

A THEORETICAL FRAMEWORK ON FACTORS AFFECTING ENTRY MODE CHOICES OF MNCs

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ABSTRACT

All the multinationals have to confront a critical situation of choosing from the various modes of entering a foreign country. Deciding the right entry mode is the first step of the success ladder of the MNCs. A wrong entry mode choice can cannibalize the entire business operation. The purpose of this paper is to explore the factors that influence the firm's choice of entry mode strategy. The study relies on secondary data, the data for which was obtained from numerous journals (both online and print). Nuances of significant determinants that were likely to influence the entry mode choice of the MNCs were studied.

Keywords: Entry Mode Choice, MNC, FDI, Globalization.

INTRODUCTION:

All multinationals tend to confront a critical situation of choosing the modes from the available various modes to enter a foreign country. There has been an extensive amount of research around the area of entry modes and what affects the MNC's entry mode choice. Kumar and Subramaniam (1997), Chung and Enderwick (2001), as well as Nakos and Brouthers (2002) emphasized that the choice of market entry mode is a critical strategic decision for firms intending to conduct business overseas. Choosing the entry mode is a fundamental decision for a company as it impacts its marketing and production strategy (Johnson & Tellis, 2008). One way of viewing the entry mode alternatives is to view them as either equity modes or non-equity modes. Equity based modes include wholly owned operations and equity joint ventures; while non-equity based modes include contractual agreements and export (Ozlati & Abrami, 2008). "Equity modes differ dramatically from non-equity modes in resource commitment, risk, return, control, and other characteristics"(Pan & Tse, 2000). The study sheds light on the numerous factors that influence the firm's choice of entry mode strategy and its functioning in the host country. Some are related to the general business environment of the host country, the nature of product/service, company related factors, competitiveness of the indigenous firm's, host country production factors and so on.

RESEARCH METHODOLOGY:

The purpose of this paper is to explore the determinants that influence the firm's choice of entry mode strategy. The study relies on secondary research, the data for which was obtained from numerous journals (both online and print). Nuances of significant determinants that are likely to influence the entry mode choice of the MNCs were studied.

FACTORS AFFECTING ENTRY MODE CHOICES OF MNC:

The various factors and their influence on the foreign market entry mode decision are studied separately to explore their impact on the entry mode choices on MNCs .

Cultural Distance:

Cultural distance refers to the difference between the cultural parameters of two nations. The literature review revealed a dichotomous opinion about the culture distance and firm's choice of entry mode. Some studies indicate that higher the cultural distance is, the control required to mitigate the transaction costs increases. As a result the firm has to choose a high equity mode to enter the foreign country (Hennart & Reddy, 1997; and Li & Guisinger, 1992). Brouthers and Brouthers (2003) have stated that the firms may select wholly owned entry modes in countries that depict a larger cultural distance. Barkema et al (1997), and Anderson and Gatignon (1986) on contrary are of the view that higher cultural distance is associated with higher risk; hence, equity modes with lesser degree of control should be preferred. Hsieh and Shen (2003) explored that in Asia, with a greater cultural distance, banks tend to establish low control entry modes to avoid uncertainty in the region. However, Ozlati and Abrami (2008) in their study have found that cultural distance doesn't seem to affect the entry mode decision of Swedish companies in United Arab Emirates (U.A.E) to great extent. The studies are indicative of the fact the companies perceive the risk associated with cultural distance differently as a result of which they may differ in their entry mode choices.

Political Risk:

Hill (2007) defines political risk as a change in the political regime that result in enactment of laws that are less favorable to international business. Political risks are critical determinant of FDI (Chan and Gemayel, 2004). Dow and Karunaratna (2006) argued that, the dissimilarities in the political systems increase the cost and uncertainty of business – government communication channels. Loree and Guisinger (1995) in their study on the influence of political institutions on US FDI have explored a positive relation between equity FDI and political stability. Kinoshita and Campos (2002) have also empirically supported that countries with political stability attract more FDI. Moreover a similarity in the political system of two nations also favors higher equity modes as mentioned by Flores and Aguilera (2007).

Economic Risk:

International Business is susceptible to both external and internal economic condition of the country. "*A host government's political situation or desires may lead it to impose economic regulations*" Czinkota, Ronkainen

and Moffett (2003). Chan and Gemayel (2004) considered economic risk to be an important determinant of FDI. If MNC poses an economic risk in a nation, it avoids opting for high equity modes of entry to mitigate such risks. Dealing with country that is not close in economic distance could prove to be risky. According to the study results of Johnson and Tellis (2008) on success for market entry into china and India, the success is attributed to economic similarity.

Legal Risk:

The firms have to take into account the legal stability of the host country while choosing foreign entry mode. The empirical findings of the study conducted by Ozlali and Abrami (2008) indicated that the Swedish firms that consider legal risk as an important factor in UAE prefer joint venture (LLC) mode of entry. Globerman and Shapiro (2003) stated that, “countries whose legal systems are rooted in English common laws are more likely to be recipient of US FDI flows.”

Currency Risk:

Currency risk is a risk that stems from the change in the price of one currency against the other. This leads to both transaction risk (a risk of unfavorable fluctuation of exchange rates) and translation risk (accounting risk). The fluctuation in the currency impacts the international business dramatically. Notwithstanding the importance of assessing currency risk, Zhao and Decker (2004) found that currency risk doesn't seem to be affecting the choice of entry mode of Swedish companies in UAE.

Natural Resources:

Chen (1996) argued that natural resources of the host country play an important role in magnetizing FDI in that region. In other words, while making a choice of foreign entry modes, a firm opts for equity modes in a country blessed with adequate natural resources in order to benefit from it. Bhaumik and Gelb (2003) have found that in South Africa the entry mode choice significantly depends on the fact whether or not the country is resource seeking. Notwithstanding these studies, Lu, Brennan, Chang and Luo (2008) explore that presence of natural resources is not sufficient to attract FDI in inland areas of China.

Labor Cost and Quality:

It is believed that lower labor cost in the host country is likely to attract more FDI as MNCs gain from the reduced labor cost abroad (Kinoshita & Campos, 2002). “Labor are effective in the choice of Istanbul over the other cities within Turkey” (Berkoz and Turk ,2005). Opposing these study are the studies conducted by Wei et al (1999);Fu (2000); and Lu, Brennan and Luo (2008) that indicated a negative correlation between effective wage and FDI. Advocating the importance of labor quality, Lu, et al. (2008) stated that “ MNCs choose location that are capable of supporting high-valued activities rather than production sites that have abundant low –cost laborers”.

Industrial Agglomeration:

Empirical study by Kinoshita and Campos (2002) revealed that industrial agglomeration in a region is the main determinant of attracting FDI. Consistent with their study was the empirical finding of Lu, Brennan and Luo (2008) who indicated that industrial agglomeration is an important factor for FDI investments in China's inland area as MNCs largely benefit from it. In metropolitan areas of Turkey, industrial agglomeration was not considered to be an important determinant of FDI (Berkoz & Turk, 2005).

Market Attractiveness:

Market attractiveness is size, present wealth, future wealth and other such attributes of a market. An increase in the market size will lead to an increase in the demand that will drive more direct investment in the country (Chakrabarti, 2003). Moreover, empirical study on FDI location choice in China's Inland area depicted a 'market- seeking nature' (Lu, Brennan and Luo , 2008). Kwon and Konopa (1992) also have significantly found that size of the market is one of the significant factors that determine the firm's likelihood to choose higher equity mode entries.

Infrastructure:

Certain studies indicate that physical infrastructure influences the MNCs' decision to enter the region due to expected cost of operation in a particular host country (Root and Ahmed ,1978; Loree and Guisinger ,1995 ;and

Berkoz and Turk,2005) . A positive relationship between infrastructure and inward FDI was observed in various studies such as Wei and et al. (1999) , Mariotti and Pischitello (1995) etc. If better and quality infrastructure are provided by the host country, the firm will prefer choosing higher equity modes like FDI over exports in those region .

Host Government Ownership Restriction:

Bhaumik and Gelb (2003) have explored that in Egypt, the entry mode choice significantly depends on the government attitude towards foreign investor and extent of liberalization of FDI regulation. Agarwal and Ramaswami (1992) suggested that if host government ownership restrictions are found in a country, a firm prefers non- equity mode. Kinoshita and Campos (2002) also stated that more liberalized is the country towards external trade, more FDI it will attract. Ozlati and Abrami (2008) in their study found that government ownership do influence the choice of entry mode, their study indicated that owing to the government ownership restriction, Swedish firms in UAE opt for wholly owned firms (free zones) as opposed to joint ventures which were indicated in the previous researches.

Control:

Control refers to the firm's ability to influence system, take decisions and monitor the method to operate that collectively impacts the future growth and prospects of the firm. A firm while making a choice of entry mode considers the degree of control it can receive by resorting to that particular mode of foreign entry. Johnson and Tellis (2008) have advocated the choice of an entry mode that renders the firm highest degree of control. Empirical study conducted by Ozlati and Abrami (2008) also provided enough evidence that Swedish firms in UAE used higher equity modes like free zones (wholly owned firm) to establish high control.

Competitiveness of Indigenous Firms:

Competitiveness of indigenous firm is attributed to the product differentiation, product quality, brand name, control of distribution channels, corporate size and many more factors. If the firm entering in a foreign market does not witness a competitive advantage over the local firm, it prefers either not entering the market or opt lower equity modes according to Caves (1974). Contradicting to this, Kwon and Konopa (1992) empirically found that firms choose higher equity modes like FDIs that provide them with greater access to foreign market when local firms' competitiveness is high.

Nature of Industry:

Nature of industry also influences the entry mode decision of a firm. Ghahroudi (2009) has found that Japanese MNCs in India prefer to acquire high level of equity ownership especially when subsidiary is in the manufacturing industry.

Provided below is the table (refer table 1) that summarizes the different factors and their impact on the entry mode choice of the multinational companies.

CONCLUSION:

One of the key decisions that a firm has to take when it decides to operate in a foreign land is choosing the ideal entry mode strategy. The mode of entry impacts the vital strategies of the firm in the nation that it decides to function. The business environment of the host country and the policy of the entering firm collectively affect the entry mode choice. Nuances of factors namely cultural distance between the region, political risk, economic risk, legal risk, currency risk involved, presence of natural resources, the cost and quality of labor in the foreign land, the industrial agglomeration, lucrativeness of the foreign market, the prevailing infrastructure, the host government ownership restriction, the company's need to control, the competitiveness of indigenous firms, and the nature of industry were studied. It was revealed that these factors impact different multinationals entering different foreign locations differently as several factors reflected dichotomous opinion. The study aimed at providing a theoretical framework to facilitate a conceptual understanding of the factors affecting the entry mode choices of MNCs. However, the impact of these factors on the entry mode decision may vary dramatically owing to the nature of the industry, difference in the company's internal policies and the perceived risks associated with entering a specific region. Since the study doesn't shed light on a specific sector, an empirical study should be conducted to gauge how strongly these factors would influence MNCs of different sectors while entering a particular foreign region.

Table 1: Summarized Findings on the Factors Influencing Foreign Entry Mode Decision

S. No.	Factors Studied	Finding	Authors
1.	Cultural Distance	Higher cultural distance results in higher equity modes	Hennart and Reddy(1997) Brouthers and Brouthers (2003) Li and Guisinger (1992)
		Higher cultural distance results in lower equity mode	Barkema et al(1997) Hsieh and Shen (2003) Flores and Aguilera (2007) Tihanji, Griffith and Russell (2005) Esperanca and Gulamhussen (2001) Quer, Claver, and Rienda (2007)
		Higher cultural distance reduce the success rate of MNC in host country	Johnson and Tellis (2008)
		Cultural distance does not affect the entry mode choice	Ozlati and Abrami (2008)
2.	Political Risk	Critical determinant of FDI	Chan and Gemayel (2008) Sundaram and Black (1999)
		Political risk increases the uncertainty of business	Dow and Karunaratna (2006)
		Political closeness increases the likelihood of higher mode of entry	Loree and Guisinger (1995) Kinoshita and Campos (2002) Flores and Aguilera (2007)
3.	Economic Risk	Important determinant of FDI	Chan and Gemayel (2008)
		Economic similarity results in success	Johnson and Tellis (2008)
4.	Legal risk	Firm prefer joint venture in case of high legal risk	Ozlati and Abrami (2008)
		Legal similarity attracts more FDI	Globerman and Shapiro (2003)
5.	Currency risk	Currency risk has the lowest affect on the choice of entry mode.	Ozlati and Abrami (2008)
6.	Natural resources	Presence of natural resources attract FDI	Chen (1996)
		Entry mode decision in South Africa is resource-seeking	Bhaumik and Gelb (2003)
		Natural resource is not sufficient to attract FDI	Lu,Brennam, Chang and Luo (2008)

7.	Labor cost	Effective labor wage attract higher mode like FDI	Kumar (1994) Berkoz and Turk (2005) Cheng (2006) Kinoshita and Campos(2004)
		Negative correlation between effective wage and FDI	Wei el al (1999) Fu (2000) Lu,Brennam, Chang and Luo (2008)
		US MNCs choose foreign location with higher wages	Flores and Aguilera (2007)
		Effective wage don't effect the choice	Ondrich and Wasylenko (1993)
		MNCs value high-quality activities rather lower wages	Lu, Brenan , Chang and Luo (2008)
8.	Industrial agglomeration	Main determinant of FDI	Kinoshita and Campos (2002) Lu,Brennam, Chang and Luo (2008) He (2003) Berkoz, L., and Turk, S.S.(2005)
9.	Market Attractiveness	Positive relationship between market size and FDI	Chakrabarti (2003) Loree and Guisinger (1995) Wenget (1995) Lu,Brennam, Chang and Luo (2008) Kwon and Konopa (1992) Flores and Aguilera (2007)
		Market size is no longer a determinant of FDI	Kinoshita and Campos (2002)
10.	Infrastructure	Better infrastructure attract higher equity modes	Wei et al. (1999) Mariotti and Pischitello (1995)
		Infrastructure influences entry decision of firm	Root and Ahmed (1978) Loree and Guisinger (1995) Berkoz and Turk (2005)
11.	Host Government ownership restriction	Presence of host Government ownership restriction results in choice of low equity mode	Agarwal and Ramaswami (1992) Kwon and Kanopa (1993) Kinoshita and Campos (2002) Yin and Makino (2002)
		Entry mode choice in Egypt depends on liberalization of FDI	Bhaumik and Gelb (2003)
		Firm choose high equity mode in the presence government ownership restrictions	Ozlati and Abrami (2008)
12.	Control	Firms should choose the modes that render them higher degree of control	Johnson and Tellis (2008)
		Control is an important determinant of entry choice in UAE	Ozlati and Abrami (2008)

13.	Competitiveness of Indigenous firm	When competitiveness of local firms is high, lower equity modes should be preferred.	Caves (1974)
		Higher equity modes should be preferred when competitiveness of local firm is high.	Kwon and Konopa (1992)
14.	Nature of Industry	Japanese manufacturing industry prefer high equity mode in India	Ghahroudi (2009)
		The extent to which it sources tangible resources from the local partner is an important determinant for service sector in Egypt and the extent of liberalization of local industry is important entry mode determinant for manufacturing firms	Bhaumik and Gelb (2003)

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