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8. Institutional diversity in international business: the free-standing company and the managing agency

8.1 INTRODUCTION

Hennart (1994) has recently offered an explanation of free-standing companies couched in terms of the theory of transaction costs. Free-standing companies accounted for a significant proportion of capital exports from Britain – particularly to Latin America, Africa and parts of Asia – in the period 1870–1914 (Harvey and Taylor, 1987). According to Wilkins (1988a), these companies 'were registered in the United Kingdom and were established to do business typically in a single country abroad ... Each usually operated a single economic activity overseas, but together they covered the economic spectrum ... Each had a board of directors in Britain, charged with managing the overseas business.'

Because free-standing firms were headquartered in one country but operated in another, they are regarded by Wilkins as multinational enterprises. Since they do not conform to the pattern of multinational activity exemplified by manufacturing firms, however, they are perceived to challenge conventional theory. In particular they appear to challenge Vernon's 'product cycle' theory (Vernon, 1966) and the early version of Dunning's 'eclectic' theory (1981), in which the multinational transfers abroad a firm-specific competitive advantage which has first been developed at home.

But do they challenge the more general internalization theory too? Hennart argues that they do not. He says that competitive advantage is not internalized by the free-standing firm, but that the market for capital is internalized instead. He then attempts to explain exactly how the internalization of the capital market is effected by the free-standing firm.

This chapter suggests that while Hennart is correct to emphasize the power and generality of internalization theory, he is wrong to reject the competitive advantage view. The key to understanding the free-standing company lies not in the distinction between competitive advantage and capital made by Hennart, but in the different nature of competitive advantages in manufacturing and property-related industries.

The limitations of conventional theory lie in its implicit orientation to manufacturing industry (Casson, 1986). Free-standing companies were mainly concerned, not with manufacturing, but with property development in its various manifestations. Once the general principle of internalization is applied to the specific issues of property development – including the specific nature of competitive advantage in the property-related industries – the rationale for the free-standing firm is obvious. Hennart's attempt to extend the principle of internalization to the capital market is of only peripheral relevance.

8.2 TWO TYPES OF INDUSTRY: A COMPARISON OF PROPERTY DEVELOPMENT AND MANUFACTURING

Although Wilkins claims that the free-standing companies spanned the economic spectrum, her evidence actually indicates a significant concentration on property-related industries (Wilkins, 1988b, p. 262). The projects financed by free-standing companies were mainly concerned with

(i) *transport infrastructure*: railway lines, ports, etc.
(ii) *utilities*: gas, electricity and water supply;
(iii) *primary-sector investments*: sinking mines, creating plantations, drilling for oil; and
(iv) *urban development*: hotels, offices, housing, etc.

There are exceptions, though, such as cotton and jute mills, which will be considered later.

It is well known that the management of property, once it has been developed, calls for very different skills from the development process itself. Thus the development is often promoted by one company, and the operation of the completed property is managed by another. This is true today, for example, in the hotel industry: one firm develops the site and owns the building, while another runs the hotel – operating the reservation system, training and supervising the staff, and so on. In the nineteenth century the development process was managed by the free-standing company, and the operations were managed by local interests.

These interests might be a local branch of a managing agency whose senior partners were based in London. In the case of primary investments whose output was exported, management might be undertaken by a local merchant house instead. Indeed, anticipating profits from such operations, partners in the managing agencies and merchant houses often played a leading role in the promotion of free-standing companies – especially in Asia (see below).

In contrast to this, manufacturing industries tend to require rather similar skills in the initial investment phase and the subsequent operational phase. For example, the key to successful initial investment often lies in good product design, while the key to continued success in subsequent operations lies in the continual improvement of this design in the light of information fed back from production and marketing activities (Buckley and Casson, 1976). Thus both initial investment and subsequent operation call for effective R & D. There is a difference, of course: initially it is the generic design that is important, whilst subsequently it is the refinement of different variants of this design, adapted to different local conditions, which is important. Nevertheless, both initially and subsequently it is the stream of competitive advantage generated by successful R & D, and the internalization of the information flows connected with it, that is crucial to the firm.

There is, therefore, little case in manufacturing for externalizing the management of the subsequent operations. Because the skills required at each stage are so different in property development, however, it is very sensible to internalize the first stage but to externalize the second. This allows different management teams to bring their particular expertise to bear on different stages of the project (see Table 8.1).

Table 8.1 Comparison of internalization strategies in manufacturing and property-related industries

Management of	Sector: Manufacturing	Property-related
Initial investment phase	Internal	Internal
Subsequent operations	Internal	External

Note: The 'externalization' of subsequent operations in property-related industries does not necessarily imply that the management of each subsequent operation is in the hands of a separate independent firm. Thus a firm endowed with special operating skills might well operate several property-related projects. The market in these operating skills would then be internalized by the operating company. But because this company is entirely independent of the initial investor responsible for each project, the market in operating skills is external so far as the initial investor is concerned. Some of the multi-branch managing agencies may have been endowed with special operating skills of this kind.

In property development the first stage of the project is particularly important. This is because property is a highly idiosyncratic asset. Unlike the machinery with which a typical factory is equipped, which is relatively standardized, divisible and mobile, a mine, plantation or railway is a highly customized asset which is indivisible and quite immobile. The design and layout must be tailored to the specificities of the site. Construction must normally take place on site; unlike machinery, it is difficult to prefabricate the asset elsewhere and simply transport it to the site. Thus most of the labour and materials required for the fabrication of the asset must be brought to the site – which is a major logistical operation.

Just as in manufacturing, some construction work can be subcontracted, but the supervision of the subcontractor remains a huge task. Because of hidden geological problems that may come to light, new political difficulties that may arise with a change of local regime, etc., the continuation of the project must be kept under constant review. The initial phase of property development therefore requires a high quality of entrepreneurial judgement if it is to be carried out successfully. It is this entrepreneurial judgement that is supplied by the free-standing firm.

The specificities of a development project also explain why most free-standing companies had only one project. They did not normally evolve into major conglomerates with a family of projects because each project was so heterogeneous. Local knowledge of the site, of routes for construction traffic, and the attitudes of political leaders was important. So too was knowledge of the specialist skills offered by different firms of consulting engineers. In the case of export-oriented projects, this information had to be combined with knowledge of overseas market conditions too. Thus each project required a unique synthesis of specialized knowledge to carry out the development process properly. While Hennart correctly emphasizes the great riskiness of the free-standing companies' projects, the really important point is that a unique combination of skills was required to *manage* the risks and prevent them from becoming any greater than they had to be.

Another reason why free-standing companies did not evolve into conglomerates was that individual investors did not need to buy shares in a conglomerate in order to diversify their risks. Given the low transaction costs of the London Stock Exchange, it was relatively easy to 'buy the market', by assembling a personal portfolio of shares in free-standing firms. The one-project free-standing company also allowed the more speculative shareholders to specialize in financing individual projects about which they felt particularly knowledgeable themselves. Furthermore the financial transparency afforded by the single-project form assured investors that profits on successful projects would not be wasted by the management on cross-subsidizing unsuccessful ones.

Compared to the initial investment phase, the routine operation of a completed project in the property sector requires very different skills. Typically (but not invariably) these skills are more modest. In contrast to manufacturing, the technology is often quite simple. In some cases the completed asset is simply divided into sub-units and rented out – in housing developments by the year, in hotels by the night, etc. This means that the management of routine operations can often be externalized to people lacking any proprietary skills. The publicly

available knowledge possessed by the average well-educated and experienced individual will suffice.

This distinction between the very scarce skills required in the investment phase and the more abundant skills used in the operating phase explains why the former skills were located in a major business centre such as London whilst the other skills were dispersed around the sites. The agglomeration of headquarters in London kept the specialists based in London fully utilized. They could switch from one project to another as one completed its investment phase and another started up. Thus the expertise of explorers, engineers, lawyers and bankers could be pooled in London in a manner that would have been impossible if everyone had been distributed around the colonies managing local operations instead (Harvey and Press, 1989; Turrell with van Helten, 1986).

Proximity also helped to reduce transaction costs in the market for specialists through social networking. Specialists met at ordinary social events as well as on business assignments, and this assisted in making contacts and negotiating deals. Gossip provided a reputation mechanism which encouraged each specialist to behave with integrity (see Chapter 3). This informal mechanism was reinforced by the reputation of British law. Specialists based in London were not only closer to investors for reporting purposes; they were also more obviously 'hostage' to the legal system than they would have been if based in the outposts of the empire, or beyond them.

Managers in charge of routine operations do not need to be networked so intensively. Their competencies are more general, and therefore easier to appraise without recourse to second opinions. They do not need to socialize to strike new deals because they are kept fully occupied on a single job. In any case they cannot agglomerate so heavily because, given poor communications, they have to remain close to the site. Nevertheless informal social mechanisms still have an important role even in colonial outposts: recruitment from particular schools and particular ethnic groups ensured a degree of cultural homogeneity amongst the managers, and the resulting atmosphere of trust was reinforced by the obligation to participate in local club life (Jones, 1993).

8.3 THE MANAGING AGENCY SYSTEM AND THE FREE-STANDING FIRM

Not all property-related industries involve low-technology operations, however. Railways, utilities and mines have a continuing need for engineering expertise, and have to upgrade their equipment regularly to achieve full efficiency. This expertise can be provided in two main ways. Either the free-standing company can extend its managerial involvement beyond the investment phase, or the management of the project can be vested in the hands of a firm which manages similar operations elsewhere. The former is most appropriate when the operational problems are highly specific to the site, whilst the latter is more appropriate if the operational problems are generic. In the latter case, which is most common, economies of scope in operational skill will be maximized by placing the operation of several projects in the hands of the same specialized managing agency. If the projects are in different countries, this will generate a multinational managing agency. This is, in fact, exactly the kind of institution that evolved alongside the free-standing firm in a number of industries.

Many managing agencies evolved out of merchant houses which in turn evolved out of commission houses (Chapman, 1985). The commission houses acted as marketing agents for British exporters and purchasing agents for British importers. As the parties began trading more on their own account, there was a strong incentive to improve the quality of their purchases by assuming management of the production process in underdeveloped economies. Because of the limited capital available to the partners it was advantageous to use management contracts, rather than to integrate backwards by outright purchase of the operations. In some cases the local expatriate capital market was deep enough to provide the funds, supplemented by capital supplied by the indigenous landed élite (Brown, 1992). Where capital requirements were heavy, however, the British market might be tapped instead. Friends, relatives and business partners in, say, London, Glasgow or Dundee would organize a flotation to procure the necessary funds.

There are, therefore, two main differences between the multinational managing agency and the conventional multinational firm. The first is that the agency is typically a partnership, with senior partners having shares in the London offices and certain branches, and junior partners having shares in a single branch in which they are employed. The second is that the agency does not own the assets it manages, whereas the conventional multinational does. These two differences are linked. As indicated above, the fact that the managing agency is a partnership limits its access to capital, and prevents it issuing shares to buy outright the assets it controls. An agency pursuing organic expansion must therefore promote nominally independent companies which will own the assets it plans to manage instead. If it were fully incorporated, and issued its own equity, then it could use the funds from the equity issue to buy the assets outright.

The multinational managing agencies appear to have exploited two particular kinds of management skill. The first is a specific skill relating to a particular technology, for example the organization of work and the procurement and maintenance of machinery in a textile mill. A managing agency might, for example, arrange for the export of secondhand machinery from Lancashire to India and its subsequent utilization in an Indian mill. The initial investment would be organized through a free-standing company and the management of subsequent

operations organized through a management contract with the free-standing company's mill. In contrast to the typical form of property development discussed above, this manufacturing investment probably requires greater skill in its operation than it does in its initial investment phase, which is why it is important to give explicit recognition to the role of the managing agency in the promotion of the free-standing firm. It is probably this kind of activity that explains the presence of cotton and jute mills in Wilkins's population of freestanding firms, as noted earlier.

Some managing agencies do not appear to have exploited specific skills of this kind. Their skills were of a more general kind – skills which all successful multinational managing agencies appear to have enjoyed to some degree. These are the skills of recruiting people with the right combination of academic achievement, social aptitude and physical strength to manage overseas operations successfully. Like the free-standing firms, they internalized a particular type of entrepreneurial judgement – not judgements about idiosyncratic problems arising in the initial investment phase, but judgements about the qualities required by managerial personnel, and about which potential recruits actually possessed them.

It is, therefore, the role of managing agencies in exploiting their management skills whilst maintaining their partnership structure that explains the emergence of free-standing firms in manufacturing industries. Rather than reconstitute themselves as corporations, the partners in the agency simply launched free-standing companies in conjunction with their business contacts in Britain in order to finance investment of a kind which an ordinary corporation could have funded through debenture finance. By avoiding corporate reconstruction it minimized transaction costs in the short run. With the benefit of hindsight, though, it appears to have been a short-sighted strategy in the more technologically progressive industries.

The more significant is technology to the operation of the assets, the more serious is the failure to incorporate. Technological progress confronts the management with a succession of innovation decisions. Mistaken decisions will have a major impact on the value of the assets. This strengthens the case for forcing the operator to carry all the equity risk once the assets have been created. It therefore favours the formal incorporation of the operating company and its outright acquisition of the assets that it manages.

The incorporation of the operating company does not, though, imply that the company should integrate forward into the management of the initial investment process as well. So long as project management involves its own special risks, it may be advantageous to leave the development in the hands of a separate company. It does imply, however, that once the initial phase has been completed, the operating company should buy out the investing company. This is, in fact, the way that most modern property development in high-technology activities is done. A special 'free-standing' company is formed – often financed as a consortium – which develops the property, operates it for a short period to train personnel, and then sells it to an indigenous company (often state-owned) which manages it independently thereafter. This is the 'build–operate–transfer' system. The key difference between this and the free-standing company system is simply that ownership of the assets is indigenized once the development is complete. (This was, in fact, the eventual fate of a number of free-standing companies, whose assets were eventually nationalized by unsympathetic host governments – see below.)

Some managing agencies in technologically progressive industries made the transition to a conventional multinational by acquiring the assets they managed and others did not. In one respect, though, the multinational that resulted was not always conventional, for its British operations might consist simply of a headquarters office. All the physical production of goods and services would be effected overseas. The British operation merely exported management services through the equity route. This produced what may be called the 'expatriate multinational.' This term does not, of course, signify that the firm relied on resident expatriate employees, but only that its operations, though controlled from home, were all located abroad. The overseas operations might span several countries and be highly integrated, unlike the operations of the single-project free-standing firm. It is important not to confuse the expatriate multinational, which seems to have been quite common in banking and oil, with the pure form of free-standing company emphasized by Wilkins and Hennart in which the headquarters had no influence on the ordinary operations of the firm. While the expatriate multinational by definition actively controlled its overseas operations on a continuing basis, the pure free-standing company exercised control only in the initial investment phase.

In some instances the problems of 'management at a distance' within the expatriate multinational proved insuperable, and the headquarters eventually shifted overseas closer to the main operations. This generally seems to have occurred when there was a sufficiently large pool of management expertise abroad, and a well-established system of local law under which the company could be incorporated.

8.4 FOREIGN INVESTMENT BY FREE-STANDING FIRMS: PORTFOLIO OR DIRECT?

The question was raised earlier as to whether free-standing firms are true multinationals. Conventional wisdom today is that they are (Corley, 1993). Previous generations of scholars assumed that they were not. Certainly they classified

free-standing investments as portfolio-type rather than direct. They did this, it is now suggested, because they had no theory of the multinational enterprise to guide them.

The acid test for direct investment is whether control is actively exercised from the source-country headquarters. In terms of internalization theory, this translates into the question of whether an intermediate product market of some kind is internalized or not. In a pure free-standing firm control was exercised only during the initial development phase. During this phase there was an active export of project management services through an internal market. The services were procured in Britain – chiefly in London – and used to value natural resources, to negotiate, monitor and enforce contracts within construction firms and suppliers and offer technical advice. Thereafter control was surrendered to local managing agents. The internal market for the export of specialized project management skills dried up, and was replaced by an external local market for the supply of operational management skills. This contrasts with the typical manufacturing firm in which the internal market for the export of incremental product improvements is continually active – although the intensity of flow may diminish beyond a certain point in the life of the firm.

A consistent application of the test for direct investment therefore leads to the paradoxical conclusion that investment by pure free-standing companies is direct only for the initial period during which the net export of capital occurs, and that it becomes portfolio-type thereafter. In accounting terms this means that after the initial investment phase is completed, and local management takes over, there is a net repatriation of direct investment equivalent to the previous outflow, coupled with a net portfolio investment of equal size. In terms of the accumulated stock of foreign direct investment it means the stock is portfolio-type. Thus most of the investments originally classified as portfolio-type were indeed correctly classified .

The only exception concerns firms which have been wrongly classified as free-standing, and were in reality expatriate multinationals. The expatriate multinational is a true direct investor because its headquarters exercises significant operational control, associated with an export of management services through an internal market. The real issue in the history of British foreign direct investment is not, therefore, whether pure free-standing firms should be included in the foreign direct investment statistics, for modern theory indicates that early writers were correct, and they should not be. It is rather what proportion of British-based companies were actually of the free-standing type rather than the expatriate type. This hinges on the nature of the firm's headquarters operations once the initial investment phase had been completed. It is an empirical question to be decided by reference to business biographies and archives. Theory suggests that industry-wide patterns will emerge. In industries where operations require proprietary technology and offer significant economies of vertical integration in international trade, such as oil, the expatriate firm will predominate. Here an upward revision of foreign direct investment statistics may be warranted. In industries relying on standard technologies, and where economies of vertical integration are local rather than international, such as utilities and urban rail transport, the free-standing form will predominate. Here the earlier estimates of foreign direct investment are likely to be accurate.

8.5 THE DECLINE OF THE FREE-STANDING FIRM

Few free-standing firms were formed after 1914. This has led some writers to infer that the hidden flaws of informal British capitalism were finally revealed at this time. Furthermore, contemplating the rather mixed results obtained by free-standing firms before 1914 – especially in US mining and real estate – they conclude that British firms would have done better if they had adopted US-style hierarchical organization at an earlier date.

The preceding analysis suggests, however, that this rather negative view is misleading. The free-standing firms, it can be argued, were well adapted to the mission of imperial development. Nineteenth century Britain appears to have acquired a national comparative advantage in property development, partly as a result of the domestic exploits of Victorian engineers. The export of these skills was encouraged by a tradition of exploration, reinforced by emigration pressures, which generated overseas opportunities for the use of these skills. The combination of the free-standing company and the managing agency was a rational institutional response to the challenge of the times. The free-standing company transferred project management skills, which had agglomerated in London, to overseas sites where they were combined with other inputs to complete the project. The equity route gave the London managers the ultimate right to veto further funding and 'kill off' the project if it seemed likely that, in the light of the latest information, 'good money' would merely follow 'bad'. By forcing the London managers to subscribe some of the equity they were incentivized to give their best efforts. By allowing the remaining risks to be borne by the equity market as a whole, limitations of personal wealth did not become an insuperable barrier to participation in management by the most able people. Overall, the arrangements minimized the transaction costs of exporting management expertise in property-related industries.

The free-standing companies did not decline after 1914 because hidden flaws emerged, but because the world had changed. To some extent, the free-standing companies had been so successful that they had worked themselves out of a job – much of the task of imperial development had already been accomplished. Second, economic policy problems of the interwar period undermined the profitability of overseas investments. The problems encountered in restoring the gold standard, and the subsequent failure to avert protectionism, undermined primary product trade and hindered export-oriented colonial investment. Adverse political changes – such as Latin American nationalism – and doubts over the long-term viability of the empire added a new dimension of political risk to overseas investment. There were growing demands from host governments for the state management of the export trade, and the nationalization of railways and utilities, which made further investment foolhardy.

Finally – and perhaps most significantly for the British companies – technological progress was beginning to make itself felt even in traditionally low-technology property-related industries. Thus the advent of refrigeration altered the logistics of exporting perishable foodstuffs and favoured closer integration of plantation operations with shipping schedules. The British managing agency, with its partnership structure, found it difficult to cope with this, whereas the hierarchical US corporation coped quite easily by extending skills originally developed for the integrated sourcing of local markets in the US. The British managing agents failed to adapt by incorporating themselves and buying out the companies whose assets they managed in order to rationalize their international operations.

It is, perhaps, in the failure to perceive and respond to the operational implications of new technology that the cause of the decline of the British system of overseas investment is to be found. This would tie in with existing explanations of general British decline in the early twentieth century. The British system was well adapted to managing resource-based investments, and associated infrastructure projects, which exploited the trading opportunities afforded by the imperial system. But it relied on public rather than proprietary technology, and on arm's length rather than vertically integrated international markets. As new process technologies made themselves felt in resource-based industries many British firms allowed themselves to become locked into the old system. US rivals, recruiting university-educated technologists to cut production costs by adapting the mass production methods of manufacturing industries, proved themselves to be more efficient. This is only a hypothesis at this stage, but it suggests a promising agenda for further research.

8.6 SUMMARY AND CONCLUSIONS

This chapter has argued that the free-standing firms identified by Wilkins actually comprise two distinct types of firm. The first is the pure free-standing firm which exports project management services through an internal market but externalizes operational management. In this type of firm the headquarters has little influence on normal operations. Its administrative arrangements correspond to those described by Wilkins, and it is concentrated in property-related industries. When compiling statistics of foreign investment it is best classified as a portfolio-type investor. The second type of firm is the expatriate multinational. Here the headquarters, though possibly quite small, actively controls overseas operations. It may therefore be regarded as a true direct investor.

Free-standing firms were sometimes promoted by senior partners in multinational managing agencies in order to construct assets which the agency would manage. The division of responsibilities between the management of the development and the management of the subsequent operations has an economic logic. But the separation of the management of the operations from the ownership of the assets, once developed, was more dubious.

As the age of imperialism ended, and the number of new project opportunities declined, the project management function became less important. As a result, the specialization between project management and operational management effected by free-standing firms became less of an issue. On the other hand, as technological sophistication increased, the quality of operational management became more important. As a result, combining the ownership and the operational management of existing assets within a single firm became a major issue. Thus the decline in the number of new projects, coupled with the increasing sophistication of operations in existing projects, favoured the US corporate system over the British one.

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