Analytical Study of International Market Entry Modes Decision

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ABSTRACT

Paradigm shift towards global business has opened innovative ways of expansion for those who want to avail the fruits of free flow of resources beyond national boundaries. Selecting a vehicles for entering or expanding in a foreign market is a crucial strategic decision for foreign firm. This paper identifies and compares the most influential factors that affect the expansion vehicles decisions of foreign firm. This paper aims at exploring various properties of expansion vehicles into a foreign market, the need for such vehicles and outcomes. A company expanding their business into a foreign market use one or more of the expansion vehicles that is, exporting, licensing, international joint venture, and setting up a wholly owned subsidiary. Foreign firms are sensitive to external risk and other factors. International environmental knowledge and experience, appear to be most significant when selecting modes of expansion. International Joint Ventures and wholly owned subsidiary may be more appropriate for internationally-experienced firms, than inexperienced companies.

KEY WORDS: International Market Entry Mode, International Joint Venture, Wholly Owned Subsidiary, Exporting, Licensing.

INTRODUCTION

The rapid globalization of business in the last two decades has prompted an increasing number of firms to develop strategies to enter and expand into markets outside their home locations. Dynamic, emerging market in India having large, stable markets and now attract both small and large companies from around the world. But once a firm has decided to enter or expand in a foreign market, it must determine the structural nature of its operations in that nation.

Being present and having to enter foreign markets is for many companies natural, while for other it is a new challenge that they have to face. The major challenges are market entry and expansion. Foreign (host) companies are forced to internationalize to take the benefits of home company strengths and avail the cheap labor skills while other companies choose to go abroad because of the great opportunities new markets might bring (Peng, 2006). At the same time home (domestic) company needs to go for alliance to take the advantages of good resources and increasing the market size through exporting. Regardless of the motives, once deciding to go abroad, companies need to consider the choice for entry modes and expansions. There are several entry modes like exporting, licensing, international joint ventures and wholly-owned subsidiaries to choose from; however, in specific industries such as retailing the most common entry modes are: Wholly Owned Subsidiary, International Joint Venture (IJV) and Licensing (Dawson et al., 2006). Risk assessment, the

level of control and return on investment are some of the main factors that decide the choice of entry modes.

Selecting an institutional arrangement - a mode for entering or expanding in a foreign market - is one of the most crucial strategic decisions that an international firm has to make (Root, 1994). A well-chosen mode can enable a firm to create global wing through international mode of entry and expansion.

Strategic alliances observed in India through various modes in different sectors by outnumbering with 3266 in last five years. In which 1282 alliance taken place in the area of Computer software, during 2007-2012. The other sectors like Telecommunications, Drug Pharmaceuticals, Hotels & restaurants, Electronic equipments also managed to draw brisk number of strategic alliance with Government policies and other factors making the investment conditions favorable to foreign companies. The foreign companies by entering through various modes such as exporting, licensing, international joint ventures and wholly-owned subsidiaries with Indian partners invested a lot mainly in sectors such as Commercial complexes, Drugs and pharmaceuticals, Refinery, Misc. financial services, Other Telecommunication services and Brokers etc. In terms of total foreign equity flowing US$ 4.48 billion through foreign direct investment (FDI) in India (CMIE, 2013).

In the present paper an attempt is being made to scan the literature and its evidences on international mode of entry and expansion through exporting, licensing, international joint ventures and wholly-owned subsidiaries. The paper starts with a brief definitional discussion on various options and their modes for alliances.As an outcome of analysis the paper focuses on the influential factors that affect the international modes of entry and expansion decisions of foreign firms and enhance global wing through these modes.

ELEMENTS OF MODE OF ENTRY AND EXPANSION

Firms that are beginning to internationalize and multinational companies that are expanding in nations outside their home base are both faced with the challenge of choosing the best structural arrangement. Four major alternatives are exporting, licensing, international joint ventures and wholly-owned subsidiaries (Root, 1994).

Exporting differs from the other modes in that a company's final or intermediate product is manufactured outside the target country and subsequently transferred to it. Indirect exporting uses intermediaries who are located in the company's home country. These four entry modes may be differentiated according to three characteristics of the modes that have been identified in previous research (Maignan and Lukas, 1997; Woodcock et al., 1994, Gregory, Charles and Shaoming, 2001):

1. Quantity of resource commitment required;
2. Amount of control;
3. Level of technology risk.

Figure 1 illustrates the relationships between these elements and the entry modes. Resource commitments are the dedicated assets that cannot be employed for other uses without incurring costs. Resources may be intangible such as managerial skills, or tangible such as machines and money. The amount of required resources varies dramatically with the entry mode, ranging from almost none with indirect exporting, to minimal training costs in licensing, to extensive investments in facilities and human resources in international joint ventures and wholly-owned subsidiaries.

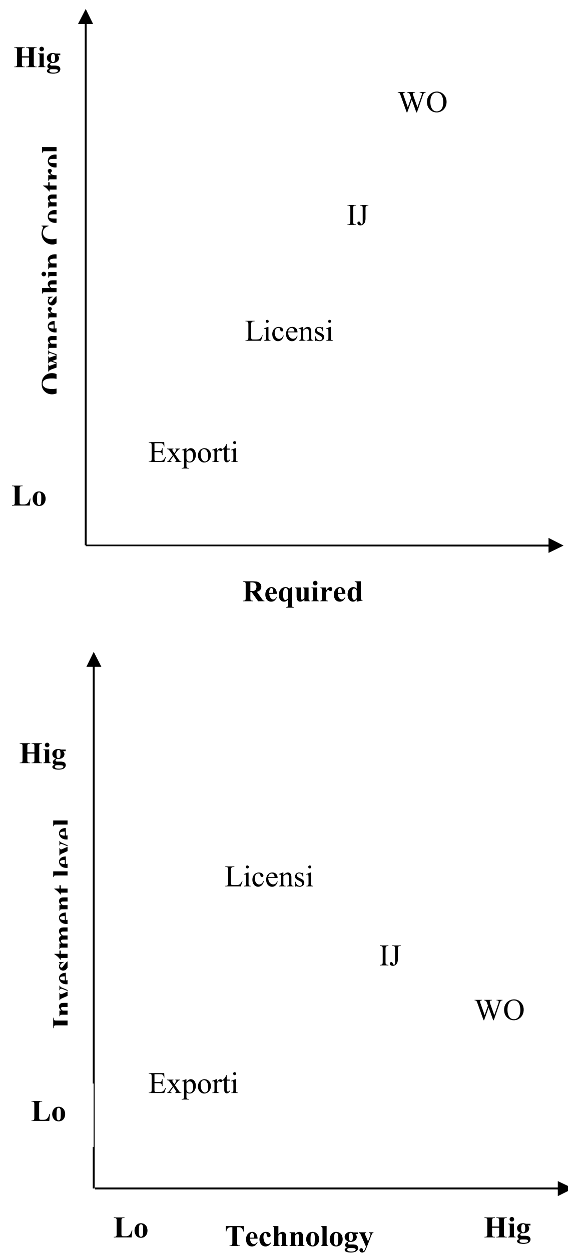

Figure 1: Key characteristics of modal alternatives (Adapted from Gregory, Charles and Shaoming, 2001)

Control is the ability and willingness of a firm to influence decisions, systems, and methods in foreign markets. In a franchise type of licensing agreement, control over the operations is granted to the franchisee in exchange for some type of payment and for the promise to abide by the terms of the contract. Thus, the licensor has little direct control. In an international joint venture control is shared formally according to level of ownership, as when equity ownership over 50 percent gives one of the partners the largest number of directors on the board. However, informal control mechanisms may also be exerted as when one partner

possesses and uses knowledge and information that the other lacks. Wholly-owned subsidiaries are attractive to many companies because this mode enables the MNC to exert the most control in decision-making.

Technology risk is a third parameter of modal forms and decision-making. This concept can be defined as the potential that a firm's applied knowledge (tangible and/or intangible) will be unintentionally transferred to a local firm. In a licensing agreement, the risk of the licensee reproducing and using the licensor's technology in the future is fairly high. International Joint Venture partners may also learn and acquire unspecified elements of the other firm's technology in the context of their partnership. Technology risk is probably lowest in a wholly-owned subsidiary, since the operations are under the control of only one firm.

Resource commitment, control, and technology risk are highly correlated (Woodcock et al., 1994). For example, as implied above, increased control leads to lower technology risk. Yet, control also requires increased resource commitment. Some researchers have argued that the entry mode decision consists mainly of determining the levels of resource commitment, control, and technology risk that the international entrant desires or can accept (Maignan and Lukes, 1997; Woodcock et al., 1994). Since each mode has a certain level of each factor, the entry decision can seem clear cut.

In practice, the entry mode decision is highly complex. Besides the previously discussed qualities of each mode, there are a host of target market factors and within company factors that may affect decision-making. Certain antecedent conditions affect whether to use, say, a high control mode or a method that requires few resources (Gregory, Charles and Shaoming, 2001).

The optimal choice of the mode of entry depends on the company. Each entails a different level and type of risk and control. The various modes of entry into a foreign market and the risks involved with each. Typically, a company starts with the low-risk/low-control option and then advances to higher levels of risk and control as it gains experience and builds confidence.The various different modes of entry for international expansion are strategic alliance, exporting, licensing, international joint ventures and wholly-owned subsidiaries (Kiruba Jeyaseeli Benjamin Levi, 2006).

MODES OF ENTRY AND OPTIONS AS A COMPONENT OF AN INTERNATIONAL MARKET EXPANSION

An individual alliance is a formal agreement that establishes a relationship between two independent entities. These alliances may range from more complex equity joint ventures to somewhat loser arrangements to corporate in R & D or for managing supply and sales relationships. Alliances are important for any organization not only to growth and prosperity, but sometimes even to survival.

Companies expanding their operations to international markets employ five different modes to enter the foreign market:

- Exporting,
- Licensing,
- Strategic Alliance (SA)
- International Joint Venture (IJV)
- Wholly Owned Subsidiary (WOS)

Strategic alliance and international joint venture has been considered together because strategic alliance is a contract in the beginning, which if successful, usually leads to an international joint venture. Figure 2 showsperformance of international joint ventures

companies depends on the alliance options and their modes, if they opt for short term contracts the costs, management times, performance is low and risk is high and in long term contracts the costs, management times, performance is high and risk is less whereas in medium term contracts the costs, management times, performance are risk is moderately.

On the other hand, an internationaljoint venture can be defined as a venture between an international company and a national company in which the international company has enough equity stake to have voice in the management but not enough to completely dominate the venture. The equity share of the international company can vary from minority to majority. The most typical form of venture is 50/50 in which each party takes 50% ownership stake. Also the ownership stake is shared by the team of managers from both the parent companies. The reasons that propel firms towards alliance networks lie in various opportunities to combine knowledge and physical assets (Dussauge P., Garrette, B. & Mitcholl, w. 2000).

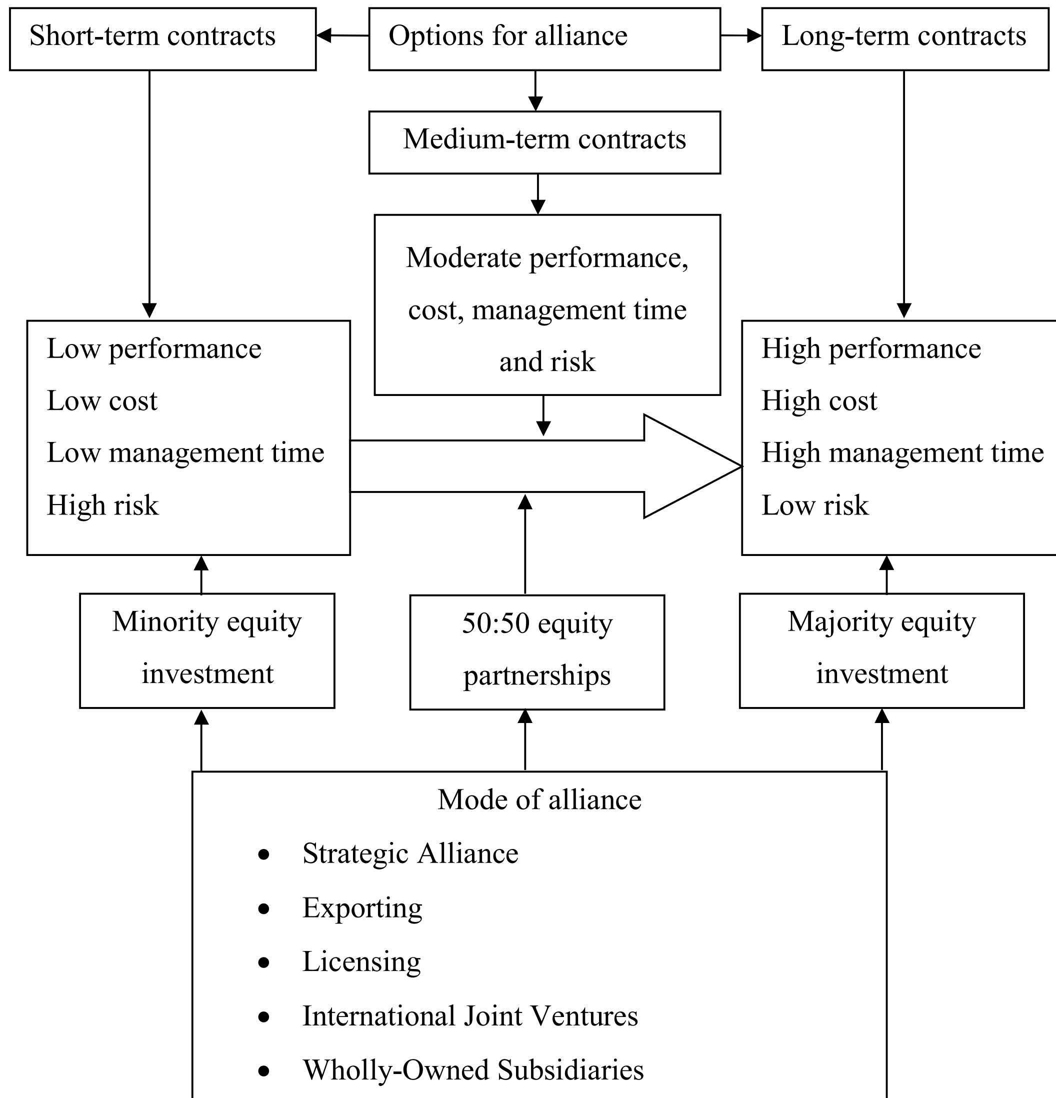

Figure 2: Options and mode for organizing an alliance along a continuum*

The present research is an analytical study to explore access and analyze the outcomes of such alliances especially those in the form of strategic alliances, exporting, licensing, international joint ventures and wholly-owned subsidiary.

IMPORTANT FACTORS AFFECTING ENTRY MODE CHOICES

Knowing the factors that were central considerations in the modal choices made by other companies can improve a firm's competitive advantages and decision-making. Understanding why certain factors are associated with particular entry mode choices can be useful in developing and predicting international strategies.

In the present paper study exporting was the most frequently used mode of entry into a foreign country. However, when combined, the investment modes of joint ventures and wholly-owned subsidiaries were used even more than exporting. Licensing was the least frequently chosen mode.

By evaluating the relative importance of a large set of factors that may have affected his/her decision to use a particular mode. The following section analyzes the decisions to select strategic alliance, exporting, licensing, international joint ventures, and wholly-owned subsidiaries.

EXPORTING

Exporting is the transfer of goods or services across national boundaries. Most companies begin their expansion into the international arena by exporting into a foreign market and then move to the other modes of entry. Foreign companies prefer entry mode through exporting due to certain reasons.

- The company entering a foreign market can maintain production facilities at home and transport the goods or services abroad. In this way, the company can avoid the substantial cost which it would incur if it were to establish production facilities in the host country.
- The company benefits from the economies of scale and from its global sales volume. Hence, exporting enables a company to benefit from the experience-curve, cost economies and from location economies.
- Exporting does not require a very substantial presence abroad.

By choosing to export, a company can avoid the substantial costs of establishing its own operations in the new country, but it must find a way to market and distribute its goods in that country The foreign companies, who recently chose to use exporting to enter a foreign nation, highlighted the fact that their target market is very competitive and that their competitors' products are viewed as similar and easily substitutable by customers.

The foreign firms, who recently chose to use exporting to enter a foreign nation, highlighted the fact that their target market is very competitive and that their competitors' products are viewed as similar and easily substitutable by customers. The foreign company managers favor the use of exporting, rather than direct investment. They feel that there is no clear advantage in using a high control mode that requires high levels of resources, such as a wholly-owned subsidiary. When the products are easily substitutable, customers are sensitive to price. Costs and prices may be lowest if production occurs in only a few locations around the world and the efficiently produced goods are exported to markets.

The study stated that an important factor in the choice of exporting is that this mode is the quickest means to enter a new market. For strategic reasons, foreign firms use exporting to prevent competitors from gaining first-mover advantages in new markets and to not be left behind. Previous studies have also shown that the foreign firms have a preoccupation with

competition, especially with other IJVs firms (Anand and Delios, 1996; Genestre et al., 1995).

Many foreign firms prefer exporting as a mode of entry. When the host government does not require locally-produced content in goods sold in the nation, or make other restrictions on exporting, foreign firm's executives emphasized that this condition is an important factor in their choice of exporting.

LICENSING

Foreign companies often use licensing reluctantly. The important factors of foreign companies to use of licensing all involve pressures from the host government. One factor associated with the use of licensing is that the host government can easily find alternative companies to do business with. When many foreign competitors attempt to enter a market, the host government has more bargaining power than an individual MNC. Thus, when the host government expects new businesses to be managed by nationals and when the government prefers the use of cooperative arrangements, an MNC who wants to enter the foreign market must comply with the government's modal preferences (Gregory, Charles and Shaoming, 2001)).

Firms used licensing when their company had no viable modal alternative. This situation occurs when a firm wants to expand into a country, but lacks the capital to do so. In licensing arrangements, a local licensee contributes all of the capital to establish the business. Thus, licensing is a quick and easy way for firms to expand into other nations when they lack the resources to do it alone. Another factor that is important to licensors is low political risk. When governments support foreign businesses and protect intellectual property, there is less likelihood of licensees reneging on contracts or stealing technology. This condition of a target market with a stable, firm government produces low political risk, which encourages the use of licensing as a mode of entry.

INTERNATIONAL JOINT VENTURES

An internationaljoint venture can be defined as a venture between an international company and a national company in which the international company has enough equity stakes to have voice in the management but not enough to completely dominate the venture. The basis of an international joint venture is to benefit from the complementary competitive advantages of the two companies. International Joint Ventures have numerous advantages.

- Gives greater return from equity participation than other modes of entry.
- Enable greater control over production, marketing and operations.
- Reduce political and economic risks as a result of the involvement of the native partner.
- It is the finest mode of entry where foreign ownership is not permitted.
- It is the quickest mode of entry.
- An international company has direct participation in the foreign market and thus it can understand the international market better and take sounder decisions for the future.

The host government policies and preferences are an important factor when foreign firms use international joint ventures. Many nations have encouraged the use of IJVs as a means for local companies to acquire technology. It is well known that the two largest nations of Asia, China and India, have pressured MNCs to develop joint ventures with local firms, rather than to set up wholly-owned subsidiaries (Anand and Delios, 1996).

The companies chose to use IJVs. As a firm gains experience internationally, it is more willing and able to commit the high levels of resources required to initiate and manage an IJV or a wholly-owned subsidiary. Experience in exporting and/or licensing gives managers a better feel for a market, with a clearer perception of the risks and rewards of investing

there. This increase in knowledge increases confidence and decreases risk aversion. Several other strategic factors are also associated with the use of IJVs by foreign companies. Because of strategic decisions to participate in such large potential market as in India. The fact that technology is often disseminated from one partner to another in an international joint venture.

WHOLLY-OWNED SUBSIDIARIES

A wholly owned subsidiary is a mode of entry in which the parent company has 100% ownership of the subsidiary's stock. A wholly owned subsidiary can be set up either by acquisition or by establishing a completely new entity (Hill and Jones, 1998, pp. 26). Wholly-owned subsidiaries (WOS) offer firms the highest levels of control and the lowest technology risk, but they require the highest resource commitments. Some companies still fear this drastic event and factor the possibility into their entry mode decisions. Hyperinflation and other economic crises may increase the investment risk.

The foreign firms seem to prefer to use WOS rather than international joint ventures, since they use WOS when host governments have open trade and investment policies. Government incentives for IJVs and restrictions on WOS are important factors in modal choices.

One strategic factor that is particularly important to foreign firms that use WOS is their commitment to respond quickly to competitors in foreign markets. Because of the high control possible in wholly-owned subsidiaries, this mode enables firms to act and react more quickly than when using international joint ventures. It often takes less time to build a new facility than to select and negotiate with local JV partners. In addition, decision-making is often slower in IJVs, since multiple parties are involved in the process. Wholly-owned subsidiaries have several advantages over international joint ventures. Yet, few companies possess the resources to be able to establish operations independently. The foreign companies who chose WOS stated that one reason they did so was because they possessed the capital and local market knowledge to be able to ``go it alone."

CONCLUSIONS AND IMPLICATIONS

The firms attempt to seize new opportunities for growth and/or cost reduction in foreign markets face complex, significant modal decisions. First, need to understand the nature of each of their modal choices. Modes vary in terms of the level of control, the quantity of required resources, and the amount of technology risk. The joint venture firms identified different factors that are most important to them in making modal entry decisions such as:

1. Domestic company factors
- Political risk.
- Investment risk.
- Host government local content requirements.

2. Foreign Company factors:
- International experience.
- Need for local knowledge.
- Synergies among global operations.
- Competitive position.
- Need to protect technology.

Domestic company factors seem to be more important and are sensitive to external risk. The political stability of the domestic company and the risk of losing their investments are important considerations to them. In high-risk situations, foreign firm may face less competition and when investment risk is low, wholly-owned subsidiaries become a viable

alternative to opt as a model for expansion. However, exporting is often a preferred mode for foreign firms.

Foreign company factors identified a large set of company factors, particularly strategic factors that were important to them, this study reveals an important insight those international joint ventures, rather than WOS, may be more appropriate for internationally-experienced foreign firms than for novice companies. Because of the difficulty in selecting appropriate partners and managing complex IJV relationships, new firms should be cautious about selecting IJVs as a mode of entry. Firms that know the local situation, and that have experience from elsewhere in managing IJVs, may be best suited to use this cooperative arrangement. Another factor important in international joint ventures is technology. When it is not crucial to protect technology, IJVs are more likely to be used. However, with core technologies, wholly-owned subsidiaries are a superior mode of entry, due to the high control offered by this mode.

The role of governments is a major factor in international business decisions. Even in so-called “open markets," governments provide incentives or encouragement for foreign corporations to use certain modes. In every nation where they want to do business, MNCs must know the “local rules" regarding local content requirements, market access requirements, etc., and play according to those rules. Wholly-owned subsidiaries are used by foreign company when the regulations do not prevent full foreign ownership of corporations. Furthermore, when a firm can acquire capital and local market knowledge on its own, firms from both nations prefer wholly-owned subsidiaries over international joint ventures.

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