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Global Vision

How Companies Can Overcome the Pitfalls of Globalization

THE SUMMARY IN BRIEF

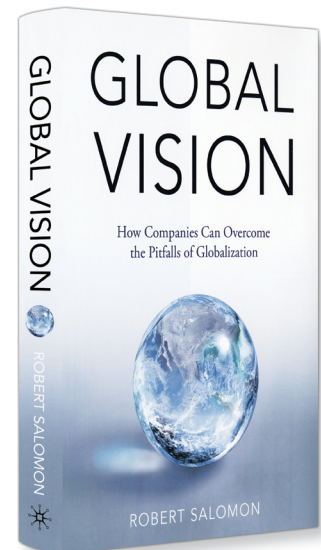
In an increasingly interconnected world, managers frequently turn to global markets as a means of achieving profitability and growth targets despite accumulating evidence that globalizing is fraught with risk. In the last 20 years alone, high-profile companies like Tesco, IKEA, AES and Walmart (among others) have been hobbled by globalization.

Global Vision offers a lens through which to view globalization in a new and compelling way, helping managers understand the risks associated with globalization while equipping them with the necessary tools to overcome those risks.

Author Robert Salomon defines country institutions across political, economic and cultural dimensions and demonstrates how to measure them so that managers can estimate the risks that institutional differences pose to global companies. *Global Vision* will help unlock the mysteries of globalization using a framework and a tool — Global Acumen — that managers can immediately apply to successfully navigate globalization's institutional hazards.

IN THIS SUMMARY, YOU WILL LEARN:

- How to assess institutional distance.
- How to make better-informed, smarter globalization decisions.
- How to select the appropriate mode of entry into foreign markets.
- How to optimally structure your global operations.



by Robert Salomon

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THE COMPLETE SUMMARY: GLOBAL VISION

by Robert Salomon

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Globalization: A Cautionary Tale

When it comes to globalization, managers are not just optimists; all too often, they are *unbridled* optimists. They habitually overestimate the benefits of globalization and underestimate its costs. In evaluating globalization opportunities, managers often forget the other side of the opportunity equation: risk. Risk goes hand in hand with opportunity, and managers fail to accurately account for the risks they face in global markets.

Managers often make dangerous assumptions about what it takes to succeed in global markets. They tend to assume that their current business model, one they successfully and profitably exploit in their home country, will translate simply and effectively to other countries, yielding similar levels of profitability. These same managers fail to account for real and alien differences between nations and to consider how those differences generate operational risks that may negatively impact their business. Unfortunately, they end up learning the hard way that the risk borne out of cross-country differences can overwhelm even the best-laid globalization plans.

Failure to Globalize Effectively

Globalizing companies habitually underperform in foreign markets, and more often than not, they fail to achieve desired performance targets in global markets. Globalizing companies take about three months longer and spend anywhere from 5 to 25 percent more than domestic companies just to get their businesses off the ground. Foreign companies pay higher wages, on average, than their domestic competitors. They are also more likely to get sued than domestic companies and more likely to lose local lawsuits. All of this translates into a higher

general cost structure for foreign firms and significantly higher rates of failure for global business expansions compared to domestic business expansions.

Even those companies that are lucky enough to achieve profitability in global markets tend to earn lower returns in their foreign-market operations than in their domestic ones.

Starbucks, for example, which has been relatively successful in global markets, has operating margins in Japan — its second-largest market in terms of revenue — that are half those of its U.S. business. Similarly, Lincoln Electric, one of the world's largest and most profitable welding equipment manufacturers, has been making profits in Asia that are only one-third of those in the United States. Its profitability in South America is about half that in the United States.

Institutional Distance: A Key Factor

As you might expect, it is easier to conduct business in countries that share commonalities in institutional profile. Successful global expansion is more likely in a country that is institutionally similar to your own — where you not only speak the language but also understand the culture as well as the political and economic environments.

For example, institutional distance is relatively small between Canada and the United States, between Spain and Mexico, and between the United Kingdom and Australia. (There are obvious cultural, political and economic similarities that make this seem like common sense.) When institutions differ substantially between countries, institutional distance is great. For example, institutional distance is relatively great between China and the United States, between India and Brazil, and between Indonesia and Spain.



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Institutional proximity by no means guarantees success in global expansion. Globalizing to an institutionally similar country still requires overcoming numerous institutional obstacles. ●

The Globalization Process

The process of globalization generally starts with managers identifying an opportunity to increase profits. At some point, managers recognize that operating globally has the potential to generate additional revenues or lower costs.

Companies of all types can increase revenues and/or reduce costs via globalization. Logoplaste, for example, a relatively small Portuguese packaging company, has been able to lower its operating costs by manufacturing in Eastern Europe. Similarly, the Selkirk Group, a small, family-owned Australian building-materials company, has been able to effectively tap into the Japanese export market to increase its overall revenues by 10 percent.

The kinds of expansion where local customers pull a company into a foreign market are known as “follow-the-customer globalization strategies.” They are fairly typical in the service sector, where retailers, banks, accounting firms, consulting companies and law firms follow clients from the home country into global markets to serve them there.

There are also cases in which opportunity arises on the cost side of business operations. Managers might not be looking specifically to globalize their supply chain to reduce costs, but sometimes foreign suppliers will approach a company with offers in hand.

Globalization strategies typically are devised by managers who are continually scanning the environment, looking for an opportunity to pounce. They often carry out or commission studies of foreign markets in advance, looking for opportunities to grow the business and streamline operations.

Regardless of how globalization opportunities arise — by chance or by design — global expansion requires careful analysis. Managers can build a business plan to justify their globalization efforts, comprehensively projecting revenues and costs to assess whether they can profitably globalize. They can express their business plan in financial terms reflecting

- the duration of the opportunity;
- the projected revenues and operating costs;
- the investment costs;

- the residual value of the business (should the company decide to sell the business);
- the exchange-rate considerations (should the company do business in a foreign currency);
- the tax implications (associated with tax policies in both the home country and the host country);
- the overall profitability associated with the opportunity. ●

The Impact of National Institutions on Globalization

The most egregious mistakes managers make in global markets are not a result of misreading opportunities to increase revenues or decrease costs, but of applying domestic financial models without repurposing them to account for globalization’s institutional risks. Managers must examine the role of institutions, institutional differences and the institutional risks they generate to determine how all these are likely to influence financial projections.

National institutions can be formal or informal. Formal institutions are those that govern behavior in a society. Structural entities that make up the formal institutional environment include governments, political parties, legal bodies, law enforcement and military organizations, and regulatory agencies.

Informal institutions, in contrast, sanction activity through a series of unwritten, tacit rules that evolve in a society. Informal institutions impose order through social conventions — by condoning and even rewarding certain behaviors and discouraging or ostracizing those who engage in others. Academics typically refer to informal institutions of this sort as culture.

Whether members of a society create its institutions by design or they evolve historically without intention, they differ from country to country and sometimes markedly so. The United States and India, for example, have political institutions that resemble one another. Why? Because they share a common colonizer — England — that played a critical role in developing the institutions of both countries. And yet, although their political institutions are similar, their cultures are very different in religious makeup, philosophical leanings, familial structure and demographic composition.

Japan and China, by contrast, share cultural similarities that date back centuries because Japan imported a system of philosophical and cultural ideals from China.

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However, culture is largely where the similarity ends; the two countries differ significantly in their political and economic institutions.

Foreign companies are generally unfamiliar with the local institutional environment; they don't know the laws, the rules or the customs; they cannot fully appreciate how the local economy works; they lack ties to powerful and well-connected local individuals and organizations that can act on their behalf; and they cannot rely on an established set of suppliers with which they have been working for years. Even the customers are new to foreign companies.

Typically, it takes foreign companies longer to set up their operations, and they often have a higher cost structure; they also generally experience more run-ins with the law. Ultimately, the profitability of global companies suffers. They perform worse and exhibit a higher rate of failure than similar domestic competitors. This disadvantage born out of institutional differences is known as the "liability of foreignness."

It Takes an Intangible (or Two or Three)

If foreign companies are generally at a disadvantage compared to domestic companies, then there must be specific factors that enable certain multinational companies to succeed where others fail. Research demonstrates that, indeed, successful global companies tend to have competitive advantages in the form of intangible assets: technological, marketing and managerial capabilities that domestic competitors cannot match or easily imitate. These capabilities allow companies to overcome the liability of foreignness and earn profits in global markets.

Coca-Cola, for example, relies on its marketing prowess to succeed in global markets, and companies such as Apple and Google rely on "killer" technologies that are far superior to those of their rivals.

The most successful global companies typically do not rely on only one valuable intangible asset — whether technology, marketing or management — but exhibit strength in several of these areas. For example, powerful brand names and strong marketing have helped to complement and reinforce the management intangibles of IKEA and Goldman Sachs. In addition, IKEA boasts technological capabilities in furniture design, and Goldman develops and exploits proprietary technologies that its rivals struggle to match.

Yet, even for companies that have painstakingly developed valuable technological, marketing and management intangibles to overcome disadvantages in global markets, there are limits. Strong technological, marketing and

management intangibles neither guarantee a company's success in global markets nor imply that it will succeed in all countries. Success is not as simple as determining *if* a company possesses valuable intangibles; it is important to know *whether* those intangibles are appropriate to the host country.

As you might expect, the greater the institutional distance between countries, the more inhospitable the host country is likely to be, and the more difficult it will be for companies to extend their intangibles there. ●

Political Institutions and Globalization

The natural place to start to understand a country's political institutions — its structure, system, activities and entities — is with its constitution. Next, it is essential to dig deeper into the country's political and governmental bodies: the executive, legislative and judicial branches; the roles and responsibilities of each branch; the scope of power each one holds. Managers should consider the structure of each entity and the individuals who are empowered to lead them:

- how these leaders come to power (are they elected, appointed or chosen in another way?);
- the roles and responsibilities of those who hold political positions of authority;
- the frequency of elections — if any — that determine who holds those positions of authority; and
- how long individuals in positions of authority can serve in those positions.

It is also important to examine more practical considerations, such as

- the type and number of political parties;
- the extent to which the political system has built-in checks and balances (such as veto power);
- whether the judicial branch is independent of the executive and/or legislative branches;
- the relative balance of power within a country — whether the power lies with the central government or with the individual regions, provinces or states.

Beyond the political institutions themselves, understanding their stability is essential to understanding their viability. It is crucial to know the extent to which the populace views the government as legitimate and the

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likelihood that the government is under threat from some sort of internal or external shock.

A common internal shock could be a protest intended to effect change or challenge the existing government. External shocks, by contrast, are extraterritorial; they involve other countries.

Managers need to have a basic familiarity with political institutions and understand the challenges that differences in political institutions can cause when conducting business overseas. Practically speaking, however, managers have neither time for, nor do they need deep, detailed insight into how a country's political, legal and regulatory institutions were designed, created and structured, or how they function on a day-to-day basis. It is wise to turn to specialists — scholars, consultants, lawyers and accountants — who have developed an expertise in dealing with political institutions. ●

Economic Institutions and Globalization

Managers intuitively recognize the importance of economic institutions to their bottom line, and yet they continue to make countless mistakes when they expand into global markets. Among these mistakes may be the following:

- overestimating a particular market's potential;
- misjudging the quality of local employees or local inputs;
- underestimating the likelihood that the market is vulnerable to a recession or other adverse developments;
- overlooking the impact of currency fluctuations;
- failing to realize how a country's physical and economic infrastructure will impact the company's business operations.

Economic institutions are the basic units of an economy — comprised of economic actors, systems and structures — and the essential building blocks to economic activity.

Think of economic actors as parties engaged in business activity. They can be individuals or organizations that own, allocate, use and direct factors of production and engage in transactions involving said factors in exchange for some consideration, either monetary or otherwise.

Economic systems and structures refer to a country's market orientation — the well-established sets of arrangements that govern economic activity as well as the behavior of economic actors. These include

- the allocation of resources among the various economic actors in society;
- the means of exchange of goods and services;
- the rules that govern ownership — who owns (or can legally own) the factors of production;
- the roles of economic actors that exchange economic inputs (i.e., the factors of production) or economic outputs (i.e., goods and services developed using the factors of production);
- the rules that govern interactions among economic actors.

There are two primary economic systems/structures that currently dominate the global landscape: capitalist and command.

Capitalist Economic Systems. These systems typically permit private economic actors to own factors of production, and they afford those actors wide latitude in deciding how to allocate those factors to productive ends. In a capitalist system, the market plays a central role in coordinating economic activity, and market-based considerations influence the allocation of resources and the decisions of economic actors. The United States, for example, is a country that likely comes to mind when one thinks of a capitalist economy.

Command Economic Systems. In command economic systems, the state (rather than private economic actors) typically owns the factors of production. The state generally acts as the economic coordinating mechanism, allocating and directing factors of production — determining how factors of production are put to use, by whom, and which goods and services are produced and in what quantities. As a result, the market plays a relatively small role. For example, to some extent China exhibits characteristics of a command economy.

Less common economic systems and structures include the feudal systems of medieval times, gift economies and barter economies. Most countries are a hybrid of capitalist and command economies.

Indirect Measures of Institutions

Although economic development indicators might not directly measure economic institutions, they are correlates of those institutions and are useful for gauging differences in economic institutions in different countries. Measures of economic development include the following:

- indicators of educational attainment (literacy rates and rates of tertiary education);

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- indicators of infrastructure development for transportation, energy and for information and communications.
- indicators of knowledge development (e.g., research and development in science and technology, patents and intellectual property).

Understanding the economic institutions in those countries where managers plan to do business empowers them to better appraise and account for the risks they will face in those markets. ●

Cultural Institutions and Globalization

Culture is an important social institution in its own right, and research demonstrates quite convincingly that it has a great influence on business — especially global business.

Culture takes on heightened importance in global business settings, and business owners, managers, employees, customers and suppliers expect — and require — greater cultural sensitivity. Interpersonal interactions matter a great deal when managing employees with different cultural backgrounds and negotiating transactions with foreign businesspersons.

Culture affects not only the decisions a manager makes but, by extension, how the local market views a company. A seemingly minor cultural faux pas that a manager commits can hamstring a company and torpedo even the best-laid global business plans.

Offensive advertising campaigns that culturally misjudge local consumers, serious religious transgressions and failing to account for culture in negotiations with business partners: These can all negatively impact profitability and, in the extreme, destroy businesses.

When it comes to globalization and cross-border business dealings, national culture matters a great deal. Because culture is familiar and habitual to those from a particular country, it can be hard for members of a collective from one country to understand how others from another country could possibly not share their world view.

An appreciation for differing cultures enables us not only to understand the motivations behind certain behaviors but also — even more useful — to predict future behavior. Managers who understand the significance of culture are therefore well-positioned to devise strategies for effectively dealing with and managing the cultural complexities inherent in global business.

How Culture Relates to Other Institutions

We cannot consider any one institution — politics, economics or culture — in a vacuum, given that they are all interrelated. Researchers have discovered that certain cultural leanings tend to correlate with specific political and economic structures and vice versa.

However, they are not perfectly related. Research suggests that cultural institutions typically change at a much slower rate than political and economic institutions — over generations rather than in years. For example, in a coup d'état, political institutions change radically overnight, and yet a culture — with its shared systems of meanings, ideas, thought, values and socially acceptable behaviors — tends to endure, regardless of sudden political institutional changes.

Because cultural, political and economic institutions can and do change separately from one another, failing to measure one of them can lead to significant gaps in our understanding of all of them and to a flawed understanding of globalization. ●

Using Global Acumen to Account for Risk

Researchers have made great strides in identifying countries' key institutions, developing and validating measures of those institutions and using those measures to calculate institutional distances between countries. Studies show a positive correlation between institutional distance and the level of risk in doing business across countries: the larger the institutional distance between one country and another, the higher the risk.

Research links institutional distance not only to globalization and global performance but also to market-entry strategies in foreign markets (that is, the governance structures companies select in global markets) and global subsidiary management (how companies manage far-flung global operations). The greater the institutional distance, the more likely a company is to opt for shared forms of ownership and control, such as alliances and joint ventures. In addition, the greater the institutional distance, the more likely a company's product offerings are to vary from one country to another, and the less likely a company is to centralize decision making at its domestic headquarters.

In practice, this suggests that a U.S. company is (on average) more likely to own its own operations in the United Kingdom than in China and more likely to use a joint venture in China than in the United Kingdom.

Likewise, the company's product mix is likely to be more similar in the U.S. and the U.K. markets than in the U.S. and Chinese markets. Finally, U.S. companies are likely to allow managers in the Chinese market greater latitude in making decisions for the Chinese market than they allow managers in the U.K. market.

Most seasoned managers already recognize that global business is fraught with risk, but they have failed to develop the systematic tools — such as a detailed measure of institutional distance — to meaningfully express or account for that risk.

Managers from some of the largest and most sophisticated companies in the world recognize the importance of political, economic and cultural institutions to globalization. They are also highly aware of the incredible challenges inherent in managing the many differences in institutions across borders. However, despite this awareness, many managers openly admit that in their global operations they do not explicitly account for these differences.

For example, when reflecting on his business in India, a chief financial officer (CFO) at a Fortune 100 said, “We know India is different [from the United States]; we just don't know how to measure it.” When a chief strategy officer (CSO) of a Fortune 500 company was asked, he acknowledged, “We do not approach global acquisitions any differently than domestic acquisitions... not because we do not want to but because we are unsure how to.”

Global Acumen is a great place to start when it comes to assessing global risk, especially for the far too many companies that have no system in place to evaluate these risks. The beauty of this approach is that the raw materials needed to compute the Global Acumen algorithm are the same ones that would be used to calculate institutional distance between two countries.

Global Acumen generates globalization risk values between pairs of countries

- over a range that extends from 0 to 30;
- using mathematical distances to account for differences in cultural and political institutions across countries;
- using mathematical differences to account for differences in economic institutions across countries.

However, knowing the institutional risk spread between two countries is only half the battle; the real value is in knowing how to use risk spreads to improve decision making. Meaningful risk spreads can complement existing strategic and financial decision-making models — if they are applied effectively. ●

Global Acumen in Practice

Global Acumen generates risk spreads that indicate the additional political, economic and cultural risks that a company faces when it does business in another country. The Global Acumen tool reports risk spreads in a way that reflects the additional compensation — expressed in interest-rate terms — that a company ought to expect in exchange for bearing the political, economic and cultural risks of doing business in that country.

Generically, the process works as follows:

1. Add the Global Acumen risk spread to the domestic discount rate.
2. Generate a country-specific, risk-adjusted discount rate.
3. Replace the domestic discount rate with this new, country-specific, risk-adjusted discount rate.

Step 1 retains the domestic discount rate because risks in global markets are risks added to a company's existing operations — risks that a company takes on over and above those it already faces in the domestic market. The opportunity cost of capital reflected in a company's domestic discount rate serves as an important signal about a company's health and well-being: its underlying “quality” and risk characteristics. Typically a strong company that is managerially sound and operates in a less risky market has a lower discount rate and a lower opportunity cost of capital because it presents fewer risks to potential investors; there is a greater likelihood that the company will deliver results for investors.

Apple, Inc., for example, has an opportunity cost of capital around 6 percent, whereas Cisco Systems Inc. has an opportunity cost of capital of around 7 percent. Market participants currently view Apple as having lower levels of risk, better future prospects, better products and a better overall management team.

When companies such as Apple or Cisco expand abroad, their idiosyncratic features — management, product and industry characteristics — do not change. Investors still expect rates of return that are at least commensurate with the risk factors specific to the company. However, in addition, investors also expect compensation for the country-specific institutional risk companies will take on by operating abroad. And the greater the levels of risk that companies face in foreign markets, the greater those country-specific returns should be. This is why Global Acumen risk spreads were designed to be conjunctive with (rather than disjunctive to) the discount rate. ●

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Using Global Acumen in Other Contexts

One advantage of the Global Acumen tool is that it is designed to be flexible. Managers can tailor the baseline risk spreads to an expansive set of global strategy problems and a wide variety of company-specific situations. With only slight adjustments, Global Acumen can help managers to do the following:

- assess different foreign market entry modes and ownership structures;
- accommodate for different industry characteristics;
- account for a company's prior international experience;
- benchmark the performance of existing foreign operations;
- monitor institutional developments in a particular country.

Irrespective of how a company decides to globalize, there is one constant: The level of institutional risk a company bears in a particular country varies with how it expands into that market. Export and import modes of globalization entail much less risk, for example, than subsidiary investments in which a company ties up capital in a long-term investment.

A company can export products from its home market with little change, whereby foreign customers purchase the product on an "as is" basis. Similarly, a company can import products from a foreign supplier without having to spend much time in the foreign market. Recent advances in information technology have made it possible to purchase foreign-made inputs or sell domestically made outputs directly over the Internet. So compared to foreign market entry modes that require a physical presence, export and import strategies can minimize the institutional disruption globalization can cause to a company's operations. ●

The End of the Beginning for Global Acumen

We should, of course, exercise caution in applying (or relying too much on) algorithmic procedures to solve complex globalization problems that, at their root, are a product of social interaction. Algorithmic approaches can certainly help us simplify and make sense of complex globalization problems, but we should always view them as a complement to managerial intuition and as a

decision-making aid. With respect to Global Acumen, that means that there is no substitute for a deep qualitative and intuitive understanding of globalization's risks to help guide, inform and improve Global Acumen's quantitative, algorithmic nature.

A manager should temper any application of Global Acumen with a healthy dose of realism. Sometimes understanding *why* institutions change and anticipating *how* they are likely to change in the future is more important than knowing a specific number attached to that change.

Rather than merely taking output from Global Acumen and blindly plugging it into a financial model, a manager would be wise to carefully consider whether the output

- suits the intended application;
- makes sense given any recent or sudden changes to the institutional environment — either in the firm's home country or in the intended host country.

These considerations will only enhance the tool's value and utility.

Finally Bringing It All Together

Managers see unbridled opportunity the world over, making globalization an exciting proposition for businesses everywhere. And they are right; there are tremendous opportunities in global markets. Tapping into global markets, especially fast-growing and developing ones, not only promises riches beyond our wildest imagination but also empowers people the world over to work toward creating a better economic future.

But as we have seen, there can be trouble when two opposing forces collide: the optimistic nature of managers and the fact that global markets, especially developing ones, can be precarious. To play the complicated and high-stakes game of global strategy and reap the potentially high rewards, a manager needs to understand the risks and be empowered to accurately take them into account and outmaneuver them. ●

RECOMMENDED READING LIST

If you liked *Global Vision*, you'll also like:

1. ***Flex* by Jane Hyun and Audrey S. Lee.** Flex offers a proactive strategy for managers to navigate and leverage diversity effectively.
2. ***Leadership 2030* by Georg Vielmetter and Yvonne Sell.** The authors present six megatrends that will reshape businesses by the year 2030, including the forces of globalization 2.0.
3. ***Winning with Transglobal Leadership* by Nazneen Razi, Ph.D., Peter Barge, Robert A. Cooke, Ph.D., Linda D. Sharkey, Ph.D.** The authors draw on an impressive range of resources to deliver an easily implemented process for assessing your organization's global capability.