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An Internalization Approach to Joint Ventures: The Case of Coca-Cola in China

VINCENT MOK, XIUDIAN DAI AND GODFREY YEUNG

ABSTRACT

In the presence of high transaction costs due to market imperfections, it is normally less expensive for multinational corporations (MNCs) to conduct their business activities in new markets through their internal corporate structures rather than by relying on the markets. Based on a case study of Coca-Cola's entry into the Chinese market, this paper tests the applicability of internalization theory to explaining the entry mode choices of MNCs in developing countries. Internalization theory reveals the economic rationale that was behind the changes in Coca-Cola's modes of entry as it moved from franchising to joint ventures (JVs) with selected local partners, and more recently to the combination of JVs and franchising.

Key words: internalization, joint ventures, market imperfections, Coca-Cola, China.

INTRODUCTION

When a multinational corporation (MNC) enters into new markets, it is rather costly for it to conduct business activities in imperfect markets due to high transaction costs. These costs include those accruing from the problems of opportunism, small numbers of market agents, uncertainty, and bounded rationality, as outlined by Williamson (1975). He argued that the transaction costs of writing, executing, and enforcing contracts via the market are greater than the costs of internalizing the market. The situation is further

worsened when the business transactions involve complex contractual contingencies. As such, it appears that an MNC will prefer to establish wholly owned subsidiaries (WOSs) to deal with market imperfections. Apart from the choice of WOSs, there are also other commonly used modes, such as joint ventures (JVs). Based on a case study of Coca-Cola in China, this paper tests the applicability of the internalization theory to explain the entry mode choice of MNCs in developing countries.

Coca-Cola in China has been chosen as a case study for a number of reasons. First, Coca-Cola is the world's largest cola producer and one of the biggest MNCs. Second, Coca-Cola has a relatively long history of investment in China since 1979, when economic reform was implemented under the *de facto* leadership of Deng Xiaoping.[1] Third, faced with keen competition from its close competitor, Pepsi-Cola, and an unfamiliar and highly versatile local market environment, Coca-Cola's ability, experience and success in capturing a large market share in China seem to constitute an interesting case, upon which implications may be drawn for the understanding of MNCs' market entry into developing countries *via* establishing equity joint ventures (EJVs). Fourth, there are only two previous studies on the operation of Coca-Cola in China: Nolan (1995) and PU-TU-USC (2000). Based on a case study of the Coca-Cola bottling plant in Tianjin, Nolan (1995) conducted the first in-depth analysis of the micro-economic impact of a single Coca-Cola plant in China. He found that the Coca-Cola business system in general has positive impacts on the development of labour, capital and product markets in China. The findings of Nolan (1995) are in-line with the conclusion of the large-scale study conducted by a team of economists at Peking University, Tsinghua University and the University of South Carolina (PU-TU-USC, 2000). Based on an input-output model,

they estimate that the economic multiplier effects of Coca-Cola's capital investment and ongoing operation [including the upstream (suppliers) and downstream (distribution) business linkages in the Coca-Cola business system] in China generated a total of about 414,000 jobs, 21.7 billion *yuan* of output and 1.2 billion *yuan* of tax payment in 1998 (PU-TU-USC, 2000: ii-iii).

Despite the valuable information provided by the above meticulous studies, there is no specific literature providing the theoretical foundation for the entry mode choice of Coca-Cola in China. To fill this gap, this paper tests the applicability of the internalization theory in explaining the entry mode choice of Coca-Cola in China since 1979. The contributions of our paper not only produce implications for the applicability of the internalization theory, but also provide an insight into the market expansion strategy of a global soft drink manufacturer in China. It must be emphasized that other relevant impacts of the Coca-Cola businesses, such as the economic impacts of the Coca-Cola business system in China, are not the focus and thus will not be discussed in this paper.

METHODOLOGY

Internalization theory is used as a conceptual framework to analyse Coca-Cola's evolving modes of entry into the Chinese market. The framework helps to explain why JVs are the company's favoured choice of economic structure. This theoretical approach is complemented by empirical research that was conducted in China. The principal author made two research trips to China between November 1999 and March 2000. In addition to general data collection, face-to-face interviews were carried out with high-level management staff members of Coca-Cola. The General Manager of the Department of

Operations, and the Director of Marketing of Coca-Cola's head office in Beijing were interviewed in November 1999, and the Deputy General Manager of Coca-Cola's bottling plant in Tianjin was interviewed in March 2000.[2] Prior to the field visits, questions were sent to interviewees at Coca-Cola's head office in Beijing. For further details of the questions that were posed and other related information, see Appendix A.

Apart from discussing Coca-Cola's expansion in China since 1979, the interviews focused on the qualitative aspects of the company's business operations, in particular its relationship with local partners. Only rarely was this type of information obtainable from any other publicly available sources. To facilitate conversation in a friendly environment, all of the interviews were conducted in a semi-structured and informal manner. Chinese government officials were not present. Whilst each interview had a specific focus, open-ended questions were posed, and the interviewees were encouraged to guide the conversation as the situation allowed.[3]

Furthermore, throughout the process of research the principal author maintained close personal contact with Coca-Cola's regional office in Hong Kong, which was a reliable source of general and up-to-date information about the company's presence, operations and management in Southeast Asia.

In the following sections we discuss the key arguments that concern the entry mode choices of MNCs, and examine the economic rationale and conditions that allow JVs to be more efficient than WOSs. The discussion then extends to a brief review of the development of foreign direct investment (FDI) in China since the late 1970s, which is a process that is relevant to Coca-Cola's entry into the Chinese market. This is followed by an analysis of Coca-Cola's business strategy of internalizing the Chinese market since

1979. Finally, implications are drawn about Coca-Cola's experiences with reference to the market entry strategies of other MNCs.

THE ENTRY MODE CHOICES OF MNCs

Transaction costs are increasingly important for MNCs in the selection of host countries for FDI (Sara and Newhouse, 1995). According to Buckley and Casson (1976, 1985) and Hennart (1982, 1991), internalization theory proposes that in the event of high transaction costs which are caused by market imperfections, it is normally less expensive for an MNC to use its internal corporate structure to conduct business transactions rather than by relying on the market (McManus, 1972; Dunning, 1981). Imperfections may be the result of uncertainty in the market, the small number of agents that are available, opportunism or bounded rationality (Williamson, 1975; Buckley, 1992).

The internalization approach further suggests that a rational profit-maximizing MNC would tend to establish a WOS, either in the form of greenfield investment or the acquisition of another firm in the host country. However, there are other modes that MNCs can adopt to deal with market imperfections, *viz.* joint ventures.[4] It is crucial to identify the economic rationale behind the theory that the establishment of JVs may generate more efficiency gains than the establishment of WOSs for MNCs in the host country (Beamish, 1988: 96-101; Luo, 1998: 145-148).

According to Teece (1983), the basic argument for the attractiveness of JVs over WOSs is the potential for reaping revenue-enhancing and cost-reducing benefits. Lacking nation-specific knowledge of the host country, such as the nature of the local market (including its culture, business practices, contacts, *etc*.) and the local government, it could

be costly for an MNC to engage in business transactions involving writing, executing, and enforcing complex contracts with market intermediaries (Beamish, 1988; Meyer, 1998: 87-113). However, the usual attractiveness of an MNC is its possession of a rent-yielding asset. When an MNC's rent-yielding asset is combined with the assets of its local partners, the synergistic effect may produce more rents to offset the costs of forming JVs. The revenue-enhancing and cost-reducing potential in JVs may outweigh the advantages of WOSs (Stuckey, 1983; Hennart, 1991).

In the context of the transaction cost paradigm, an obvious question comes to mind: why and under what conditions are JVs a better solution than WOSs to the problems of opportunism, small numbers of market agents, uncertainty and bounded rationality? Some of the literature has touched upon this question, e.g. Buckley and Casson (1985), Beamish (1988) and Hennart (1991).

Opportunism**:** Williamson (1975) argues that the problems of opportunism while not uncommon, are not necessarily inevitable. Beamish (1988: 98) suggests that JVs can mitigate the problem of opportunism via mutual trust and forbearance. Based on mutual trust, both an MNC and its local partners would be more willing to tolerate their relationship in order to ensure the long-term viability of their JV. Relying on the managerial talent of the JV that may accrue from mutual trust may be a more efficient way of dealing with opportunism than relying on explicit legal efforts to complete all contingencies. Moreover, Casson (1990) explains that a high degree of trust between agents could promote economic performance. Berg and Friedman (1980) suggest that when there are reasonable mechanisms for profit division, joint decision-making and monitoring, both the MNC and its local partners would have less incentive to behave

opportunistically. Insofar as the mechanism for profit division is determined in an open manner and is accepted by all parties of the JV, they may be willing to aim for the same goal of long-term profit maximization. Consequently, the problem of opportunism may be mitigated.

***Small numbers of market agents*:** Small numbers of market agents can be an acute problem when an MNC wishes to seek a new venture partner in the host country. Since the initial local partner has cost advantage over other local market agents, it is thus not always optimal for the MNC to switch its partners. If the above-mentioned mechanisms for profit division, joint decision-making and monitoring are well-developed enough to sustain the viability of a long-term commitment of joint maximization of profits, there will be less incentive for both parties of the JV to switch partners (Contractor, 1985).

***Uncertainty*:** With the presence of uncertainty in the market environment, there is an incentive for an MNC to form a JV in order to economize on the information requirements for FDI (Mutinelli and Piscitello, 1998: 491-506). This objective can be achieved by pooling the resources of the MNC and its local partners (Caves, 1982). The competitive advantages of an MNC are its firm-specific knowledge in terms of technology, management and capital markets. The competitive advantages of its local partners are mainly their location-specific knowledge about the local market, such as its culture, business practices, contacts and the local government. The synergistic effects of combining the resources of all parties of the JV could possibly result in a lower long-term average cost accruing from uncertainty than in the case of a WOS.

***Bounded rationality*:** In his study of human behaviour, Simon (1957) used the term 'bounded rationality' to indicate that human beings have limited knowledge. In the

process of making a decision, the information and knowledge that are acquired by economic agents are limited. This in itself is one source of market imperfections. Despite the imperfection of human knowledge, economic structures are required to reduce uncertainty in the market environment (Hayek, 1945). When entering foreign markets, it is essential for MNCs to devise economic structures that lessen the costs of bounded rationality and minimize the losses from other sources of market imperfections (Sara and Newhouse, 1995). Beamish (1988) argues that the problem of bounded rationality also exists in JVs and WOSs. In fact, there is no substantial evidence to support the argument that this problem can be less severe in JVs than in WOSs. As an alternative mode of foreign market entry, JVs incur lower costs that are associated with the problems of opportunism, small numbers of agents and uncertainty under the conditions that are specified above.

Apart from discussing entry mode choices with reference to the transaction cost paradigm, some studies (e.g. Erramilli, 1996) suggest that the national culture of MNCs explains, to a degree, the variation in ownership levels of their FDI. However, the effect of the national culture on the level of equity ownership is not the focus of this paper.

FOREIGN DIRECT INVESTMENT IN CHINA

China has been considerably successful in attracting FDI since the implementation of economic reform in 1979. According to the Ministry of Foreign Trade and Economic Co-operation (MOFTEC), the total utilized value of FDI reached US$385 billion till October 2001 (Table 1). EJV has been the most popular mode for MNCs to enter the Chinese market during this period. The total number of EJVs reached 213,780 in October 2001,

accounting for 56 per cent of the total number of FDI firms in China. Together with other types of JVs [e.g. contractual joint ventures and joint R&D ventures], JVs owned and/or operated by Chinese and foreign firms accounted for 69 per cent of all firms with FDI. In comparison, there were 119,589 WOSs of foreign firms, which accounted for 31 per cent of the total number of firms with FDI.

[Insert Table 1 about here]

In terms of the share in the total utilized value of FDI, EJVs accounted for 45 per cent, amounting to US$172 billion, during the period 1979-October 2001 (Table 1). In comparison, WOSs accounted for 34 per cent of total utilized value of FDI at the same time. This suggests that the mode of EJVs was popular in China among foreign direct investors. During the two decades of economic reform, the Chinese market remained a relatively new territory for foreign firms. In other words, China was a typical 'imperfect market' for foreign MNCs – the result of, among others, uncertainty, small numbers of agents, opportunism, bounded rationality and a lack of knowledge about the local market. To reduce the risks associated with the 'imperfect market', JVs in many cases could be a more effective mode of entry than WOSs for the MNCs.

Coca-Cola's decision to invest in China represents one MNC's response to the growth opportunities that are available. That Coca-Cola considered different market entry models is indicative of the company's efforts to produce a strategy that was capable of coping with the potential problems of a new and 'imperfect' market. The choice of entry modes will be the focus of the next section.

COCA-COLA'S CHOICE OF ENTRY MODE IN CHINA

Given China's enormous population and relatively high growth rate of real GDP (about nine per cent on average since 1979), the country has long been viewed as an important market with great potential for many of the world's giant MNCs, including the carbonated cola producers Coca-Cola and Pepsi-Cola. To achieve unprecedented market accessibility, Coca-Cola utilized different modes of market entry over three different stages of operation after 1979. A brief outline of these three stages is as follows.[5]

- During the first stage (1979-84), Coca-Cola sold concentrate to its franchised Chinese-owned bottlers. Its local market agents were fully responsible for production and distribution. Market agents were opportunistic in running the bottling business because they wanted to focus on their bottom lines. This limited the expansion of Coca-Cola's market share.
- During the second stage (1985-92), Coca-Cola bought equity shares in the bottling businesses to reduce the effect of uncertainty and to restrict the opportunistic behaviour of its local partners.
- During the third stage (1993-present), Coca-Cola teamed up with two foreign bottlers, the Kerry group and the Swire group, under a franchise agreement. Apart from internalizing management control, Coca-Cola also internalized procurement transactions and the labour section of its bottling business by localizing its management team and upstream suppliers. The synergistic effect appeared to be high, and it brought revenue-enhancing and cost-reducing benefits to the company.

In 1992, there were about ten Coca-Cola bottling plants in the form of JVs, in which Coca-Cola only had minority shares. In eight years, eighteen new JVs were established. Coca-Cola has majority stakes (directly or indirectly) in all twenty-eight

bottling plants (Table 2). Among these only three plants located in Hainan, Tianjin and Shanghai are under the direct control of Coca-Cola. The Kerry Group and the Swire Group share the management of the other 25 plants. After investments of more than US$1 billion by the Coca-Cola system (including investments by the anchor and key bottlers) during the last two decades, Coca-Cola products are now available to about 80 per cent of the Chinese population via a comprehensive network of production and distribution systems (relying on both in-house direct distribution and third-party wholesale) all over the country (PU-TU-USC, 2000: 24). In 2000, the share of Coca-Cola brands (including Sprite and Fanta) in China's carbonated soft drinks market was 40 per cent, while that of Pepsi-Cola was only 15 per cent (Table 3) (Field survey, 1999 and 2000; hereinafter see Appendix A for further details about the field survey).[6]

[Insert Tables 2 and 3 about here]

The Franchise Mode of Entry (1979-84)

Franchise was Coca-Cola's entry mode during this period. The bottling plants were exclusively wholly owned by China's state-owned enterprises. Right after China launched its open door policy in 1979, Coca-Cola began a lengthy process of negotiation with the Chinese Government on accessing the Chinese market. The outcome of the negotiation was the permission for the sale of imported Coca-Cola soft drinks to foreigners only in China's three 'economic cities', viz. Beijing, Shanghai, and Guangzhou. Between 1980 and1984, Coca-Cola built three bottling plants in Beijing (1981), Guangzhou (1983) and Xiamen (1984) and then transferred all its ownership rights to various Chinese state-owned enterprises due to the restriction of Chinese government policy on the beverage sector. Foreign firms, such as Coca-Cola, were not

allowed to own bottling plants in China.[7] In return, the Chinese-owned bottling plants bought concentrate imported by Coca-Cola. On receiving the concentrate imported by Coca-Cola, the bottling plants added syrup, water, sugar and gas (CO_2) into the concentrate and the carbonated soft drinks were then ready for sale. Under this type of arrangement, Coca-Cola worked like a **wholesaler,** while the bottling plants were market agents, performing the functions of production and distribution. Furthermore, the only return for Coca-Cola's investment in China during the first stage was the sale of concentrate to the bottling plants. The profit from this type of business activity was considerably limited (Field survey, 1999 and 2000).

As all bottling plants were wholly owned by local Chinese enterprises, Coca-Cola had neither management rights in the operation of the plants, nor control over the volume of production, sales or distribution strategy, not to mention a long-term policy on penetration into the vast Chinese market. Being a *de facto* wholesaler of concentrate and facing uncertainty on the long-term accessibility in the Chinese market, Coca-Cola lacked market information or the permission by the Chinese government to expand its business in China. Besides, Coca-Cola faced problems of opportunism. Its market agents were invariably passive and merely focused on their own bottom lines (Field survey, 1999 and 2000; *Business China*, 19 February 1996: 1-2). They did not have the same goal as Coca-Cola to pursue a long-term marketing strategy for the soft drink business in China. This can largely be explained by the typical problem of a socialist regime in which the ownership rights of enterprises were not clearly defined. Claims on the residuals of enterprises were vague. On the operation side of the bottling business, Coca-Cola did not have any say on the output level. Although the local partners held the management and

control rights, their production behaviour was highly influenced by the operational policy of ‘promoting’ sales which was in turn subjected to the constraints of production targets (*yichan dingxiao*) (Field survey, 2000).[8] Under this policy, production units produced a level of output that was based on readily available raw materials, energy supply and production ability. Related distributors were expected to handle and market the output. The distributors provided the market information to the production units, but the producers decided the output level according to their readily available resources. In fact, the producers did not necessarily adjust their production outputs according to the market information. Consequently, there was often a disparity between output and market demand.[9]

Apart from the opportunistic behaviour of its market agents in China, Coca-Cola faced various uncertainties in the market environment, including uncertainties in the transport system and national wholesale networks. The transport system was at best primitive and antiquated, and at that time no wholesale network existed. In cities, large fleets of peddle-wheeled tricycles were still used to distribute soft drinks from one location to another. The distribution network was highly cost-ineffective and time-consuming (Field survey, 1999; Clifford, 1993). Thus, during the first stage of its entry into the market, Coca-Cola targeted bottling and concentrate plants in China’s coastal cities, where a greater degree of economic liberalization had enhanced the consumption ability of consumers (*AWSJ*, 15 February 1994: 1).

Faced with the above challenges, Coca-Cola’s expansion stagnated. By 1984 there were only three bottling plants in China (Table 2), and by 1985 the company’s

market share was less than two per cent (*Advertising Age*, 9 June 1986: 56). Such constraints greatly hindered the long-term objectives of Coca-Cola's FDI in China.

The Joint Venture Mode of Entry (1985-92)

In order to penetrate the Chinese market, Coca-Cola prepared to internalize its market transactions by acquiring the management rights to the bottling plants through the establishment of JVs.[10] With its liberalization policy to attract FDI in the mid-1980s, China permitted Coca-Cola's bottling partner in Macau and a local enterprise in Zhuhai to form the first JV bottling plant in 1985. In order to handle the uncertainty on market expansion and to mitigate the constraints compounded by the opportunistic behaviour of its local partners, Coca-Cola started to actively involve in the operation of the bottling plants by entering into JV arrangements with local partners. This marked the beginning of the second stage of mode of entry in China (Field survey, 2000).

In 1986, Coca-Cola was allowed to build a concentrate plant in Shanghai in the form of WOS. To keep concentrate plants in the form of WOSs was, and still is, Coca-Cola's strategy to safeguard the formula of producing its concentrate.[11] In return for the permission to run the concentrate plant on sole-proprietorship, Coca-Cola let its Chinese partners hold the ownership of the bottling plant, which was jointly built near the concentrate plant in Shanghai. Coca-Cola entered a 50-50 JV with the former Ministry of Light Industry (now called the State Light Industry Bureau, reporting to the State Economic and Trade Commission) and the Shanghai Investment and Trust Company to establish the Shanghai Shenmei Beverage Co. Ltd. in 1986 (Field survey, 2000). The

business relationship between Coca-Cola's concentrate plants in Shanghai and its local partners is delineated in Figure 1.

[Insert Figure 1 about here]

Meantime, the Chinese Government actually still maintained tight control over the development of soft drink industry in China with an aim to nurture local Chinese brands. This was mostly due to the shortage of fund for local soft drink makers to catch up with foreign soft drink makers, notably as Coca-Cola and Pepsi-Cola (*South China Morning Post (SCMP)*, 8 June 1996: 6). Coca-Cola might have had limited knowledge about the paternalistic attitude of the Chinese Government to protect its local brands. This was a problem of bounded rationality faced by foreign firms (Field survey, 2000). However, with its liberalization policy to attract FDI and partly due to the opening up of the beverage market in China since the mid-1980s, foreign soft drink makers such as Coca-Cola were allowed to jointly own bottling plants with local partners but at minority shares (Table 4). The number of Coca-Cola's bottling plants had increased rapidly from four in 1985 to ten in 1992 (Table 2). A decade after re-entering the Chinese market, Coca-Cola's business in China started to become profitable in 1990 (PU-TU-USC, 2000: 15). Coca-Cola's strategy was to **acquire management rights** of its JVs regardless of the amount of its shares in the plants. The main objective was to exert control over the bottling operations, otherwise, the opportunistic behaviour of the market agents would seriously hamper the growth of Coca-Cola business in China. For example, Coca-Cola only acquired 25 per cent of shares in its JV bottling plant in Hainan, yet its local partners focused on retaining a controlling block of shares. By surrendering their management rights to their Western partners, the local partners could earn decent profits by off-loading

part of their shares in bottling plants. In addition, the local partners hoped to learn the management expertise of western MNCs. On acquiring management rights, Coca-Cola had the authority to appoint general managers to consolidate the production and marketing of its products in China (Field survey, 1999).

[Insert Table 4 about here]

During the second stage, when the entry mode was JVs, Coca-Cola faced several constraints to further expand its business in China. Some of them were basically the same as those in the first stage. The behaviour of its local partners was opportunistic, in that they still wanted to focus on their own bottom lines rather than the maximization of Coca-Cola's market share in China. More importantly, the local partners did not have a strong grasp of the concept of marketing and market share. The operational policy of *yichan dingxiao* highly constrained the growth potential of the JVs in the carbonated soft drinks market. Another serious difficulty faced by Coca-Cola was its limited knowledge (i.e. bounded rationality) to fully appreciate the financial difficulties that were faced by its local partners for a long-term expansion strategy of their JV businesses. This was largely because Coca-Cola's partners were partially owned by local governments or various ministries. They were too poor to finance the JV expansion (Field survey, 1999 and 2000).[12] Furthermore, any major decisions about additional investment from the JV partners had to be approved by the corresponding governments or bureaux. The transaction costs that were involved in cutting through local government red tape were very high. Besides, Coca-Cola was constrained by the rigidities in the labour market and the lack of experienced managerial staff with whom to oversee new plants. As a result, the company's market share increased only slightly during the second stage of its entry.

Between 1992 and 1993, when local soft drink producers controlled up to 70 per cent of the market, Coca-Cola's market share stagnated at 12 per cent (Table 3).

A Hybrid Mode of Entry (1993-Present)

To reduce the impact of the above problems, Coca-Cola internalized the market transactions through its strategy of long-term investments combined with its control of production and the domestic distribution channel. In addition, the company also internalized the procurement transactions and labour market of its bottling business by localising its management team and upstream suppliers. During the 1980s, most of the inputs, such as glass bottles, aluminium cans, polyethylene terephthalate bottles, were imported because the locally produced ones failed to meet the standard established by Coca-Cola. With technical assistance from Coca-Cola, a number of Chinese suppliers are able to produce the quality products demanded by Coca-Cola. Since the mid-1990s, more than 98 per cent of the supplies were sourced in the local Chinese market (*AWSJ*, 5 March 1996: 3; PU-TS-USC, 2000: 22-23).

For the market expansion in China, Coca-Cola's strategy was to ensure that the company was not excessively involved in production and distribution. A cost-effective way to reduce risk and to overcome the problem of shortage of human resources was to manipulate the business functions indirectly through a **franchise arrangement with foreign partners**.[13] As such, Coca-Cola teamed up with two foreign bottlers, namely Malaysia's Kerry Group and Hong Kong's Swire Group. The Swire Group mainly produces and distributes Coca-Cola products in southern and central China, while the Kerry Group focuses on northern and interior China. These foreign partners were able to bring in capital and human resources. The Coca-Cola bottling business was undertaken in

the form of a JV between Coca-Cola and its local partners.[14] The involvement of the Kerry Group and the Swire Group was in the form of a franchise agreement with Coca-Cola. This arrangement has shaped the basic features of the third stage of Coca-Cola's business development in China (Field survey, 1999). Together, Coca-Cola's franchising arrangements with foreign partners (i.e., the Kerry and Swire Groups) and its JVs with Chinese partners constitute the main elements of the company's internalization strategy.

Franchising is a method of producing and/or marketing goods and services in which the franchiser customarily grants the franchisee the right, or privilege, to operate the business in a prescribed manner over a period limited by the term of the franchise agreement. A large element of the franchise represents the market alternative to the internalized transfer of managerial and marketing skills (Buckley and Casson, 1985: 45-49). In the case of Coca-Cola in China, the transfer includes manufacturing technology (Field survey, 2000). Mendelsohn and Bynoe (1995: 7) noted that "the investment in and ownership by the franchisee of the franchised business is a key feature (of franchising) since the franchisee is committed by his investment and expected, as owner, to be better motivated than would be a manager. Although there are references to the business being owned by the franchisee, there are two factors that make that ownership different from that enjoyed by a non-franchised businessman. The franchisee must operate under the franchiser's name, using his system and within the terms of the franchise agreement." They added that the ability of a franchised business to achieve growth is by linking the franchiser with his franchisees, who possess the capital and manpower to operate the business. This type of agreement fundamentally addresses the shortages of capital and human resources faced by Coca-Cola in its strategy of expanding market share in China.

The above mode of investment by a hybrid of JVs and franchising could potentially bring in revenue-enhancing, cost-reducing and risk-avoiding benefits to Coca-Cola. Coca-Cola possesses rent-yielding assets, *viz.* the technology of producing Coca-Cola and marketing expertise. Its local partners have the advantages of strong distribution arms and knowledge of local beverage markets (the nation-specific knowledge mentioned by Beamish (1988: 106)). The Kerry and Swire Groups are rich in cash, share the goal of long-term profit and market share maximization of Coca-Cola, and have strong political connections to the Chinese Government. The synergistic effect of combining the assets of various parties appeared to achieve the objective of maximization of Coca-Cola's beverage market share in China. For instance, Coca-Cola was able to capture a market share of 40 per cent in 2000, almost three times that of Peps-Cola, its close international competitor (Table 3). These revenue-enhancing and cost-reducing potentials in JVs outweighed the advantages of WOSs. One way to guarantee these benefits was to make sure that the Kerry and Swire Groups obtained management rights in overseeing the bottling plants and assuming direct control of distribution via the acquisition of majority shares in the JV bottling business in China. The Kerry Group has in fact obtained about 50-60 per cent equity shares of all its bottling plants, while the Swire Group was able to keep a controlling block of shares at 51 per cent in the bottling plants under its management control (Field survey, 1999 and 2000).[15]

It has been argued that ownership is often used to control residual rights in international operations. An MNC's ownership share in its foreign operation reflects the importance of the assets used in its operation and more importantly the bargaining power relative to its local partners (Nakamura and Xie, 1998: 571-99). Coca-Cola started to

negotiate with the Chinese Government in the early 1990s to buy-out the majority shares of all existing and newly planned bottling plants. The negotiation process was lengthy and difficult. The local partners were demanding high prices for the buy-outs, based on unreasonably high levels of projected future earnings.[16] How to resolve the problem often relates to the art of 'give and take'. The prime wish of the Chinese Government was for Coca-Cola to transfer its asset-specific knowledge and equipment in beverage production to its local partners to develop local branded beverages (*SCMP*, 27 January 1994: 14). This arrangement could be worked out in the form of a JV. For example, through the set-up of a new 50-50 JV in Tianjin with China's Ministry of Light Industries, Tianjin Jinmei Beverage Co. Ltd., Coca-Cola has been helping its local partners in Tianjin to develop some local branded drinks, e.g. *Xingmu* ("Smart") soft drinks, *TianYuDi* ("Heaven and Earth") fruit juice drinks, tea and bottled mineral water (Wang, 1998).

IMPLICATIONS OF COCA-COLA'S CHOICE OF ENTRY MODE

A review of Coca-Cola's business development in China during the first two stages of its market entry (1979-1992) highlights four major challenges to the company's long-term development strategy:

- Initially, the Chinese market was highly fragmented, and the wholesale and distributional systems were outdated. This was further complicated because Coca-Cola was the *de facto* wholesaler of concentrate, and did not have access to the operation of the bottling plants. To add to this problem, the company's local market agents were fully responsible for production and distribution during the initial stages of market entry.

- Coca-Cola's local partners played a passive role in the company's market entry. Market agents acted out of self-interest and were opportunistic in running the bottling business. They had neither a strong incentive to acquire market share nor a long-term development strategy.
- The Chinese government exerted tight control over the development of the soft drink industry and was careful to nurture domestic brands. Coca-Cola was not permitted to enter into a JV bottling business with its local partners until 1985, and even then it was restricted to a minority stake.
- The local partners were too poor to finance further business expansion. As they were partially owned by local governments or various ministries, the major investment decisions that were made by the JV partners had to gain official approval. These experiences explain why Coca-Cola's market share increased but slightly before the early 1990s.

The first two challenges can be regarded as the high transaction costs that were incurred through **uncertainty** in the market environment and the **opportunistic behaviour** of market agents. The following two challenges were consequences of **bounded rationality**. Coca-Cola might have had limited knowledge about the paternalistic attitude of the Chinese Government in nurturing indigenous soft drink makers. It was certainly difficult for Coca-Cola to fully appreciate the financial difficulties that were faced by some of its local partners in expanding business operations. These challenges were further intensified by opportunism and uncertainty in the market environment. To reduce the impact of these constraints, a change in Coca-Cola's operations was required.

To overcome the above challenges, Coca-Cola internalized market transactions through a strategy of long-term investment and, with the approval of the Ministry of Light Industry, was able to co-ordinate this with an increased control of production and domestic distribution. In the highly competitive market share driven business of carbonated soft drinks, to assume control of production and distribution is strategically essential. This meant that the acquisition of majority stakes in the bottling plants is almost a prerequisite for gaining the control over management. However, gaining this control was costly. To reduce the high risk of direct investment, Coca-Cola teamed up with two foreign bottlers under a franchise agreement. The synergistic effect of pooling the resources of Coca-Cola, its local partners and its foreign bottlers was high, and it delivered revenue-enhancing and cost-reducing benefits.

CONCLUSIONS

This paper applies the internalization theory to explain the entry mode choice of Coca-Cola in China since 1979. The findings not only have implications for the applicability of the internalization theory, but also provide an insight into the market expansion strategy of a global soft drink manufacturer in China. To examine the change in Coca-Cola's mode of market entry from franchises to JVs, and then to the current combination of franchises and JVs, we have employed internalization theory to address the issue of how and to what extent shifts in various investment modes can reduce the effects of market imperfections. Furthermore, the empirical data that we have presented suggest that adjustments in Coca-Cola's modes of investment have contributed to a steady growth in market share and a high degree of market penetration in China.

This paper complements the existing literature on Coca-Cola's business in China, e.g. Nolan (1995) and PU-TU-USC (2000), and argues that internalization theory is a useful conceptual framework for the analysis of its modes of investment in China. However, the application of any theoretical approach to firm-level study may be affected by deviations at the sectoral level, and by government policies. Moreover, national culture at the macro-level is also influential. Hence, any generalizations that are drawn from the present study of Coca-Cola's experiences in China must be treated with care. Further studies should focus on local perspectives, in particular those of Coca-Cola's Chinese JV partners and franchisees.

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NOTES

1. Coca-Cola soft drinks first appeared on the Chinese market in 1923. The first bottling plant was built in Shanghai in 1927. Soon afterwards, Coca-Cola was bottled in other cities, including Tianjin in 1927 and Qingdao in 1930. The company left China after the socialist regime came to power in 1949 (Wang, 1998: 36).
2. Each of the two interviews in Beijing lasted for approximately one and a half hours. The interview in Tianjin lasted for almost two hours, and was followed by a working lunch for another one and a half hours.
3. Similar research methods have been used by many academics. Among others, see Yeung (2001: 8-12). Besides, in the context of the global economy, Nolan (2001) presents detailed case studies of the interaction between China's big enterprises system and the global business revolution.
4. There are two major types of JVs, *viz*. equity joint ventures (EJVs) and contractual joint ventures (CJVs). The former is characterized by a long-term relationship among the partners that manage the JV. The latter, in contrast, has the basic feature that the partnership will dissolve after a specified period (Yeung, 2001: 3-6).
5. The three different stages were suggested by the interviewees (Field survey, 1999, see Sections [I] and [II] in Appendix A for further details).

6. The interviewees were reluctant to disclose Coca-Cola's sales value in China, which was regarded as a commercial secret.
7. The Chinese Government exerted tight control over the development of the soft drink industry to nurture domestic brands (Field survey, 2000; *Asian Wall Street Journal (AWSJ)*, 15 February 1994: 1).
8. Literally, '*yichan dingxiao*' means that the output level (rather than the market demand) determines sales and distribution (Yu, 1991: 380). In a report on the branding revolution in China, Schlevogt (2000) explains the evolving behaviour of Chinese managers in production and marketing, as well as their attitudes towards branding, from the central planning era to the current competitive period. He shows that during the central planning era, production depended on resource availability but not on market demand.
9. Quite often, producers were not concerned about product quality because they were not responsible for marketing. Consequently, products went unsold and had to be stockpiled in warehouses. This was a common production problem in the pre-reform era in China. See Dong, 1987:52-53.
10. However, Coca-Cola was restricted to minority stakes in the plants.
11. In the late 1970s, the Indian Government requested Coca-Cola to publicize the ingredients of its concentrate. The company preferred to abandon the market rather than comply (*Economist*, 15 July 1989: 67).
12. For example, when the Chinese government selected one local enterprise to form a JV with Pepsi-Cola, it was found to be bankrupt (*Business China*, 19 February 1996: 2).
13. Approval from the former Ministry of Light Industry and the State Economic and Trade Commission to build an additional ten bottling plants in 1993 made it necessary for Coca-Cola to expand its operations in a more cost-effective manner (PU-TU-USC, 2000: 16).
14. Coca-Cola has been very selective in choosing its Chinese JV partners. Partners have been confined to the China International Trust and Investment Corporation, the China National Cereals, Oils, and Foodstuffs Import and Export Corporations and affiliates of the former Ministry of Light Industry (PU-TU-USC, 2000: 19-21).
15. For example, in Xiamen, the bottling plant was 51 per cent owned by the Swire Group. A local partner, Xiamen Luquan Industrial General Company, held the remaining 49 per cent. The plant had an annual production capacity of 30 million unit cases (*AWSJ*, 11 May 1998: 4).
16. The Deputy General Manager of the Tianjin bottling plant was quite assertive on this point. However, he was not willing to release information on monetary figures in the bargaining process. He informed us that Coca-Cola promised to help its local partners to develop local branded beverages, among other terms, to arrive at an agreement for the Coca-Cola buy-out of the majority of shares of all existing and planned bottling plants (Field survey, 2000).

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APPENDIX A: QUESTIONS POSED DURING THE THREE INTERVIEWS TO COCA-COLA COMPANY IN CHINA, 1999-2000

[I] First Interview in China
Date of Interview: 18 November 1999
Time: 9:30 a.m. – 11:00 a.m.
Place: Department of Operations, Coca-Cola's head office in Beijing
Interviewee: General Manager of Operations

(A) General background, history, and figures

(1) How many subsidiaries do you have in China in 1999? Can you give me a breakdown by nature of ownership/relationship? Among these, what are the involvement of Kerry Group and Swire Group?

(2) Please tell me about the changes in the number of Coca-Cola subsidiaries, in particular the number of joint ventures during the period after Coca-Cola has re-entered China. (e.g. early 1980s, mid-1980s, early 1990s, and mid-1990s).

(3) What is the total number of employees in Coca-Cola China Ltd? How many of them are managerial staff? Among them, how many are Chinese nationals recruited from the local market in China? How many are expatriates from overseas, including US/HK *etc*.?

(B) Strategy of expansion and changes in business environment in China:

(4) Coke has bought the majority equity of bottling plants and distribution channel in mid-1990s. Why has the strategy of Coke changed in such a direction? Was this change attributed to the behaviour of hold-up and opportunism of Coke's partners in China when Coke wanted to expand its market in China during that period?

(5) In relation to point (4), we have an initial suspicion. Whilst equity joint ventures (EJVs) were an important mode (and absolutely necessary by host-country law) for Coke to re-enter the Chinese market in early 1980s, was the costs of doing so might be too high to Coke.

(C) Uncertainty and specific advantages in the execution of contracts / business operation

(6) On the issue of uncertainty in the business environment in China, over the period of the last two decades, did Coke suffer/benefit from changes in China's policy regarding foreign direct investment as far as carbonated soft drinks sector is concerned?

(7) In terms of asset specificity endowed in the Coke's product, what were the bargaining chips of Coke in the negotiation processes with its partners in China?

(8) What sort of "specific" advantages did the Chinese partners have? "Specific" advantages mean those advantages that were not easily provided by other firms in China. It being so, what were the bargaining chips of Chinese partners in the negotiation processes with Coke? Did those bargaining chips bring in some favourable terms to the Chinese partners?

(9) On the issue of small number of agents in the operation of bottling plants in China, did Coke face difficulties in writing, executing and enforcing complex contracts with the Chinese partners? Any examples of damages/add extra costs to Coke?

(D) Technology transfer

(10) Is there any government requirement for technology transfer? How do you cope with this requirement?

(11) Have you identified any damage/risk caused by your previous Chinese partners (in terms of trade secrets, technology, *etc*.)?

(E) Coke's investment in China, and other issues

(12) What are the main incentives for local partners to collaborate with Coca-Cola?

(13) After weighing over all sorts of benefits and costs to Coke's investment in China, do you see the collaboration with local partners in the form of joint ventures an advantage or a risk to the company? In what aspects?

[II] Second Interview in China
Date of Interview: 19 November 1999
Time: 10:00 a.m. – 11:30 a.m.
Place: Department of Marketing, Coca-Cola's head office in Beijing
Interviewee: Director of Marketing

(A) General background, history and figures

(1) Please provide me with the figures of market shares and sales volume (in bottles) of Coke in the last three years in China. (and Pepsi as well, if available)

(2) Coke has been bottled in 13 sites in China in 1994. It has majority equity in all 16 bottling plants in 1996. In 1998 and 1999, how many bottling plants does Coke have?
Among them, how many are state-owned plants?
Why to allow state-owned plants to produce bottled Coke?
What are the other forms of co-operation with Chinese partners?
Among them, how many are under equity joint venture and the corresponding percentage of equity?

(B) Marketing: Coke and its competitors

(3) What are the major factors contributing to the success of Coke in terms of its marketing strategy? Can we say that Coke's achievement reflects its status of success as marketer and a franchiser, but not as a manufacturer or a distributor?

(4) Before 1996, the distribution was handled by state-owned third party wholesalers. They were criticised being invariably passive. Why? Opportunism? Incentives?

(5) In 1996, Coke adopted a hybrid distribution system consisting of direct distribution & third party wholesalers. Why Coke adopts the hybrid distribution system? Is it due to cost reducing or else? Any hold-up behaviour of third party wholesalers?

(6) In relation to point (5), implementing direct distribution requires direct management controls. Was gaining this control expensive? How long was the period of calculating the projected future earnings? How much did this increase Coke's costs to acquire the buy-out? Do you think this is a hold-up/opportunistic behaviour?

(7) Distributing goods in China appears to be an expensive business. The privatisation of logistic businesses in China brings in competition, which may bring prices down. How true is it?

(8) In relation to points (3) & (5), what are the roles of Robert Kuok's Kerry Group & Swire Group?

(9) Pepsi is lagging behind Coke in the Chinese market. This is partly due to the fact that Coke has successfully explored the 'first-mover advantage'. Are there other reasons?

(10) What kind of competition do you have from the domestic soft drink manufacturers?

(C) Joint venture and other alternative arrangements

(11) How important are the JV arrangements for Coke to initially get into the Chinese market?
(12) Can you provide an overview on the Coke's operation in China since 1979 with particular reference to their joint venture (JV) arrangements

(D) Regulations and *guanxi* in China

(13) What is your experience in dealing with policymakers and regulators in China? Is the bureaucratic process less efficient that that of many other developing countries?

(14) How important is *guanxi* to the successful operation of Coke in the Chinese market?

(15) What are the 'grey areas' (semi-legitimate areas) in Chinese regulations and government policy regarding foreign investment in the soft drinks industry? Do these 'grey areas' add costs or provide opportunities for Coke?

[III] Third Interview in China
Date of Interview: 29 March 2000
Time: 10:15 a.m. – 12:00 noon
Place: Coca-Cola's bottling plant in Tianjin
Interviewee: Deputy General Manager, Coca-Cola's bottling plant in Tianjin.

Questions asked in the interview: We did not fax questions to the Deputy General Managers before the visit. The principal author conducted the interview in a semi-structured mode. Questions were selected from the above list.

TABLE 1
MODES AND STRUCTURE OF FOREIGN DIRECT INVESTMENT IN CHINA
(1979 – OCTOBER 2001)

Mode of FDI	*Number of Firms*	*Percentage of Total Firms*	*Actual Utilization of FDI (US$100 million)*	*Percentage of Total Utilization of FDI*
Equity Joint Ventures	213,780	55.59	1,717.64	44.64
Co-operative Joint Ventures	51,046	13.27	761.69	19.79
Joint R&D Ventures	180	0.05	70.78	1.84
Wholly-Owned Subsidiaries	119,589	31.09	1,297.73	33.73
Total	384,595	100	3,847.84	100

Source: Adapted from MOFTEC (2002).

TABLE 2
NUMBERS OF COCA-COLA'S BOTTLING PLANTS IN CHINA, 1982-2000

Year	*No. of Bottling Plants in China*
1982	1
1984	3
1985	4
1992	10
1993	11
1996	16[a]
1999	24[b]
2000	28

Note: The numbers of Coca-Cola bottling plants in China do not correspond directly to Table 4 because some JV bottling plants have been re-named since Coca-Cola bought the majority shares.

Sources:
[a]: *Asian Wall Street Journal (AWSJ)*, 31 May 1996: 12.
[b]: *AWSJ*, 26 November 1999: 11.
Others: Field survey, 1999 and 2000.

TABLE 3
MARKET SHARES OF COCA-COLA AND PEPSI-COLA IN CHINA
(PER CENT)

Year	*Coca-Cola*	*Pepsi-Cola*
1992	12[a]	5[a]
1993	12[b]	7[c]
1994	19[d]	N.A.
1995	23[e]	N.A.
1996	26[f]	9[f]
1998	33[g]	11[g]
2000	40[h]	15[h]

Note: N.A. = not available.

Sources:
[a]: *AWSJ*, 15 February 1994: 1.
[b]: *AWSJ*, 27 Jan 1994: 1.
[c]: *South China Morning Post (SCMP)*, 27 January 1994: 14.
[d]: *SCMP*, 22 July 1995: 3
[e]: *AWSJ*, 31 May 1996: 12.
[f]: *SCMP,* 3 March 1998: 4.
[g]: *China Daily*, 19 September 1999: 7.
[h]: Field survey, 2000.

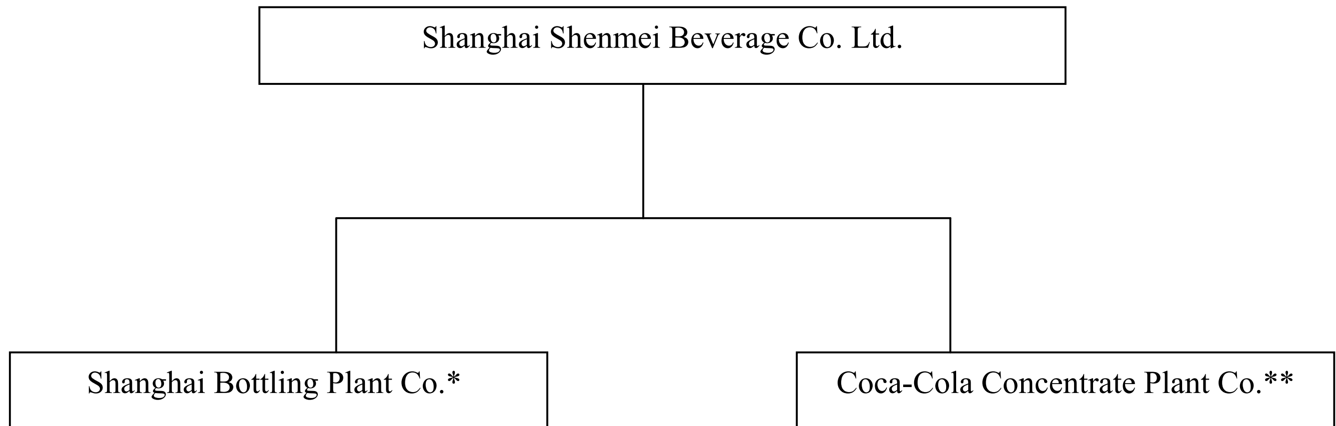
TABLE 4
LOCATION AND NAME OF COCA-COLA'S JOINT VENTURE BOTTLING PLANTS IN CHINA, 2000

Location	*Name of the Joint Venture Bottling Plant*	*Year of Start*
1. Beijing*	Coca-Cola Beverages (Beijing) Ltd.	1981 & 1999
2 Chengdu	Coca-Cola Beverages (Chengdu) Ltd.	1995
3 Dalian*	Coca-Cola Beverages (Dalian) Ltd.	1987 & 1993
4 Guangzhou*	Taigu-Coca-Cola (Guangzhou) Ltd.	1983 & 1999
5 Harbin	Coca-Cola Beverages (Harbin) Ltd.	1996
6 Haikou	Coca-Cola Beverages (Hainan) Ltd.	1991
7 Hangzhou	Zhongcui Food (Hangzhou) Ltd.	1989
8 Hefei	Taigu-Coca-Cola Beverages (Hefei) Ltd	1996
9 Kunming	Coca-Cola Beverages (Kunming) Ltd.	1996
10 Nanjing	Zhongcui Food (Nanjing) Ltd.	1989
11 Nanning	Coca-Cola Beverages (Nanning) Ltd.	1994
12 Qingdao	Coca-Cola Beverages (Qingdao) Ltd.	1997
13 Shanghai*	Shenmei Food (Shanghai) Ltd.	1986 & 1998
14 Shenyang	Coca-Cola Beverages (Shenyang) Ltd.	1995
15 Taiyuan	Coca-Cola Beverages (Taiyuan) Ltd.	1994
16 Tianjin	Coca-Cola Beverages (Tianjin) Ltd.	1990
17 Tianjin	Jinmei Beverages (Tianjin) Ltd.	1987
18 Wuhan	Coca-Cola Beverages (Wuhan) Ltd.	1993
19 Xian	Zhongcui Food (Xian) Ltd.	1995
20 Xiamen*	Taigu-Coca-Cola Beverages (Xiamen) Ltd.	1984 & 1996
21 Zhengzhou	Taigu-Coca-Cola Beverages (Zhengzhou) Ltd.	1995
22 Zhuhai	Coca-Cola Beverages (Zhuhai) Ltd.	1985
23 Dongguan	Taigu Beverages (Dongguan) Ltd.	1997

Note: * with two bottling plants

Sources: Field survey, 1999 and 2000; PU-TU-USC, 2000:17-18; Wang, 1998: 36.

FIGURE 1
THE OPERATIONAL MODE OF COCA-COLA BUSINESS IN SHANGHAI
DURING THE 1980s



Notes:

* This was wholly-owned by a state-owned enterprise. Coca-Cola had no involvement in production, distribution, or profit-division of the company.

** This was (and still is) wholly-owned by Coca-Cola.

Source: Field survey, 1999 and 2000.