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How to Select an Export Mode without Bias

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How to Select an Export Mode without Bias

Abstract Managers of start-ups and small and medium-sized enterprises (SMEs) tend to view subsidiaries as the preferred international export mode. Yet this type of organization is associated with a high failure rate. In-depth interviews with more than 40 managers show that their bias in favor of foreign sales subsidiaries is rooted in unsubstantiated beliefs about control and the superiority of subsidiaries over other export modes. This article details the faulty reasoning that supports these prejudices and proposes a simple method for selecting more profitable and less risky export strategies.

KEYWORDS: decision bias; export management; foreign subsidiaries; foreign distributors; export modes selection, exporting SMEs

In an increasingly globalized economy, many firms seek growth abroad and, as a result, find themselves involved in complex and risky international business operations. Nonetheless, for many firms, exporting represents a critical part of their growth strategy. In the quest to achieve international success, firms must first assess markets with high potential, and then they must then decide on the best way to penetrate the selected markets via an appropriate export strategy. Despite the possibilities available to them, managers of start-ups and small and medium-sized enterprises (SMEs) tend toward the myopic view that subsidiaries[1] are the preferable mode of international operations (Jean-Amans & Abdellatif, 2014; Kuivalainen, Saarenketo & Puumalainen, 2012).

Yet the subsidiary strategy is associated with a high failure rate (Obadia & Vida 2006). Given the investments in financial and intangible assets necessary to establish a foreign subsidiary, failure affects the firm on three levels: (1) poor local performance and/or exit from the foreign market, (2) a slowdown, if not complete termination, of the firm's international efforts, and (3) the deterioration of the overall firm performance, sometimes ending in bankruptcy. These failures can affect internationalizing start-ups, SMEs, and large multinational corporations (MNCs) (consider the recent case of ABB in Korea; see *Financial Times* 2017). Large MNCs often prove more resilient to failures in this context, as they can benefit from a portfolio effect that compensates for losses associated with low-performing foreign subsidiaries with the profits garnered from more successful ones. For the start-up or the SME, however, a foreign subsidiary failure can be lethal. Therefore, it is important for managers of small firms exploring the possibility internationalization to reflect upon their capabilities and potential for resiliency, to understand the factors they will face in foreign markets, and to entertain the suite of options available to them rather than doggedly pursuing a singular strategy that may ultimately prove to be their demise.

In-depth interviews with more than 40 managers of small firms reveal a strong bias in favor of using foreign sales subsidiaries as an internationalization strategy. This bias is rooted in the erroneous beliefs that (1) only a foreign subsidiary will give the exporter sufficient control over its foreign venture—especially when there are complex and innovative products and services involved—and (2) foreign intermediaries' margins are too high and therefore profits will be greater with a subsidiary.

This article integrates many of Soll, Milkman, and Payne's (2015) recommendations in their guide to *debiasing* decision making. First, we shine a spotlight on the sources of bias that affect export mode decisions and show that managers systematically associate subsidiaries with positive outcomes. Second, we underscore the myopia and narrow thinking of many managers, who seem to have a singular fixation on the subsidiary-based export strategy. Third, we document how managers' lack of knowledge about the variety and efficacy of export modes available to them perpetuates this bias.

Employing a cognitive *debiasing* strategy, we venture to temper managers' optimism about subsidiaries. As an alternative, we suggest the foreign distributor option and detail the strengths and weaknesses of this strategy. While managers may ultimately avail themselves of several different export strategies, we keep things simple by sticking to this dichotomy of foreign subsidiary versus foreign distributor—two of the most commonly used export modes.[2] Moreover, we provide additional insights into managing the export mode of choice. Our objective is not to say that one export mode is better than the other per se, but rather to provide managers with sufficient knowledge and a systematic method to engage in a more active and intentional selection process, as opposed to adopting a default export mode due to false rationale and biased beliefs. Thus, we propose a simple method that will help managers choose and engage in more profitable export modes by assessing and reducing risk.

1. Why do managers prefer subsidiaries?

Of the 300,000 U.S. firms that exported goods, 2,270 firms had set up international subsidiaries (United States International Trade Commission [USITC], 2010). Of these, 555 SMEs owned 1,588 foreign subsidiaries (or approximately 2.9 subsidiaries per firm) and realized 39.8% of their foreign sales through these subsidiaries. While similar statistics for start-ups are rare, a study of 106 U.S. venture capital–backed firms indicates that 34 firms reported facilities or offices outside the United States (in USITC, 2010). These figures indicate the importance of foreign subsidiaries in both small firms' and start-ups' international operations.

As noted earlier, managers' bias toward using foreign sales subsidiaries stems from the belief that subsidiaries afford greater control and yield higher margins than foreign intermediaries. To understand the faulty cognitive frameworks that support these often-misguided attitudes and biased decisions, we conducted in-depth interviews with 42 European, Latin American, and U.S exporters. We also employ evidence from 200 Latin American SME exporters gathered by one of the coauthors while serving as an international marketing consultant in Argentina.

1.1. The bias against intermediaries: high margins versus hidden costs

Managers contended that their firms earned reduced profits when using intermediaries due to the high compensation that intermediaries demand. They claimed that using intermediaries was a costly arrangement that sacrificed large margins to the foreign agents. These high margins created

an easy rationale for bias, and managers reasoned that this money could be saved if they were to use a subsidiary instead.

Managers did not seem account for many of the intangible or less obvious costs of the myriad channel functions that are necessary to make their products available to foreign consumers. Consequently, they did not realize that the contribution of a subsidiary to the profits of a company does not necessarily equal its gross margin. To calculate a subsidiary's profits, it is first necessary to deduct operating costs (e.g., logistics, marketing, financing, overhead) and local taxes from the gross margin. Second, the important cost of coordinating with headquarters and subsequent control efforts must be taken into account. When the gross margin exceeds these costs, only then can the subsidiary be considered profitable to the exporting firm.

In addition, these profits (and corresponding cash flows) must first be applied to repay the substantial investments incurred in establishing the subsidiary. Especially when assessing new market entry, managers found it difficult to anticipate all the upfront investments and operating costs that go into establishing a foreign subsidiary. In addition, most managers did not fully understand the influence of transfer prices on profits. When operating a subsidiary, an exporter's profits derived from the export venture are split between those accrued at home (which are higher with *higher* transfer prices) and those made in the foreign market with the subsidiary (which are higher with *lower* transfer prices). However, most managers believed that transfer prices to a subsidiary were sufficiently adjustable to ensure profitability. Importantly, they did not take into account the reduction of headquarters' profits due to the lower transfer prices.

In short, when forming opinions about the profitability of various entry modes, most of the managers we interviewed did not adequately or accurately assess the profit structure of their foreign subsidiaries. Moreover, they failed to take into account the relationship between headquarters and subsidiary profits. In contrast, importers' margins proved easier to figure out and therefore were always top of mind. Consequently, managers tended to overestimate the profitability of their subsidiaries and held negative opinions of pursuing arrangements with independent distributors.

1.2. The bias in favor of subsidiaries: ownership equals control

Managers agreed that without the legitimacy inherent in ownership, it was not possible to influence the behaviors of independent distributors. These presumed conflicts were considered obstacles that would obfuscate the exporter's understanding of the foreign market and would hinder the implementation of the exporter's international strategy.

For managers of most start-ups and SMEs, ownership control was an end in itself. In their minds, ownership control precluded the need for any additional action. In other words, subsidiaries seemed to create a (false) notion of safety among managers who viewed them as a safeguard against any malfeasant actions against the firm's tangible and intangible assets. This belief was particularly present in tech firms (both start-ups and established firms), whose management was concerned about protecting their firms' technological assets. The problem was aggravated because these SMEs and start-ups primarily used informal controls. Managers of smaller firms' believed that they could control their remote operations (i.e., their foreign subsidiaries) in a similar manner and were unaware of effective formal control techniques they could use. Because actual controls were not even envisioned, this lack of knowledge deepened their bias in favor of subsidiaries because managers were not able to effectively consider the resources, competencies, and costs of using these controls when selecting an integrated entry mode.

1.3. *Nosce te ipsum:* "we know it all"

Another contributing factor to the bias in favor of subsidiaries occurred when managers overestimated their ability to duplicate the operating skills of a local distributor. Indeed, the very act of choosing a subsidiary indicates that managers believed that their firm could outperform local distributors. They were convinced that their firm could conduct operational tasks in the foreign market better and cheaper than local companies that were historically embedded in the foreign environment. For most firms, this is a bold and often incorrect assumption, given their reduced local market experience compared with indigenous firms whose survival depends on possessing a sustainable competitive advantage in conducting distributor-related tasks.

2. Toward a better understanding of export modes

2.1. Problems with SMEs' foreign subsidiaries

Statistics on foreign subsidiary performance are rare. Yet a study of 1,033 foreign subsidiaries in Portugal indicates that over a period of eight years after entry, 77% were terminated (Mata & Portugal, 2000). However, the study does not reveal the direct causes of these terminations. A more recent study of Japanese foreign subsidiaries in the United States between 1992 and 2003 indicates that 35% of these were terminated (Boeh & Beamish, 2015). In this study, the authors find that the travel time between the Japanese headquarters and the U.S. branches negatively influenced the performance and survival of the subsidiaries. They contend that distance thwarted communication between headquarters and the branch and increased coordination costs. Smaller size also appears to be related to low foreign subsidiary performance. A comparative study of SME exporters and large MNCs from the United States, Europe, Japan, and Canada reports a subsidiary success rate of only 36% for SMEs versus 87% for larger firms (Cavusgil & Kirpalani, 1993).

Obadia and Vida (2006) interviewed top managers of ten SMEs from various countries that had to terminate their foreign subsidiaries. These subsidiaries were located in the Americas and Europe, in markets that the interviewees deemed to have high potential. Thus, given this context, low demand for the exported products was not sufficient justification for closure of the branches. Instead, respondents associated low performance and the demise of their branches with behaviors the authors refer to as "endogenous opportunism." Opportunistic behaviors are intentional actions by one party to maximize its benefits at the expense of another party's interests. These behaviors involve various forms of deceit. In the case of the failed subsidiaries, the subsidiary (endogenous) staff engaged in opportunistic behaviors, including the misappropriation of both tangible (e.g., cash, inventory, equipment) and intangible (e.g., brands, technologies, industrial secrets, sales permits) assets. Moreover, local management of the subsidiaries would be absent or would dedicate themselves to the activities of other business interests. In several cases, the subsidiary's facilities were used to operate external businesses owned by the staff. Some of the respondents indicated that they only realized the extent of these problems when, during a visit to their branch, they found the facilities empty and their bank accounts vacated. A relevant case of a technology start-up is presented in the Appendix.

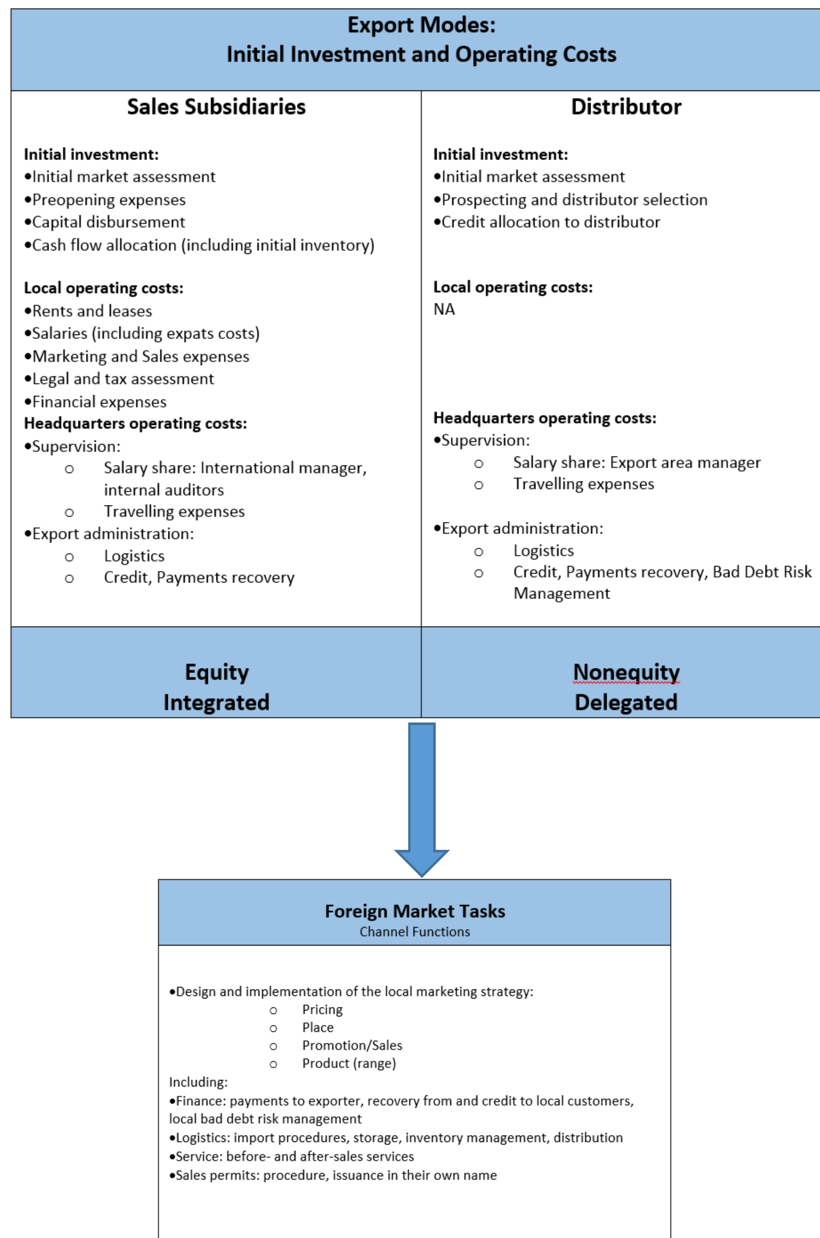
2.2. Comparing investments, operating costs, and roles of export modes

A primary reason for the biases in decision making about export strategy comes down to a lack of understanding about the investments and costs associated with the functions assumed in different

export modes. In this section, we detail these costs and compare the two options exporters most often consider: foreign sales subsidiaries[3] and foreign distributors.[4]

Figure 1 summarizes the main characteristics of the two export modes. It specifies the exporter's initial investments as well as the operating costs at home and abroad for each mode. Moreover, it clarifies the typical role of each mode by articulating their main functions.

Figure 1. **Export modes: investments, operating costs, and channel functions**



Export modes can be categorized according to two key criteria: equity versus nonequity, integrated versus delegated. Equity export modes involve financial investments by the exporter that owns the entity (e.g., the sales subsidiary). The most typical nonequity export modes involve foreign distributors (or importers). Nonequity export modes are also delegated, which means that the exporter delegates the implementation of (at least) part of the local marketing mix (in the foreign market) to an independent company that acts as a distributor for the parent company. Conversely, in an integrated mode, the strategy in the foreign market is designed and implemented by a subsidiary that operates within the boundaries of the exporting firm. Finally, it is important that both modes effectively work as a "distributorship." With a distributorship mode, the foreign entity (i.e., the sales subsidiary or the foreign distributor) takes ownership of the exporter's products and resells them to local retailers or end users.

Thus, both the sales subsidiary and the foreign distributor are "distributorships" and accomplish the same tasks for the exporter, which relies on them to design and implement the local marketing policy. They import the product and store it before reselling it to local customers. Local customers can be retailers or professional end users of the exporter's product. Subsidiaries and distributors design and implement pricing policies for local customers, which includes payment recovery and debt management. They define the type of customers they will pursue and territory coverage. They organize and implement the local sales promotions. Within the larger context of the exporter's offerings, they select the product range they believe to have the most potential in the given market and eventually recommend adaptations to the products that will best suit the needs of local retailers or end users.

Importantly, these two organizational settings require different patterns of investments. The most notable differences are in the equity expenditures necessary under the subsidiary model. Moreover, more capital expenditures are necessary to provide subsidiaries with an operating cash flow. Both export modes require cash allocations to grant credit terms to local customers. It is typical that the largest financing needs of a subsidiary correspond with the credit granted to build initial inventory, which can only be repaid in the midterm.

In terms of costs, the most obvious difference resides in the fact that working with an independent distributor does not generate any operating costs in the local market. In addition, only subsidiaries incur internal auditing costs. By definition, independent intermediaries do not shelf exporters assets to be audited.

The costs incurred for supervising and controlling export modes were almost never considered—or at least were not top of mind—among the managers we interviewed. Next, we explore the notion of control in international marketing channels to highlight the importance of and costs associated with this crucial function.

2.3. Understanding the notion of control in export operations

Another bias fueling subpar exporting decisions is a poor understanding of control mechanisms. In Table 1, we summarize different types of controls used in channel management.

Table 1. **Types and forms of control of foreign market tasks**

Control Type	Characteristics	Examples	Application
Ownership control	Legitimate authority and formal decision rights	• Appointment/dismissal of board members and top management • Capital increase • Transfer of equity shares	Equity export modes only: • Sales subsidiary
Internal auditing	Internal auditing oversees finances, accounting, taxes, and legal matters to secure tangible and intangible assets and to provide unbiased information about the financial performance of an entity	• Reporting of financial and accounting situation • Internal controls over cash, credit, and inventories • Powers of attorney granted to local management • Due diligence with regard to legal situation	Equity export modes only: • Sales subsidiary
Monitoring	Surveillance aimed at checking that a party's actions (process control) and/or results (output control) are in conformance with agreements or expectations	Process control: • Check execution of marketing plan • Check quality of after-sales • Check storage conditions Output control: • Check sales volume (of one's products) • Check customer base (for one's products)	Equity export modes only: • Sales subsidiary All export modes: • Sales subsidiary • Distributor
Social control	Norm based self-control that occurs in close interfirm relationships. Each party promotes own pro-relationship behaviors and censors (own) counter-productive actions.	Respect of formal and informal commitments Role performance Transparency in information exchange Flexibility	All export modes: • Sales subsidiary • Distributor
Managerial control	One party's influence over the strategy design, strategy implementation, and daily actions of the other	• Local marketing plan design and implementation • Pricing policy • Customers policy (place) • Promotion policy (sales) • Product policy (range, technical support)	All export modes: • Sales subsidiary • Distributor

Ownership control refers to the proprietary rights of shareholders. Ownership allows for the definition of the power structure of the entity by naming the top management and transferring shares. Ownership provides the right to exert all other forms of control that we define hereafter.

Internal auditing refers to collecting financial and legal information about a subsidiary in order to secure the tangible and intangible assets of the subsidiary and assess its financial performance. The owner of an entity is entitled to receive, on a regular basis, detailed reports about the financial and legal situation of the company. Moreover, ownership gives the right to conduct in-depth audits to determine the accuracy of those reports. It should be noted that, in the vast majority of cases, intermediaries do not allow their suppliers to conduct such audits.

Monitoring refers to collecting nonfinancial information via the surveillance of a company's actions (process control) and results (output control). A company's headquarters is entitled to monitor any process and output of a subsidiary as it sees fit. In contrast, monitoring an independent distributor requires a previous agreement and understanding and is generally limited to output control—namely, surveillance related to results (e.g., sales volume, market share, territory coverage) achieved with the exporter's products. In most cases, process control and formal inspections of distributors are not possible. However, informal monitoring is sometimes welcome. For example, missionary selling, which consists of sending technical or sales personnel to accompany the distributor's sales force during their customer calls, is often valued by distributors and provides firsthand information to the exporter about the intermediary's sales force performance and customers' demands and satisfaction levels.

Social control refers to the extent of self-control each party in a relationship exercises (Heide, 1994). In the case of self-monitoring, each party takes into account the interest of its counterpart, censoring counterproductive behaviors and promoting actions that help develop and sustain the relationship. This phenomenon occurs when the social bond between two parties is strong. It usually involves cases in which there is a high level of perceived integration of the staff of a foreign subsidiary in a MNC structure or when a high level of trust exists between an exporter and an importer. Most of all, it concerns relationships that both parties consider long term.

Managerial control refers to the influence of a firm on another firm's strategic design and implementation and its decisions. Ownership confers the rights to enforce such an influence. However, it should be noted that without appropriate levels of information about subsidiaries, which only can be ascertained by means of thorough auditing and painstaking monitoring, firms are not able to achieve managerial control over their foreign subsidiaries. Experienced MNCs have teams of international auditors who continuously inspect and review their foreign subsidiaries. They put trusted expatriates in key positions to benefit from their loyalty and self-control. They adopt personnel policies that facilitate their integration into the MNC. Without the careful implementation of these costly and complex managerial processes, firms cannot achieve sufficient levels of managerial control, and their subsidiaries can be vulnerable to the most severe problems (Obadia & Vida, 2006). In summary, managers must remember that "ownership is *not* control."

Given our findings about the biases of managers, we dedicate part of our discussion to understanding the notion of control in the context of foreign intermediaries. Contrary to the common belief among managers, research has shown how exporters can achieve high levels of managerial control with independent intermediaries such as foreign distributors. Indeed, the study that launched the research field of control in marketing channels focused on export operations (Bello & Gilliland, 1997). This seminal work shows that, despite a lack of ownership, firms can

achieve sufficient and effective managerial control through the use of various governance mechanisms, such as output control and by allowing and promoting the development of bilateral behavioral norms, such as flexibility. The results of the study indicate that exporters show improved performance in markets in which they are represented by a distributor when they successfully monitor the results of their representative (output control) and strive for mutual flexibility (norms). In addition to monitoring, other governance mechanisms, such as providing incentives, have been shown to improve foreign distributors' role performance. Obadia, Bello, and Gilliland (2015) show that low-powered incentives—nonfinancial rewards aimed at strengthening the social relationship between the exporter and the importer—can help exporters achieve managerial control over their distributors. Such incentives include the following:

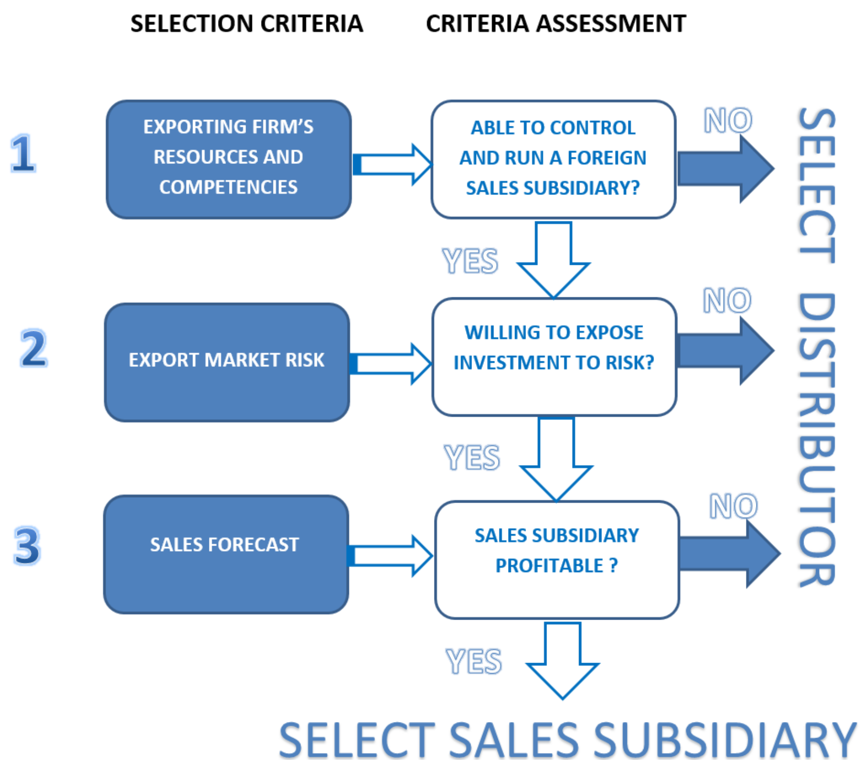
- *Conflict resolution policies*: steps the exporter takes to prevent and settle conflict in its export territory.
- *Market development*: when the exporter provides support for the development of the foreign distributor's activities in its market.
- *Territory protection policies*: when the exporter defends the foreign distributor's interests by protecting it from territory incursion from a competitive channel member.
- *Training programs*: when the exporter supports the foreign distributor's staff with selling, marketing, and other forms of training.
- *Managerial advice*: covers marketing and nonmarketing topics and helps improve the everyday running of the distributorship.

As the study further explains, these incentives are effective because they are in line with the deeper motivations of foreign distributors. Yet one commonly recognized problem of governance mechanisms such as incentives or monitoring is the cost of deploying them in foreign markets. Thus, they may be best reserved for large-volume export ventures or larger firms. However, a recent study (Obadia, Vida, & Pla-Barber, 2017) investigates economic solutions for smaller firms to achieve control over their foreign operations with independent distributors. In this study, the authors find that building strong social relationships, reflected in the development of bilateral behavioral norms, helps mitigate foreign distributors' counterproductive behaviors and increases their actions on behalf of the exporters' products. Interestingly, for long-haul exporters, the study finds that the effect of bilateral norms is stronger when cultural differences between the exporter and the importer are high.

Thus, when firms recognize that their business with their foreign distributors is not a series of spot transactions but rather is rooted in long-term relationships, they are in a position to develop many effective tools to manage these interactions and achieve a high level of managerial control in their international operations. Because exporting through a foreign distributor requires less investment and can be profitable at lower sales levels than a subsidiary, firms should not eliminate this possibility when considering their export options due to unfounded biases about the controllability of foreign distributors.

3. An unbiased method for selecting a safer and more economically beneficial export mode
Does a start-up have the same ability to control remote affiliates as a large MNC? Is it smart to invest (and take risks) in the same way in Canada and in Venezuela? Is the same organizational approach equally effective for achieving $1 million in sales per year and $20 million in sales? The answers to these questions might seem obvious. Yet when firms systematically choose subsidiaries as their preferred export mode, managers are unconsciously answering "Yes" to each question. To avoid making such mistakes, we suggest a three-step method[5] to more effectively select an export mode that is best in line with the exporter's capabilities, is adapted to the risks inherent in the foreign market, and is sized properly so that the firm has a reasonable chance to generate profits. The proposed method consists of assessing the more demanding export mode (i.e., the sales subsidiary) using three criteria: the exporting firm, the foreign market, and the business forecast. At each step, if the analysis shows that a subsidiary is not appropriate, the exporter should stop the selection process and opt instead to use a foreign distributor.[6] When the choice of subsidiary passes all three selection criteria, it can be considered the more appropriate option. Figure 2 summarizes our proposed methodology.

Figure 2. **Selecting a less risky and more profitable export mode**



3.1. Assessing the exporting firm's resources and competencies

Research has shown that firms that select export modes as a function of their resources and competencies are more likely to achieve positive export performance (He, Brouthers, & Filatochev, 2013). Figure 1 helps define the resources and competencies required for operating sales subsidiaries. They include financial and human resources that can be translated into competencies to control and manage a foreign subsidiary and interact with its environment—specifically, its government, regulatory bodies, retailers, end users, and so forth. Based on a reinterpretation of the data used to support the original Uppsala model (Johanson & Vahlne, 1977), Håkanson and Kappen (2017) show that the key resources that explain firms' internationalization are the control structures used to coordinate international operations. Firms adopt international operations modes as a function of their available control structures. Control structures aimed at delegated export modes are easier and less expensive to deploy first. They give way to a first wave of international expansion using foreign distributors and agents. After building a more demanding control structure for international subsidiaries, firms proceed to a second wave of international expansion that requires a presence in numerous foreign markets in order to spread out the heavy costs of such a structure.

Experienced MNCs can skip this step of the export mode selection process. However, it is a crucial phase for start-ups and SMEs, which should evaluate with the utmost objectivity and rigor their capability of managing foreign subsidiaries.

3.2. Assessing the export market risks

The same research that highlights the need to align firms' capabilities with choice of export mode also stresses the need to take into account the characteristics of the foreign market (He, Brouthers & Filatochev, 2013). We focus on the risks inherent to the foreign market and adopt a logic derived from research findings. In risky markets, firms should adopt less integrated export modes—that is, they should consider using a distributor. In evaluating the risks taken by the exporting firm, we distinguish the risks themselves, which arise from characteristics of the foreign markets, from exposure to these risks, which is linked to the export mode that is chosen. The move from a distributor strategy to a subsidiary strategy implies a transfer of risks back to the exporter. This transfer is performed in parallel to the change of *depth* and *scope* of the exposure to risks. First, integrated modes, such as establishing a sales subsidiary, increase the depth of the exposure (i.e., the amount of money that is at risk). Moreover, sales subsidiaries increase the scope of the exposure because they render firms vulnerable to new forms of damages. Table 2[7] summarizes risks and risk exposure as a function of export mode.

Table 2. Examples of risks inherent to certain export modes

CATEGORY OF RISK	EXAMPLES OF RISK	EXPOSURE WITH DISTRIBUTOR	EXPOSURE WITH SALES SUBSIDIARY	
			Within subsidiary	Outside subsidiary
FINANCIAL RISK	Payments	Credit to distributor	Credit to subsidiary	Credit to local customers
	Foreign Exchange	Payments from distributor	Payments from subsidiary Investment in subsidiary	NA
COUNTRY RISK	Customs regulations	Imports by distributor	Imports by subsidiary	NA
	Sales permits	Imports by distributor	Imports by subsidiary	NA
	FDI regulations	NA	Ownership subsidiary	NA
CULTURAL RISK	Foreignness	Negotiation and control; Admin staffs interactions	Controlling subsidiary Managing local staff Admin staffs interactions	Interaction with government entities Interaction with regulatory bodies Understanding needs, wants and purchasing habits of foreign buyers
OPPORTUNISM	Shirking	Role performance	Role performance Compliance with control	NA
	Deception	Information received Negotiations	Information received Inaccurate reporting (finance, tax, legal)	NA
	Stealing	NA	Tangible and intangible assets	NA

International business risk is a multifaceted phenomenon, some aspects of which are less known to managers. While some exporters are familiar with the first two facets, financial and country risk, they rarely consider the cultural risks that arise from the cognitive difficulties experienced by foreign parties when they interact for business purposes. As for the fourth risk, we prefer the microeconomics term "opportunism"[8] to the more common, but vague, term "commercial risk" to describe the severe operational difficulties that firms can experience with distributors or with their subsidiary staff. Opportunism is present in all human interactions. However, it tends to be more frequent and more severe in international business (Leonidou, Aykol, Fotiadis, Christodoulides & Zeriti, 2017; Obadia & Vida, 2006).

The difference in financial exposure (depth) to risk between the two entry modes can be easily deduced from an examination of Figure 1 and Table 2. A subsidiary requires a much higher initial investment than a distributor. This upfront cost exposes the firm to many risks, such as foreign exchange risk (e.g., devaluation of the foreign currency) or foreign direct investment regulations that can alter the value of the subsidiary (an extreme case being the confiscation of the subsidiary by the government, as happened, for example, in Venezuela). Exposure depth is also increased due to the nature of subsidiary operations. Indeed, a problem with customs regulations

or sales permits can halt the importation of the exporter's products. With a subsidiary, the loss of sales at headquarters is aggravated by the fact that the foreign branch will continue incurring fixed costs and reimbursing its debts to third parties until the situation is resolved.

The change in scope of risk exposure may be more difficult to assess because, for the most part, it cannot be expressed in monetary units. While payment-related risk from local customers is easier to measure, the capability of effectively implementing local recovery procedures should also be considered. This issue illustrates an increase in the scope of risk exposure that is more related to the firm's competencies than to its financial strength. Indeed, even the most seasoned exporter may face difficulties due to cultural differences with the management and supervision of the local subsidiary staff. With an integrated mode, the exporter has to manage relationships with local government entities, regulatory bodies, and local customers. In the distributor mode, these interactions are managed by the local intermediary. Finally, exposure to opportunism grows in scope and depth with a subsidiary, particularly in the presence of valuable tangible and intangible assets.

Although companies may recognize the reality and significance of these and other international business risks, few adopt a formal approach to risk evaluation. This is an essential step because a high level of risk can force the cancellation of investments and require the use of a nonequity export mode.

3.3. Assessing the sales forecast of the export venture

The third decision filter is the projected size of the foreign operation and, consequently, its profit potential. Subsidiaries have significant operating costs, most of which are fixed. To be profitable, subsidiaries require a much larger volume of business than is the case with distributors. Thus, an additional requirement in terms of exporter capabilities is the resources and competencies necessary to produce reliable sales forecasts upon entry in a foreign market. These forecasts should define the volumes expected to be sold in the market and the prices that the customers of a subsidiary (or a distributor) will be ready to pay. Depending on the decision rules of each exporter, a horizon of 3, 5, or more years could be used to calculate profitability. Table 1 provides information about the operating costs of a subsidiary that can be used to perform a quick evaluation. To perform this evaluation, firms need to define their projected transfer prices. The subsidiary margin should be set at a similar level to that required by local distributors.[9] Then, over a period chosen by the exporter, this margin should be compared with the cost of capital + the local operating cost + the supervision marginal cost. If the gross margin yields a profit, then a subsidiary should be chosen because it can perform the same tasks as a distributor at a lower cost.[10] If not, a distributor is the proper choice because it will provide the same margin at headquarters, there will be limited control costs, and there will be no losses at the foreign market level (see Table 1). However, we believe that in some situations strategic considerations should supersede short-term profit considerations. Firms may decide to invest in building sophisticated control structures while they know that the cost will be covered only after launching multiple foreign subsidiaries. Such structures involve international auditors, managers, and expats. It is not possible to make such firms profitable with a low numbers of subsidiaries (e.g., U.S. SMEs average 2.9 foreign subsidiaries per firm, see paragraph 1 p.5). Only a quick succession of international subsidiary openings allow for profitability (Håkanson & Kappen, 2017). Thus, the decision to develop internationally with an integrated export mode is a crucial strategic decision that requires substantial investments both at headquarters and in the foreign operations.

4. Discussion and Conclusion

Our proposed method offers a simple and quick way to assess the choice between a sales subsidiary and foreign distributor when firms are looking to penetrate foreign markets. The method can be adapted to each unique situation and can include more export modes. Yet our baseline recommendation, which departs from the behaviors we detected in our interviews, is that a contingency approach to export mode selection is essential if firms want to maximize their international profits. Firms must learn how to choose from a menu of potential export modes as a means to reduce their risk and increase their performance.

Foreign subsidiaries can be powerful entities that help exporting firms penetrate foreign markets when the exporters are equipped with the proper control and coordination structures in low-risk and high-potential markets. Yet as soon as one of these conditions is not met, firms should ask themselves if a local distributor might be more suitable. It is essential that this complex decision process is *not* informed by preconceived biases. In this article, we identify these prejudices and show how they can lead to unprofitable and unnecessarily risky international operations. In addition, we provide detailed information and a methodology for firms to achieve outstanding results without exposing themselves to the risks and demands of foreign subsidiaries. International marketing managers should select the appropriate export strategy that best fits the characteristics of their firm, those of the market, and their firm's strategic objectives.

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Appendix: A case of inadequate control of a foreign subsidiary

The case of Aurora (pseudonym), a fast-growing French start-up specializing in hi-tech dental surgical equipment, provides a good example of the difficulties start-ups can face when attempting to enter a new market. As soon as Aurora registered some commercial successes in France, its bank and the regional export promotion office contacted the company to initiate international development. Aurora was advised to target the market most commonly believed to have the highest potential: China. The export promotion entity had settled a kind of subsidiaries' "nursery" in Beijing, where it would host the new branches it had helped create. A full array of services was supplied, including market information, legal advice for the incorporation of subsidiaries, and selection of the local branch managers. These services were costly but highly appreciated by Aurora's management, a team of sharp engineers and dental surgeons with limited managerial skills and no international experience. For them and for their advisors, there was no other entry mode option: their hi-tech products were so technically demanding that only the firm itself could promote them. As soon as the Chinese general manager was appointed, the branch could leave the nest and rented its own offices and a warehouse. The operating costs of the new Chinese subsidiary represented well over 50% of the overall revenue of the firm. Yet this cost was deemed to be acceptable to penetrate the large Chinese market. French technical staff members were sent nearly every month to train the subsidiary sales force and advise potential customers. Large quantities of samples were dispatched to facilitate potential users' field trials. However, after a year without any sales and the constant outpouring of capital resources, the French management started to question the potential of the Chinese market. During the same period, the French sales force started to report the existence of directly competing products being sold at a fraction of the price by a European distributor. It took Aurora's management a few weeks to realize that their Chinese general manager had organized the production of cheap copies of their products. These copies had already been sold in large quantities in China, and an importer had begun to promote them all over Europe. Legal action in China was quickly dismissed given its cost and the reduced likelihood of success for a foreign firm in Chinese courts. The substantial financial losses in China and the competition from pirated products in Europe hit the small firm hard, and months after the story emerged, it was still struggling for survival.

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[1] We define a subsidiary as a firm owned in part or in full by another firm.

[2] We restrict the choice to the two most frequent options exporters consider: sales subsidiary and foreign distributor.

[3] Because this article focuses on exporting, we only examine foreign sales subsidiaries. However, we believe that most of our analysis also applies to both research and development and manufacturing subsidiaries. Moreover, the distinctions between fully owned subsidiaries and partnerships/joint ventures, acquisitions, and green field investments are beyond the scope of this article.

[4] We focus on export modes that secure a presence in the foreign market and therefore ignore direct sales from headquarters and indirect exporting. Licensing and franchising are also beyond the scope of this article. Although common in international business, licensing is rarely used to secure an actual presence in the foreign market. International franchising is a multifaceted entry mode used mostly by large service MNCs. Both licensing and franchising are rarely included in entry mode selection processes that involve subsidiaries and intermediaries.

[5] The method is tailored to help exporters choose between the two most frequent options they consider: the sales subsidiary and the foreign distributor. However, it can be adapted for more complex choices between multiple international entry modes. For an example see Root (1987)

[6] Although it can be used by export novices, this method is best suited for firms that are experienced in exporting.

[7] Note that Table 2 is not exhaustive and presents only the risks we consider most relevant for export mode selection.

[8] See the definition on p. 9

[9] In most countries, this is also a requirement of the tax authorities.

[10] We suggest this simple rule based on the problems we detected in our interviews. However, more advanced firms will use more sophisticated criteria, such as return on investments, return on assets, and so forth, and will adjust their discount rate as a function of the risk in the foreign market.