In "Good Times and Bad Times": The Effect of Political Relations between Nations on Firms' International Management Strategies[1]

> "Suddenly, there was [IPO] money. When we raised it, we had the R&D center in Israel, and a production facility in Europe. That was all. We were moving to the next stage, to become a big player, which meant worldwide presence. So, we looked for great production and sales locations." Ari Osher, CEO of RayTech

In July 2005, when Ari Osher, the financial controller and assistant CFO of RayTech, landed in Istanbul, the weather was hot and humid as it was in Israel. "It feels like home" he thought and smiled to himself. He had been in Istanbul eight times in the last two months, rarely with his family as a tourist, mostly alone for long business meetings. Now, when he entered the new office in Istanbul, curious but smiling faces welcomed him, and he greeted them back: "Shalom Turkey".

Background: RayTech's History and Internationalization Efforts[2]

RayTech was formed in the early 1970s as a local high-tech firm in the suburbs of Tel Aviv, Israel. The market for its products was characterized by rapid technological changes, short product life cycles, evolving industry performance standards as well as changes in customer and end-user requirements. The firm's strategic vision was to become a leading provider of innovative products and technologies by covering the whole value chain: from design to development, production, distribution and marketing of its products. For that purpose, the firm devised and considered implementing a differentiation strategy, focusing on higher-value product categories. Cutting-edge product design would be the main differentiator requiring strong research and development (R&D) capabilities to develop and maintain a competitive advantage. RayTech understood that it had to continuously invest in its proprietary technology and to innovate.

Initially, the firm's revenues were generated from royalties received from customers who licensed their intellectual property. The ultimate revenue generation model, however, was based on sales of finished and semi-finished products as well as licensing the technology to other manufacturers under service and royalty agreements. Sales revenues would come through independent retailers, national retail chains, and retail buying groups, under a Business-to-Business (B2B) model. During the first half of the 1980s,

[1] We gratefully acknowledge the support of the Eli Hurvitz Institute for Strategic Management for the preparation of this case study.
[2] Source: SEC filings during February 2005 – July 2011 and interviews with the RayTech's senior managers.

RayTech focused on developing its own signature products and then moved along the value chain to engage in manufacturing and marketing. Later, in the 1990s, the firm began developing its proprietary product design simulation software that was based on its proprietary mathematical algorithms. The firm also built tools that were specifically designed for R&D and production requirements. Thanks to these technologies, the firm enhanced its competitive advantage and introduced several new products.

RayTech's vision of becoming a market leader required growth not only locally but also globally. Thus, the firm engaged in internationalization efforts. As reported by senior managers: "As part of our growth strategy, we seek to acquire independent entities in order to strengthen our distribution network and to gain market share. We continuously seek to identify companies as potential objects of an acquisition". In line with this strategy, RayTech stepped out of its local territory in 1994 to found a US subsidiary that would establish its marketing presence. Four years later, the firm enhanced its operations in the US and established a distribution center supplying semi-finished products to the US market. In the onset of the 2000s, RayTech took another big step and acquired majority shares of its European distributor, ABC Holding, which was founded by two Israelis living in Germany. The subsidiary would serve as the main entity that would perform RayTech's acquisitions in Europe. The first acquisition came just one year later and was followed by further expansions to other European countries. Eventually, RayTech acquired the remaining 49% of ABC Holding.

By that time, significant portion of RayTech's business was conducted outside of Israel. Notwithstanding its success, the firm's internationalization strategy increased its exposure to risks associated with the host countries. These risks included but were not limited to market-specific uncertainties such as the nature of the political and economic environment, tariffs and exchange controls, tax rates, currency exchange, technology export licensing and trade regulations. Firm specific uncertainties included safeguarding the intellectual property and collections of trade receivables. Moreover, most of the raw materials were available from a limited number of suppliers that dominated the markets. Indeed the firm's competitiveness depended on mitigation of these risks.

In mid-2005, RayTech went public to raise funds needed for the US subsidiary's marketing and distribution activities, construction of a new production facility in Israel, payment of debt, investment in R&D, and other international expansion. Yet, six years later, the firm would be delisted from the stock exchange to become private again; as it was acquired by the leader of the industry, Excellence Inc. At the end of the 2000s, RayTech became a vertically-integrated firm that served all of the industry's value chain

activities from design, R&D, production, to distribution and marketing, competing with firms larger than itself and having greater benefits from economies of scale. Approximately 70% of revenues originated equally from North America and Europe; the remainder came from Russia, Asia and the Middle East, including Israel and Turkey. The firm expanded its operations to 22 countries, with two main production centers located in Israel and 12 fully automated production facilities in Europe, North America and Asia, with a total workforce comprising 2,600 employees. The Headquarters still remained in its birth place in Israel.

Investment Environment in Turkey

A. Turkey - Israel International Relations: Swinging between Cooperation and Animosity

Diplomatic relations between Turkey and Israel were established in 1949 when Turkey recognized Israel one year following its foundation. Turkey was the first Muslim country that recognized the State of Israel and opened its embassy in Tel Aviv in 1950. Throughout the years, the bilateral relations have been affected by regional politics (especially the Arab-Israeli conflict) as well as domestic politics in both countries, going through upheavals with periods of close cooperation but also animosity. Although Turkey never denied the right for existence of the State of Israel, it adopted a pro-Arab stance during times of conflicts between Israel and its Arab neighbors.

The first challenge to an otherwise good start came with the Suez Crisis in 1956 – a military confrontation between Egypt, Israel, the United Kingdom and France over control and access rights of the Suez Canal. Responding to the call of Arab countries to condemn Israel, Turkey withdrew its ambassador and lowered the diplomatic relationship to the *deputy level*. Israel replied in a reciprocal manner. In the early 1960s, Turkey and Israel started improving and eventually normalized their diplomatic relations in 1963. Yet, during the 1967 Arab-Israeli war, Turkey supported the Palestine Liberation Organization (PLO) in the international arena and openly condemned Israel for the regional implications of the war. Diplomatic relations gradually became tenser in the 70s especially during Yom Kippur war in 1973 when Turkey opened its airspace to Soviet aircrafts delivering fuel to Egypt and voted in parallel with the Arabs in the United Nations.

Diplomatic relations improved in the mid-1980s, when Turkey adopted a balanced attitude in the region, in favor of the US as well as Israel over Arab countries, and increased its diplomatic relations to the *representation level* in Tel Aviv. This change was attributed to the influence of the European Union on Turkish foreign policy in general. Following the launch of the Arab-Israeli Peace process in 1991 (that

culminated with signing of the Oslo Accords between the Israel and the Palestine Liberation Organization), Turkey raised its diplomatic relations in 1992 to the *ambassadorial level* and—after 11 years—reopened the Jerusalem Consulate General. Consequently, the two countries entered an era of strong cooperation; the strategic partnership included high-tech cooperation, water sharing, tourism, and military collaboration predominantly in the form of intelligence exchange, joint military exercises and military equipment sales. During 1994 and 1998, the two countries signed several agreements including the military agreement, the free-trade agreement, the treaty on avoidance of double-taxation and bilateral investments.

In the beginning of the 21st century, the Middle East started first boiling with the Arab-Israeli peace process, and then coming to a deadlock followed by the launch of Second Intifada. Concurrently, Turkey's foreign policy changed as the *Justice and Development Party* lead by Recep Tayyip Erdogan came into power. These regional and domestic developments led to regression in Turkey-Israel relations. Specifically, Israel's Gaza operations in the end of 2008 (Operation Cast Lead) set the stage for an exceptional "One Minute" event at Davos in 2009 in which Erdogan openly criticized Israeli policies, made harsh remarks to Israeli President Shimon Peres who attended the event, and left the meeting. The years 2009 and 2010 were eventful: Turkish TV series degrading the State of Israel, Israel's response of humiliating Turkey's Tel Aviv ambassador (aka "Low Chair Crisis"), and cancellation of joint military drills to name a few. The tension reached a peak on May 31, 2010 with the Gaza flotilla raid (aka "Mavi Marmara") following which Turkey and Israel mutually broke their diplomatic relationship. The animosity endured until Israel formally apologized in 2013, after a long reconciliation period and numerous direct and indirect meetings. In 2016, finally, the governments signed a formal agreement as a sign of normalization of their relations. Nevertheless, the conflict in the Middle East impaired the repaired bilateral relations following Temple Mount tensions in July 2017 and the US decision to move its embassy to Jerusalem in December 2017. Another strained period for Turkey and Israel relations has started.

Table 1 lists major events that negatively affected the dyadic diplomatic relations between Turkey and Israel. Figure 1 depicts the dyadic diplomatic relations[3] between January 2000 and December 2017.

[3] Dyadic relations has been measured by the Conflict and Mediation Events Observations (CAMEO) framework. CAMEO is an event coding scheme that employs Goldstein scale (1992) ranging from -10 (conflict) to +10 (cooperation). Using news on dyadic relationship from mainstream media.
Goldstein, J. S. (1992). A Conflict-Cooperation Scale for WEIS Events Data. Journal of Conflict Resolution, 36:2, 369-385.

B. Turkey - Israel Economic Relations: Complementary Markets[4]

Economic relations between Turkey and Israel began to improve in parallel to the development of diplomatic relations in mid 80s. The enactment of agreements to bilateral free trade and avoidance of double taxation in 1997 and 1998 contributed to the increase of trade volume between the countries. In 2000s, the countries further developed their economic relations via periodic joint committee meetings and negotiated on different facets of collaboration. With the exception of the first half of 90s, Turkey's export to Israel exceeded its import from Israel. The total trade volume reached 1 billion US$ in 2001 and climbed to 2.4 billion US$ by the end of 2008. Although it contracted by 18.7% following Israel's Gaza Operations and tension between the countries (e.g. "One Minute") in 2009, it recovered and stabilized at 2.8 billion US$ during "Mavi Marmara" crisis and its aftermath. The tension and harsh rhetoric of the political leaders, especially of Erdogan and Netanyahu, did not lead to drastic changes to economic policies and existing bilateral agreements. Both leaders refrained from taking damaging steps, leaving room for economic cooperation and "separation of politics and business". Hence, during this period, the joint investment projects and trade activities maintained their normal course. Following Israel's formal apology in March 2013 and subsequent normalization of diplomatic relations, the total trade volume consistently increased on average by 20% annually, rising to 6 billion US$ by the end of 2018. One of the drivers behind enhanced trade was the fact that Israeli firms could not directly engage in economic relations with Arab countries and, thus utilized Turkish firms as proxies. Table 2 and Figure 2 describe the trade relations between Turkey and Israel.

The rationale behind flourishing economic relations rests in the complementarity of the two economies. Turkey's industrial infrastructure is characterized by mass production capabilities and a large human resource base, whereas the Israeli economy offers advanced technologies and innovative capabilities that can boost production. Moreover, Turkey comprises a considerably larger market; thus, it offers scale economies for Israeli high-tech products while providing high quality and cost-efficient consumer products and services—especially in textile, home products and appliances—and tourism to the Israeli society. These complementarities create and grow business opportunities primarily for export/import.

Similar to trade activities, foreign direct investment (FDI) were unbalanced with FDI inflow by Israeli firms to Turkey almost 40 times higher than that of the Turkish firms. In total, Israeli firms invested 395 million US$ in Turkey during 2005 and 2017, corresponding to approximately 0.2% of the total FDI in

[4] Source : UN Comtrade statistics and Turkish Central Bank statistics

Turkey, whereas Turkish firms invested only 10 million US$ in Israel during the same period. From 2009 onward, Israeli and Turkish FDI reduced dramatically with few exceptions. Figure 3 describes the FDI inflow from Turkey to Israel and vice versa.

Episode 1: "Shalom Turkey"

It was only two months after Ari Osher joined RayTech as a financial controller and assistant CFO in 2005. He was assigned to analyze international expansion opportunities. RayTech wanted to invest the remainder of the firm's IPO proceedings in production and/or distribution facilities outside of Israel. The firm was not experienced in international business; however, it already had set three main principles:

1. We go to a place that we can manage. If we don't have a strong local management, we will not enter.
2. We produce high-tech products that offer significant value to the market. We will not expand into low-level markets.
3. The market should be profitable. The subsidiary should not put the losses on our shoulders, since we don't have a financing program.

Turkey appeared on Ari's radar as the primary option for retail and wholesale of RayTech's products and for finalizing the imported semi-finished products. The initial analysis pointed to many advantages: Turkey's cultural, historical and geographical proximity to Israel, its large market size in general, a positive political and economic environment, liberal regulations, relatively cheap labor, and the prospect of Turkey soon becoming a European Union member. Especially for RayTech's industry, there was substantial room for growth. Annual consumption was between 20-25 million units; demand compared to actual need was approximately 15%, very low compared to the 50-60% in developed countries. On the supply side, 20 importers and 7 manufacturers engaged both in finalizing the semi-finished products and importing others. The total capacity of the local producers was around 5.3 million units in 2003; yet their total production barely reached 1 million units[5].

Ari has been to Turkey before, as a tourist. He felt at ease and had a positive impression about the local mentality. In his own words, "Turkey was like home for us. It was close, we felt comfortable. The relationship [with Israel] was great and the economy was strong in Turkey in those days. The regulation was very relaxed and we realized that Israeli companies that wanted to manufacture outside of Israel were doing it in Turkey. We were sure that Turkey would be part of the European Union. So, our projection

[5] Source: Istanbul Chamber of Commerce publications

was that this place would be the production base for Europe, covering Central and Eastern Europe and the Balkans and even exporting to Israel". With these motivations, Ari was favoring Turkey for investment.

Ari's mandate was not only to prepare a report on the Turkish market, but also to evaluate modes of foreign entry. Among the alternatives were developing a subsidiary from the ground up, forming a joint venture with a Turkish or foreign firm. Ari was also considering the acquisition option. At that time, there were three local producers located in Istanbul. One of them was ETA, a customer and a licensee of RayTech. ETA's market share was approximately 20%. The firm owed to RayTech and the owner seemed to be willing to sell his assets against its debts. It might be a feasible and cost-efficient acquisition for RayTech. On a very hectic day, the 25th of May, 2005, when the finals of the 2004–05 UEFA Champions League between Liverpool and Milan was played at the Atatürk Stadium in Istanbul, Ari and the owner of ETA met for the first time.

Besides choosing the entry mode into Turkey, Ari was concerned about how to implement the expansion strategy. Was the timing correct considering the status of diplomatic relations between Turkey and Israel? Although the political environment was peaceful and stable at that time, given the fact that there were many ups and downs, the Israeli team was cautious. Were there tradeoffs for RayTech in terms of building a corporate identity in Turkey? In other words, how should the brand be presented? One of the alternatives was to disguise the Israeli identity, fully or partially. For that purpose, ABC Holding, RayTech's European subsidiary in Germany that owned and managed other subsidiaries, could acquire ETA and be the owner and the namesake of the Turkish subsidiary. The name "ABC Technology" could insulate the parent firm and the Israeli products, if things wouldn't go smoothly in Turkey. This option would also help to strengthen the already-established European brand. Alternatively and in contrast to this low-profile attitude, RayTech could enter the Turkish market as RayTech Turkey, expose its brand fully and openly, as it was exercised by some other Israeli firms before. This decision depended on the extent of the firm's market visibility preferred as "an Israeli firm operating in Turkey". Finally, how should local management be structured and what senior manager profile would be best to entrust with the new subsidiary? Ari only had two months to complete his report. Having all these questions in mind, he conducted a thorough due diligence single–handedly and presented a detailed analysis about the new investment opportunity in Turkey to RayTech's CEO.

In July, Ari flew to Istanbul with all the answers and greeted his new colleagues with "Shalom Turkey".

Episode 2:"We are a German company" or "Mavi Marmara Crisis and its Aftermath"

The Board of RayTech approved Ari's proposed expansion strategy, which entailed acquiring ETA with all its assets, taking over 20% of the market and accounting the FDI amount for its debts. As stated by Alon Mazal, RayTech's senior manager responsible for supporting the Turkish subsidiary:

> "In these days, it was the right decision. First of all, we secured the money that he owed us. Then, we also saw that there is a potential in the market, which was ok."

ABC Technology made a successful entry into the Turkish market. RayTech preferred to realize the acquisition via its European subsidy, ABC Holding; the brand "ABC" was already established in Europe. Another reason for this choice was the impression that the Turkish society liked German goods. RayTech was indeed concerned about the reaction of the market to an Israeli brand, even though the technology would be appreciated. So, they decided to disguise the Israeli corporate identity for the time being and to wait until the products were known in the market. Hence, ABC Technology's identification in the market was like "a German firm using Israeli technology in production". Still, the competitors were aware that the firm was indeed the subsidiary of RayTech, a reputable Israeli firm. Internally, the employees adopted the "German" identity, even introducing themselves as if they worked for a German firm.

RayTech appointed an Industrial Engineer, who had extensive experience in business development, sales and marketing as the country General Manager. However, his business experience was built in various industries outside of the high tech industry and mainly in domestic firms.

Until the end of 2008, ABC Technology kept growing: revenues increased, new branches were opened. While the global economic crisis in 2008 affected Turkey and the firm as well; it managed to recover rapidly. For a while, the firm exported its products to some European countries; eventually, it stopped exporting and started serving the local market only. In terms of marketing and branding, the firm adopted a low profile approach with limited public appearance and emphasis on its Israeli corporate identity. In rare industry news and interviews, the words "ABC Technology" and "Israel" did not appear together; ABC Technology was referred as being part of the RayTech Group. There were two product-launch events in 2008 and 2010; each time Alon Mazal attended on behalf of RayTech to show support to the subsidiary. Related to the information exchange between the subsidiary and the Headquarters, the information flow

was channeled and filtered through the country General Manager; the Turkish team was not in contact with their counterparts.[6]

Towards the end of 2008 and in the following year, the relations between Turkey and Israel became sour. The firm's Marketing Manager described how they managed customer relations meanwhile:

> "There were some customers here and there who explicitly stated that they did not want to work with us, because we were an Israeli company. We also selected customer profiles that we wanted work with. For example, those who were against buying Israeli goods were eliminated. Also, our collection principles were strict, the payment terms were shorter. This was not appealing to everyone. For the remainder, anyhow it was a "relationship business" and even the sensitive or religious customers appreciated Israeli technology."

Then, the Mavi Marmara crisis erupted on May 31st, 2010. About its aftermath, the ABC Technology team and RayTech reported slightly different perspectives. The Turkish subsidy's Marketing Manager stated that there were no negative reactions from customers. Yet, the competitors used the opportunity to launch negative campaigns against the firm: there were boycott groups on social media, protesting against Israel and Israeli firms. ABC Technology was subjected as well. Surprisingly, the employees reacted emotionally on social media and criticized Israel's attitude openly. The local management was worried and demotivated; that was reflected to the team as well as to RayTech. This demotivation led to lower sales expectation in the eyes of the local sales team as well as of RayTech. Soon, this expectation would be realized.

From RayTech's perspective, Ari described the situation as follows:

> "After the Mavi Marmara, we suffered. Many customers reduced their purchases from us. There were times when it was hard to convince people [from RayTech] to fly to Turkey. It was very hard to send my engineers, my marketing team to do the training. They were afraid. It was not so nice to go to a hotel [in Istanbul] and say that you were Israeli."

Ari remembered that RayTech's management debated extensively whether to divest their investment in ABC Technology and exit Turkey or not. The majority preferred exiting, because they knew that RayTech should continue investing in technology, if they were to decide to stay. Nevertheless, RayTech's CEO and Ari did not give up on their Turkish subsidy, and decided to stay. Yet, the firm skipped essential investments in technology upgrades; this led to some problems in production. Unfortunately, this crisis coincided with the entry of big players into the Turkish market. One of the new entrants was the current shareholder of RayTech, Excellence Inc. that had left Turkey during the 2001 economic crisis and renewed

[6] Based on employee reports

its interest in Turkish market in 2012. As a result, ABC Technology's market share eroded from 20-25% to 6%.

One day in October 2014, the country General Manager called Ari and told him: "Look, I cannot work for an Israeli company. I like Israel, I like everything, but I cannot". Then he left. "He could not stand the pressure" thought Ari, and asked himself: "What did we do wrong? How shall we proceed?"

Table 1 Crisis / Events Affecting Turkey Israel Relations Negatively

Event	**Start Date**	**End Date**
Second Intifada	28-Sep-00	8-Feb-05
Israel's Gaza Operations "Operation Defensive Shield"	29-Mar-02	3-May-02
Justice and Development Party lead by Recep Tayyip Erdogan came into power in Turkey	3-Nov-02	Ongoing
Israel's Gaza Operations "Operation Rainbow"	13-May-04	24-May-04
Hamas came into power in Gaza	25-Jan-06	Ongoing
Israel's Gaza Operations "Operation Summer Rains"	28-Jun-06	26-Nov-06
Israel Lebanon War	12-Jul-06	14-Aug-06
Israel's Gaza Operations "Operation Autumn Clouds"	31-Oct-06	7-Nov-06
Gaza Blockade	15-Jun-07	Ongoing
Israel's Gaza Operations "Operation Hot Winter"	28-Feb-08	3-Mar-08
Israel's Gaza Operations "Operation Cast Lead"	27-Dec-08	18-Jan-09
"One Minute" at Davos	29-Jan-09	
Turkish TV Series "Ayrılık" Degrading Israel	15-Oct-09	
Turkish TV Series "Kurtlar Vadisi" Degrading Israel	11-Jan-10	
Israel diplomatic humiliation of Turkish ambassador "Low Chair Crisis"	11-Jan-10	
Gaza flotilla raid "Mavi Marmara"	28-May-10	31-May-10
Israel's Gaza Operations "Operation Pillar of Defense"	14-Nov-12	21-Nov-12
Israel's Gaza Operations "Operation Protective Edge"	8-Jul-14	26-Aug-14
Temple Mount tension	14-Jul-17	
US Embassy move to Jerusalem	6-Dec-17	

Table 2 Turkey and Israel Bilateral Trade Volume (in mio US$)

YEAR	TR EXPORT TO ISRAEL	TR IMPORT FROM ISRAEL	TRADE BALANCE	TOTAL TRADE
1990	46.49	62.51	(16.01)	30.48
1991	78.65	78.04	0.62	79.27
1992	89.83	97.07	(7.23)	82.60
1993	80.22	121.78	(41.56)	38.66
1994	178.06	125.88	52.18	230.23
1995	239.53	166.62	72.90	312.43
1996	253.92	192.02	61.90	315.82
1997	391.48	233.66	157.82	549.30
1998	479.39	282.90	196.49	675.89
1999	587.02	298.23	288.80	875.82
2000	622.04	503.21	118.83	740.87
2001	805.22	529.49	275.73	1,080.95
2002	850.86	541.32	309.54	1,160.40
2003	1,083.00	459.49	623.51	1,706.51
2004	1,313.89	714.14	599.75	1,913.64
2005	1,466.91	804.69	662.22	2,129.14
2006	1,529.16	782.15	747.01	2,276.17
2007	1,658.19	1,081.74	576.45	2,234.65
2008	1,935.23	1,447.92	487.32	2,422.55
2009	1,522.44	1,074.73	447.71	1,970.15
2010	2,080.15	1,359.64	720.51	2,800.66
2011	2,391.15	2,057.31	333.83	2,724.98
2012	2,329.53	1,710.40	619.13	2,948.66
2013	2,649.66	2,417.95	231.71	2,881.37
2014	2,950.90	2,881.26	69.64	3,020.54
2015	2,698.13	1,672.50	1,025.63	3,723.76
2016	2,955.54	1,385.61	1,569.94	4,525.48
2017	3,407.44	1,505.11	1,902.32	5,309.76
2018	3,900.32	1,713.60	2,186.72	6,087.03

Figure 1 Turkey and Israel – Nature of the Dyadic Relations measured by CAMEO

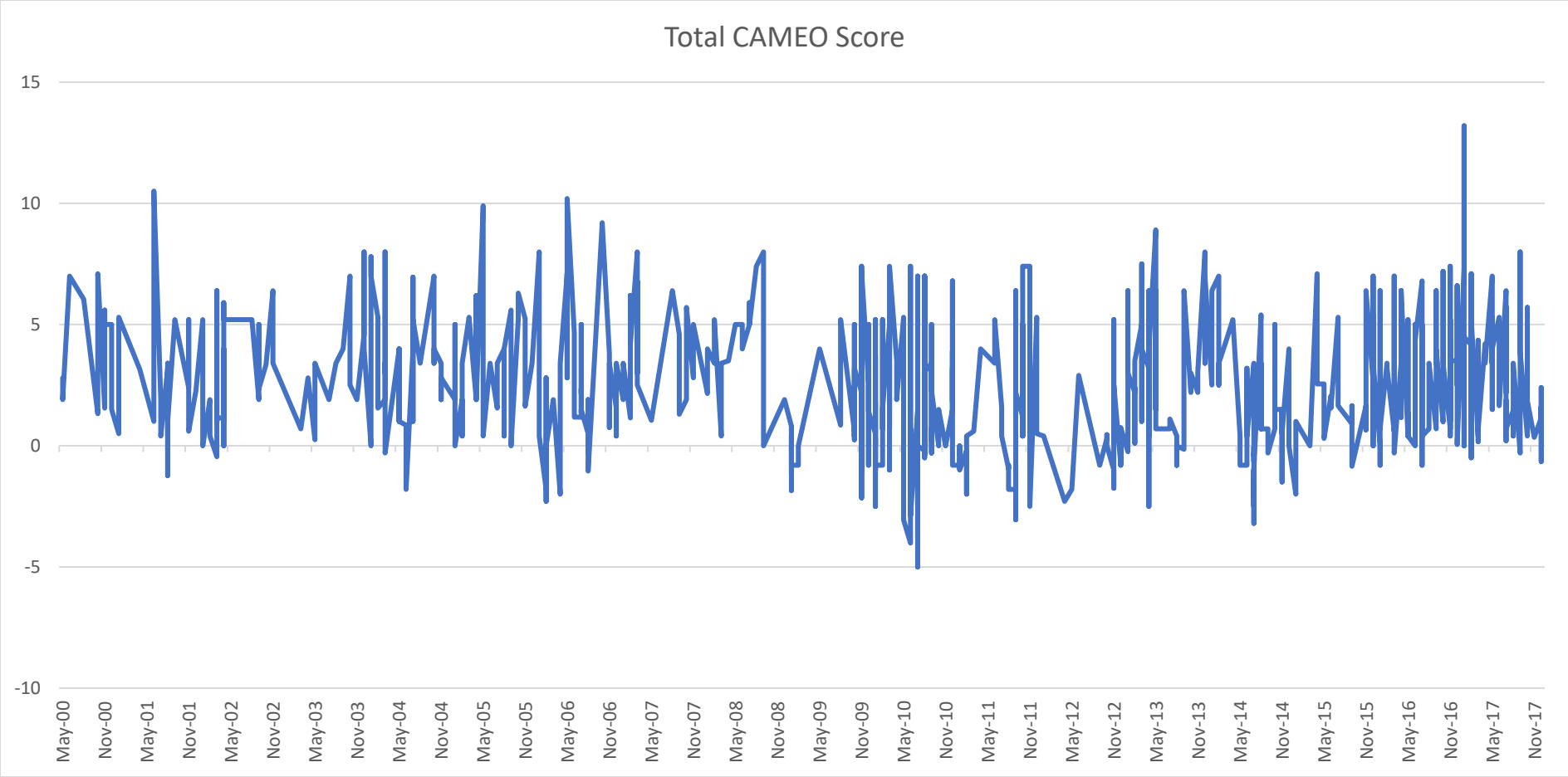

Figure 2 Turkey and Israel Bilateral Trade

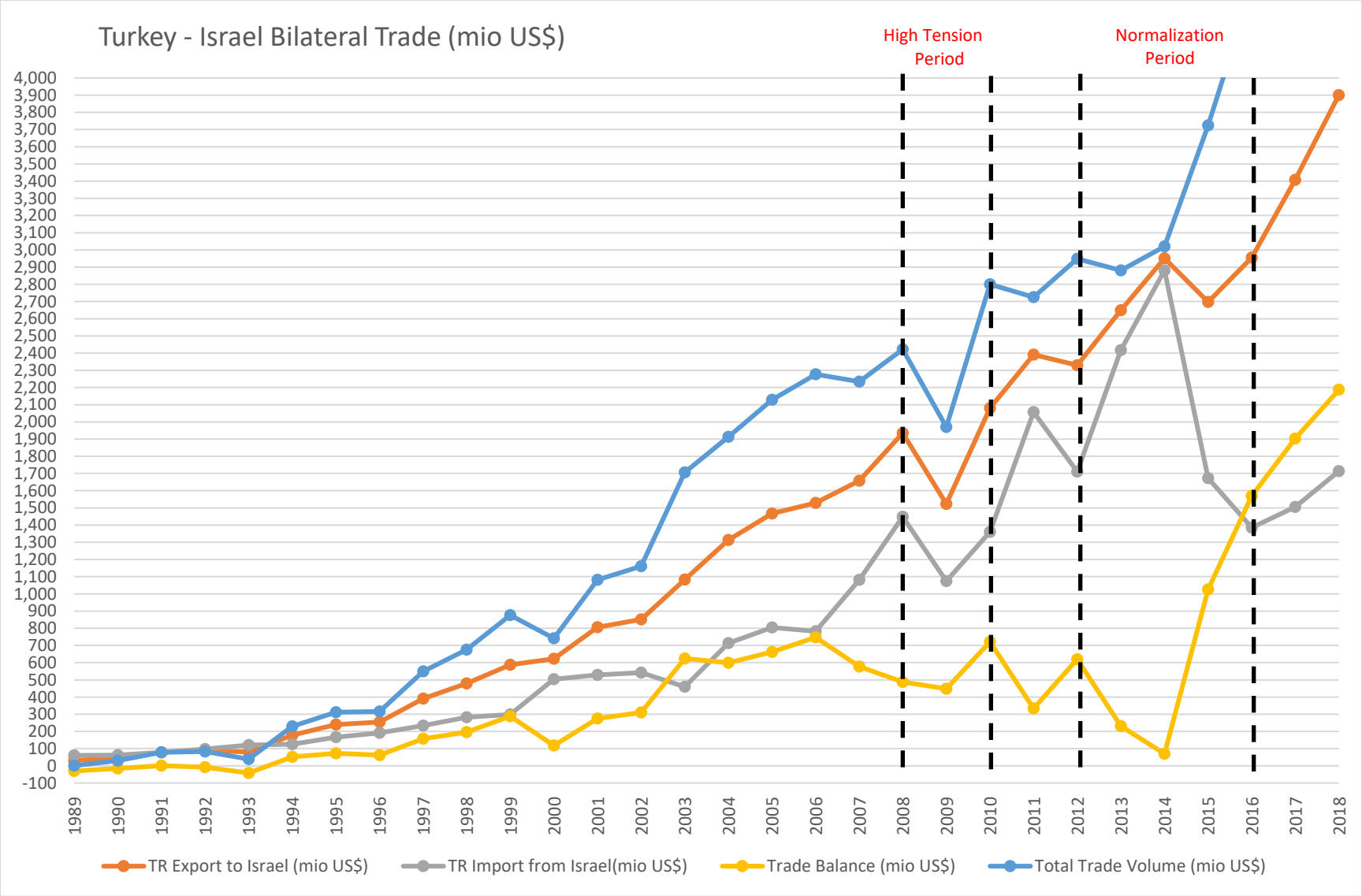

Figure 3 Turkey and Israel FDI Inflow