

Dusko Lukac

Key Success Factors for Foreign Direct Investment (FDI)

The Case of FDI in Western Balkan



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1 Executive Summary

International expansion present new opportunities for companies to generate extra value added and have become a vital aspect of corporate strategy development and implementation. Nowadays most European Foreign Direct Investments (FDI) within European continent outflows towards Eastern Europe in the countries like Hungary or Czech Republic. Each nation-state will have some competitive advantages. Why should non-for-profit company like RFH choose to enter just Bosnian market, the country which was destroyed by the war a few years ago and where progress is still needed in many areas and not some of markets mentioned above? Which special strategic and legal issues non-for-profit organisation must consider in such case? Why choices of investment locations, mode of entry and initial pricing strategy have critical impact on value added to the firm's competitive advantage?

This report will give answers on these and further arising questions. It concerns Information technological (IT)-Centre of one German non-for-profit organisation (RFH), and its attempts to benefit of global capital while diminishing the negative effects of economic swings in the home country. On studying and analysis of the literature relevant and reliable sources of information, to invest in Bosnia and Herzegovina in the vocational training and educational sector is nowadays moreover absolutely a recommendable commercial decision. All economic indicators argue for it. The analysis determinate four main reasons for it:

- Improvement of vocational Training and Adult Training sector is one of the emergent sector priorities settled in governmental Poverty Reduction Strategy Paper and European Commission "Feasibility Study" as a precondition for cooperation between EU and Bosnia.
- Local competition in the area of Vocational and Adult Training is extremely weak (currently there are existing only 2 private companies similarly to RFH).
- Bosnian market offers enough potential customers which may use Vocational and Adult Training offers. These customers are local industry as well as students, scholars and unemployed people (Rate of unemployment in Bosnia amounts to 43%).
- A row of investment incentives and financial incentives are offered by European Union (EU), Bosnian government and Germany they reduce risks of FDI in Bosnia.

The idea of the expansion is interesting for every company, but, nevertheless, it requires detailed analysis of foreign market. This report includes *determination and analysis* of basic

FDI conditions, competition analysis and *development of key success factors* for FDI in educational sector in Bosnia. Furthermore, the analysis in this work determines how the RFH is affected by local business conditions and what are its strengths and weaknesses on the Bosnian market.

The following major points can be ascertained from the report:

- Analyses have shown that FDI is as the best mode of entry for company which offers separable services on the Bosnian market, in educational sector.
- Foreign firm performance is determined not only by firm-specific characteristics, but also by location. Investigations have indicated that Banja Luka compared with Sarajevo has more favourable investment conditions with regard to expenses and legislation within the single entities in Bosnia.
- Ltd. is the most appropriate company legal form for RFH subsidiary in Bosnia.
- Pricing and product differentiation combined with response to local needs are the source for competitive advantage.
- Most favourable source for financing of international business by credit is the offer by KFW (German Loan Corporation for reconstruction).
- Recommended assistance sources for RFH are offers by the German government, the so-called PPP (Public Private Partnership) and offer by EU, so called CARDS-Program.
- Combination of incentive systems and control of subsidiary in the form of output control is most appropriate initial way for RFH to conduct the business abroad.
- RFH benefits of choose of international division structure.

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3 Introduction

The aim of the work is to investigate and examine the success factors and conditions for Foreign Direct Investment (FDI) in the educational sector, in South Eastern Europe for Western European enterprises, with country focus on Bosnia and Herzegovina.

This work deals with considerations and intention of Information technological (IT)-Centre of one non for profit company (RFH) to set up the branch in Bosnia, which should offer occupational and vocational training courses. This FDI activity is considered to be used as possible alternative way of funding.

RFH is non-for-profit organisation, private university in free sponsorship. The responsible body *RFH* (Incorporated Society) is responsible for the establishment, the maintenance and the organization of the university (RFH, 2005). University is sponsored financially partly by the state. RFH works with long-standing experience in the area of the IT-services as well as the continuing education and vocational training in different areas, inter alia the areas of usage of the topical industrial software applications. RFH provides among other things certificate-linked courses as for example Cisco Network Academy courses (certificated continuing education in the IT area), Catia V5 courses (construction software for the automobile industry), E-Plan courses (Certificated continuing education in the area of computer aided engineering) etc.. For instance, Eplan application is used for all computer-assisted electrical engineering tasks, both prior to and during the development of a product and is most-used industrial engineering software globally (Eplan, 2005). The kinds of courses which are provided by IT-Centre of RFH in Germany are very popular at the home market, what doesn't justify assumption at all that these will be accepted on foreign market. Entering new markets with new or existing products is fraught with challenges (Koudal, 2005). Thus precisely investigations of foreign market are necessary.

Bosnia and Herzegovina have got out a little from the vantage point in the euphoria around the EU Eastern extension (Bfai, 2004). It led to interesting development of business conditions in certain areas. While some of the sectors like Training and Adult Training sectors are underdeveloped in Bosnia (PRSP, 2004), in the same time developing sectors, like local automotive and IT industry has a huge demand for skilled labour, products and services. Due to lack of suitable know-how on the local-market a local Bosnian companies often concluding the contracts and place an order to Croatian, Serbian or even German companies (Lorenz, 2003). Improvement of educational sector in Bosnia, especially vocational Training and Adult Training sector is one of the emergent sector priorities settled

in Bosnian governmental Poverty Reduction Strategy Paper and European Commission "Feasibility Study" (IBF International Consulting and the British Council, 2004) as one of the steps *"to be taken by Bosnia and Herzegovina to prepare for a Feasibility Study on opening Negotiations on a Stabilisation and Association Agreement"* (Commission of the European Communities , Report from the Commission to Council , 2003). Vocational education in Bosnia must enable its recipients to use the skills they have acquired at school and to swiftly enter the labour market. It is of *"utmost importance to ensure that vocational education and training correspond with labour market needs"* (OSCE, 2005).

My research will rely on resource-based theory and partly on eclectic theory. At the beginning I'll investigate and theoretically analyse three basic decisions that firm contemplating foreign expansion should make (Lynch, 2003): *which markets to enter, when to enter those markets and on what scale*. In this work I'll also deal with the question of choosing of the most suitable expanding strategy, entry modes as well with the main *strategic issues in non-profit organisations*. I'll evaluate theory and current trends in co-ordinating of the subsidiary in Western Balkan.

Specific focus will be given to determination of organizational structure. As stated by Campbel, Goold and Alexander (1995), if there is a fit between parent and its business, the parent is likely to create the value. In this work I'll asses fit between RFH (corporate parent) and its business (subsidiary in Bosnia). This can help to identify opportunities of parenting, particularly if e.g. business-unit mangers in subsidiary abroad lack the time and skills to become expert in engineering and technical issues, parent company (an expert) can create values by helping the business unit raise technical standards. I'll analyse furthermore, all aspects they have impact on choice of business location, because determination of business location (Bishop, Gripaios and Gillian Bristow, 2003) and choice of new location supports not only the company's survival, but also its ability to continue to grow (Hsing, 2003). Location also influences development of customer retention strategy (Laurino and Lindel, 2004). Identification of appropriate means of control and coordination (Smith, 2002) as well as development of suitable financing policy and enabling policies (Pastakia, 2002) are further aspects they contribute to creation of competitive advantage. In this work I'll analyse them and will give according to analysis certain recommendations to RFH. I'll develop framework with basics of marketing and pricing policy, specially tailored for RFH international business in Bosnia. I'll also deal with legal issues concerning international and national business (e.g. legal specialties concerning non-for-profit organizations), considering questions like choice of most appropriate legal form for subsidiary in Bosnia or choice of legal business

representatives. Furthermore, it will be necessary *to design the* framework of decision-making responsibilities within the organisational structure and to establish integrating mechanism in order to *coordinate the activities of the subunit* in Bosnia. In addition I'll develop forecasting scheme in order to develop basics for financial policy and financial controlling of subsidiary on the Bosnian market. At least, alternatives for reduction of risks of international expansion will be illustrated as well as possibilities for foreign business coverage. In all mentioned issues concerning key success factors I'll refer to possible failure factors and sources of failures occurring in foreign business. *In order to make idea of this work in short time feasible* I will to descry necessary steps for successful FDI in Bosnia and Herzegovina, and give *recommendations* what are the main issues and problems to look up. To do that I'll critically review existing theoretical and practical approaches and apply them. The work should be also a general example for the company concerning the most important issues to look up, in the case of international expansion in South-Eastern Europe. *This Management Reports is developed according to the guidelines UEL* (Cocking, 2004) which contains predetermined structure and description how Management Report (MR) is commonly to be written. I used also further reading about how to write MR, especially the book Research Methods for Business Students from Saunders, Lewis and Thorhill (2003).

3.1 Occupational training as successful business idea

The globalisation of the markets concerns not only the industries produce the tangible products (Hodgetts and Rugman, 2003) as for example automobile industry or textile industry, which mostly move its production plants because of good wage conditions, in the cheap wage countries. More and more service suppliers like banks ,assurances, IT companies or educational institutions see a chance to achieve superior financial position through capture of the new finance markets (Martin, 2004) by e.g. the establishment of new subsidies in the cheap wage and poor countries in Eastern- or South Eastern-Europe, which above all make them available very good manpower (Bfai, 2003). A job can be seen as the start on the road out of poverty (Kemp, 2005), and the questions how one can get a good workplace or maintain it, are arising not only from people in the developed economic nations, but particularly also in the countries affected by the globalisation. Most people do need to acquire new skills if they want to remain competitive, or even employable, in the workplace (Hubbard, 2005). Computer training goals and software skills of employees should be updated and reviewed on a regular basis (Welch, 1993).

The times of the socialist system in many countries, as for example in the East-European or Southeast-European countries, where almost every one had established post, are over. The

fall of Communism is sharply boosting global competition and creating new markets (Manzella, 2004). The people (employers and employees) have realized that they are individually responsible for themselves and their career advancement and less the state. Hence, many people try to reach their career purposes by continuing education (Suarez-Orozco and Baolian Qin-Hilliard, 2005).

As stated by Manzella (2004) unemployment is lower among workers with higher levels of education, thus the companies they offer occupational training courses gain governmental support as a part of unemployment reduction strategy as well as a big customer base (especially in countries with high level of unemployment like Bosnia) which allows educational institutions to achieve superior financial results through internationalisation of their curriculum (Wynne and Filante, 2004). An essential and global need of people for constantly education in order to achieve their career purposes, gives reason to educational institutions to set up subsidiaries in emerging markets and to float a business. Companies look to hire the best and the brightest and then give them the experience and education they need to advance through the ranks or to educate existing employees and retain their talent. Along with irreplaceable on-the-job experience, many experts have identified advanced education as an important way to improve skills and gain knowledge and exposure to new ideas (Fenton, 2004). Bommer (2004) explains that training is one of the most crucial aspects of the firm's strategy. As stated by Zorn (2004) entrepreneurial capital (composed of human and social capital) is the most important factor for entrepreneurial success. Companies' productivity hinges on employees skills development (Young, 1999). Training is an excellent tool to recruit the best and brightest employees and to retain them. Furthermore, it ties directly into firm's strategy by helping employees increase productivity and develop personally and professionally into future leaders of the firm. According to research by Zwick (2005) external courses (in special educational institutions) have the largest positive impact on productivity while self-induced learning, participation at seminars and talks and job rotation do not enhance productivity and training on the job has a negative productivity impact. Most employers consider their employees an important investment both to accomplish the organization's current goals and to have the right people in place for the future (Rasmussen, 2005) and by that reason they (financially) support their education. Many of the courses that RFH offers in Germany are visited very well. It appears that occupational training and providing of certified courses is a successful business idea, which can be conveyed to other markets, especially to emerging countries. From this point of view potential customers, which are willing to educate themselves in order to achieve their career goals will be likely to find also on the foreign market.

4 Strategic Issues in RFH as non-for-profit company

“Twenty years ago, management was a dirty word for those involved in non profit organizations. It meant business, and non profits prided themselves on being free of the taint of commercialism and above such sordid considerations as the bottom line. Now most of them have learned that nonprofits need management even more than business does, precisely because they lack the discipline of the bottom line”

P.F. Drucker (1989) in Harvard Business Review, as cited by Speckbacher (2003), p. 267

According to Peter F. Drucker (1989), as one of the world's most influential writers on management and organization, management is a crucial and vital component to all organizations in society. Non-for-profit organisations gain benefits inter alia of effective marketing management and public relations in communities and in the same time they are obliged to maintain public trust (Clarke, 2005). The sole reason that non-for-profit organisations account for average 1 in every 20 jobs in nations throughout the world (Economist, 1998) affirms that knowledge of non-profit organisations is important. Typically non-profit organisations can be both private and public organisations (Wheelen, 2004), and are usually founded for reasons other than commercial considerations as for example welfare, research or education or wealth-care. The non-for-profit sector is important for *two reasons* (Lynch, 2003). *On the one side from society perspective* because society desires goods and services that profit-making companies cannot or will not provide as for example paved roads, museums, schools etc. *On the other side from non-for-profit organisational perspective*, because private non-profit organisations tends to receive benefits from society that private profit-making firm cannot obtain, like preferred tax status to non-stock corporations, or exemptions from various other states, local and federal taxes. In Germany, for instance, non-for-profit associations are released from the sales tax and corporation tax because they serve the general good. But advanced governmental considerations like to allow nonprofits groups to sell tax-exempt bonds to purchase land and then use revenue from selling like in USA (Enochs, 2005) do not existing in Germany. The German (Bürgerliches Gesetzbuch) civil law code (BGB = Civil Code) makes a distinction between economic and to the not economic (ideal) association. The objective is determining. For example RFH as not economic (ideal) association and private non-for profit organization, is released from:

-
- The corporation tax - §5 paragraph 1 No. 9 KStG (corporation tax law)
 - The trade tax - §3 No. 6 GewStG (trade tax law),
 - The property tax - §3 paragraph 1 No. 12 VStG (withholding tax),
 - The inheritance and donation tax - §13 paragraph 1 No. 16 ErbStG (Capital transfer Tax) and
 - The real estate tax, provided if the property is used for non-profit, charitable or ecclesiastical purposes (§3 paragraph No.1 , No. 3b and 4 GrStG (Real estate Tax Law)). Also they need to pay only the half one of
 - Sales tax (nowadays 7%) (§12 paragraph 2 No. 8a UStG (sales tax law)).

All these benefits are allowed (as in many countries throughout the world) because private non-profit organisations are *service organisations* which are expected to use any excess of revenue over costs and expenses (a surplus rather than profit) either to improve service or to reduce the price of their service for society. But on another side non-for-profit organisations do not have access to capital equity market (Wareham, 2004) and need to find alternative funding sources because governmental funding is usually *not unlimited!*. Also selling an intangible product has challenges: There are no fancy product shots to grab people's attention, because company can't increase sales by offering a lifetime warranty (Sausik, 2005).

Till recently traditionally studies in strategic management have dealt with profit-making companies to the exclusion of non-profit or public governmental organisations (Wheelen, 2004). But these tendencies are changing because public service and non-for-profit organisations depends heavily for financial support either on government funds or on private donations, assessments or dues like tuition fees as in the case of RFH. Every nonprofit may not be able to generate all its *funding* through revenue-generation, but every nonprofit certainly can generate a greater percentage than it is doing now (Shuman and Fuller, 2005). Thus, non-for-profit organisations need to recognise the impact on they market orientation and to develop sustainable **competitive advantage** in the sense to compete for finance from potential providers (Kara, Spillan, DeShields, 2005). Many of strategic management concepts can be equally applied to business and for non-for-profit organisations, where others cannot. As stated by McGill (1988) mission statements, SWOT analysis, stakeholder analysis and corporate governance are, however, just as relevant to a non-for-profit as they are to profit-making organizations.

4.1 Strategy evaluation in non-for-profit organisation

In the public governmental units and non-for-profit organisations, the criteria need to reflect the broader aspect of their service or contribution to the public. The best strategic way always depend on the nature and needs of the business (Campbell and Goold, 1987), thus different decision-making processes and beliefs that motivate many organisations make evaluation of strategy options in not-for-profit organisations more diffuse and open ended (Lynch, 2003). Decision-making methods traditionally employed by public sector agencies are inadequate for dealing with the demands facing (Smith and Stupak, 1994). **The key criteria for strategy development** in non-for-profit organisations is the *pressure* on such organisations, to *provide more services* than sponsors and clients can pay for, and to develop strategies to help them meet their desired service objectives (Wheelen, 2004). Non-for-profit organizations often rely on volunteers (Ratje, 2003). *“Some smart nonprofits are letting others do the work for them”* (Fielding, 2005), by use of e.g. college students as volunteers in order to keep costs low brings financial benefits (Farrell, 2005) but it is usually heavy, because such a resource needs to be handled with care, by reason that perceptions of their status can affect their ability (Watts, 2002) and some need to be given greater degree of freedom that would be appropriate in commercial organisation. Thus non-for-profit organisations are often choosing strategies of *piggybacking, mergers and strategic alliances to reduce its costs and to find new sources of funding* (Wheelen, 2004). Nielsen (1984) explains the term of **strategic piggybacking** as the development of a new activity for non-for-profit organisation that would generate the funds needed to make up the difference between revenues and expenses. This strategy is not new and companies are often trying to jolt sales by piggybacking (Reynolds, 2004). The purpose of the strategy is to help subsidize *the primary service program*, as a form of diversification around the core business (*concentric diversification*) *engaged only for money-generating value* (Rijamampianina, Abratt and February, 2003). The organisation invests, in new, safe cash cows to fund its current cash-hungry, question marks and dogs, in an inverted use of portfolio analysis. According to research of Bacon (1995), 70% of colleges and universities now offer *“auxiliary” services*, such as bookstores, conference rooms, computer centres or stores *outside of the main building* or even allowing of the companies name to appear on products as source of income. The critics as for example U.S. Internal Revenue Service (IRS) (2005) (<http://www.irs.gov/>) advises that non-for-profit organisations engaged in a business not related to the organisation’s exempt purposes (central mission) may jeopardize its tax-exempt status, if income exceeds approximately 20% of total organisations revenue. *In Germany the taxation border for corporation tax and trade tax is 30678 Euro*. If the gross

incomes is higher as the taxation border of 30.678 Euro (§ 64 paragraph 3 AO = Abgabenordnung (German Fiscal Code)), and the profit lies more than 3.835 Euro, corporation tax has to be paid. According to law, corporation tax results *only in the area of the economic business concern*. It results *not in the ideal area* e.g. if the association works for instance in scientific, artistic, beneficent, sporty, sociable one or ecclesiastical tasks and in the area of the administration of property. It follows: even if the economic business concern serves merely to finance the non-for-profit activity, the profit *while crossing of above mentioned taxation borders are paid tax on*.

Even though, strategic piggybacks can help non-for-profit organisations better use their resources and self-subsidize their primary mission. As stated by Nielsen (1986) there are several *potential drawbacks*. For instance, the venture *could subvert, interfere with, or even take over* the primary mission. Or the public, as well as other *sponsors, could reduce their contributions* because of negative responses to such “*money-grubbing activities*” or because of *mistaken belief* that the non-for-profit organisation is becoming *self-supporting*. Research by U.S. National Association of College and University Business Officers (1995) predicts that 90% of U.S. colleges and universities will use strategic piggybacks and for other non-for-profit organisations similar trends are expected. Usage of the strategy heavily relies on donations and taxpayer support for non-for-profit organisations revenue.

As stated in Wheelen (2004), based on experiences of Edward Skooldt, an consultant to not-for-profit organisations, not-for-profit should have five resources *before engaging in strategic piggybacking*: *something to sell* (people may be willing to pay for services and goods closely related to organisations primary activity), *critical mass of management talent* (most competent not-for-profit professionals don't want to be managers), *trustee support* (trustees can have strong feelings against earned-income venture like in the case of licensing of Sesame Street to toy companies by Children's Television Workshop), *entrepreneurial attitude* (Non-profit-organisation must have able management who can combine interests in innovative ideas and businesslike practicality) and *venture capital* (because it takes money to make money). Further corporate level strategic alternatives for non-for profit organisations are **strategic alliances** and **mergers and acquisitions**. Increasing number of non-for-profits consider mergers and acquisitions as a way of reducing costs (Collins, 1993). According to Hiland (2003) reasons for nonprofits to consider merger are numerous but the primary drivers, however, are financial and include the desire to grow or to strengthen market share. Rugman (2003) defines strategic alliances “*as a business relationship in which two or more companies work together to achieve collective competitive advantage*”. Strategic alliances is

an term often used to embrace a variety of arrangements between potential or actual competitors including *licensing agreements, formal joint ventures or informal cooperative arrangements* (Hill, 2005). As stated by Provan (1984) and Pointer (1989) strategic alliances are often used by not-for-profit organizations e.g. in Health Care industry, as a way to serve clients, to acquire resources while still enabling them to keep their identity or as a way to enhance their capacity. But already business corporations are forming alliances with universities to fund university research and gain value of partnering (Whitaker, Henderson and Altman-Sauer, 2004), in exchange for options on the result of that research or to educate their employees. An example for such kind of alliances is collaboration between RFH and Ford Company in Cologne. Business firms find it cheaper to meld the right resources (Leonavičienė and Ilonienė, 2005) thus to pay universities to do basic research, or to educate their employees on the universities than to do it themselves. In return, universities receive research funds to attract top professors and to maintain expensive labs.

Such kind of alliances of convenience is being criticized, but they are likely to continue (Wheelen, 2004). Strategic alliances have risks because organization can give away more than it receives. The failure rate for international strategic alliances seems to be high. According to Ernst and Bleeke (1991) research including 49 international strategic alliances, 33% are ultimately rated as failures. In order to make strategic alliances efficient is to select the right ally, which can achieve the firm's goals or shares the firm's vision without to try to opportunistically exploit the alliance for its own ends. As stated by Perks (2004), value in long-term co-development derives from the enduring exchange processes developed throughout the collaboration. In foreign business, intercultural business competence is related to the quality of long-term relationships (Huang, Rayner and Zhuang, 2003). Very important factor in the case of international business deals with sensitivity to cultural differences, which requires building interpersonal relationship between the firm's managers (Hill, 2005). Impact on strategy implementation in non-for-profit organizations and complications to implementation are possible, because **decentralization in non-for-profit organization** is complicated. The company heavily depends on sponsors for revenue support and the top managers of the non-for-profit organization must always *alert to the sponsor's view of an organizational activity*, even though *decentralization allows the introduction of flexible HR systems and practices* (Shim, 2001). Further problems in such organizations can be that *executive development and job enlargement can be restrained by professionalism* (Lynch, 2003), because the difficulty is that there is much confusion about the definition of quality among the professionals (Milliken and Colohan, 2004). According to Wheelen, (2004) organisations that employ large number of professionals, like in universities or hospitals,