase-out of participation in an overseas operation. This third phase in the life of a joint venture may be brought on by:

1. the entrepreneur himself who wishes to divest the organization of a particular affiliate which does not meet the criteria established for return on investment, etc.

2. the laws of the country may require a partial phase-out of foreign investment.

3. the entrepreneur may decide, as a basic strategy, to broaden and strengthen the local affiliate's position by bringing in a greater degree of local participation.

In each case the entrepreneur is faced with the problems associated with divestiture and in some cases with the consideration of a management contract and either a no-equity or less-than-control equity position. The following are some of the considerations associated with this phase:

1. Problems of Divestiture

Most investments in developing countries involve a higher degree of perceived risk due to inflation, currency devaluation, political

instability, and the volatility of economic activity. Partly due to this and partly due to the shortage of entrepreneurial capital for various reasons, the potential local entrepreneur in some cases expects extremely high rates of return on his investment to compensate lower risks perceived in other areas. Due to the short supply and high demand for local capital, the local entrepreneur is in a favorable bargaining position and therefore the main problems for the foreign divestor appear to be:

a) locating the local source of capital (e.g., individual, firm, stock exchange, etc.) under conditions which permit a satisfactory negotiation and sale.

b) freedom to choose the correct timing for the negotiation in order to assure a fair exchange through dealing from a sound base.

The creation of international investment unions has been suggested which would allow investors in developing countries to hold assets from several developing countries rather than being limited to securities from their own countries.¹ Capital from this union could then be made available at reasonable rates to local entrepreneurs in order to allow them to offer better terms for their own phase-in and the satisfactory divestiture of the foreign interests.

An ideal source of capital for divestiture would be the local stock exchanges. As of December, 1963, there were approximately 61 countries with their own stock exchanges.² In most of these countries, however, the

¹LESSARD, Donald R. "The Case For A Latin American Investment Union". Study prepared and published under the Working Paper Series of the Amos Tuck School of Business Administration, August, 1971, p. 28.

²"Individual Shareownership Around The World". Study published by the New York Stock Exchange, December, 1963.

average citizen does not understand or has no experience with individual risk taking as represented by individual shareownership. The majority of the exchanges, then, do not present a real strategy option for the international entrepreneur.

Firms that have experience with international divestiture consider the following options:¹

- a) negotiate with the existing partner
- b) locate a new partner or firm²
- c) go public
- d) at the outset, negotiate a put/call article of agreement with joint venture partner.

2. Management Contract

The problem of who has effective control of the foreign investment represented by the international joint venture may be solved to the satisfaction of everyone concerned by the use of a management contract. This is an arrangement by which a foreign firm performs managerial functions for a local enterprise in which it has limited or no ownership interests.³ This device removes the principal objection of host countries to direct investment from abroad--foreign ownership of local industry.

¹information obtained in interviews with officials of the First National City Overseas Investment Corporation.

²HIRSCHMAN, Albert O. "How To Divest In Latin America And Why". Essay In International Finance No. 76, International Finance Section, Department of Economics, Princeton University, November, 1969, p. 30.

³GABRIEL, Peter P. The International Transfer Of Corporate Skills: Management Contracts In Less Developed Countries. Harvard University Press, 1967.

It enables less developed countries to benefit from foreign corporate expertise in situations where conventional direct investment is impossible or very difficult to come by. From the standpoint of the foreign corporation, the management contract reduces or virtually eliminates the risk of property seizure by host governments.¹ The combination of equity participation, management contract, and phase-out, have to be handled with care in many countries due to possible charges of conflict of interest.²

¹ROBINSON, Richard D. "The Global Firm-To-Be: Who Needs Equity?", Columbia Journal Of World Business (Jan/Feb, 1968).

²"Consultants Clash Over Ownership". Business Week (Nov. 27, 1971), 66-72.

CHAPTER 5

COMPANY PRACTICE (CASES)

The purpose of this chapter is to provide case material on three companies with international experience on a worldwide basis. The three companies chosen each have operations in many countries including; Mexico (increased restrictions on foreign investment), Phillipines (phase-out requirements), Europe (Common Market), Venezuela (candidate for the Andean Common Market), and Canada (rising nationalism in a historically free-investment country). The intent is not to provide an exhaustive case study on each company, but to provide enough background information of the type developed in the previous chapters in order to get a feel for each company's corporate strategy philosophy as applied to direct foreign private investment and, if possible, to joint ventures. Because of the extensive exposure that each company has it is felt that each is in a unique position to comment on worldwide trends in rising nationalism and the implications for the international entrepreneur. Information was obtained from annual reports and from interviews with company personnel. In order to protect confidences, company personnel have not been identified and in the cases where information is considered sensitive it is included in the final chapter in order not to identify the company. In any case, the interpretation of each company's corporate strategy philosophy is the author's as perceived from information obtained.

1. Rheem International, Inc.

1. The Industry/Parent Company

- a) History--Rheem International, Inc.'s parent company, Rheem Manufacturing Co., was incorporated in Delaware in 1930 and started manufacturing their famous water heaters soon after. Rheem prided itself on having an improved product with such later innovations as a corrosion-resistant glass-lined tank, larger capacity and higher rates of heat input.
- b) Products--The company has evolved a varied line of consumer and industrial products including the following; steel shipping containers, water heaters, heating and air conditioning equipment, some equipment that provides the right water temperature for other processes, sound motion picture projectors, tape recorders, a line of high quality audio products, systems to help produce, process, measure, test, ship and refine oil; two-man electrically operated submarines; packaging closure systems for food products, etc.
- c) Technology--requirements vary with the product, and in most cases are from medium to high.
- d) Patents/Legal--patents have been obtained on many of the products and these are administered from corporate headquarters in New York.
- e) Competition--while competition exists for each of the products, single competitors are limited by product or by geographic

region.

f) Sales--

1. Domestic:	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
Domestic Sales	\$120M	\$150M	\$140M	\$165M	\$160M	\$170M
Domestic Profits (before taxes)	\$5.2M	\$7.5M	\$7.0M	\$10.M	\$12.M	
2. Consolidated:	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
Net Earnings (after tax)	\$6.0M	\$5.0M	\$7.5M	\$8.0M	\$9.3M	\$
Total Assets	\$90M	\$105M	\$107M	\$126M	\$150M	
Net Worth	\$50M	\$52M	\$61M	\$65M	\$72M	

3. Profits from 1965 through 1969 increased from \$7.7M to \$15.8M growing at a compounded rate of 19.5% per year.

4. Net earnings after tax increased during the above period at a compounded rate of 8% per year.

g) Goals--During the early 1960 's, Rheem Manufacturing Company set specific goals to provide a stable and profitable growth pattern.

1. Develop and maintain business activities with a potential of returning pre-tax earnings on investment at the rate of 30% per year.

2. Achieve growth in earnings at the rate of 15% per year, compounded.

3. Grow through acquisitions, provided that the acquired company has the potential for reaching the first two objectives.

2. THE COMPANY

a) History--Rheem International Inc. was incorporated as a separate international corporation in Delaware in 1963, and is wholly owned by Rheem Manufacturing Co. It had previously been the international division of the company.

b) Sales--

	<u>1965</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
Total Sales	\$115M	\$121M	\$130M	\$155M	\$170M	\$220M
Profit (before tax)	\$7.7M	\$8.5M	\$8.0M	\$8.1M	\$11.M	\$13.5M

c) Organization--Rheem International, Inc. has approximately fourteen thousand people working in 88 plants in 33 countries. It has centered the management of all overseas operations in the hands of its board of directors. A coordinated policy and line direction of its parent company (domestic) and the international company is assured by having the chief executive officer of the parent company act as one of the three board members, and as chief executive officer of the international subsidiary. (Note: this is now outdated information to some extent as the company continues to modify its organization). The three man board of Rheem International Inc. (R.I.I.) consists of the president, the vice-president & general manager of R.I.I., and the Rheem International Director-Europe. The secretary of the parent company also acts as the secretary-treasurer of R.I.I. The headquarters staff of R.I.I. is small--22 people--and includes a controller,

an assistant manager operations, and an administrative manager.

d) Basic Strategy--Rheem International Inc. has the same goals as its parent company, i.e., 30% ROI, 15% growth in earnings, and growth through acquisition. Included in its strategy are the following:

1. Continued preference for the joint venture method of operation. Each subsidiary is to be managed by qualified local management responsible to a local board of directors. This board of directors is responsible in turn to the Rheem International, Inc. board.
2. It is Rheem's basic policy not to have 100% owned companies overseas where it can find suitable local partners. R.I.I. does own 50% or more of most of the affiliated companies, but the joint venture concept of operation implies that major decisions are made primarily on a consultative basis between Rheem and the foreign partners.
3. A primary interest of the R.I.I. board of directors is that the overseas companies should operate with a high degree of autonomy. They have primary responsibility for the day-to-day operations. The only absolute requirement is the achievement of a satisfactory return on investment by each company.
4. Management participation by Rheem is assured through the overseas boards of directors on which are seated representatives both of Rheem Manufacturing Co. and Rheem International (propor-

tional to Rheem's equity holding). The board of directors is in a position to transmit Rheem's viewpoint to local management. The strong personal relations required to make this system most effective are maintained through frequent meetings between the overseas partners and the president, general manager, and overseas representatives of Rheem International.

5. The subsidiaries submit forward plans and budgets to the parent company board of directors (R.I.I.) for review and approval but once the annual operating and financial budget has been approved there is no obligation to seek clearance on specific operating decisions that arise in the course of the year.

6. Financial control of the widespread international operations is exercised through the controller's office of Rheem International. The requirement of accurate monthly financial reporting permits R.I.I.'s management to evaluate possible trouble spots before they become serious, and information and assistance can be offered immediately as needed. This indirect control is backed by frequent first-hand reports received from foreign partners visiting New York and Rheem officials travelling abroad.

7. In emphasizing through the local boards return on investment as the basic concern of the owners, Rheem identifies its interests with those of the local partners. This tends to make the welfare of the jointly-owned company more important to the partners than any special interest which they may have.

8. The various licensed affiliates of Rheem International have exclusive distribution rights of the licensed products within their assigned territories and nonexclusive rights in other areas.

9. Rheem has a policy of achieving cross-fertilization of ideas in all phases of business, by bringing representatives of the various affiliates together to exchange views and ideas. This has permitted the home office to limit its management staff both in New York and overseas.

10. The selection of each new acquisition and of each new country of operation is made on its merits on a case-by-case basis. What Rheem looks for first is the quality of management that the foreign candidate can bring to the proposed joint venture. Then a thorough analysis is made of the market as well as the legal, tax, and political situations. The company then makes its move when it is assured that there is a "fit" (compatibility), and that the venture has the potential of meeting the overall profitability goals of the corporation.

11. The new joint venture company is given access to all the services of the parent organization in return for a management fee. The amount of the annual fee is set to cover the estimated costs of all corporate services to be provided to the subsidiary including patent, trademark and know-how rights; legal, tax, accounting, market, and engineering assistance; purchasing

services.

12. The company does not have a formal strategy for finding new business opportunities. Rheem has found that after 35 years of international experience and with the collective knowledge of its group of "consultants-from-within", it is able, through its myriad of contacts, to be aware of opportunities as they arise. Opportunities are being proposed continually by local entrepreneurs who are looking for a foreign partner.

13. Rheem attempts to provide its share of equity participation in new ventures from within the group. In those cases where it does obtain local financing, it attempts to cover itself through the use of hedging operations. Rheem has not made a policy of protecting its foreign assets through insurance with the Overseas Private Investment Corp (OPIC).

14. Rheem has limited experience with management contracts, and cannot see itself entering into an agreement where it has no equity participation because this is where it sees its profit base. The company has not set minimum limits on equity participation, each case is decided on its own merits.

e) Market/Products--while the basic Rheem domestic products such as steel shipping containers, water heaters, heating and air conditioning equipment, etc., are very much a part of the growth industries in other countries, the overseas product line is much broader and includes automobile springs, nuts & bolts, highway

guard rails, industrial storage systems, plastic packages, fabrics and yarn, etc. Each subsidiary tries to adapt to the requirements of its own territory and make the most of the opportunities it encounters. The subsidiaries have exclusive distribution rights of the licensed products within their assigned territories and nonexclusive rights in other areas. Little need has been found to try and coordinate the marketing activity of the subsidiaries in the unassigned markets. This is partly due to the nature of the majority of the products (e.g., steel drums are too bulky to be competitively marketed at any great distance from the production facility, water heaters have to be adapted in design to the particular locality, etc.).

f) Strategy Shifts--There appear to have been no dramatic strategy shifts in Rheem International, Inc.'s history, but more an evolved response to changing environment and increasing company expertise. Two examples are the following;

1. In the beginning, Rheem was less experienced internationally and needed local partners for their knowledge of local conditions. Now that it has its own vast experience it can take a stronger position in the establishment of joint ventures.
2. Rheem International, Inc. has initiated a profit-incentive (bonus) plan in some of its subsidiaries in an effort to produce a greater effort towards goal achievement.
3. Listing some of the subsidiaries on their local stock ex-

changes is being considered in order to provide a stronger local base.

2. Union Carbide Corporation

1. The Company--Union Carbide, incorporated in New York in 1917, is now well diversified and its operations encompass chemicals, plastics, industrial gases, metals, carbons, and consumer and related products.

2. Sales/Net Income

<u>Amounts in Millions</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
Net Sales.....	2587	2546	2686	2933	3026	3038
Net Income.....	240	171	157	186	157	158

3. Organization--The company is made up of four domestic groups each headed by a Group Vice-President, and an international operations made up of three subsidiaries also each reporting to a group Vice-President. The domestic groups are as follows;

1. Chemicals and Plastics (Group V.P.)
 - a) Operations (Manager)
 - b) Commercial (Manager)
 - c) Planning (Manager)
2. Gases, Metals and Carbons (Group V.P.)
 - a) Carbon Products Division (President)
 - b) Ferroalloys Division (President)
 - c) Linde Division (President)
 - d) Mining and Metals Division (President)
3. Corporate and Related Products
 - a) Consumer Products Division (President)
 - b) Fibers and Fabrics Division (President)
 - c) Films-Packaging Division (President)

4. Corporate Development (Group V.P.)
 - a) Materials Systems Division (President)
 - b) Nuclear Division (President)
 - c) Ocean Systems, Inc. (President)

Each of the Group Vice-Presidents wears two hats, in addition to his primary position is also chairman of one of the international subsidiary companies which have been set up to control the individual international subsidiaries. The international operations are grouped as follows:

1. Canada and Europe (Group V.P.)
 2. Far East and Latin America (Group V.P.)
 3. Africa and Middle East (Group V.P.)
4. Goals--stated in broad terms as follows:
- a) major drive is to acquire affiliated companies.
 - b) presently setting a minimum of 5-to-10% earnings/share.
 - c) maintenance of stable capital structure.
5. Strategy/Policy/Events
- a) Union Carbide has 79 joint ventures representing 30% of the total business of the corporation.
 - b) Union Carbide requires 50% and up equity participation as a general rule. In Japan the company has a 49/49 split with the local partner with Union Carbide having the "big" 49% (i.e., control). The company feels that if it loses control it might as well "pack up".
 - c) Union Carbide is opposed to any phase-out agreement if it means that the company is going to lose control.

- d) Comments on strategy, policy, and experience in certain specific countries are as follows;

Mexico--the increased restrictions on foreign investment is considered only "irritating", and the company feels it can live with them.

Phillipines--in spite of the phase-out requirement, the company has managed to maintain a 93% equity position (battery business) through negotiation, and therefore feels it can "live with" the local requirements. The company does feel that its strong position is due to flow of technology from the parent company, and if this were to stop the Japanese companies would take over the markets in one year.

Canada--the company has gone through a voluntary phase-out of its equity position by divesting itself of 20% on the local stock exchanges. This represents a sizable recapture of capital for the company which it can now apply elsewhere.

- e) Although management policy is not standardized, the company does use third country nationals in foreign management positions.

They are often brought to the U.S. for familiarization then sent somewhere else.

- f) R & D has been done only domestically.

6. Strategy Shifts

- a) Union Carbide is in the process of redesigning the framework of corporate strategy assessment. The company feels that planning

is a line function and that the Corporate Planning Group's job is to monitor and guide. The group is fairly new and has only two people.

- b) The company had an international company which was started as an "export division". This group ran into trouble when the company initiated foreign manufacturing operations and it was then necessary to undertake a major reorganization. The company now feels that in heavy technology manufacturing companies it is necessary to have a central product-controlled organization.

3. The Singer Company

1. The Company--Singer is a major producer of a wide range of products and services, with sales in excess of \$2 billion. Since its incorporation in New Jersey in 1873, it has largely been dependent on the sale of sewing machines and related items. Singer became involved overseas soon after through direct marketing outlets.
2. Sales/Products--The company is now highly diversified although sewing machines and related items still account for 60% of the business. Foreign sales account for 32% of the business.

<u>Amounts in Millions</u>	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>	<u>1971</u>
Sales/Revenue	1644	1729	1912	2044	2088	2135
Earnings	65.9	66.0	70.2	80.0	75.1	70.8

3. Organization--functionally, the company is made up of seven major product groups, each reporting to a group vice-president, plus related companies and/or divisions. The seven major product (operations) groups are:

1. International Group
2. Information Systems Group
3. Industrial Products Group
4. Education and Training Products Group
5. Home Furnishings Group
6. North Atlantic Consumer Products Group
7. Aerospace and Marine Systems Group

There is also an extensive corporate staff organization with each of the "offices" reporting to a vice-president. These are as follows:

1. Tax
2. Administration
3. Acquisitions
4. Employee Relations & Management Development
5. Corporate Planning
6. Controller
7. Corporate Relations
8. Financial
9. Chief Technical Officer
10. Corporate Manufacturing Staff

4. Goals--stated in broad terms are;

- a) 8-to-10% annual growth in earnings per share.
- b) stability
- c) overall return on assets approximately 15%, pretax
- d) maintain a leading position in major markets (No. 5 is not good enough)
- e) growth is not an objective--the company feels that \$2.5 billion annual sales is sufficient for the present, improving the earnings per share record is more important.

5. Strategy/Policy/Events

- a) in order to meet the goals, the company has divested itself of 22 (out of 110) investments in the last two and a half years.
- b) Singer has a worldwide policy of selling on credit. In order to make this work it is necessary to have a strong organization in each country. Employees up to shop manager are local. Above shop manager the management is international and transferred from country according to language ability. Individual management contracts are given to key managers in high risk areas in order to help them protect their careers from uncontrollable events. There is a program of moving managers from one area to another controlled by the Group personnel management.
- c) Singer prefers to have 100% equity positions in its foreign operations but will consider joint ventures if there is no other way.
- d) Singer has noticed definite trends of rising nationalism worldwide (especially in Africa and South America). Although Singer maintains a low profile and is usually thought of as a local company wherever it operates, it has noted two events which usually occur whenever there are indications that nationalism is on the uprise; sales start to go down, and receivables become uncollectable.

e) Comments on strategy and policy in specific countries are as follows;

Colombia--due to the increased restrictions and unsatisfactory performance, the company will probably negotiate a sale to the employees, leaving the operation in the form of licensed dealership.

Mexico--the company maintains a 100% equity position in an assemble plant due to a special deal with the Mexican government.

Venezuela--the company has had bad experience with the collection of receivables. Singer will probably also negotiate a sale of its equity to the employees leaving a local dealership.

Phillipines--the company has pulled out, selling its equity share to locals who now maintain the operation as a distribution network.

Europe--there has been no change noted in doing business in Europe due to the Common Market. The sequence followed in the evolution of Singer business in Europe has been;

a) U.S. based imports to Europe to test the market followed by

b) acquisition or build; Singer insists on a 100% equity position (Spain excluded).

Canada--even with the recent writings on the rise of nationalism in Canada, Singer looks on the country as a safe place to invest. Singer does have marketing problems in Canada due to the rela-

tively smaller population spread over a vast area. The company is considering retrenching its operations, selling its equity position to locals leaving a dealership. Where it does invest, Singer wants to have a 100% equity position.

Japan--Singer would like to invest in Japan and will consider entering into joint venture relationships because they are required. The company is now involved in 6 joint ventures with 50% equity positions.

- f) in order to analyze foreign investment possibilities and the foreign investment climate, the company relies heavily on information from the local level. Singer also calls in outside consultants where it is thought necessary. The company feels it will not invest in countries where there are definite phase-out requirements, but each review is done on a case-by-case basis.
- g) in Japan, when Singer wishes to locate a new local partner it goes through one of the existing local partners, being careful not to hurt existing relationships.
- h) Singer has no experience with management contracts and feels that in any case, the locals know better how to run the business.

6. Strategy Shifts

There are three definite stages in Singer's strategy;

- a) Sewing Machines (1860 to 1958)--during this period the sewing machine and related items business accounted for 95% of the

annual sales.

- b) Diversification (1958 to 1968)--in 1958, when Mr. Donald F. Kircher became President he started the company on a program of broad diversification. The company started to get into trouble when it found that the dealers could not efficiently handle smaller volumes of widely diverse items. In 1968 the company under Mr. Kircher shifted its strategy.
- c) Divestiture/Selected Diversification (1968 to present)--the new strategy is to concentrate primarily on sewing related products, keep the door open for good, selected diversification opportunities, and begin to focus on higher opportunity or lower risk countries. Those operations which cannot meet the goals established will be divested.

7. Financial Planning

- a) Process--in July of each year each profit center submits a preliminary summary view of the next year in financial terms. There are planning reviews with each profit center executive in a joint evaluation. Based on external factors and internal data, financial performance standards are set for each profit center in each of the following areas; 1) sales growth, 2) operating margin, 3) asset turnover (total assets net of depreciation). This is accomplished in a joint profit center meeting with the President. There are neither group standards nor a corporate standard as such since these are the sums of the pieces. In

August the President writes letters (personally) to each group V.P. identifying; 1) objectives for the company as a whole, 2) assesment of the external environment, 3) evaluation of each profit center for the group identifying major problem areas and improvements required. Objectives and priorities are established for each center. The letters suggest that any differences in viewpoint be discussed. An attachment identifies specific objectives for each profit center for: sales growth, gross margin, receivable turnover, inventory turnover, etc. In October the Budget Plan is published with the first year being the budget for the upcoming annual period.

- b) Evaluation--the planning organization independently (from the profit centers) evaluates expected market growth, performance of competitors, etc. There is no corporate economist. The company does, however, make use of the banks, the financial community and occasionally an industry consultant for assistance in developing these evaluations. The profit centers do have market research staffs of varying skill and capabilities.

8. Corporate Financial Models

These models are used for financial strategy and evaluation which is distinct from the Controllers function of consolidating the long range plan, as follows:

1. Projection Model--this model is very simple employing three basic relationships: sales growth; operating margin on sales;

asset turnover. The model applies asset turnover to sales in the 5th year to determine the asset requirement. The progression is smoothed through the 5 year period. Operating margin is applied to get operating income. The model incorporates and applies factors for interest and taxes for each operating group to obtain net income.

2. Top-Side Consolidation Model--This model is used to consolidate all operations and can be used to test the impact of various relationships on the total company. Divisions have option of using those models for their own planning, but only one or two actually do. This model is also used in acquisition and divestment studies.
3. Foreign Exchange Model--This is a short term financial planning model that handles 6 to 8 different currencies and a trading pattern that produces an assesment on debt location to produce an optimum U.S. after tax return. The model incorporates so many variables that it can be run only on the largest computer at low demand times. The company has approximately 50 years experience with hedging operations but has been using the model for this purpose for only the last 2 years.

CHAPTER 6

CONCLUSIONS

After looking at what is involved in setting up a foreign joint venture, it is easy to see why the average entrepreneur would be very reluctant to accept strict phase-out requirements. The effect of shortening the expected pay-out period will force the entrepreneur to consider the investment a higher risk, and will therefore require a higher rate of return. When compared with other possibilities, it will probably make investments in other parts of the world appear more attractive. From information received from opinions in interviews and other sources, it appears that some companies, even those which are strongly opposed to the phase-out requirements in principle, have learned to live with the phase-out requirements in the Phillipines and the increased restrictions in Mexico. Reasons for this are the following; 1. misunderstanding of what the phase-out requirement really means (i.e., a lessening of equity position and not necessarily a 100% divestiture.); 2. it apparently is possible to negotiate an acceptable agreement in some cases; 3. there are many advantages to having a local partner, once the entrepreneur is satisfied that his local partner is very competent and is doing a better job than he could under the circumstances, it may become more acceptable to take a minor equity position.

In answer to the questions posed in Chapter 1;

1. Do companies that are doing business in several countries notice any trends in restrictions on investment and if so, what strategies have they developed to deal with this?

"analysts of the world scene are noting a decline in ideology which is producing a generation of leaders in less developed countries who are more pragmatic and less dogmatic about how to develop an economy than were their predecessors".¹

Comments about the case companies are as follows;

Rheem--although the company has noted the rising nationalism, there is nothing which affects its mode of operations because the Rheem organization structure is more ideally suited to adapt to the individual local conditions, i.e., already semi-phased-out.

Union Carbide--has noted the rise in nationalism and feels it can live with increased restrictions on foreign investment so long as it is allowed to maintain control. Its central product-controlled organization necessitates a control oriented strategy. The company's response to phase-out will therefore tend to be one of avoidance of those investment markets which will not allow this control.

Singer--the company's strategy of increasing sales by maintaining a worldwide policy of selling on credit puts it in a very vulnerable position with respect to restrictions on foreign investment. Being more sensitive to changes the company has long noted that increases in national

¹ASHER, Robert E. Development Assistance In The Seventies. Washington: The Brookings Institution, 1970.

sentiment seem to be followed by problems with the receivables. The company strategy has been to divest itself completely through a sale to its employees, where possible. In this way the company is left with a reliable licensed local dealer. Singer has not chosen to form joint ventures anywhere but Japan, preferring to maintain a 100% equity position.

2. Is it possible to learn to live with increasing nationalism and greatly increased restrictions on investment?

The short answer to this appears to be yes, using the Rheem International, Inc.'s history and organizational form as an example. One of the interesting things noted while talking to the various companies is that the explicit and formal formulation of strategy for doing business internationally, followed by a conscious effort to restructure the organization to be more responsive to its environment, is a relatively new development in many companies. It would appear that where a company makes the effort to be sensitive to the changing environment and organizes accordingly, it is in effect "living with nationalism".

The main questions raised by Guy B. Meeker's thesis,¹ and of vital interest to the international entrepreneur, are:

1. How will the phase-out be accomplished?
2. How will fair compensation be accomplished?

¹MEEKER, Guy Bentley. "The Feasibility Of The Fade-Out Joint Venture Principle As A Form Of Direct U.S. Private Investment In Latin America (An Empirical Study)". Unpublished M.B.A. Thesis, George Washington University, 1970.

This would appear to be handled best by the Decentralized Joint-Venture type of organization structure and a formal agreement between the partners of the "put/call" type.¹ The advantage of this arrangement is that the details can be outlined at the outset and made legally binding. This assures a fair price for both parties and assures full participation to the last.

¹This technique is used by First National City Overseas Investment Corporation for their joint venture operations. After a specified number of years either partner can exercise the option using a predetermined formula.

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