

# Chapter 12

## Basic Types and Theoretical Explanations of Foreign Operation Modes

The choice of a foreign operation mode is considered one of the most important components of an internationalisation strategy, since the operation mode determines the type and intensity of control over the foreign market activity, the necessary resource transfers as well as the associated risks. In this Chapter, an overview of different operation modes is given, characteristics of operation modes are highlighted and theoretical explanations for the choice of a foreign operation mode presented.

### Introduction

A company planning to conduct any business activities in a foreign market must choose an appropriate operation mode for this activity. Each task can be performed in various ways, including by vertically integrated organisational units in the foreign country (wholly-owned subsidiaries), by external organisational units (e.g. distributors in the foreign market), or jointly (cooperative arrangements).

The foreign operation mode can be defined as an institutional arrangement for organising and conducting international business transactions (Andersen 1997, p. 29). The choice of a foreign operation mode is strategically highly relevant. It is a core component of the internationalisation strategy and it exerts a strong and lasting influence on many other activities and options of the company. It is seen as a crucial success factor, also because it is not easily reversible in the short- and mid-term.

In many textbooks, the issue of foreign operation modes is discussed under the heading of *market entry modes*. For two main reasons, throughout this book, the term “foreign operation mode” is used instead: First, the issue is also of relevance when the entry context no longer applies (Welch/Benito/Petersen 2007, p. 10). In the last decades, the focus has shifted from “going international” to “being international” (Bäurle 1996, p. 123). Thus, for a MNC, the initial market entry mode is often less important than the operation mode chosen at a certain point in time. Second, the term “market entry” suggests that the international activities are sales-related. Even though this Chapter mainly focuses on this dimension, foreign operation modes are broader, and also apply to procurement activities, R&D activities, production activities, etc.

*Market Entry Modes vs. Foreign Operation Modes*

## The Basic Types of Foreign Operation Modes

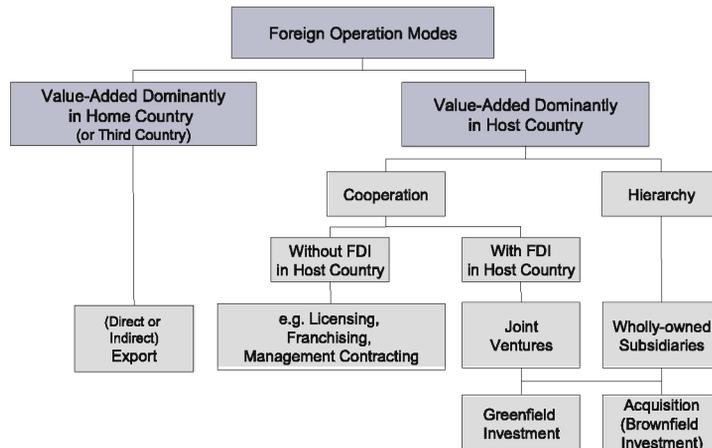
To classify foreign operation modes, different schemas can be found in the literature. Very commonly, a distinction is made between

- export modes (indirect export, direct export via agents, etc.)
- contractual modes (e.g. licensing, franchising, contract manufacturing)
- investment equity entry modes (e.g. joint ventures, wholly-owned subsidiaries).

Here, generally, an increasing level of vertical integration can be seen: Export modes are – at least when intermediaries in the host country are used – market modes (see Chapter 13), contractual and equity alliances are cooperative modes (see Chapter 14) and wholly-owned subsidiaries constitute the highest level of vertical integration (i.e. “hierarchy”) (see Chapter 15). It has to be noted, though, that export modes can significantly differ. If, e.g., a MNC exports with a direct customer relationship to a foreign customer, this allows a very high level of control by the MNC over this transaction.

Figure 12.1

Classification of Selected Foreign Operation Modes



Source: Adapted from Zentes 1993, p. 67.

More concretely, the choice of a foreign operation mode involves several different dimensions: *Where* to locate production whether to *cooperate* and

whether an *investment* abroad by the MNC should be undertaken. Considering the *establishment process*, joint ventures and wholly-owned subsidiaries can be established by a greenfield investment, i.e., the (joint) building of a new facility in the host country, or by acquisition of existing facilities.

### Location of Value-Added

Considering the location decision, different determinants have been investigated in the literature. In the early economic approaches, international trade (and, thus, the location of value-added) was explained, e.g., with *comparative cost advantages* (Ricardo) or, building on these, with *relative factor endowments* in a country (Heckscher-Ohlin).

Later, dynamic approaches were developed. In the *international product lifecycle theory* of international trade, Vernon (1966) argued that *new product innovations* are usually developed and produced in the home country of a company, even if factor costs are high. In the early stage, cost is of secondary importance due to the monopoly situation of the innovating company. Also, demand is difficult to predict. In the later stage of a *maturing product*, competition rises, foreign demand also and cost pressure by new competitors. Production is partly shifted to foreign countries, closer to the new sales markets. Finally, in the third stage (*standardised product*), industrialised countries may still be the most important markets, but they have become too expensive for production. Thus, production is shifted to emerging countries. From there, the MNC (or competitors) exports the product to the relevant markets.

Generally, location theories of internationalisation assume that the decision for value-added in a specific country is determined by location characteristics. Relevant characteristics are *market factors* (e.g. market size, market potential) and *cost-related factors* (e.g. differences in labour costs, input goods, taxes). Another relevant location factor is the *country risk*. In cases of high risk, exporting or contractual arrangements reduce the risk exposure of the MNC compared with a wholly-owned subsidiary where the commitment of the MNC's own resources is substantial.

The configuration decision is discussed in more detail for the different value-chain activities, i.e., production (Chapter 16) and R&D (Chapter 17).

### Cooperation vs. Hierarchy

The decision whether to establish foreign value-added via cooperation or in a hierarchical operation mode depends on many influence factors. A comprehensive study by Morschett, Schramm-Klein and Swoboda (2008a, 2008b) has shown that a number of aspects have a strong influence on this decision.

### International Product Lifecycle

The likelihood that a MNC uses a wholly-owned subsidiary instead of a cooperative arrangement increases with:

- the *number of employees* of the MNC, because larger MNCs can more easily afford to establish a subsidiary on their own and have the necessary management capacity to coordinate that subsidiary
- *experience* of the MNC in the host country, because increased knowledge about the country decreases the uncertainty in the market and makes a partner less necessary
- *advertising intensity* of the MNC, since a partner in a foreign country may “free-ride” on the high reputation of the MNC which can best be avoided by exploiting the good reputation of the MNC with a wholly-owned subsidiary (advertising intensity is usually seen as having high specificity)
- *export intensity* of the MNC, because a higher percentage of foreign sales indicates that the MNC has substantial knowledge about foreign markets, and thus is less dependent on a partner.

On the contrary, MNCs seem to prefer cooperation over a wholly-owned subsidiary, if

- *country risk* is high,
- *legal restrictions* in the host country are tight,
- the *market size* of the foreign market is large (which might be explained by the high investments that is necessary in large markets),
- *resource intensity* of the foreign activity is high, since often, host-country companies have a first-mover advantage regarding local resources which can only be tapped in a partnership
- the subsidiary is active in a business field that is *not closely related* to the business of the parent company, thus, leading to the necessity of external (partner) knowledge for this subsidiary.

Additional arguments for cooperative operation modes and hierarchical operation modes are discussed in Chapters 14 and 15.

## Characteristics of Foreign Operation Modes

To make a rational decision on a foreign operation mode, several partly interconnected characteristics have to be regarded. In Table 12.1, these are listed and evaluated for selected operation modes.

*Characteristics of Selected Foreign Operation Modes**Table 12.1*

	Export	Contractual Cooperation	Equity Cooperation	Wholly-owned Subsidiary
Control	low/medium/high	low	medium	high
Resource Commitment	low	low	medium	high
Flexibility	high	medium	medium-low	low
Knowledge Dissemination Risk	low	high	medium	low

Source: Adapted from Driscoll/Paliwoda 1997, p. 60.

The ability to exert tight control over foreign operations is seen as the main advantage of the stronger internalised operation modes. Control refers to the authority over strategic and operational decisions concerning the foreign operations. Compared with cooperative operation modes, “maintaining decision-making control allows the MNC to determine its own destiny” (Driscoll/Paliwoda 1997, p. 64), and control is “the single most important determinant of both risk and return” (Anderson/Gatignon 1986, p. 3). As Table 12.1 illustrates, different operation modes imply different levels of control. While wholly-owned subsidiaries allow a tight coordination (“full-control modes”), most cooperative modes lead to limited and to a joint control (“shared-control modes”). In the case of contractual agreements (like licensing), the control over the foreign markets is – against payment – largely shifted to the licensee.

Often, the trade-off between control on the one side (“benefit of integration”) and the necessary resource commitment (“cost of integration”) is highlighted as the main decision for a MNC. Resource commitment refers to the assets that a MNC needs to dedicate to the foreign market operations. Obviously, a high resource commitment of a MNC enhances its risk exposure. In the case of export and contractual cooperations, it is rather low. In the case of wholly-owned subsidiaries, the resources have to be invested by the company on its own. Equity cooperations fall between these two extremes. Sharing equity investment with a cooperation partner allows to reduce the own risk.

Flexibility is closely linked to resource commitment. It refers to the ability of a company to switch the chosen operation mode rapidly and with rather low cost or even to withdraw from a foreign market when external conditions have changed (Anderson/Gatignon 1986). High resource commitment acts as market exit barrier and thus reduces strategic flexibility of the MNC.

*Control**Resource Commitment**Flexibility*

**Dissemination  
Risk**

A fourth characteristic of foreign operation modes is the so-called “dissemination risk”, i.e., the risk that knowledge is absorbed by another company who uses this knowledge against the interest of the MNC (Agarwal/Ramaswami 1992). Since the technological know-how and the marketing know-how are seen as crucial competitive advantages of a company, it is important to secure the company against uncontrolled knowledge outflows, since this may reduce the income a company can generate from its knowledge. Protection against knowledge dissemination is, thus, a main criterion for the choice of an operation mode (Driscoll/Paliwoda 1997, p. 66). In particular, cooperative operation modes, where a partner company (e.g. a licensee) is actively provided with the company’s knowledge, are characterised by a high risk of knowledge dissemination. The lowest risk exists in the case of wholly-owned subsidiaries (or by direct exports to a foreign customer).

**Theoretical Explanations**

To explain the choice of international market entry mode, a number of different theories are used in the literature. The most important ones will be discussed briefly in the following part of this Chapter.

**Stages Models of Internationalisation**

The stages models of internationalisation (in particular the “Uppsala model” by Johanson and Vahlne (1977)) are rooted in the *behavioural theory* of the firm. These models propose an association between the knowledge of the decision makers in the company and the level of resource commitment in a foreign market. The core assumption is that companies with low market knowledge about a specific foreign market prefer a low commitment in this market, i.e., market-based operation modes. Once in the market, the company accumulates experiential knowledge and this, in turn, leads to the willingness to commit additional resources. In the so-called *establishment chain*, the model proposes that foreign operation modes in a specific foreign country are switched along a certain path:

- no international activities
- export activities via agents
- export activities via own sales subsidiaries
- establishment of production subsidiaries in the foreign country.

**Psychic Distance  
Chain**

In addition, the Uppsala model suggests that companies often select foreign markets based on the psychic distance to that market and that internationalisation often occurs along a “psychic distance chain”, with psychologically

close markets being entered first and then, subsequently, more distant countries.

In general, the common assumptions of all stages models are (Swoboda 2002, pp. 72-73):

- Internationalisation is a slow and gradual process.
- The process of internationalisation is not the result of a long-term strategic planning, but of incremental decisions.
- Internationalisation is an adaptive process, and with time, resource commitment in the foreign market and changes in the management of the foreign organisational unit occur.
- Internationalisation is a process occurring in stages, characterised by different speed of change and un-steady development.
- During internationalisation, companies accumulate experiential knowledge which facilitates foreign activities and further internationalisation.

In all, the stages models explain foreign operation modes mainly with the country-specific knowledge of a company that determines the perceived uncertainty and, thus, the willingness of the company to invest resources in that country.

While the stages models have a high level of plausibility, criticisms have emerged over the years. First, the models neglect that management has a strategic choice and that the operation mode decision is not only determined by a single influence factor. In particular, external influence factors (like host country conditions) are neglected. Second, the models over-simplify a complex process and certain operation modes – in particular cooperative modes – are not considered. Cooperations (and acquisitions) offer the possibility to gain knowledge without the MNC having long-term experience of its own in the host-country. Finally, MNCs often leap over certain stages in the establishment chain. In particular the observation of “*born globals*” in the last two decades, i.e., companies that internationalise immediately after their foundation without slow and incremental processes (Oviatt/McDougall 1994; Knight/Cavusgil 1996), has challenged the theory. However, for many companies, the stages models of internationalisation offer a good explanation of their observed behaviour.

*Born Globals*

### Transaction Cost Theory and Internalisation Theory

The dominant theory to explain choice of foreign operation mode over the last decades has been the *transaction cost approach* (Williamson 1985) and the closely related *internalisation theory* (Buckley/Casson 1976). These approaches

**Transaction  
Costs**

argue that companies choose operation modes that minimise the cost of cross-border transactions.

Transaction costs refer to: *search and information costs*, i.e., costs such as those incurred in determining that the required good is available on the market, who has the lowest price, etc., *bargaining costs*, i.e. the costs required to come to an acceptable agreement with the other party to the transaction, drawing up an appropriate contract, etc., *monitoring and enforcement costs* to ensure the other party sticks to the terms of the contract, and taking appropriate action if this turns out not to be the case. For example, monitoring costs might include the measurement of the output (e.g. quality control in the factory of a supplier). If conditions change, contracts might have to be adjusted which causes *adjustment costs*.

The two basic assumptions of the transaction cost approach are:

- *Bounded rationality*, i.e., actors might intend to act rationally but are only capable of doing so in a limited way, partly because they have incomplete information, partly because they have limited processing capacity.
- *Opportunistic behaviour*, i.e., business partners are expected to use the incompleteness of contracts and changing circumstances for their own self-interest and they only stick to the contract if they are monitored.

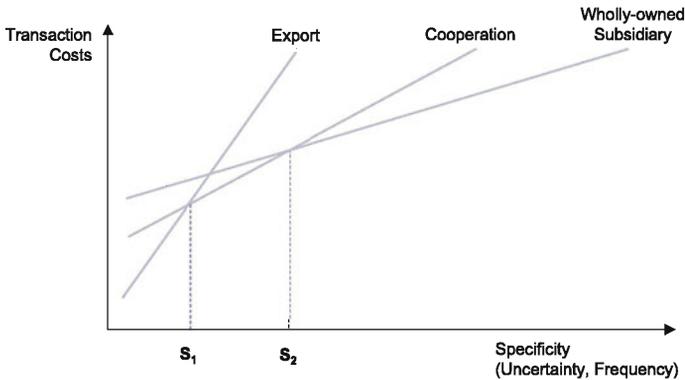
**Imperfect  
Markets**

If markets function well, with a large number of potential business partners, competition ensures efficient results. In these cases, a MNC will favour low control modes. Business partners can be replaced easily and this threat protects the companies from opportunistic behaviour. In other cases, markets may fail. This may be the case for different types of transactions (Malhotra/Agarwal/Ulgado 2004, p. 4):

- *Imperfect markets for goods* that are caused by brand names, marketing capabilities, product differentiation.
- *Imperfect markets for intermediate goods*, such as knowledge. Here, it is assumed that the cross-border transfer of knowledge is less efficient among separate companies than within one MNC.
- *Imperfect markets for production factors* that may be caused by exclusive procurement capabilities, particular management know-how or certain technologies.
- Imperfect competition through *economies of scale* that lead to cost advantages of internalisation.

## Transaction Cost Reasoning for Foreign Operation Mode Decisions

Figure 12.2



Source: Adapted from Welch/Benito/Petersen 2007, p. 26.

However, it is mainly three characteristics of a transaction that may cause market imperfections:

First of all, *asset specificity*, the degree to which an asset loses its value when put to an alternative use, may cause a situation where the actor who has carried out specific investments runs the risk of being exploited by its partner. In this case, market transactions between independent actors might not offer sufficient protection for the business partners. Thus, the MNC might decide to carry out the transaction internally, i.e., with a wholly-owned subsidiary. Similarly, *uncertainty* may lead to market imperfections (Welch/Benito/Petersen 2007, pp. 24-25). If all future eventualities were known in advance, contract parties could plan ahead and develop comprehensive contracts. The stronger the uncertainty (e.g. changes in the external environment), the more likely it is that contracts are incomplete and have to be adjusted. These renegotiations, however, are costly and lead to high transaction costs. Again, the necessary flexibility to adapt to changing situations may be better granted with internalised operation modes. Third, the *frequency of transactions* plays a role. Setting up a wholly-owned foreign subsidiary is often linked to relatively high fixed costs but the subsequent variable costs are usually lower than in the case of cooperative or market modes. Thus, with an increased number of transactions, the relative costs of a wholly-owned subsidiary are reduced.

To summarise, the transaction cost approach compares the costs of internalisation of external markets with the costs of market transactions and the costs of cooperation (see Figure 12.2). Under certain circumstances, markets are

*Asset  
Specificity*

*Uncertainty*

*Frequency*

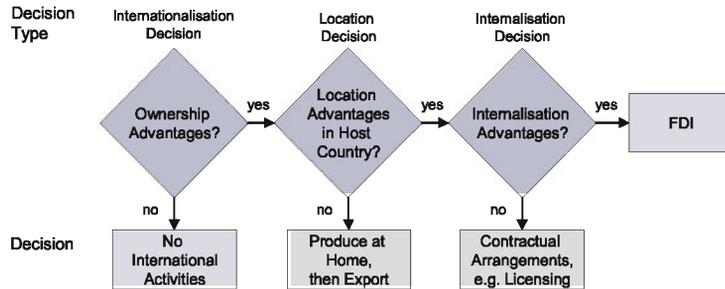
imperfect and in this case, companies are forced to internalise transactions to substitute imperfect markets by internal transactions.

### Dunning's OLI Paradigm

Since the existing approaches (e.g. the location theory or the internalisation theory) alone did not suffice to fully explain the choice of a foreign operation mode, *John Dunning* developed a comprehensive approach, the so-called *Eclectic Paradigm* that seeks to offer a general framework to determine which operation mode is the most appropriate.

Figure 12.3

The OLI Decision Tree for Foreign Operation Modes



Source: Adapted from Sudarsanam 2003, p. 201; Welch/Benito/Petersen 2007, p. 31.

It specifies a set of three *conditions* that must prevail simultaneously to stimulate FDI by a company (Rugman/Collinson 2009, pp. 68-70; Dunning/Lundan 2008, pp. 96-108):

- *Ownership-specific advantages (O)*: The firm must own some unique competitive advantages (*firm-specific advantages*, FSA) that overcompensate the disadvantages of competing with local firms in their home market ("*liability of foreignness*"). Often, ownership-specific advantages take the form of the possession of intangible assets, which (at least temporarily) are specific to the firm. Examples of firm-specific advantages are proprietary technology (e.g. due to R&D activities), product differentiation or brands.

- *Location-specific advantages (L)*: If foreign direct investment is to take place, it must be more profitable for the company to undertake the activity in the foreign country than in the home country. Otherwise foreign markets would be served by other internationalisation modes. Location-specific advantages can include, for example, labour cost, efficient and skilled labour force, tariffs, transport cost, or natural resources.
- *Internalisation advantages (I)*: Companies that possess specific advantages can either exploit them themselves (*internalise* them) or they can sell the advantage to other companies. The internalisation choice can be explained by the *transaction cost theory*, as pointed out above.

The decision as to whether foreign direct investment is favourable depends on which types of advantage prevail. For an internationalisation via wholly-owned subsidiary, all three types of benefits, O, L and I, have to be present simultaneously. This case is illustrated in Figure 12.3, along with other situations that lead to different operation mode decisions.

### Corporate Strategy Approach

An influence factor on choice of foreign operation mode that has been largely neglected in the described approaches is the *corporate strategy*. For example, the concrete motive of a MNC to enter the host-country (see Chapter 4) is likely to have an effect on the chosen operation mode.

The corporate strategy approach puts its focus on the competition and the required characteristics of the operation mode that stem from the corporate strategy and the specific role of the foreign subsidiary in its host-country. Following the general idea that *structure and strategy* should be aligned, they investigate strategy variables and their influence on the operation mode choice. More particularly, “the strategy approach regards the issue of ownership structure primarily as a question of the level of control that is needed in order to coordinate global strategic action” (Benito 1996, p. 164). Strategy variables that can exert an influence are manifold (Kim/Hwang 1992; Malhotra/Agarwal/Ulgado 2004, p. 19):

- *Synergy effects* emerge if companies can use certain resources and processes like R&D, production or marketing to achieve economies of scale and economies of scope across different host countries. Usually, a tight control and the corresponding operation modes are considered to be favourable to achieve synergy effects.
- *Global strategic motives* refer to the question whether the MNC follows a global or a multinational orientation (see Chapter 2). Obviously, a multinational orientation allows for low-control operation modes and – for

*Structure and Strategy*

example – partnerships in the host countries while a global strategy implies wholly-owned and tightly controlled subsidiaries.

- *Market concentration* is a relevant external factor since it leads to a situation of a worldwide oligopoly. Following Knickerbocker's theory of *oligopolistic reactions* (Knickerbocker 1973), it is argued that the interdependency of different countries is high in this case and a tight coordination of the foreign subsidiaries is necessary to react flexibly to a competitor's actions. In this perspective, direct investment in a foreign country can also be seen as an "exchange of threats" between competitors.

## Conclusion and Outlook

The choice of a foreign operation mode is considered one of the most important internationalisation strategy decisions and in this Chapter, the basic types have been presented. For each of the three options – market, cooperation and hierarchy – the following Chapters will provide a more detailed discussion.

It has to be pointed out, however, that the decision on foreign operation mode has to be made for each value-chain activity. Thus, a MNC might – for a specific foreign country – decide to outsource its R&D, internalise the sales and marketing activities, offer its after-sales service in a joint venture with a local partner and have major production steps carried out by a contract manufacturer. In addition, the interdependence between these activities has to be considered, since the inter-functional coordination is also affected by the chosen operation modes. Also, the choice of a foreign operation mode is usually not stable but changes over time, thus, mode switches are very common.

Considering the theoretical explanations and the complex influences on the choice of operation mode, most recent texts argue that the different theories should be seen as complementary. Thus, instead of a single theoretical approach, a multi-theoretical framework is often better suited to explain – and to support the – choice of foreign operation mode.

## Further Reading

WELCH, L.; BENITO, G.; PETERSEN, B. (2007): *Foreign Operation Methods – Theory, Analysis, Strategy*, Glos, UK, Edward Elgar Publishing.

ANDERSEN, O. (1997): *Internationalization and Market Entry Mode: A Review of Theories and Conceptual Framework*, in: *Management International Review*, Vol. 27, No. 2, pp. 27-42.

## Case Study: Accor<sup>1</sup>

### Profile, History and Status Quo

In the 1960s, travel was booming in France, but the French hotel industry had not met the rising demand. The visionary entrepreneur P. Dubrule and his business partner, G. Péliesson, foresaw the upcoming need and market potential and hence founded the *Société d'Investissement et d'Exploitation Hôtelières (SIEH)* in 1967. Shortly afterwards, they followed this with the opening of an American-style hotel, an innovative concept to the unexploited French and later European market within the medium price range. Actually, Dubrule used the US chain *Holiday Inn* as source for his business inspirations. As an outsider to the hotel business, the management of *Holiday Inn* group did not take Dubrule seriously. Thus, he decided to launch his own hotel chain and drew up a plan by adopting the concept of the US chain.

The two founders launched their brand *Novotel* in Lille-Lesquin in 1967. Only five years later, two hotels were opened abroad, in Neufchâtel (Switzerland) and Brussels. In 1974, the holding company *Sphere S.A.* was founded to roll out the new *Ibis* chain with its first two-star classified hotel located in Bordeaux. The year after, the *Société* acquired the *Mercure* hotel chain, a traditional three-star arrangement. In 1980, a further transaction took place – the acquisition of the upscale brand *Sofitel* which owned 43 hotels. Afterwards, the *Novotel SIEH Group* sought a major diversified extension through a merger with *Jacques Borel International* – a leader in managed food service and concession restaurants in Europe and world market leader in issuing about 165 million meal vouchers per year within eight countries. The newly emerged company was called *Accor*.

The *Accor Group* kept its tremendous growth and diversified expansion pace over the years by creating the no-star *Formule 1* chain. Furthermore, the company pursued its US market entry through the acquisition of the *Motel 6* chain in 1990. Additionally, in 1999 its overall hotel network grew by 22 % particularly based on the acquisition of *Red Roof Inn* in America. Hence, *Accor* became a leading hotel group globally in the early 1990s. Consequently, the company went public in 1997 and became *Accor S.A.* In 2001, the company further internationalised, including into the Chinese hotel market. *Accor's* latest strategic decision was to increase its stake in the largest hotel and tourist group in Poland and Central Europe, the *Orbis Group*, to 50 % in 2008.

*Foundation of  
Accor*

*Diversification &  
Internationalisation*

<sup>1</sup> Sources used for this case study include various annual reports, press releases, the web site <http://www.accor.com> as well as explicitly cited sources.

*Actual Business  
and Figures*

Being an innovative hotel group, business concepts are constantly revised or launched. For example, the new brand *Suitehotel* for medium-stay customers started in Europe in 2001. In addition, the new upscale brand *Pullman* was relaunched in 2007 and in 2008 *MGallery* was created. Otherwise, *Accor* kept its dynamic expansion growing through investments, such as the investment in 1985 in *Lenôtre* which owned gourmet restaurants, luxury caterer boutiques and a cooking school, and through the acquisition of the majority stake in *SPIC* to form subsequently *Accor Casinos* in 1997.

Today, *Accor* is Europe's leading hospitality group and focuses on two core businesses: *Hotel* and *Services*. In 2010, the company decided to demerge these two businesses and to become a pure player in the hotel sector. The case study will focus on the hotel business and describe the company's multiple strategic entry modes. Figure 12.4 highlights the group's brands. In 2009, the group comprised about 4,100 hotels with 500,000 rooms in total in about 90 countries.

In summary, for over 40 years *Accor* has been developing its expertise and skills across management, marketing & sales, purchasing, human resources, assets, finance, construction, technological support and online booking as a leader within the hospitality industry. In doing so, the company is high-performing with a strong growth potential in both global core businesses.

### Accor's Hotel Business Development

*Outlook of  
Hotel Industry*

As the history of *Accor* has already shown, its worldwide expansion is due to a successful organic development within the company. Furthermore, ongoing acquisitions, mergers and consolidations are very important management business tools for the sustainable growth of the group. It is estimated that the number of hotel nights will increase globally by 3.7 % per year until 2012, whereas just in China an outstanding rise of 12 % p.a. is anticipated. For hotel chains a rise by 5.7 % is expected. Thus, *Accor* had to respond by redefining its positioning of the brand portfolio to benefit from the overall trend in both mature and emerging markets and from changes within the hotel industry itself, too. In doing so, the company first of all initiated in 2007 a more profitable hotel business model. Thereby, *Accor's* strategic outlook will be implemented in a second step through revised operating and ownership structures of its hotel division. The reorganisation will then disclose the group's decision on the different market entry modes.

## Strategic Vision of the Hotel Division

As the *first* objective within its new business model, *Accor* pursues an increase of the market share in the European midscale and economy segment by offering a more segmented hotel network. The group's brands *Suitehotel*, *Novotel*, *Adagio* and *Mercure* are within the midscale range, *All Seasons* represent the economy range, and new-builds *Etap* the budget segment. *Second*, the US hotel division should be strengthened through a special focus on *Motel 6*. *Accor* sees in its *third* strategic orientation a huge potential in emerging countries and is about to concentrate there on *Novotel* for the midscale and *Ibis* for the economy segment. *Fourth*, to respond to a more and more fragmented demand for its products, *Accor* will redefine its brands to become more specified and thus, expand the portfolio with innovative brands to cover all segments, for example with the creation of *Sofitel* and *Pullman*.

All in all, *Accor's* focus is very global and consequently, a continuing strong internationalisation of its hotel chains needs to take place. Hereby, the crucial question arises how the hospitality group will be able to keep pace with the changing customer, client and market demands throughout the world.

## Implementation of the Reorganisation: The Asset-Right Strategy

To meet the new challenges *Accor's* major step was the reorganisation of its business base. Thus, the company had to evaluate its whole hotel network and brand portfolio to match a rising fragmented demand as follows:

- *First*, the decision has to be made whether each individual hotel should be maintained, sold or restructured.
- *Second*, the management has to determine how each hotel should be managed and owned.

All in all around 1,400 hotels had a change in their operating structure between 2005 and 2010. To implement the profound business model, the company created the *asset-right strategy* with the following three dimensions:

- First of all, *Accor's* management uses the disposal of underperforming property assets as a tool for a restructured network. With this divestment strategy the group releases hotels which do not fit its overall strategic orientation. For example in 2007, *Accor* sold 30 hotels in the UK to *Land Securities* for 683 million EUR; 67 hotels in Germany and 19 hotels in the Netherlands to *Moor Park Real Estate* for 747 million EUR. Here it can be seen that the *Accor* management formed close alliances with major real estate companies to push its refocusing on hotel operations and thus, improved margins. Moreover, the group gave up its side branches (*Go*

### First Dimension Disposals

### Restructuring and Rebranding

*Voyages, Club Med, etc.*) to focus even more on its core business. Further, the *Accor* group sold whole fully-owned chains for its reorganisation. For example, the American chain *Red Roof Inn* with 341 hotels was sold for about 1.3 billion USD in 2007.

- *Accor's* second measure is the partial restructuring of its hotel business. A classical way of the group has been selling assets and simultaneously negotiating management-back agreements. *Sofitel The Grand* in Amsterdam is an example of implementing the *asset-right strategy* in May 2008. This management strategy reduces capital intensity and earnings volatility and enables *Accor* to focus primary on hotel management – its actual core competency. Additionally, variable lease backs and franchise-back arrangements following disposals are other ways to restructure. Hotel rebranding again is another management tool for restructuring brands. By using a “new” name for a brand, *Accor* has a good opportunity to achieve a momentous impact on its business within a short time. Quite an eventful history happened to the brand *Pullman* whose hotels were acquired in 1991. *Accor* began rebranding in 1993 to eliminate the *Pullman Hotels International* chain, then, years later in 2007, the old brand *Pullman* with its prestigious past was reborn.

### Repositioning of Brands

- Finally, *repositioning* is a further management tool in conjunction with reorganisation. For instance, this occurred when *Accor* relaunched *Pullman* and upgraded it to a four-star deluxe hotel chain for business customers in 2007. Another example of repositioning is the upgrading of *Sofitel* hotels within the network. The brand thus upgraded to five stars with “French Touch” elegance in the luxury segment in the world's most beautiful destinations. *Accor* intends to be a major competitor in this segment with about 250 luxury hotels worldwide by 2010. Therefore, renovations and new product designs within all of *Accor's* reorganised brands are also crucial, particularly within the last two presented dimensions, to maintain and even extend the group's competitive advantage.

### Global Launch of 200,000 Rooms

The *asset-right strategy* is accompanied by *Accor's* ambitious development project of launching 200,000 new rooms within the five years from 2005 until 2010 and another 200,000 new rooms until 2015. The planned openings cover all market segments and continents, but 60 % of the openings from 2010 until 2015 will be in the economy (36 %) and budget (23 %) segment. In this process, 40 % of the rooms will be opened in Europe and about one third in Asia-Pacific.

Altogether, the network of about 4,100 hotels is being optimised since 2007 and the reorganisation is embedded into the *asset-right strategy*. This includes divestments, restructurings, renovations and an expansion to a total of 5,000 highly customised hotels by 2010. In this way, the company wants to open

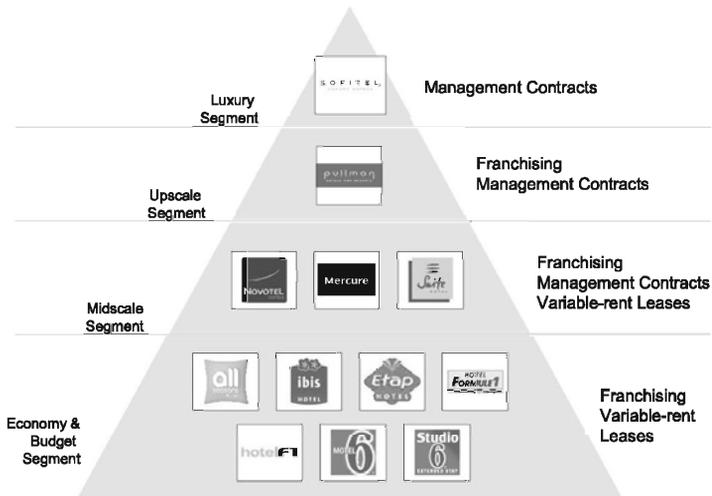
new rooms at the best rates in global growth territories. Therefore, *Accor* expects to justify rising prices for its noticeable value-added offerings and thus, a higher revenue growth.

### Implementation of the Market (Entry) Penetration

Simultaneously to the reorganisation of its network, *Accor* brings a second step into focus: a new *real estate management strategy* within the *asset-right strategy*. This strategy complements the new business model which ought to foster the hotel portfolio and thus, *Accor's* business development and expansion. Hereby, the hotel division shifts its hotel operating structure from *ownership* and (fixed) *leases* to prevalent *management contracts*, *franchise agreements* and (variable-rent) *leases* due to the evaluation of each individual hotel's engagement according to location, market segment and margin. Hence, it can be seen in Figure 12.5 how *Accor* concentrates increasingly on managing instead of owning hotels, which perceptibly changes the culture within the group. Thus, *Accor's* adaption of its new oriented hotel operating and owning structure unveils its *strategic market entry modes*.

*The Asset-Right Strategy: Trends by Market Segment*

Figure 12.4

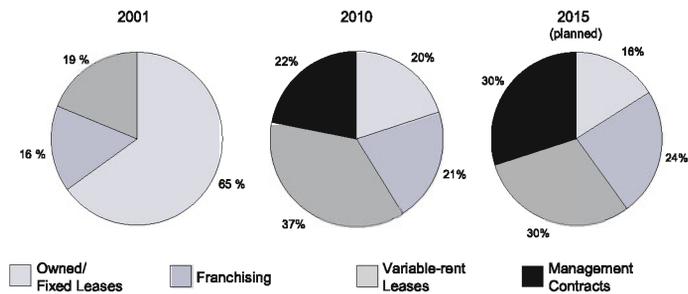


Source: Adapted from Accor 2010, p. 28, p. 47.

In particular, Figure 12.5 discloses the drastic change in the ownership structure of the whole group that has already been achieved from 2001, when about two thirds of the hotels of the group were owned by Accor or in fixed leases, until 2010, when only 20 % of the group's hotels were still owned. Furthermore, the chart on the right shows the intended move in ownership structure in the coming years which clearly demonstrates that the trend towards less capital-intensive operating structure will continue.

Figure 12.5

Hotel Portfolio by Ownership Structure



Source: Accor 2010, p. 29; [www.accor.com](http://www.accor.com).

### Management Contracts

At the outset, *Accor* used to be primarily a builder, owner and operator, which possessed full control over its hotels in France. Abroad, the company had to develop a management style similar to the other large hotel chains. So next to owning property, as early as the 1970s, the group negotiated management contracts or signed franchise agreements for a certain period with either hotel owners or investors. Hence, according to a management contract, *Accor* manages the hotel under one of its banners for the hotel's owner in exchange for a management fee – in general, approximately 5 to 7 % of the revenues gained by the hotel (see Schuette/Jurgens 1997, pp. 3-4). Usually, the management staff is brought in by the group and the non-managerial staff is recruited in the local area. Employees working under a hotel management contract will then apply *Accor's* methods, capabilities and training to provide high value-added services on behalf of the investor or the owner of the hotel. The owner or investor retains the right to participate in decision making with regard to investments for its property. Due to increased use of this entry mode, *Accor* anticipated an internal need for about 1,000 additional hotel general managers by 2010 and thus it intensified recruitment initiatives.

Franchise agreements are the reverse of a management contract. The franchised hotel is operated by its owner. The group temporarily transfers the right to adopt its brand name and concept to a hotel owner or operator in exchange for about 2 to 3 % of the revenues (see Schuette/Jurgens 1997, p. 4). *Accor* commenced its first franchise activities already as early as 1970 in Reims and Nancy, in France. Lately, *All Seasons*, a network of quite independent hotels were mainly franchised. The first hotel of this two-star non-standardised economy hotel chain was opened in France in 2007. Many US companies already have a profound knowledge and management capabilities concerning franchising concepts, thus, local franchisees have the know-how to run hotels, accept the brands, the reservation system, etc. Hence, *Accor* seeks another major franchise programme to accelerate the development of its leadership in the economy segment there, the *Motel 6*. In 2007, *Accor* introduced the *Partnership Charter* where all partners declared they would pursue the fundamentals of the business, like customer satisfaction, brand development, corporate culture, etc. Therewith, the company wanted to increase what was already a balanced and strong relationship.

Once again, by carrying out the *asset management strategy*, *Accor* pursued the reorganisation of its hotel portfolio first. Thereby, the company executes restructuring, repositioning and also outright sales of non-strategic properties. Thus, the *Accor* group conducted several sales between 2005 and 2007 but continued to manage these hotels either by management contracts (17 hotels), franchise-back arrangements (86 hotels) or variable lease-backs (317 hotels) with an overall cash impact of 1,288 million EUR. In variable-rent leases, *Accor* leases the hotel from an investor but instead of paying a fixed rent, it pays a rent that varies according to the hotel revenue. This solution is used extensively in the Midscale and Economy segments. In detail, variable leases were created for many *Novotel*, *Mercure* and *Ibis* hotels in France when they were sold to *Foncière des Murs*. After that transaction the hotels were leased back at a variable rent of 15.5 % of the revenue. Those 12-year leases can be extended up to four times. Besides variable leases the group also still manages hotels where it pays fixed leases to the owner or investor.

All the examples show that the *Accor* group welcomes partnerships when they are arranged by mutual agreements. Thus, Figure 12.5 highlights the company's priority to implement a less capital-intensive and cyclical ownership structure with the *asset-right* strategy. Though, it is impossible to generalise a specific entry mode according to a segment, brand or location because the *Accor* management determines each kind of market entry from case to case. Hence, for example, *Pullman* is planned to be reorganised through rebranding and repositioning and will be operated by management contracts or franchise agreements with the objective of 300 operating hotels by 2015.

## Summary and Outlook

Summing up, with the new business model for its hotel division, *Accor* targets more profitable and customised investments, less cyclical operations and thus reduced earnings volatility to satisfy not only its customers but investors as well. In doing so, *the company continuously transforms itself from a hotel owner to a hotel operator* which uses its skills and expertise to serve clients. Thus, to leverage a competitive and more effective hotel business model with a low capital-intensive operating structure, the group has been pursuing major property disposals and intensive reorganisations – including the ideal strategic entry mode – of its existing hotel portfolio. Furthermore, the group is about to open around 200,000 additional rooms between 2010 and 2015, in countries and segments with strong growth potential. The demerger of its service business will help to concentrate management capacity on the hotel business. As the Annual Report 2009 argues: “By becoming a pure player in the hotel sector, the Group will be more agile and more efficient in its operations, management of capital employed and customer relations” (Accor 2010, p. 84).

## Questions

1. Explain the basic types of strategic market operation modes a hotel company can pursue when it is considering an international expansion of its business operations.
2. To implement optimal strategic market entries *Accor* formulated a new business model for its hotel division whereby the *asset-right strategy* was the cornerstone. Describe the objectives of the new model and pinpoint that strategy in its two main implementing steps.
3. Provide an overview of the tremendous expansion of the *Accor* business. Furthermore, pay special attention to the accompanying market entry strategies and modes.

## Hints

1. The first part of this Chapter describes the basic operation modes.
2. See [www.accor.com](http://www.accor.com) and Luc 1998 for an overview on *Accor's* history.