Arla Foods seizing opportunities in Chile

Master Thesis

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Executive Summary

As part of the “Strategy 2017” plan Arla Foods commits to search for growth outside its core markets. With ambition to grow in the Latin American region, and reduced overall investment expenditure in the short-to-medium term, the company’s Business Development Department is striving to identify attractive markets to enter into. They identified an opportunity to enter Chile, and this thesis aims at proposing the optimal entry strategy to tap into this market’s potential. This is done by assessing the interaction of external factors, namely macroeconomic, market and industry related elements with internal factors, such as Arla Foods own resources, experiences and capabilities. The analysis is structured around a proposed analytical framework, which combines quantitative and qualitative data with some of the models and theories which are most commonly used in entry modes studies.

According to findings Chile is a moderately attractive market for Arla Foods. The growing consumption of dairy products, a relatively large middle class and the progressive match of consumers’ preferences towards Arla Foods’ value proposition are identified as the main drivers for an entry in this market.

Nevertheless, Arla Foods faces some challenges in Chile. Specifically: a consolidated industry with very strong competitors, a lack of local market knowledge and overall, a reduced investment expenditure in the short-to-medium term.

The proposed low-risk entry mode in Chile revolves around a 3-steps approach. First of all, Arla Foods is recommended to enter a non-equity-based Strategic Partnership with a local player. This partnership is aimed at gaining market knowledge and access to distribution channels, raise brand awareness and increase sales volumes. Second, once the partnership has been tested and Arla Foods has worked in the Chilean market for some time, the company needs to reassess internal and external variables in order to reshape the strategy. Third, according to the outcomes of strategy reshaping, the company either commits more resources to enter the market full-scale via Joint Venture or Acquisition, or decides to exit the market.
<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Introduction</td>
<td>5</td>
</tr>
<tr>
<td>1.1. Research question</td>
<td>6</td>
</tr>
<tr>
<td>1.2. The analytical framework</td>
<td>7</td>
</tr>
<tr>
<td>1.3. Data collection</td>
<td>9</td>
</tr>
<tr>
<td>1.4. Literature review</td>
<td>9</td>
</tr>
<tr>
<td>1.4.1. External Factors Analysis</td>
<td>9</td>
</tr>
<tr>
<td>1.4.2. External and Internal Factors Assessment</td>
<td>10</td>
</tr>
<tr>
<td>1.4.3. Entry Mode</td>
<td>11</td>
</tr>
<tr>
<td>2. External Factors Analysis</td>
<td>14</td>
</tr>
<tr>
<td>2.1. PEST Analysis</td>
<td>14</td>
</tr>
<tr>
<td>2.1.1. Political Analysis</td>
<td>14</td>
</tr>
<tr>
<td>2.1.2. Economic Analysis</td>
<td>15</td>
</tr>
<tr>
<td>2.1.3. Social Analysis</td>
<td>18</td>
</tr>
<tr>
<td>2.1.4. Technologic Analysis</td>
<td>20</td>
</tr>
<tr>
<td>2.2. Market Analysis</td>
<td>21</td>
</tr>
<tr>
<td>2.2.1. Demand for dairy products</td>
<td>21</td>
</tr>
<tr>
<td>2.2.1.1. Hard Cheese</td>
<td>22</td>
</tr>
<tr>
<td>2.2.1.2. Milk Powder</td>
<td>23</td>
</tr>
<tr>
<td>2.2.1.3. Yoghurt</td>
<td>24</td>
</tr>
<tr>
<td>2.2.2. Consumer Behavior – Eating Habits</td>
<td>25</td>
</tr>
<tr>
<td>2.2.3. Consumer Trends</td>
<td>25</td>
</tr>
<tr>
<td>2.2.4. Distribution Channels</td>
<td>26</td>
</tr>
<tr>
<td>2.3. Industry Analysis</td>
<td>29</td>
</tr>
<tr>
<td>2.3.1. Bargaining Power of Buyers</td>
<td>29</td>
</tr>
</tbody>
</table>
2.3.2. Bargaining Power of Suppliers…………………………………… 30
2.3.3. Threat of Potential Entrants…………………………………… 30
2.3.4. Threat of Substitutes…………………………………………… 30
2.3.5. Degree of Rivalry………………………………………………… 31
2.3.6. Implications – Why should Arla Foods enter the Chilean Market?.................................................................................... 33

3. Internal Factors Analysis.................................................................................................................. 35
   3.1. Arla Foods Overview.......................................................... 35
   3.2. Financials........................................................................... 37
   3.3. Previous Internationalization Experience......................... 37
   3.4. Arla Foods Presence in Latin America............................. 37
   3.5. Summary........................................................................... 38

4. SWOT Analysis................................................................................................................................. 39

5. Entry Mode.................................................................................................................................... 41
   5.1. Ownership Advantage....................................................... 42
   5.2. Location Advantage........................................................ 43
   5.3. Internalization Advantage............................................... 46
   5.4. The Selected Entry Mode - How should Arla Foods enter the Chilean Market?.......................... 49

6. Conclusions.................................................................................................................................... 54

7. Bibliography................................................................................................................................. 55

8. Appendix 1 – Interview with Martin Falch Jakobsen................................................................. 62

9. Appendix 2 – Interview with Guillermo Molina................................................................. 64
1. Introduction

The global dairy industry is witnessing a consolidation game, where firms need to achieve large sizes to be successful (Arla Foods Annual Report, 2011). Multinational Enterprises (MNEs) expand their activities in foreign markets in order to achieve competitive advantage for a number of different underlying reasons.

At the current stage, Arla Foods is increasingly committed to generate growth in foreign markets. Increasing volumes of products sold and raising brand awareness in new geographical areas become therefore key objectives.

With growing ambitions in Latin America, Arla Foods perceives business potential in Chile. The country has recently entered the Organization for Economic Cooperation and Development (OECD), gaining formal recognition as a developed economy. With a relatively interesting market size (Jakobsen, 2015) Chile shares some socio-economic traits with other mature economies such as a fairly stable business environment, open policies towards foreign direct investment and low population growth rates. However, the Chilean cultural settings, consumer preferences and market structures differ from what Arla Foods experiences in its core markets. Hence, the company might need to adapt its strategy to the local context in order to be successful.

Taking into consideration Arla Foods’ Internal capabilities and Chile’s market conditions becomes therefore essential to design the optimal entry strategy that ensures success in this market.
1.1. Research question
The entry into a foreign market presents both challenges and opportunities. The strategic decisions connected to this operation often involve commitment of resources that are hard to reverse and are dependent on both External Factors, which are out of the firm’s control, and Internal Factors, which fall under the firm’s domain. Therefore, when preparing for such decisions it becomes vital to design an efficient entry strategy. This leads to the following research question:

*What entry strategy should Arla Foods pursue in Chile?*

This question is addressed by splitting it in two further subquestions: *why* should Arla enter this market and *how* to do it. Both components are regarded as important elements in the strategic management literature (Lasserre, 2007; Peng & Meyer, 2011).

The *why* refers to the market attractiveness in relation to company’s ambition for seeking growth in foreign countries.

The *how* revolves around the choice of the optimal entry mode that Arla Foods should adopt in Chile, given the company’s own capabilities and the market contingencies.

Hence, two supporting questions are addressed:

1) *Why should Arla Foods enter the Chilean Market?*
   This question lays the foundation for the analysis. It addresses the evaluation of market potential, aiming at clarifying whether Arla’s objectives fit with the existing market opportunities.

2) *How should Arla foods enter the Chilean Market?*
   This question aims at concluding the discussion of determining the most beneficial entry strategy in Chile based on the preceding analysis of External and Internal Factors.
1.2. The analytical framework

The proposed framework aims at providing response to the research question by addressing the two supportive questions.

First of all, why should Arla Foods enter the Chilean market? The answer to this question is provided by an in-depth analysis of External Factors. This analysis aims at assessing the attractiveness of the market through the use of a number of theoretical frameworks and an evaluation of sales trends and retail value figures. On a macroeconomic level, a PEST Analysis is used to scan the Chilean business environment. Then on a micro level, a market analysis is carried out to assess local demand for dairy, identify attractive product categories, study consumer trends and distribution channels. Finally, the Chilean dairy industry is analyzed through Porter’s 5 Forces model.

Second, how should Arla Foods enter the Chilean market? This question revolves around the choice of entry mode. The answer is provided by the use of Dunning’s Eclectic Paradigm. Each component of the paradigm is supported by additional theoretical perspectives to provide a comprehensive approach to the choice of the entry mode. The Ownership dimension is supported by the Resource Based View while the Localization dimension is supported by the Institution Based View and the Cultural Distance. Finally, the Internalization is supported by the Transaction Cost Economics.

The chosen framework is graphically depicted in Figure 1.
Figure 1: the proposed framework

External Factors Analysis

WHY

Internal Factors Analysis

SWOT Analysis

OLI

Ownership

Ressource Based View

Location
Institution Based View
Hofstede’s Cultural Distance

Internalization
Transaction Cost Economics

HOW

Source: own contribution
1.3. **Data collection**

This analysis relies on primary and secondary data. Primary data is collected from interviews with Arla Foods’ employees who possess extensive knowledge of the company’s operations in foreign markets, namely: Guillermo Molina - Export Manager, Latin America Region, Martin Falch Jakobsen - Business Development Manager. The interviews were conducted on April and May 2015 and the validity of this information is high. These interviews were semi-structured, and the questions asked were aimed at spurring conversation on the topics of internationalization, Arla Foods’ previous experience in foreign contexts and specific information regarding the Chilean dairy market.

Primary data is supported by secondary data, which includes qualitative and quantitative information. In this respect, market data was collected through external sources, such as Euromonitor database, the World Bank, the United States Foreign Agricultural Service and the Chilean Ministry of Agriculture. Also, International business theories and previous studies of firms’ internationalization, expansion and foreign markets were gathered by business journals and books.

1.4. **Literature Review**

The objective of this section is to review the theories and models applied in each part of this thesis, and to discuss the rationale behind their application within the overall analytical framework.

1.4.1. **External Factors Analysis**

Two frameworks are used to carry out the external factors analysis on a macroeconomic and microeconomic level, respectively the PEST Analysis and Porter’s Five Forces.

The PEST analysis is used to identify the forces in the macroeconomic environment that affect the business at present and are likely to continue affecting the business in the future (Haberberg & Rieple 2008). The model takes into consideration the Political, Economic, Social and Technological forces that affect the Chilean business
environment. According to Jobber (2004) the interaction of these forces is an important determinant of the opportunities and threats affecting companies in a given industry.

The framework used to scan the microeconomic environment is Porter’s Five Forces. This is a powerful management tool for analyzing the attractiveness and profitability of an industry (Johnson et al., 2008) and allows the comprehension of the “root causes of profitability” (Porter, 2008, p. 29). The model identifies four forces affecting the intensity of competition in a given industry, namely: Bargaining Power of Buyers, Bargaining Power of Suppliers, Threat of Substitutes, Threat of New Entrants and Internal Rivalry (Porter, 1979).

Though a strong tool for industry analysis and strategic design, Porter’s Five Forces model is not immune to criticism. According to a number of scholars, the model’s focus on the entire industry is too broad given that industry factors can only justify around 20 percent of business performance variations in terms of profitability, growth and market share (Hill & Jones, 1995; Grant, Butler et al. 2011). Further, the model does not value company’s resources and capabilities, which represent as well a major determinant of profitability (Hill & Jones, 1995). Finally, the model assumes static industry nature and does not take into account changing dynamics over time (Thurlby, 1998). These critics were taken into account when formulating the analytical framework. Hence, in order to assess market profitability Porter’s Five Forces model is supported by an in-depth market analysis, so to mitigate the model’s broad focus. Further, the lack of firm own resources and capabilities evaluation was addressed through the Internal Analysis. Finally, the model’s stativity is addressed in the Entry Mode section where an incremental approach, which is dynamic by nature, is proposed.

1.4.2. External and Internal Factors assessment

In this paper a SWOT analysis is used to assess the interaction of external and internal factors and generate input for the entry mode selection. The SWOT analysis is a tool that assesses the company’s Strengths, Weaknesses, Opportunities and Threats in relation to a specific market. According to Nasri (2011), SWOT provides meaningful
insights about organizational key competencies after analyzing data collected through market intelligence. Further, it allows marketers to make best use of that data by utilizing opportunities, linking those with organizational strengths, identifying threats and minimizing weaknesses (Nasri, 2011).

According to Curry (1996), SWOT acts as a tool for associating quantitative and qualitative aspects of decision, improving strategic planning.

1.4.3. Entry Mode

The ever rising prominence of globalization affects companies’ competitive landscape by exposing them to global competition. Hence, companies are required to look beyond traditional aspects of business operations and to apply global perspectives (Root, 1994).

According to Hoskisson (1999) the motives behind new market entries are linked to the Multinational Enterprises (MNEs) development and exploitation of resources across their operations.

The OLI eclectic paradigm, developed by John Dunning, has become one of the most commonly used perspectives within entry mode studies (Canabal & White, 2008). The paradigm takes a holistic approach to the firms’ internationalization strategy posing that ownership, location, and internalization advantages constitute the rationale for engaging in foreign direct investment (Peng & Meyer, 2011).

The first component, Ownership advantage, relates to the firm’s own resources. The idea is that companies possess context specific assets and skills that generate competitive advantage over other companies in a given market (Dunning, 2000). Within the internationalization context, the ownership issue draws on the assumption that companies’ ownership advantages are a prerequisite to offset the disadvantages of being foreign (Hennart, 1991).

The theory chosen to analyze the ownership advantage is the Resource Based View (RBV). This theory is among the most widely used perspectives within strategic management (Peng, Sun, Pinkham, Chen, 2009), and its foundation makes it useful for explaining international entry strategies (Meyer, Wright, Pruthi, 2009).
The RBV links the generation of competitive advantage to the firms’ deployment of their resources (Kostopoulos et al. 2002).

*Location advantage* refers to market specific elements that firms can exploit to create competitive advantage. (Buckley, P., Hashai N. 2005: 656). In this paper two main theories are chosen to analyze location advantage: the Institution Based View (IBV) by Peng, Sun, Pinkham and Chen (2009), and Hofstede’s Cultural Distance (1984).

The IBV focuses on the role played by the institutions, which set the rules of the game in the market (Peng, Sun, Pinkham and Chen, 2009) shaping the business environment and affecting the attractiveness of the market. Formal and informal institutions are important determinants of the IBV. The first create rules through regulation, while the latter create rules through culture, customs and ethics.

The IBV is one of the leading perspectives used to analyze success and failure of firms engaging in foreign activities (Peng & Meyer, 2011), and will be supported by Hofstede’s Cultural Dimensions to take into consideration the role played by cultural settings over firms’ performance in foreign markets.

Although cultural distance theories have been criticized for not having the necessary explanatory power to explain culture (Steenkamp, 2001), Hofstede’s model was found to be reliable for identifying the connection between cultural distance and firms’ entry modes (Drogendijk & Slangen, 2006).

The final component, *Internalization advantage*, is conceived to evaluate alternative ways of entering and operating in the selected market (Dunning, 2000). This element explains the generation of competitive advantage based on the company’s organization of its operations in the market, whether it happens within the multinational firm or by using market transactions (Peng & Meyer, 2011). The rationale behind *Internalization* is that MNEs exist because firms internalize operations to reduce transaction costs in the market.

This concept is connected to Transaction Cost Economics (TCE), the most commonly used theory to analyze market entry (Canabal & White, 2008). TCE argues that firms
are best served selecting an entry mode that minimizes costs and inefficiencies connected to entering and running operations in a foreign market (Peng & Meyer 2011).
2. External Factors Analysis

The purpose of carrying out the External Factors Analysis is to provide an answer to first supportive research question:

Why should Arla Foods enter the Chilean market?

Therefore, this section identifies the market conditions that constitute attractive elements for Arla Foods to engage in business operations in Chile. This section consists of a PEST Analysis, a Market Analysis and finally, Porter’s Five Forces framework is used to analyze the Dairy Industry.

2.1. PEST Analysis

This section analyzes the Chilean macroeconomic environment, identifying 4 main categories: Political, Economic, Social, and Technological.

2.1.1. Political Analysis

Considered to be one of the most stable states in South America, Chile has experienced a dramatic economic growth over the past two decades (Chile: Country profile). Since 2013 the country is ruled by the center-left coalition led by President Bachelet, whose widespread popularity is expected to ease the passage of bills process (Chile: In-depth PESTLE Analysis).

Chile is considered to be a global leader in economic freedom (source: International Monetary Fund) and regional leader in the South/Central America & Caribbeans. In fact, the country’s score of the Index of Economic Freedom was the highest in the region in 2014.

Globally, Chile is the 7th freest economy (source: International Monetary Fund) and according to the World Bank, the country had a percentile rank of 88.2 in the Rule of Law parameter and 93.3 in Regulatory Quality in 2012. The former index is a measure of the agents’ confidence in the rules of society, in particular the quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence. The latter instead is a measure of the government’s ability to
formulate and implement sound policies and regulations that permit and promote the
development of private sector (source: World Bank).
Furthermore, Chile appears to have relatively low levels of corruption: the country had
a percentile rank of 91.4 in Control of Corruption. Among others, these governance
indicators reflect an overall ease of doing business in this country.
Also, Chile adopted a welcoming policy towards international trade and signed a
number of free trade agreements (FTAs) with key partners, including the European
Union and the United States. Alongside, the country became a member of the Pacific
Alliance, a commercial agreement removing tariffs over 90% of merchandise trade
between Chile, Colombia, Mexico and Peru.

2.1.2. Economic Analysis
Chile’s economy depends strongly on its mineral sector, which accounted for 60% of all
exports in 2013. In the same year copper alone provided 19% of government revenues
(CIA World Factbook). The country’s annual output is a third of the world’s mined
copper (Chile: Country Profile).
This heavy dependence on mining and related exports leaves the country vulnerable to
commodities price fluctuations (Chile: Country Profile).
Real GDP is forecast to grow by 2.7% in 2015. This is an improvement over the
outcome in 2014 (when growth was negatively affected by a drop in copper prices)

Figure 2: Real GDP growth 2006-2015
The country is expected to benefit from the planned investment of US$ 23 billion in the mining sector over 2014-2018 and from a number of strategic Free Trade Agreements (FTAs) it has signed with several key partners including the USA, EU, China and Thailand. In addition, Chile is currently negotiating for establishing the Trans Pacific Partnership, one of the largest FTAs in history. The Partnership is intended to tighten economic relations with a number of countries including the USA, Japan and Australia (Business Environment: Chile).

The GDP Per Capita at Purchasing Power Parity is estimated to amount to 24170.029$ in 2015 and is forecast to keep growing until 2019 (last estimates available) at an average rate of 5.27% (source: International Monetary Fund).

Figure 3: GDP on purchasing power parity per capita

Also, private final consumption (in real terms) rose by 2.8% in 2014 and gains of 3.3% are expected in 2015. Private consumption in sustained by a rise in real wages and a moderate increase in credit (Chile: Country Profile).

Chile is considered to be the most competitive country the South American region, and according to the Global Competitiveness Report 2013-2014 it ranked 34th out of 148 economies. Also, the country ranks much higher that its peers Argentina and Brazil in
parameters such as goods market efficiency, labor market efficiency, financial market development, technological readiness and business sophistication and innovation. (Chile: In-depth PESTLE Analysis).

During the past two decades Chile has been one of Latin America’s fastest growing economies. Over the same period the poverty rate was more than halved and per capita income has more than doubled in real terms (Chile: Country Profile). The country relies on a solid banking system, making the national banks a strong pillar of the national economy. Compared to its regional peers Chile has one of the largest middle classes, which grew by an average rate of 5.27% during 2000-2009. According to MarketLine this social composition provides high consumption possibilities driving economic growth and shielding the economy from fluctuations in export revenues.

Figure 4: Class composition in selected Latin American Countries

In 2013 Chile’s middle class totaled 1.9 households, with a mean disposable income of US$23,376 (Income and Expenditure in Chile).

As an economic freedom leader, Chile maintains a policy of limited government through prudent public finance management which has kept budget deficits and public debt under control (Chile: In-depth PESTLE Analysis).

According to Doing Business 2014 Chile shows a business-friendly environment, ranking 34th out of 189 countries (Business Environment: Chile). With a relatively low total tax rate of 27.7% on commercial profits and a corporate tax of 20% as of 2014 the country appears to have a favorable tax environment for businesses. Further, the
country enjoys relative political stability in a highly volatile region: Chile ranked 80th out of 203 countries in 2012 in the World Bank’s Political Stability and Absence of Violence Index, above Brazil (104th) and Colombia (187th). The country ranked 15th out of 202 countries in the World Bank’s Regulatory Quality Index, that ”captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development” (source: World Bank). Also, Chile does not seem to be heavily affected by corruption, ranking 22nd out of 177 countries in Transparency International’s corruption Perceptions Index in 2013.

The Chilean government is a great advocate of foreign investment. FDI has become a key element of economic progress, making the country open to foreign trade. FDI intensity amounted to a significant 11.4% of total GDP in 2012 (Business Environment: Chile)

### 2.1.3. Social Analysis

Chile has witnessed a dramatic GDP growth during 1978-2013, and over the same period the poverty rate was significantly reduced. This is not only due to economic growth, as the government’s role was robust in this respect. In particular, successive governments have introduced innovative programs and transferred cash amounts to poor households (Chile: Country Profile).

Chile has joined the OECD in 2010, indicating that the country remains on the path of social improvement.

However, income distribution is one of the most unequal of all OECD economies: in these countries the richest 10% of the population earn an average income 9.4 greater than that of the poorest 10% whereas in Chile this figure amounts to 26.5 (Chile: In-depth PESTLE Analysis).
High inequality negatively affects social cohesion and creates social and economic challenges. The country needs to address this issue with redistributive policies (Chile: In-depth PESTLE Analysis).

Further, the poor quality of public education led to several protests in the whole country. In response, the Bachelet government has proposed radical reforms of the Chilean education system, aiming at making education free, creating more universities and increasing the funding for this sector.

Chile’s population amounts to 17.6 million (source: World Bank) as of 2015 and due to declining birth rates its growth is slowing down. In fact, Chilean society is experiencing a rapid ageing process (Chile: Country Profile). This demographic change may undermine the country’s growth potential. On the other hand, it is worth noting that Chile is also a favored destination for young and well-trained European job seekers. Due to forecasted mining investments of $100 billion over the next 10 to 12 years, around 100,000 new direct jobs are expected to be created. Further, another 300,000 more indirect jobs will be generated according to Sonami mining association.
In 2013, the Head of Chile’s Immigration Office, Mario Cassanello, said that:

“Chile realizes that without the help of immigrants it’ll be very difficult to fill the number of jobs required for certain investments and to ultimately boost the economy”

Spain is the largest European contributor to immigration towards Chile. In 2013 Spaniards represented almost 6,000 of new arrivals in the country, roughly double the amount of the previous year (source: Bloomberg), when the total population of Spaniards in Chile amounted to more than 48,000 individuals (source: Latin American Herald Tribune).

After Spain the main European source of job seekers in Chile is Germany. This inflow of Europeans may constitute an important element for Arla. The company may in fact leverage on this segment’s prior-to-emigration knowledge of the brand. This implies that Europe-localized marketing and branding efforts may be further exploited in Chile, tapping on European consumers.

2.1.4. Technological Analysis

Chile appears to be more technologically advanced than its peers in Latin America. On average, Chilean consumers rely habitually on the internet as a source of information, and social media literacy is widespread (Chile: Country Profile).

In 2008 a law was passed, offering tax incentives for R&D initiatives developed by private firms. In particular, companies will be able to invest 35% of the money they pay in tax for R&D activities in collaboration with universities and research centers (Chile: In-depth PESTLE Analysis). Further, firms can claim tax rebates for in-house R&D.

Despite this, innovation does not play an important role in Chilean economy. In 2011, Chile invested only 0.44% of its annual GDP in R&D (Chile: In-depth PESTLE Analysis). Low R&D expenditure indicates that the country has still a lot to do to boost innovation.
2.2. Market Analysis

The purpose of this section is to scan the Chilean market and to identify attractive trends and dynamics that constitute attractiveness for Arla Foods. The Market Analysis is carried out focusing on demand for dairy products, retail value of dairy product categories, consumer behavior, consumer trends and distribution channels.

2.2.1. Demand for Dairy Products

From 2008 to 2013 the estimated consumption of dairy products grew at an average rate of 2.1%, reaching the record high amount of 146.5 liters per capita. This was due to a number of factors: a general increase in the population’s purchasing power, the effects of marketing and promotion activities for dairy products and the consumers’ preference for healthier and more balanced diets (source: ODEPA). In an effort to increase domestic consumption of milk and dairy products, producers and the industry are continuing their promotional campaign. They jointly decided to form and finance Promolac, an association that manages the contributed funds in promotional campaigns, mainly through television and printed media (source: ODEPA).

However, it is estimated that in 2014 the consumption of dairy decreased by 3.4%, reaching 142 liters per capita (source: ODEPA). This trend might have been influenced by the country’s general poor performance in 2014, due to a fall in copper prices.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dairy Products (Lit/person)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2008</td>
<td>132.2</td>
</tr>
<tr>
<td>2009</td>
<td>126.1</td>
</tr>
<tr>
<td>2010</td>
<td>132.3</td>
</tr>
<tr>
<td>2011</td>
<td>138.9</td>
</tr>
<tr>
<td>2012</td>
<td>146.1</td>
</tr>
<tr>
<td>2013</td>
<td>146.5</td>
</tr>
<tr>
<td>2014</td>
<td>142</td>
</tr>
</tbody>
</table>

Source: ODEPA

Nevertheless, the Chilean economy is expected to perform better in 2015 and in the coming years. This will positively affect dairy products consumption, which is also forecasted to grow.
The most commonly consumed dairy products in Chile are hard cheese, powder milk and yoghurt. Jointly, these categories constituted up to 61% of the Chilean dairy market by retail value in 2014.

Figure 6: Market share by product category in retail value terms - 2014

<table>
<thead>
<tr>
<th>Market Share by product category</th>
</tr>
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<tbody>
<tr>
<td>Hard cheese</td>
</tr>
<tr>
<td>Powder Milk</td>
</tr>
<tr>
<td>Spoonable yoghurt</td>
</tr>
<tr>
<td>Milk</td>
</tr>
<tr>
<td>Flavoured Milk Drinks</td>
</tr>
<tr>
<td>Soft cheese</td>
</tr>
<tr>
<td>Other</td>
</tr>
</tbody>
</table>

Source: own contribution, data from Euromonitor International

### 2.2.1.1. Hard Cheese

The main kinds of hard cheeses by retail value are Chanco, Mantecoso and Gouda. In 2014, these constituted respectively 33%, 30% and 21.2% of the market. Within 2009-2014 the sales of hard cheese registered a steady 14.5% CAGR (source: Euromonitor).

Several reasons explain the high growth for Cheese in Chile. First, the positive economic performance experienced over the review period, which allowed consumers to perceive higher disposable incomes. This in turn, triggered the interest for higher quality food and drink products. Second, the development of a wine drinking culture, with closely related food such as cheese has also boosted growth for the category, especially among higher income population segments (source: Euromonitor).

Cheese is a very popular ingredient in the country, especially for consumption in sandwiches, for a meal called “once” by Chileans. This is a rough equivalent of tea at 17:00.
Consuming hard cheese in sandwiches is extremely common in Chile. Chilean consumers tend to prefer unpackaged cheese over packaged, mainly due to a perception of higher quality, lower prices and the chance to try a particular type of cheese available over the counter (source: Euromonitor). The significant preference for unpackaged cheese indicates that the brand is a secondary driver in the Chilean consumers buying decision.

However, cheese preferences are starting to change, as many imported varieties are becoming increasingly popular among consumers. For instance, high income households are starting to appreciate soft cheeses, particularly Brie or blue cheese (source: Euromonitor).

On the other hand, hard cheese performance is expected to slow its pace in the coming years.

According to Euromonitor, the CAGR of this category’s retail value is forecasted to shrink to 8.8% in the period 2014-2019, which is still an interesting figure. Within this category, reduced fat cheese is expected to register the best performance over this period with a CAGR of 9%. This is due to the increasing awareness among Chilean consumers concerning the negative effects of a high-fat diet, which was underpinned by public policies and programs targeting the entire population, advocating for healthier food intake and lifestyles (source: Euromonitor).

Hard cheese imports constitute amount roughly to the 30% of hard cheese production in terms of volume (source: ODEPA). This figure shows that imports play a significant role to satisfy the national demand of hard cheese.

2.2.1.2. Milk Powder

Close to 75% of Chile’s production of dry milk is whole milk powder. Nonfat dry milk is mostly processed by the industry for creating other products, such as chocolate, ice cream and yoghurt.

Most drinking milk products available in Chile are long-life/UHT with fresh or microfiltered milk products being negligible. Families that do not consume large amounts of milk or do not have refrigerators to keep UHT fresh after opening prefer dry
rather than fluid milk (source: US Ministry of Agriculture). Government food programs also account for a significant proportion of dry milk consumption. Milk powder total retail value is expected to increase in the period 2014-2019 with a CAGR of 5.65%. The local industry has the necessary capability to produce enough milk powder to satisfy the national demand. In fact, milk powder imports amount only to 4% of national production (source: ODEPA).

2.2.1.3. Yoghurt
As a widely popular product category in the national dairy industry, yoghurt has witnessed significant product development efforts by the local players. The industry has managed to develop sales and differentiation through the inclusion of new ingredients, innovative flavors, changes in functional properties and textures (source: Euromonitor). At the moment, one of the main product development trends is the search for a balance among indulgence and health. This translated into very successful thicker yoghurt with reduced sugar and fat. The yoghurt category contains very popular brands, such as Soprole’s Next and Uno al Dia and Nestle’s Chamyto. Drinking yoghurt is known in chile as Leche Cultivada, or cultured milk, that is a sour milk products having digestive benefits and is very popular among adult consumers. Despite the next years’ forecasted below-the-trend economic performance of the country, it is expected that the development and innovation of yoghurt will continue to grow. In fact, yoghurt is perceived as an affordable and highly nutritional product, particularly for children but also among adults (source: Euromonitor).

The best performance is expected for health and wellness yoghurt, especially for reduced fat products. This is due to the ever rising importance of health and wellness trend which is driving consumers towards a reduced fat diet. Constant product innovation is set to combine with significant spending on promotional activities (source: Euromonitor). Spoonable yoghurt is forecasted to register a 4.1% CAGR in retail value in the period 2014-2019. Drinkable yoghurt instead will perform better, with a 5.1% Unfortunately, it was not possible to retrieve import figures for this category. However, imports are estimated not to be significant compared to the local production.
2.2.2. Consumer Behavior - Eating Habits

Foods and non-alcoholic beverages represent Chilean households’ main category in terms of expenditure. In 2013 this category amounted to 18.6% of the total household expenditure, and dairy products are among the ones that Chileans are increasingly consuming (source: Santander Trade).

Breakfast in Chile is often quite light and is served with coffee or tea and comprises cereal with either yoghurt or milk, or toasted bread with cheese, butter or spreads.

Lunch is the main meal of the day and it is served around 1-2 pm. It includes meats, vegetables, pasta, and/or rice. Besides grated cheese on pasta, dairy is not often consumed during this meal.

In the early evening a meal called “once” is very common. It usually replaces dinner and it consists of bread, cheese, avocado, tomato and tea or milk/yoghurt with cereals.

When present, dinner tends to be a light meal, for instance just a sandwich.

Families often meet for a relaxed and traditional Sunday lunch, in which more effort is put into preparation. In these occasions barbecues are very common, and meat is the most consumed food.

While prepared food is now more common in Chile, consumers tend to prepare meals from scratch using fresh ingredients.

2.2.3. Consumer Trends

Chileans currently work long hours and women are increasingly pursuing careers or higher education rather than staying at home to care for children. These factors contribute to parents having less time to spend with their babies and infants, while having increased household incomes (Consumer Lifestyles in Chile). Women are usually the household’s main decision makers concerning grocery shopping, and are increasingly becoming more active consumers of health and wellness information. The internet and social media play a major role as their sources of information (Consumer Lifestyles in Chile).

While rates of regular physical activity remain quite low among Chileans, there have been significant increases in time spent in physical activity in the latest years. The main
drivers of this trend have been the increase in number of public areas designated for sports and the increasing influence of the media, which often highlights the benefits of exercise and healthy lifestyles (Consumer Lifestyles in Chile).

The ever rising prominence of environmental issues has affected consumer behavior in Chile. In this respect, the demand for organic food and beverage is increasing. Nevertheless, it is worth noting that Chilean food market is overall quite price-sensitive, and some consumers are still unwilling to pay higher prices for organic goods (Consumer Lifestyles in Chile). Overall, the general lack of awareness of organic products is expected to decrease in the coming years, as consumers are becoming more aware of the benefits associated to the environment and their health. (Consumer Lifestyles in Chile)

Further, consumers are showing greater interest in recycling the packaging of products they buy. In fact, while the organized collection of recyclable materials is not yet widespread, consumers are increasingly taking these materials and depositing them off at the growing number of drop-off stations situated throughout residential areas (Consumer Lifestyles in Chile).

Genetically engineered (GE) food has been a topic of debate in Chile in recent years, and consumers are increasingly opposed to these food products. Chilean consumers are increasingly searching for non-GE certified options, such as those having the GE-Free logo from New Zealand (Consumer Lifestyles in Chile).

2.2.4. Distribution Channels

Dairy products distribution in Chile revolves around three main distribution channels: hypermarkets, supermarkets and independent small grocers. The first two belong to the so-called Modern Grocery Retailers category, whereas the latter belongs to the Traditional Grocery Retailers category. These three kinds of retailers constituted up to 93% of the market by retail value.
The figures remain roughly the same when analyzing the market share by distribution channel of the single identified categories: hard cheese, milk powder and yoghurt. Many Chileans still rely on independent small grocers for small everyday purchases, particularly middle-income, middle/low-income and low-income consumers, a group which includes around 70% of the entire population. While traditional retailing in the form of independent small grocers remains a significant channel, a decline is expected in the medium term, in favor of modern grocery retailing (Grocery Retail in Chile). The growing popularity of modern retailing is due to a number of reasons, including the wide range of products and brands they supply, the proximity of the majority of outlets to residential areas and the regular use of price discounts and promotions (Grocery Retail in Chile)
Table 2 illustrates the leading players of the Chilean grocery retailing industry.

<table>
<thead>
<tr>
<th>Grocery retailer</th>
<th>Market share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wal-Mart Chile</td>
<td>20.1%</td>
</tr>
<tr>
<td>Cencosud Supermercado</td>
<td>14.0%</td>
</tr>
<tr>
<td>SMU</td>
<td>11.8%</td>
</tr>
<tr>
<td>Falabella</td>
<td>3.7%</td>
</tr>
<tr>
<td>Others</td>
<td>50.4%</td>
</tr>
</tbody>
</table>

Source: own contribution, data from Euromonitor International

Wal-Mart is the industry leader, and operates in Chile through several brands, including Lider, which maintains a strong position among all types of customers. The marketing positioning of all Wal-Mart chains in Chile is to offer low prices without compromising on quality (Grocery Retail in Chile). Cencosud has developed two different chains to target consumers with different incomes, namely Jumbo and Santa Isabel. The first brand addresses high income consumers whereas the latter addresses middle income ones. SMU has also applied a similar strategy: it developed Unimarc to premiumize its retail offer and Ok Market to address low/middle income customers.

The competitive environment in grocery retailers in Chile remained stable during 2014. This is a very mature channel and there is little space for inorganic growth. Further, the market leaders are mostly prohibited from acquiring any rival companies due to the regulation of the Court of Defence of Free Competition. This causes the competition in the channel to remain relatively tight and no major mergers or acquisitions are expected in the channel for the foreseeable future (Grocery Retail in Chile).
2.3. **Industry Analysis – Porter’s Five Forces**

The following section will investigate the competitive landscape of the Chilean dairy industry using Porter’s 5 Forces (Porter, 1980) as the underlying model. Buyers are retailing stores selling dairy products to end consumers, suppliers are local dairy farmers, new entrants are local and foreign dairy companies and substitutes are other dairy products.

2.3.1. **Bargaining power of buyers**

In Chile dairy products are mainly distributed through supermarkets and hypermarkets. In 2014 they accounted for 36.10% and 30.50% of the national dairy retail value. These retailers are strong because of the large volumes they purchase. Then, traditional grocery retailers in the form of independent small grocers constitute another 26.90% of the dairy retail value in Chile.

Food retail is quite concentrated. This fosters buyer power as market players have less choice of who to sell to (Dairy in Chile).

However, national regulation on competition prohibits the grocery retailing leaders from acquiring competing companies, leaving little room for inorganic growth. This causes the buyers’ competition to be pretty tight, mitigating their power (Grocery Retail in Chile).

Staple foods such as milk and butter are quite difficult to differentiate, unlike cheese and yoghurt, which enjoy a number of niche markets. The dairy market is price sensitive: buyers exercise their bargaining power by demanding low prices, especially in the milk market.

Under its commodity condition, dairy products create value mainly for manufacturers, not for distributors and farmers. However, supermarkets maintain valuable levels of revenues by establishing an expensive price for “shelf space”.

Producers may counteract buyer power by developing branding strategies or focusing on premium products (ex. organic products).

Overall, buyer power is assessed as strong.
2.3.2. Bargaining power of suppliers
Dairy farmers are the key suppliers in this industry. By definition dairy products are made of milk, therefore no real alternatives to raw materials exist. Hence, supplier power benefit from the lack of substitute inputs. However, suppliers’ power is limited by the nature of the product itself. Being milk a very perishable good, suppliers are compelled to accept purchase conditions imposed by manufacturers. As a matter of fact, Chile’s national dairy farmers association, Fedeleche, has lodged a claim against Soprole, Nestle' and Watt’s accusing these firms of unfair practices (Source: M-Brain). Fedeleche claims compensation of at least $737.8 mn from these three companies. Also, suppliers’ power is limited by the constant threat of milk processors switching on imported input, particularly in the case of dry milk. Overall, supplier power is assessed as low.

2.3.3. Threat of potential entrants
According to MarketLine, entry barriers are high for new entrants aiming at challenging the major players in the dairy market. The dairy industry is indeed capital-intensive and asset specialization can be an obstacle for new entrants. Due to the free market regime Chile is not imposing legal barriers or protecting legislation aimed at limiting foreign players’ entry. However scale economies are important, due to the price competition present in this market. Further, current players have strong brands, which are aimed at retaining consumers’ loyalty. On the other hand, new entrants competing at reduced prices may take advantage of the fact that goods such as milk, butter and cheese are hard to differentiate. Overall the likelihood of new players entering the Chilean dairy market is moderate.

2.3.4. Threat of substitutes
Chilean consumers tend not to differentiate a lot for products such as milk, butter and cheese (Dairy in Chile). Hence, cheaper substitutes of these products become a viable option if they compete at reduced prices.
On the other hand dairy products are a very important part of most people’s diet, with the benefits of calcium highly publicized. This makes dairy products unlikely to be completely replaced (Dairy in Chile).

Also, Chilean consumers are becoming increasingly aware of the benefits of organic and healthy food. Therefore, brands leveraging on this trend may succeed in differentiating from competitors.

Overall, the threat of substitutes is assessed as moderate.

### 2.3.5. Degree of rivalry

The Chilean dairy market is quite concentrated. As of 2014 the top four players held 74% of the total market value. Two of the largest manufacturers, Fonterra (with its local brand SOPROLE) and Nestlé’ are foreign-owned companies. Colun and Watt’s are local players.

<table>
<thead>
<tr>
<th>Companies</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fonterra Co-operative Group Ltd - SOPROLE</td>
<td>21.80</td>
<td>21.10</td>
<td>20.60</td>
</tr>
<tr>
<td>Cooperativa Agrícola y Lechera de la Union Ltda - Colun</td>
<td>20.30</td>
<td>20.50</td>
<td>20.60</td>
</tr>
<tr>
<td>Nestlé SA</td>
<td>20.60</td>
<td>20.20</td>
<td>19.70</td>
</tr>
<tr>
<td>Watt's SA</td>
<td>12.40</td>
<td>12.70</td>
<td>13.00</td>
</tr>
<tr>
<td>Iparlat SA</td>
<td>3.20</td>
<td>3.20</td>
<td>3.20</td>
</tr>
<tr>
<td>Danone, Groupe</td>
<td>3.40</td>
<td>3.20</td>
<td>3.10</td>
</tr>
<tr>
<td>Quillayes de Peteroa LTDA</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Mondelez International Inc</td>
<td>0.60</td>
<td>0.60</td>
<td>0.60</td>
</tr>
<tr>
<td>Soc Colectiva Comercial Jorge Y Mario Meyer</td>
<td>0.60</td>
<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Buschmann</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Sodiaal SA (Société de Diffusion Internationale Agro-alimentaire)</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Unilever Group</td>
<td>0.40</td>
<td>0.40</td>
<td>0.40</td>
</tr>
<tr>
<td>Nutrexpa SL</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>Company</td>
<td>2013</td>
<td>2014</td>
<td>2015</td>
</tr>
<tr>
<td>---------------------------------------------------</td>
<td>------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>PepsiCo Inc</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>General Mills Inc</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>Tresmontes Lucchetti SA</td>
<td>0.10</td>
<td>0.10</td>
<td>0.10</td>
</tr>
<tr>
<td>Córpora TresMontes SA</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Kraft Foods Inc</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Cooperativa Agrícola y Lechera de Frutillar Ltda (Cafra)</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Bethia SA</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Others</td>
<td>14.80</td>
<td>15.90</td>
<td>16.60</td>
</tr>
<tr>
<td>Total</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Source – Euromonitor International

Following a global trend companies merging and small plants purchasing have become a common practice. The dominance of leading companies causes a parallelism of price strategies, showing oligopoly characteristics. The dominant companies are perceived to play aggressively, and are expected to lower prices in response to a potential market entry of a new player (Molina, 2015).

Most dairy processors have similar product-mix and switching costs for buyers are not very high, although some retailers may have exclusive contracts with a single supplier of dairy products. Industrial production of dairy products requires specialized and solid assets. The need to sell these off when exiting the market implies high exit costs. Overall, rivalry is assessed as strong.
2.3.6. Implications – Why should Arla Foods enter the Chilean market?

The following figure summarizes the Five Forces’ intensity in the Chilean dairy industry, indicated by the green line.

Figure 8: summary of Porter’s 5 Forces in the Chilean dairy industry

Source: own contribution

It can be concluded that the overall industry can be considered moderately attractive, and the market shows potential for growth that Arla Foods could take advantage of.

The two major barriers to entry are constituted by the Buyers Power and the Internal Rivalry. According to findings, Buyer Power could be mitigated by scaling sales and building business credibility in the country, while Internal Rivalry could be addressed by either competing on price or focusing on branding and gaining consumer’s loyalty and charging premium prices.

Given the competitors’ lower cost base and Arla Foods’ premium value proposition, it is recommended to opt for the second approach.
Findings show that the most profitable categories in this market are Hard Cheese, Milk Powder and Yoghurt. However, the latter comes with a higher degree of complexity, as Chilean consumers demand locally adapted yoghurt products. Hence, it is recommended that Arla Foods enters the Chilean dairy market focusing primarily on Hard Cheese and Milk Powder, at least until necessary local market knowledge will be gained.

The outcomes of the External Factors Analysis are further studied in Section 4 – SWOT Analysis, and Section 5 – Entry Mode.
3. Internal Factors Analysis
This section aims at assessing Arla Foods’ strengths and weaknesses in relation to its own resources and capabilities. The elements analyzed are financials, previous international experience and presence in Latin America.

3.1. Arla Foods Overview
The company was born in 2000 after the merge between the Danish-based MD Foods and the Swedish-based Arla. As of 2014, Arla Foods is a cooperative owned by 13,413 farmers among northern and central Europe. The majority of them are located in Denmark, Sweden, Germany and the United Kingdom (Arla Foods Annual Report 2014). The cooperative structure calls for the farmers to be both owners and suppliers of Arla Foods. Hence, the farmers have indirect control over the cooperative (Barton 1989, McBride 1986). The company’s business model commits Arla Foods to purchase as much raw milk as its owners/suppliers produce, and to achieve a competitive buying price for it.
Overall, Arla Foods reaches its customers through a number of market-specific brands and three global ones: Arla, Lurpak and Castello.
The company operates mainly in five product categories: fresh dairy products, cheese, butter & spreads, milk powder and whey products. The total revenues of 10.6 bn EUR earned in 2014 can be split by product category in Figure 9.
Within the "Strategy 2017" plan, Arla Foods seeks to pursue three main objectives: first, to maintain a stable base in Europe by securing its core markets (Denmark, Sweden, United Kingdom and Germany) and to further develop its global brands. Second, to create growth outside the EU with a focus on Russia, China, Middle East and Africa. Third, to be more cost-effective.

In April 2015 milk quotas were abolished in EU. Therefore, European farmers are not constrained to produce a determined amount of raw milk. In fact, Arla Foods expects its milk supply to grow by 2% yearly in the medium term. Hence, it becomes vital to move this additional milk into value added products and expand the business into new markets (Arla Foods Annual Report 2014).

The “Strategy 2017” plan takes this into consideration, and commits the company to focus on increasing the volumes of products sold (Arla Foods Annual Report 2014).
3.2. Financials
Arla Foods’ earnings reached an all-time high in 2014, but the Chinese standby on dairy products import and the Russian ban on imports from EU are constraining the business (Arla Foods Annual Report 2014). From 2010 to 2014 revenues grew by 61%, and totaled 10.6 bn EUR. The company’s profits amounted to 3% of the total revenue, meeting the group’s target (Arla Foods Annual Report 2014). Further, the company’s equity grew at average rate of 12.6% from 2010 to 2014, and the ROE calculated using P/L before tax amounted to 18.04% at the end of the review period (Arla Foods Annual Report 2014). This indicates potential for generating capital to support acquisitions in new markets. However, the company is now undergoing an investment expenditure reduction due to global economic distress and the Chinese and Russian black swans. Hence, Arla Foods must now choose its market entry ambitions even more carefully than before.

3.3. Previous internationalization experience
Since its birth Arla Foods has shown a global ambition for growth, focusing on acquiring other players and establishing Joint Ventures. Evidence shows that Arla Foods tends to enter a market through exports at first, and then gradually commit more and more resources to the new business when more market knowledge is gained. Eventually, a local player is acquired or partnered through a Joint Venture, so that the resources and knowledge possessed by this other player become available (Meyer, Estrin, Bhaumik, Peng, 2009).

3.4. Arla Foods presence in Latin America
Arla Foods has already established its presence in Latin America. The company has been involved in a 50/50 Joint Venture with Vigor, a leader dairy producer in Brazil since 1986. In 2013 the Latin America Regional Office was established in Mexico City, and in 2014 Arla Foods strengthened its position in Brazil by selling the Joint Venture to Vigor in exchange of a 8% share ownership of Vigor itself and a seat in the Board of Directors. Sales offices are also present in Argentina. The rest of the region is covered by low volume export sales flowing from Mexico and Brazil. As of yet, Chile’s
contribution to Arla Foods’ business in terms of sales volume and retail value is negligible.

3.5. **Summary**

As outlined above, Arla Foods enjoys a solid financial base, which enables the company to commit resources for a market entry. However, global market volatility has significantly affected the business in 2014. In particular, the Russian embargo on EU products and the declining Chinese demand for dairy have caused the company to undergo a program of cost-freezes and reduction of capacity investment in the short-to-medium term (Arla Foods Annual report 2014).

Arla Foods benefits from a reliable supply. The cooperative structure determines a very close relationship between the company and its suppliers. This relationship ensures control over production processes and product quality.

Also, the company enjoys a high degree of product innovation that allows targeting different consumer segments and offering a broad range of products. As set out in the Strategy 2017 plan, at least 10% of the company’s earnings must be delivered from the development of new products (Arla Foods Annual Report 2014).

Considering market entry in Chile Arla Foods could take advantage of its presence in other Latin American markets, such as Mexico and Brazil. In particular, the company could liaise with the local offices to gain market knowledge, develop synergies, network with distributors and institutions.

Arla Foods relies on a strong Corporate Social Responsibility code. On top of this, the company enjoys a positioning as an environment-friendly firm, focused on spreading healthier lifestyles through healthy products. This can be very important for tapping into the Chilean consumers’ ever-rising awareness of the benefits associated to a healthy diet.

Also, the corporate organizational structure is conceived to foster quick decision making, as the decision making power lies in the hands of country managers. This becomes very important for adapting global strategies to local markets.
4. SWOT Analysis

The SWOT matrix depicted below shows a summary of internal and external factors affecting Arla Foods’ operations in Chile. The first, namely Strengths and Weaknesses, are derived from the internal analysis. The latter, Opportunities and Threats, summarize the key elements of the market and industry analysis.

Table 4: SWOT Analysis

<table>
<thead>
<tr>
<th>Internal Factors</th>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Reliable supply</td>
<td>• Lack of Chilean market knowledge</td>
</tr>
<tr>
<td></td>
<td>• Strong brand in Europe</td>
<td>• Limited investment capacity in the short-to-medium term</td>
</tr>
<tr>
<td></td>
<td>• Innovation capabilities</td>
<td>• Investment commitments in other regions</td>
</tr>
<tr>
<td></td>
<td>• Presence in Latin America</td>
<td>• Lack of brand recognition in Chile</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Higher costs than competitors in Chile</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>External Factors</th>
<th>Opportunities</th>
<th>Threats</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Growing dairy consumption in Chile</td>
<td>• Strong Competitors possessing extensive market knowledge</td>
</tr>
<tr>
<td></td>
<td>• Rising preferences for healthy products</td>
<td>• Affirmed Brands in differentiated products</td>
</tr>
<tr>
<td></td>
<td>• Ageing population seeking functional food</td>
<td>• Competitors’ value propositions are very close to Arla Foods’</td>
</tr>
<tr>
<td></td>
<td>• Relatively large middle class</td>
<td>• Price-sensitive market</td>
</tr>
</tbody>
</table>

Source: Own contribution

Currently, Arla Foods covers the Chilean market only to a very small extent through exports. However, Chilean consumers are evolving and their preferences are progressively moving towards a match with Arla Foods’ value proposition.
Hence, the Chilean market offers potential that the company should tap into by expanding its current activities in the country. However, Arla Foods is almost entirely unknown in Chile, and therefore its brand does not enjoy any recognition by local consumers. The global economic distress along with the Russian and Chinese complications has affected Arla Foods, constraining the company’s investment capabilities in the short-to-medium term. Further, strong competitors in Chile are expected to react aggressively towards a potential entrant (Molina, 2015). Finally, Arla Foods does not possess the necessary local market knowledge that would allow a smooth selection of a competitive strategy.

The outcomes of the SWOT analysis, which is the result of External and Internal analyses, constitute the input for the following section. In line with the research operationalization, the findings will be processed through the OLI paradigm in order to provide an entry strategy for Arla Foods to pursue in Chile.
5. Entry Mode

The External Analysis has provided an answer to the research first supporting question: *Why should Arla Foods enter the Chilean market?*

This section addresses the research second supporting question:

*How should Arla Foods enter the Chilean market?*

The answer is provided through the OLI paradigm, using the outcomes of the External and Internal analyses as input, as summarized in the SWOT.

One of the main considerations affecting the entry mode in a foreign market concerns ownership. In particular, whether Arla Foods should enter Chile with full ownership and control, for instance with a fully owned subsidiary or with less or no control such as relying on an export intermediary.

According to Pan & Tse (2000), entry modes in foreign markets can be of two kinds: non-equity modes and equity modes. These can be further divided into specific strategies. The below table illustrates both equity and non-equity entry strategies, and in line with the previous section findings, it assesses the associated risk, returns, control and market knowledge gain.

Table 5: Market entry modes

<table>
<thead>
<tr>
<th>Entry Modes</th>
<th>Non-Equity</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Exporting</td>
<td>Strategic Partnership</td>
</tr>
<tr>
<td>Risk</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Return</td>
<td>Low</td>
<td>Low</td>
</tr>
<tr>
<td>Control</td>
<td>Moderate</td>
<td>Low</td>
</tr>
<tr>
<td>Market Knowledge Gain</td>
<td>Low</td>
<td>Moderate</td>
</tr>
</tbody>
</table>

Source: Made by author, data from Kumar & Subramanian (1997)

Dunning’s Eclectic Paradigm, complemented by a number of other frameworks, is used to assess which entry mode Arla Foods should pursue in Chile.
5.1. Ownership Advantage

The issue of the Ownership is supported by the Resource Based View (RBV), which sees the firm’s own resources and capabilities as the elements allowing companies to create competitive advantage and underline their choice of entry strategy (Meyer, Wright, & Pruthi, 2009). These elements for Arla Foods are summarized in Table 4, under strengths and weaknesses.

According to Barney (1991) companies must support their foreign activities through firm-specific resources that allow them to offset their disadvantages related to being foreign. Within the RBV, some scholars pose particular attention on a specific set of resources and capabilities that affect entry strategies, namely firm size, multinational experience and ability to develop differentiated products (Agarwal & Ramaswami, 1992).

According to Agarwal & Ramaswami (1992), the firm’s size is related the capacity of absorbing costs arising from the establishment of foreign operations, and the multinational experience is connected to the ability of managing these operations abroad. Finally, the ability of developing differentiated products is related to the company’s skills to generate competitive advantage out of innovation.

Hence, companies possessing a large size, significant multinational experience and strong innovation skills are better suited by equity entry modes which ensure high ownership and control over activities (Agarwal & Ramaswami 1992), allowing a sustained generation and protection of competitive advantage.

With a large size, strong financials and extensive multinational experience Arla Foods is undoubtedly a strong player within the global dairy industry, ranking the 7th top dairy company in 2013 (source: Canadian Dairy Information Center). Further, Arla Foods innovation capabilities are significant and play a key role in generating competitive advantage (Arla Foods Annual Report 2014).

Hence, according to theory, the company should pursue an equity entry strategy in Chile.
However, the Chilean dairy market is dominated by global players, such as Fonterra and Nestle’, who possess a similar set of resources and capabilities, and enjoy already a consolidated business and brand recognition. Further, Arla Foods has committed to reduce investment expenditure in the short-to-medium term (Arla Foods Annual Report 2014).

Overall, Ownership Advantage forces are perceived to push with moderate intensity towards an entry mode providing high control.

5.2. Location Advantage
Location advantage relates to market specific elements that firms can exploit to create competitive advantage. These elements refer to the outcomes of the External Factors analysis, which are summarized in the SWOT analysis under Opportunities and Weaknesses. The Location advantage is assessed through the use of two frameworks, namely the Institution Based View (IBV) and Hofstede’s Cultural Dimensions.

North (1991) defines institutions as the constraints that structure human interaction by setting the rules of the game for firms and individuals. According to Peng, Sun, Pinkham and Chen (2009) institutions reduce uncertainty in a given market by conditioning the norms of behavior and defining the boundaries of what is legitimate. The Institution Based View poses that companies’ performance in a given market is not only determined by firms’ internal capabilities (RBV) and the industry degree of competitiveness (as implied in the so-called Industry Based View), but also by the institutions setup (Peng, Sun, Pinkham, & Chen, 2009).

According to the IBV strong institutions reduce uncertainty and therefore reduce the risk of opportunistic behavior, which is a key determinant of contract cost and acquisition cost (Meyer, Estrin, Bhaumik & Peng 2009). In fact, institutional frameworks that ensure transparency, predictability and contract enforcement facilitate market transactions both in relation to contracts and acquisitions (Peng & Heat, 1996; Beim & Calomiris 2001).
The idea is entry modes ensuring higher control are required to compensate for the high uncertainty arising from weak institutions.

Given Chile’s strength and stability of regulatory framework and financial markets (source: World Bank) transaction costs are assessed as low. The country’s strong institutional environment is perceived to reduce market uncertainty. Further, Chile adopts a policy of openness towards foreign direct investment and no significant restrictions apply to foreign players willing to run operations in the country. In addition, Chile signed free trade agreements with a number of countries, including the European Union, reducing furtherly the cost of transactions.

To provide a comprehensive picture of Location advantage, in this paper the IBV is supported by Hofstede’s Cultural Distance. The rationale behind this model is that different cultures have different organizational and administrative tasks and ultimately, the cultural dimension has an impact on both entry strategy (Hofstede, 1984), and post-acquisition integration activities (Jemison & Sitkin, 1986). To a high cultural distance corresponds a high overall cost of acquisition, arising from the difficulties companies have to face when integrating their management and organizational practices (Hofstede, 1984).

The idea behind cultural distance models is that greater control might be necessary in a culturally distant market because of the higher information costs and greater difficulties in transferring competencies in such markets (Li & Guisinger, 1992).

It is assumed that Arla Foods has a Danish culture, due to the company’s heritage and management practices. As illustrated in the below graph, Chile appears to have quite a high cultural distance compared to Denmark.
Chile scores significantly different than Denmark in three out of four dimensions, namely Power Distance, Individualism/Collectivism and Uncertainty Avoidance.

Although Chile scores lower on Power Distance than most other countries in the Latin American region, it still occupies a high-intermediate position in this dimension. Organizationally, the country show tall pyramids and low degrees of delegation. Status symbols are used to underline power differences and a rigid social classes structure is present.

A low score in Individualism indicates that Chilean people tend to identify their self-image in terms of “We” rather than “I”, in line with other Latin American countries. Collectivist societies such as Chile are likely to be driven by collective rationality and social forces.
A high score on Uncertainty Avoidance indicates that Chile is a society with a strong need for rules and elaborate legal systems in order to structure life. As opposed to other regional peers, Chile has quite low corruption rates. In the Chilean society, and especially within non-managerial employees, there is a high dependence on experts and authorities.

According to theory, high cultural distance determines a high acquisition cost. Hence, it is likely that in case of the acquisition of an existing local player, Arla Foods will have to face a high acquisition cost. According to Gatignon and Anderson (1988), in high cultural distance contexts, MNEs may require greater flexibility, resulting in preferences for modes of entry with lower equity commitments and control, such as licensing, strategic partnership or Joint Venture.

Overall, Location Advantage forces are perceived to push towards non-equity entry modes providing higher flexibility.

5.3. Internalization Advantage
This concept relates to the advantage arising either from internalizing transactions or relying on market transactions. The Internalization Advantage is analyzed through the Transaction Cost Economics (TCE) in this paper. The rationale is that for a given transaction, if the cost of internalizing is lower than the cost of contract, companies should internalize the transaction. Vice versa, if the cost of internalizing is higher than the cost of the contract, then companies should rely on market transactions. Hence, companies evaluate carrying out transactions according to a cost minimization principle (Williamson, 1979). The TCE poses that firms exist to reduce the threat of opportunism, or behavioral uncertainty of exchange partner occurring in market transactions (Williamson, 1979). Williamson (1979) articulates the TCE around three main elements that affect the choice of internalizing, namely: asset specificity, uncertainty and frequency.
Asset specificity refers to assets that are specific for the given transaction, and have little value for external purposes. The nature of these assets increases the dependency and the risk of opportunistic behavior between the parts (Williamson, 1979). According to Brouthers (2002), higher control entry modes are more suitable for highly specific assets, as they enable companies to prevent opportunistic behavior. Arla Foods is not perceived to require a high extent of specific assets to enter the Chilean markets. Hence, asset specificity force is not strong in this case.

Uncertainty can be either external or internal. According to Gratignon & Anderson (1988), external uncertainty refers to the host country’s political, legal, cultural and economic environment impact on business operations. External uncertainty makes it impossible to trade out every possible future contingency in a contract. This causes contract inefficiency (Williamson, 1979). According to Brouthers & Brouthers (2003), high external uncertainty is better addressed by flexible organizational structures, enabling companies to adapt to a dynamic environment. Hence, according to theory, lower equity entry modes reduce the risk arising from external uncertainty.

On the other hand, internal uncertainty relates to the difficulty of assessing contracting parts’ performance (Brouthers & Hennart, 2007), which generates costs associated to monitoring and controlling (Gatignon & Anderson, 1988). These costs are ultimately reflected in the overall contracting cost.

Besides the uncertainty arising from the lack of local market knowledge, Arla Foods is not expected to face a significant amount of external uncertainty in Chile. As outlined in the IBV analysis, the overall legal, political and economic environment is quite stable in the country. Further, Arla Foods enjoys some expertise in terms of international experience, which can be important in mitigating internal uncertainty. In fact, the company has already extensive knowledge in foreign entry strategies and strategic partnership. Hence, it is assumed that Arla Foods possesses the knowledge to deal with the selection and monitoring of contracting parts.
Frequency refers to the transaction’s rate of recurrence. Williamson (1979) suggests that high equity entry modes suit better highly frequent transactions as these entry modes overcome the costs related to integration. On the other hand, if the frequency rate is not high enough, contracts may represent the best solution.

The Chilean dairy market is already saturated and dominated by global and aggressive players. Further, the size of this market is not as interesting as in other countries already targeted by Arla Foods. Hence, it is not expected that the frequency of transactions will justify a resource-intensive equity mode, at least in a first stage.

Overall, the TCE forces are perceived to push towards a low equity entry mode.
5.4. The Selected Entry Mode – How should Arla Foods enter the Chilean Market?

The OLI forces effect on the entry mode selection is graphically depicted in Figure 11.

![OLI forces depiction](image)

Source: own contribution

According to the OLI findings, it is assessed that the company needs a low-risk and non-resource-intensive entry strategy that maximizes the gain of market knowledge at least in a first stage. Referring to the entry mode table 5, the identified entry mode is Strategic Partnership. Several theoretical studies suggest that Strategic Partnerships are beneficial for increasing market power and gaining better access to key resources such as capital and information (Mowery, Oxley, and Silverman 1996; Gulati, Nohria and Zaheer, 2000).

Hence, Arla Foods is recommended to expand the current activities in Chile by signing a strategic non-equity partnership with a local player. In line with theory, this approach maximizes knowledge gain and at the same time minimizes costs and risks, allowing the company to test the market by committing a relatively low amount of resources.

According to research findings, Arla should enter the Chilean market with Hard Cheese and Milk Powder categories. Yoghurt is also an attractive category, but it comes with a higher degree of complexity. In Chile, consumers’ tend to prefer sophisticated and locally adapted yoghurts in terms
of flavor and texture profiles, which may not match with Arla Foods’ current products (Yoghurth in Chile).

However, it is perceived that if Arla Foods manages to generate sustained sales volumes, raise brand awareness and increase its understanding of local culture and market dynamics, the Location and Internalization Advantage forces will tend to shift. In particular, given that the above conditions are met, it is expected that these two forces will change direction or at least their intensity will be mitigated.

In such a scenario, a reassessment of the overall strategy is needed in order to generate competitive advantage, as the motives that led the company to choose a Strategic Partnership are changing. It is perceived that at this point Arla Foods will need to adapt its strategy and resource commitments according to two variables: the entity of consumer demand and the partnership performance (Molina, 2015). The analysis of these two variables opens up three different strategic scenarios as explained below.

Figure 12: the proposed entry strategy

<table>
<thead>
<tr>
<th>Present</th>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export</td>
<td>Partnership with local player</td>
<td>Strategy assessment</td>
<td>Joint Venture with current partner</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Acquire a local player</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Market exit</td>
</tr>
</tbody>
</table>

Source: own contribution
Stage 1 – Partnership establishment

Arla Foods negotiates and establishes a strategic partnership with a local player. The partner will focus on distribution, sales, in-store merchandising and will provide key market knowledge and access to networks (Gulati, 1998). A local partner is also key for dealing with the national regulatory framework, which is extremely important. According to Molina (2015), regulation of food products varies to a significant extent among the Latin American region. Hence, although Arla Foods has already activities in other countries in this region, it might be necessary to partner with a local player to deal with the regulation effectively.

According to findings, the partnership should not involve equity commitments from Arla Foods, so to minimize risks. Instead, it should be based on margins sharing. Partnering with the right distributor is extremely important to penetrate the market successfully and to avoid resource waste. The target is to find a partner with complementary characteristics and ambition for creating business growth through the alliance with Arla Foods. Hence, it becomes essential to define a set of criteria which allow the identification of a suitable partner. According to Molina and Jakobsen (2015) the ideal partner has a deep knowledge of the Chilean market, compensating for Arla Foods’ lack of local knowledge, and comes with a solid reach of distribution. It employs trained merchandisers, who ensure that Arla Foods’ products enjoy a suitable positioning on retailers’ shelves. It understands and complies with Arla Foods’ code of conduct, ensuring that the company’s brand and reputation are not damaged by its activities. Further, it and possesses the ambition to develop the partnership and consolidate a longstanding relationship with Arla Foods.

Table 6 summarizes the partner selection criteria.
Table 6: Partner selection criteria

<table>
<thead>
<tr>
<th>Partner Selection Criteria</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Deep knowledge of the local market</td>
</tr>
<tr>
<td>• Wide and strong reach of distribution</td>
</tr>
<tr>
<td>• Trained in-store merchandisers</td>
</tr>
<tr>
<td>• Understanding and commitment to Arla Foods' code of conduct</td>
</tr>
<tr>
<td>• Ambition to develop the partnership with Arla Foods</td>
</tr>
</tbody>
</table>

Source: own contribution

Stage 2 – Strategy assessment

At this point Arla Foods has worked with the local partner for some time, gaining consistent market knowledge and experience. It is the moment for a selection of a consistent competitive strategy. Further, Arla Foods must now reassess its operations in Chile. Given the setup of current activities being carried out through a partner distributor, it is assumed that the two main elements that can affect Arla Foods’ operations in Chile are Consumer Demand and Partnership Performance (Molina, 2015). Arla Foods must adapt its business structure according to the outcomes of these factors as illustrated in Table 7. The response to these contingencies leads to Stage 3.

Table 7: Strategy reassessment

<table>
<thead>
<tr>
<th>Consumer Demand for Arla Foods’ products</th>
<th>Significant</th>
<th>Non-significant</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partnership Performance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>High</td>
<td>Joint Venture with partner</td>
<td>Market exit</td>
</tr>
<tr>
<td>Poor</td>
<td>Acquire a local player</td>
<td>Market exit</td>
</tr>
</tbody>
</table>

Source: own contribution
Stage 3 – Strategy Adaptation

The interaction of Consumer Demand and Partnership Performance opens three possible scenarios to which Arla Foods adapts by choosing a specific strategy, as illustrated in the above table.

1) Joint Venture with partner – If the demand for Arla Foods’ products is significant and the partner demonstrates sound capabilities and commitment to the partnership Arla Foods should invest into the development of its current partnership. The company should create a Joint Venture with its partner, establishing a solid presence in the Chilean Market. As highlighted in table 5 the business risk is higher for a Joint Venture than for a Strategic Partnership, due to the increased amount of resources to invest. However, this approach increases control over activities, improves scale and establishes a solid presence in the market. Arla Foods has already solid experience in establishing Joint Ventures in foreign markets (Arla Foods Annual Report 2014). Hence, the company possesses some expertise in managing this kind of processes.

2) Acquire a local player – In case the current partner’s performance doesn’t live up to the expectations but the market responds positively to Arla Foods’ products the company is recommended to turn down the current strategic partnership and acquire a local player, either a distributor or a small milk processor.

3) Market exit – If the demand for Arla Foods’ products is non-significant and shows no potential for growth, it is recommended to exit the market. This allows Arla Foods to direct its resources to other markets that demonstrate a higher attractiveness. The partnership agreement is not expected to constitute an exit barrier, since the partnership does not involve equity commitment from neither of the sides.
6. Conclusion

This purpose of this thesis is to provide an entry strategy for Arla Foods to pursue in Chile. In order to do so, two questions are addressed, namely:

*Why should Arla Foods enter the Chilean market*

and

*How should Arla Foods enter the Chilean market?*

The response provided to the first question allowed to determine the attractiveness of the market, identifying key trends and business potential. This response is the outcome of the External Factors Analysis, which scanned the Chilean market on a macro and micro level. The country appears to be interesting for Arla Foods due to a growing overall dairy consumption, a relatively large middle class, a progressive match of consumer preferences with Arla Foods’ value proposition and the increasing demand for functional dairy products from the older part of the population.

However, the External Factors Analysis showed that the Chilean market is quite price-sensitive and already dominated by affirmed competitors, which are expected to react aggressively to Arla Foods’ market entry.

The second question refers to the entry strategy that Arla Foods should pursue in Chile. The answer was provided through an evaluation of both External Factors and Internal Factors, Arla Foods own resources and capabilities. The strong theoretical framework applied was supported by suggestions and advices of Arla Foods direct employees, who possess expertise in the field of internationalization. The resulting recommendations call for Arla Foods to pursue an incremental approach focused on risk minimization and market knowledge gain maximization. The company is recommended to start off by changing its current export-based model to a non-equity strategic partnership with a local player focused on distribution activities. Once consistent sales volumes are achieved and necessary brand awareness is raised, Arla Foods should reassess its current strategy and consider moving to an equity based model or exit the market, according to market contingencies.
Bibliography


Appendix 1: Interview with Martin Falch Jakobsen – Business Development Manager

What is your general opinion about Chile as a potential new market for Arla Foods?
Chile is an attractive country in the Latin American Region, because you have relatively interesting market sizes and category mixes while at the same time you don’t have very high level of inflation or high crime rates unlike other areas in the region. But one of the reflections is that in LATAM we really want to do a lot but we need to maintain our resource focus, and identify top priority and lower priority countries.

What are your ideas around internationalization in markets so different from companies’ home markets, such as the case of Arla Foods in Chile?
It can be interesting to have a distributor setup where you identify a strong distributor and have an export business to them. If you get the right ones it can be a really strong proposition. You basically go into the market, get a partner building up some of the “space” categories such as cheese and milk powder that can potentially lift some volumes before going in with the more value added prods so try to build up base positions to see how it runs. If you see a high growth potential and you can see there is a huge opportunity for doing something more in Chile then it will be taking the next step after that. You don’t tap into full potential but have the opportunity to assess the market.

This gradual approach has been used [by Arla Foods] in many markets. First export, you learn about duty structure and this kind of things, and next step you may have a dedicated person to work with that market. When it grows sufficiently large you can have a person that sits locally in that market. Maybe 1 or 2 employees.

A region like LATAM is very new to us. You could start small and then incrementally when you assess potential and right partners. Definitely a low risk and logical way of doing it. The only issue is that in many of these markets there are many aggressive competitors, doing a big consolidation game in. They have different approaches, for instance going full front in a high potential market rather than gradually scaling up
activities. So they buy their way of having a platform, the idea is that they expect to build a lot of synergies on that platform and brands. You need the necessary funding for this. Since in Arla we are a cooperative we need to be very sharp when doing M&A because it’s lot of money that you get to invest.

What are the characteristics that make a local player a good partner for Arla Foods?
It’s important to define criteria we want from them, what we are looking for. It might be that we need somebody strong in distribution, strong capabilities in modern trade, how many outlets they reach.
Beyond that you will try to find someone with experience in dairy products distribution. You need someone to handle this kind of products in terms of transportation, cooling, merchandising team that nurses the products in the store. If you don’t have it in LATAM, due to different ethics the competitors will just push your products away from the shelf. It’s also important to find somebody with non-overlapping categories, as they wouldn’t have incentive for cannibalize.
Also, ethics need to be included in the criteria, so that we don’t run into CSR issues. It’s also good to find soon somebody who would be up for a JV later on, otherwise it can be time-and-resource-consuming to start again later. It is always a risk to start with a new distributor.
In some markets you just go in with premium products but it might not work everywhere. It can happen that if you want to be taken seriously by distributors you need to build up some volumes for the Arla brand first. It has to be volume driven or it’s going to be hard to convince a distributor to put a small pack of our premium products on their shelves, as it means low margins for them. If you drive scales in the distributors business they will be more inclined to get more premium prods for us. It can be hard to get a distributor agreement if you don’t build a credible volume.
Appendix 2: Interview with Guillermo Molina – Export Manager in Latin America Region

Overall, what are the things to keep in mind when entering the Chilean market?
Chile is a very stable country unlike other areas in the region. It very important to know that Chile presents some “western trends”. For instance, the retailing landscape is dominated by modern trade retail channels such as supermarkets and hypermarkets. Unlike other countries in Latin America, most Chilean consumers use credit cards.

Concerning Arla Foods market entry in Chile, I believe it is very important to be below the line, to have people in the stores to ensure your products are on the shelves. A lot of companies have these professional merchandisers in the stores, so if you don’t have yours, your products will be pushed off the shelves.

Arla is not known in Chile, so we need in-store promotion, and also social media advertisement because it is not very expensive and people in Chile use them a lot. For instance they use Facebook, twitter, and so on. Promotion in television and newspaper is very expensive, so you need to consider whether you want to invest a lot of money in marketing.

How do you think competitors would react to Arla’s entry in Chile?
The market is very price-sensitive, and I would expect these competitors to react to our entry by lowering prices, offer giveaways. I don’t believe they will use promotion and media. They will mainly act on pricing, in different ways. With discounts, giving more samples in the stores, and so on.

This is in a way logical, as they have production facilities in Chile and therefore have lower costs than entrants and they don’t pay import taxes to get the milk into the country.

We are seeing this kind of behavior in other countries in the region.

How do you think national regulation would impact Arla Foods’ business in Chile?
It is very important to verify that packaging and label comply with national regulation, as in LATAM each country has got its own regulation on food. We might achieve
synergies from developing common packaging for all the Spanish speaking countries in the region, but this has to be worked out. What we know now is that national regulations differ and hence we must pay attention.

If Arla Foods was to enter the Chilean market through a partnership, what would you look for in the potential partner?
I believe it is important for potential partners to possess financial strength and solid warehousing networks. They must have a good understanding on regulation concerning international trade, and experience working with global brands, as the approach is different than with local brands. Also, they should understand the marketing trends of the country.

Further, I would say that on average it takes from 6 months up to 1 year to find the right partner. And this of course means that time and resources have to be spent in the process.