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Choice of Market Entry Mode is Contingent on Environment: Integrating the Resource Dependence and Contingency Theory Perspectives

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Abstract

Selection of the appropriate entry mode for internationalization is a crucial decision. Global firms contemplating foreign direct investment may incur huge costs due to wrong selection of entry mode. Environment, as a non-controllable factor, should guide these firms to choose a pertinent entry mode. This conceptual paper provides key propositions of the potential impact of entry mode selection on the success of the firm, building on resource dependency theory and contingency theory. The study proposes that the choice of entry mode selection by internationalizing Chinese firms, targeting developing as well as developed economies, is contingent on the level of environmental uncertainty and risk profile of the host country. The study highlights significant environmental factors as prime determinants of the selection of an entry mode. The proposed framework can serve as a guideline for global firms to choose the host market depending on the nature of environmental factors. Choosing right entry mode will help them to reduce failures arising from the wrong choice of entry mode. Future empirical studies should test the framework to add to the international business literature.

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Introduction

For more than three decades, research on international business has focused on the factors affecting the selection of entry mode by internationalizing firms without reaching any consensus. Most of the studies report mixed findings about the choice of acquisitions and Greenfield ventures in an attempt to create a foreign subsidiary unit that provides superior performance. Several papers look at this issue, but these studies tend to compare the performance of Greenfield versus the performance of acquisitions without exploring the theoretical underpinnings of the establishment mode choice. Even a good number of literature reviews conducted by international business researchers (Martin 2013; Dikova and Brouthers 2015; Surdu and Mellahi 2016) identified that almost all the existing literature is unable to mark a clear guideline for the selection of various entry mode choices. Another issue is that internationalizing firms from emerging markets, especially from the Chinese economy, offer a unique case for the exploration of outward foreign direct investment (OFDI) to developed markets (Berning and Holtbrügge 2012). The issue has been highlighted by a number of review studies in the past five years and calls for the exploration of theoretical underpinnings of entry mode choice and OFDI drivers from EMNCS (Berning and Holtbrügge 2012; Deng 2012; Jormanainen and Koveshnikov 2012; Deng 2013; Quer, Claver et al. 2015).

Most of the past research tends to explore four groups of variables which may affect the choice of entry mode. These variables are either firm-level, country-level, industry-level, or subsidiary-level (Dikova and Brouthers 2015). The choice of these variables underestimates impact of environment, which serves as a prime determinant for the selection of entry mode, especially in case of EMNCs. This study argues that firm-specific or industry level factors are not fully explaining the selection of entry mode because the same firms, when making internationalization decisions for different countries, may opt for different entry modes. This means that decision is contingent more on the environment rather than just on firm or industry level factors. During the past few years, there is a sharp increase of multinational enterprises (MNEs) from emerging economies such as Brazil, China, South Korea, India, Malaysia, Mexico, Russia, Singapore, Taiwan, and Turkey. In 2014, among the twenty largest economies worldwide, eight of them were from developing and transition economies, in which China has constantly been securing second position since 2011. The companies internationalizing from emerging economies, especially from China, is a phenomenon, which is not well explained by existing theories. According to UNCTDA report published in 2015, China is the third-largest OFDI investor after USA and Japan. Also, there is a significant rise in the greenfield investment worth 63295 million made by Chinese firms which account for a rise of 186% as compared to the investment in merger and acquisitions of 39580 millions showing a decline of 21% from the previous year (UNCTAD 2015). According to the Fortune ranking of “Global 500,” there are 151 companies based in developing economies. This number was only 19 in 1995. While the number of multinational companies from most developing countries remained mostly stagnant, the number of Chinese companies increased much faster since 2004, accounting for 106 out of 151 of the biggest companies from developing economies in 2015. The United States still has the most significant number, 128, unchanged from last year, but the list compilers estimate that China will overtake the US by 2020.

With this rapid internationalization and the expansion of Chinese companies abroad without any superior technological and managerial resources, is unique and requires plausible explanations. The existing internationalization theories are unable to explain this phenomenon as the underlying assumptions of these theories assume that internationalizing firms emerge from mature and advanced markets. Many research studies indicate that Chinese companies internationalize to address the competitive disadvantage prevailing in the home country.

Almost all the research that has been carried out in the context of developing economies MNCs identifies the factors such as outdated technology, un-familiarized norms of the host country, weak personal management system and limited market knowledge resulting into failure of these MNCs in internationalization. Almost all the leading Chinese firms have started internationalization to become global players in international markets. These are characterized by a more focused and longer-term strategic view and developing the capacity to organize overseas operations systematically. Nolan (2001) argues that the limited market knowledge, poor R&D capabilities, poor brand development, and constraints imposed by government are the factors which may restrict the internationalization of Chinese firms. Since Chinese firms are entering in a superior market and being late entrant need to form ties with domestic partners to address their disadvantages. Child and Rodrigues (2005) have identified three internationalization routes undertook by Chinese firms. These routes include partnership by using joint ventures, acquisitions and organic expansion. Tao et al. (2013) also talk about the choice of three different types of entry modes which include greenfield investment, acquisitions, and joint ventures. These three choices appear on a continuum which depicts high risk with a high degree of control over decision making.

Greenfield investment is about taking a fresh start that means the establishment of entirely new business from scratch. The acquisition means purchasing stake in an already existing company as a whole or parts while the joint venture is defined as establishing a new company by combining two or more firms. Both joint ventures and acquisitions lead to access to resources owned by local firms, but for greenfield, the firms need to create their own resources. According to a recent survey made by Asia Pacific Foundation of Canada (2013) about the intended selection of entry mode for existing OFDI strategy of Chinese companies, 46% indicated the preference of setting up a wholly-owned new business, followed by establishing a jointly-owned new business (19%). Some 10% of respondents cited full acquisition, while another 9% said they proceeded with the partial acquisition. Establishing a representative office was cited by 17% of the companies. This finding reflects a shift of choice from acquisitions to the choice of a newly established business, which may be termed as greenfield investment. The report also identified that there were no significant differences in the intended selection of entry modes among state-owned versus private firms.

Literature review

The acquisition has been considered the most popular entry mode among Chinese firms because of the unique country environment of China and intent to reduce the perceived risk. The literature discourages the use of acquisitions as a preferred mode of entry because of high failure of mergers and acquisitions, but in China, due to its unique cultural and institutional environment, it is being considered as one of the favorite modes. Since most of the Chinese firms going abroad are unaware of the rules of the game, they lack English speaking and managerial skills, and their technologies are outdated. The poor branding skills and negative image of the country of origin have made acquisitions an attractive choice for internationalization in case of Chinese firms. The growing use of foreign companies' acquisitions as a route towards internationalization can be termed as a source of gaining rapid access to technology and international brand advantage. A number of Chinese companies like Lenovo and TCL have expanded by using this route. However, the greatest risk associated with this route could be the risk of paying a higher bid, overvaluation of acquiring assets and even the fear of post-acquisition failure because of cultural and organizational differences (Chang and Rosenzweig 2001; Dikova and Van Witteloostuijn 2007). While talking about greenfield investments, it could be considered as a mode which offers most significant control, leads to high risk of unpredictable economic and political environment and at the same time requires high level of investment and takes longer time to yield profit with a high level of managerial commitment and market knowledge (Wooster 2006; Dikova and Van Witteloostuijn 2007; Tao, Zhanming et al. 2013; Quer, Claver et al. 2015).

A joint venture is the entry strategy, which is less risky as compared to all other modes, and at the same time, it offers enormous learning opportunities with significantly low investment level and helps to make use of partner expertise as mean to make a fast entry in the market. But in the case of Chinese companies, it may lead to a conflict of interest because of varying managerial style and goals (Chang and Rosenzweig 2001; Dikova and Van Witteloostuijn 2007). Most of the existing literature also talks about the binary choices of entry modes of internationalizing firms between wholly-owned versus jointly owned business or between joint venture versus greenfield investments (Hennart and Larimo 1998; Makino and Neupert 2000; Chiu, Lo et al. 2015). However, most of the research studies report mixed findings of the selection of entry modes based on various factors and the most researched ones include cultural distance, role of government, firm size, and many others. Quer, Claver et al. (2015) in their OFDI review highlight that acquisitions and joint ventures are probably the most researched areas, but there is only one study published (Meyer, Ding et al. 2014) which analyzed the choice between establishment modes of acquisitions versus greenfield investments by Chinese companies. Thus, there is a strong need to address this issue further. Child and Tse (2001) and Warner et al. (2004) identified that the most frequent entry mode of Chinese firms is through acquisitions because of availability of state funding and support but it is also argued that greenfield investment should be a more preferred alternative as compared to other modes of entry because of the more discretion and control, its long term focus and taking national pride in the development of Chinese brands. We believe that the government of China has also recognized the importance of building global brands by establishing China Brand Strategy Promotion Commission to help in advancement of top Chinese national brands. This role of government at home country can be explained using a political economy perspective.

Theoretical contribution

This paper contributes to the existing body of knowledge in several ways. Firstly, past research has drawn a number of variables that might influence the choice of an entry mode, but no clear consensus comes out why a certain entry mode should be preferred over the other. This paper tries to explain the role of environment in selection of entry mode. Secondly drawing upon Resource Dependence Theory in combination with Contingency Theory, this study highlights that final choice of entry mode lies in the environment as all the available entry modes choices actually serve as a way to reduce environmental uncertainties. Thirdly, this study introduces a new variable for the selection of entry mode, and that is environmental uncertainty which has not yet used by any other research.

Theoretical background and research proposition

What is RDT?

Resource dependence theory was published in 1978 by Pfeffer and Salancik in their book "The External Control of Organizations: A Resource Dependence Perspective" (Pfeffer and Salancik 1978; Pfeffer and Salancik 2003). It is a theory, which helps to explain the actions and behavior of organizations in response to external environment. The underlying assumption of the theory is that the environment bounds organizations. The idea shares the proposition of open system view given by Katz and Kahn (1978). The main idea is that their external environment constrains organizations and most of the organizational actions are actually an attempt to manage their dependences on the environment, which in turn reduce their dependency on other organizations. Such activities to reduce dependency are referred to as constraint absorption activities and result in increasing the power of one organization over the others.

Using Resource Dependence logic to explain effect of environmental uncertainty on the choice of entry mode

Pfeffer and Salancik's (2003) Resource dependence theory is a study of external or environmental factors influencing the decisions of organizations. According to RDT, resources are the bases of power. According to this theory, organizations try to reduce their dependency on the environment and increase their power base by grabbing resources. The focus of RDT being on the external environment to stabilize resource exchange can help explain the action of the firm when engaging in mergers and acquisitions. Given the three modes of entry used by EMNCs in the literature, RDT has been widely applied to explain why organizations engage in merger and acquisitions or joint ventures to minimize the environmental dependency and to achieve the required resources (Peng 2012; Rabbiosi, Elia et al. 2012) but applying RDT to greenfield investments is a new phenomena. It can help to explain the role of environment in the selection of entry mode. According to the existing literature in acquisitions and joint ventures, organizations use these two modes to reduce the uncertainty of the environment. So it can be safely assumed that greenfield or wholly-owned investments can be undertaken when environment is relatively certain and predictable. Therefore, we contend that RDT can be used as a framework to explain market entry mode selection of firms from emerging economies. Davis and Cobb (2010) argue that mergers serve as a way to manage interdependence and Williamson (1979) argues that in an uncertain environment firms should try to shift control and risk to outside parties. This implies that firms should use external contracting from outside parties in case of a volatile environment. In essence, RDT has been recognized as one of the dominant theoretical rationales for identifying the antecedents of acquisitions (Hillman et al., 2009) and EMNCs are increasingly using crossborder M&As as a central option to obtain their needed vital resources to minimize environmental dependence (Peng 2012).

Hillman et al. (2009) and Davis and Cobb (2010) argued that merger and acquisition serve as an activity to manage and organize environmental uncertainty. RDT was further extended by introducing the constructs of power imbalance and interdependence (Casciaro and Piskorski 2005). It was concluded that mergers and acquisitions serve as a base to increase the power base of the organization, which means increased resource base will lead to a lesser uncertainty. According to Pfeffer and Salancik (2003), M&As serve as a way to increase the control and power in the market as they ensure the continuous flow of required resources leading to reduced dependency on the environment. Also, others (Pfeffer and Salancik 2003; Pollock, Chen et al. 2010; Peng 2012) identified that mergers and acquisitions help organizations to familiarize with market without making extensive investment and gain legitimacy for their products. Santos and Eisenhardt (2005) argue that merger and acquisitions activities serve to reduce environmental constraints by absorbing a competitor. Anand and Delios (1997) suggested that a firm's ability to utilize existing resources will determine its performance against different modes of entry. They further added that greenfield investments perform best when existing resources can be exploited, but acquisitions and joint ventures perform better when new competencies are needed to manage a changing and unpredictable environment. Thus, we posit the following research proposition,

Selection of a particular entry mode is guided by the environment rather than firms' deliberate choice.

What is contingency theory?

According to contingency theory, there is no best way of making a decision but the factors are contingent upon the external and internal environment which guides an organization for the choice of an optimal decision. The main idea of contingencies given by Morgan et al. (1997) considers organizations as open systems and identifies the need to balance internal organizational needs to adapt to environmental circumstances. According to this theory, there is no best way of organizing and the most appropriate form is dependent on the nature of the activity and the type of environment one is dealing with. So, we need many different types and forms of organizations in various types of environment. Organizations serve as open systems and for dealing with the challenges of an uncertain environment required 'adaptable' and 'situational' solutions to overcome or solve the problem or issue at hand.

Applying Contingency Theory to the entry mode selection

Hillman et al. (2009) identified that a number of assumptions used by RDT are also shared by contingency theory in terms of environmental uncertainty and dependency. They further added that both theories could help to collectively identify the sources of environmental interdependencies and highlight those having considerable influence on organizational actions.

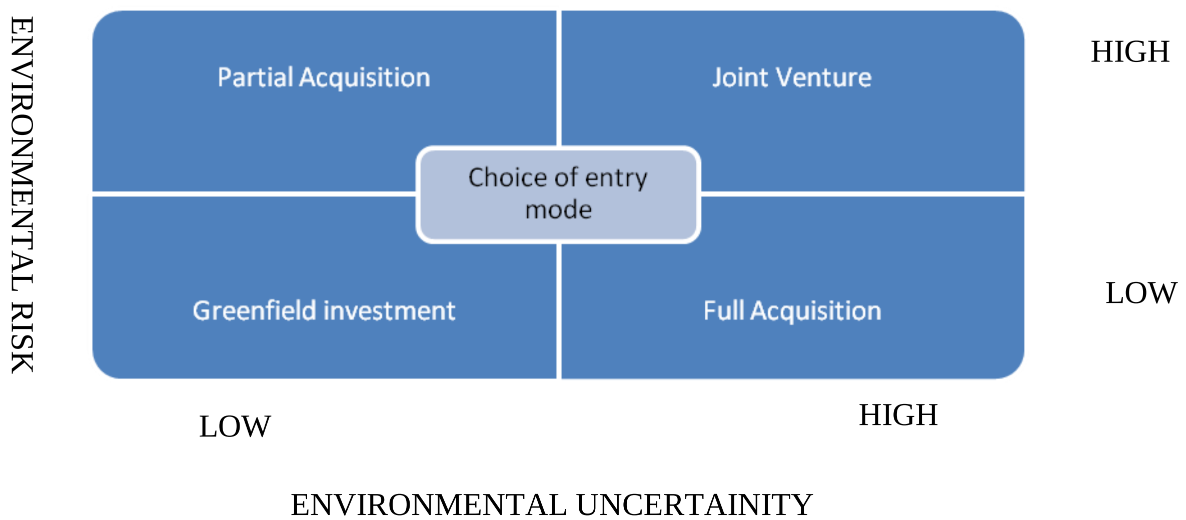
According to this theory, there is no fixed choice for any particular strategic decision. The environment is the source of uncertainties, and the ultimate choice of any particular decision lies with the environment. Anand and Delios (1997) say that most of the theories never refer to an explicit choice of entry mode. The researchers argue that the choice of a particular entry mode is associated with a varying degree of firms' performance. Time and resource constraints bound the firms selecting a particular entry mode and they try to make a rational and optimal decision. Even to the extent more than three decades of research on the selection of entry mode, no proper guideline is available, which marks the superiority of one entry mode over the other. It explicitly means that research is directing to adopt a contingency approach to the situation and directs that the environment is a better determinant of appropriate strategy mode choice. Dikova and Brouthers (2015) in their review of entry mode choices identify that most of the studies done in the context of entry mode choice have attempted to identify a universally best entry mode, but from our research, such an avenue is less likely to be achieved (Brouthers 2013). Because firms choose entry mode as strategies to

enter in the market to yield the greatest return, a particular firm is choosing one strategy and others choosing differently we cannot conclude that one strategy unconditionally leads to superior performance (Shaver 1998).
According to Berning and Holtbrügge (2012), Chinese MNCs offer a unique exploration case of OFDI investment; then according to contingency theory, it will require novel and innovative approaches to deal with as traditional theoretical lenses do not explain the phenomena. Both choices of entry mode selection offer a dilemma of decision making as acquisitions offer a fast entry into the market but the problem of overpayment for acquisition bid and post-acquisition integration issues (Dikova, Sahib et al. 2010) while Greenfield investments often take a long time to establish and result in loss of market opportunities (Pennings, Barkema et al. 1994). This means that environmental, along with firm-specific goals, lead to the selection of a particular entry mode as there exists no universally best choice. Even to the extent Meyer, Estrin et al. (2009) identified that using a different theoretical lens can lead to conflicting choices of entry mode for the same firm across different countries which leads to the conclusion that entry mode choices are contingent on the environment. The literature review by Dikova and Brouthers (2015) suggests the research to analyze the entry mode selection by using a new theoretical lens or even revising the previous ones. So, we form the same research proposition as done using RDT as a theoretical underpinning

Selection of an appropriate entry mode for any firm is contingent on the environment.

Schematic diagram of the proposed theoretical framework

As we proposed, from RDT and contingency theory perspectives, that choice of an appropriate international market entry mode is contingent on the environment, and we posit that host country environment is characterized by uncertainty and risk. Tao (2013) identified a number of factors which may guide the firms about the selection of entry mode. Based on different levels of uncertainty and risk, we propose the following matrix:



Potential operationalization of variables

The dependent variable selection of entry mode is a categorical variable, taking the value of 1 for Greenfield, 2 for acquisition, and 3 for JV. While for measuring the uncertainty of the environment in various economies, researchers can use the proxy of "ease of doing business index" compiled by World Bank. To cater to the host country risk profile, they can use the "International Country Risk Guide." These two indices collectively serve as a way to measure the uncertain environment for organizations intending to internationalize in other countries.

Conclusion

Choice of entry mode is a critical determinant of an international firm's success. Our framework proposes that firms should capitalize their resources in line with the environmental factors of the host country. Furthermore, it suggests that for host markets on the lower end of risk and uncertainty, firms can commit their resources to the fullest by opting greenfield investments because of a conducive environment for FDI. To manage high uncertainty in a low-risk environment, firms should choose full acquisitions so that they can gain greater control of the acquired firm resources and, at the same time, inherit an organization adaptive to the environmental uncertainties. On the contrary, in a high-risk environment, firms should align their resources with the local firms through joint ventures and partial acquisitions. Specifically, in highly uncertain environments, joint ventures can diversify the potential risk among parties while in relatively certain environments, partial acquisition is an appropriate choice to manage the high risk and to take advantage of environmental uncertainty.

Contributions

This study combines two important theoretical lenses—RDT and contingency theory—to propose a conceptual framework to guide entry mode choice. We provide a rationale for the need to combine the resources of the firm available for internationalization with the potential risk and uncertainty posed by the environment. This strategic fit will help firms to choose a pertinent entry mode. Empirical studies can use this framework as a conceptual base. A potential strategy is to relate the actual entry mode selection, level of environmental uncertainty, the risk profile of the host country, and the performance of the focal MNC to find out which entry mode is appropriate for different configurations of risk-uncertainty depending on the performance of the focal firm. Doing so, these empirical studies will not only further research in international business but will also help managers in their entry mode decision-making. In addition, the proposed model can be used by Chinese firms to carefully select the appropriate entry mode choice depending on the contingency factors.

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