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Firm-specific factors and entry mode choice: an analysis of Chinese hotel chains

Rosario Andreu, Enrique Claver and Diego Quer

University of Alicante, Spain

Corresponding author:

Rosario Andreu (rosario.andreu@ua.es)

Department of Business Administration,

Economics Faculty

University of Alicante

Carretera de San Vicente del Raspeig s/n

03690 San Vicente del Raspeig, Alicante (Spain)

Co-authors

Enrique Claver (enrique.claver@ua.es)

Department of Business Administration

University of Alicante, Spain.

Diego Quer (diego.quer@ua.es)

Department of Business Administration,

University of Alicante, Spain.

Firm-specific factors and entry mode choice: An analysis of Chinese hotel chains

Abstract

The Chinese hotel sector has experienced spectacular growth in recent years. Furthermore, it is expected that Chinese hotel chains will increase their presence abroad in the future. One of the key decisions in the internationalization process of hotel firms is the choice of entry mode into a foreign country. Many different factors influence this strategic decision. From a sample of 185 entries carried out by the largest Chinese hotel firms, this study analyses some of the main firm factors that might influence entry mode choice. The results support the relationship between the entry mode of Chinese hotel chains and firm size, previous international experience and asset intangibility.

Keywords: Chinese hotel chains; Entry mode; Firm factors; Internationalization.

Introduction

In recent years, tourism in China has experienced spectacular growth that has made the country move up, overtaking countries that had traditionally occupied top positions in world tourism rankings. The tourist sector in China is now one of the pillars of the country's economy (Tsang and Hsu, 2011). It is expected that in a few years China will become the first tourist destination in the world. More precisely, it is expected that by 2020 China will attract 210 million international tourists and 100 million of Chinese tourists will travel to foreign countries (World Tourism Organization [UNWTO], 2009).

Along with the rising number of tourists, the hotel industry in China has also experienced various stages of development since the country open door policy was introduced in 1978 (Guillet et al., 2011). In that year, there were less than 1,000 hotels in China.

However, since 1988 (the year when the star rating system was established), the development of the hotel industry has been dramatic with annual growth rates around 20% (Gu et al., 2012). According to the China National Tourism Administration (CNTA), by the end of 2014, China had under operation 11,180 star hotels (Travel China Guide, 2014).

Changes occurred not only in the number of establishments but also in their characteristics. Whereas in 1991 one-star hotels accounted for 9.34% of total rooms, in 2014 they represented less than 1% of the hotels. Two-star hotels decreased from representing 33% to only 23% in the same period. Three, four and five-star hotels increased their weight in China's hotel industry. The total number of three-star hotels went from 35% to 48%; four-star hotels increased from 13% to 21%, and five-star hotels slightly increased to 7% in 2014. This shows that the quality of hotels in China has improved in recent years (Gu et al., 2012).

One of the main drivers of the development of the hotel industry has been the expansion of multinational hotel groups into China. These companies operate mainly in high level market segments. Luxury brands such as Four Seasons, Ritz Carlton, Hilton, Wyndham, Marriot, Intercontinental Hotels, Accor, Starwood and Hyatt International, among others, are some of the major international hotel groups operating in China (Aliouche and Schlectrich, 2011). These groups have entered China attracted by the increase in foreign tourist arrivals to the country, the rapid growth of domestic tourism and the growth of Chinese outbound tourism that offers opportunities for the development of customer loyalty programs. Furthermore, economic factors and the impact of mega events may have influenced the decision of foreign companies to expand in China (Zhang et al., 2012). The strategy followed by these foreign hotel chains in China focus on taking advantage of their worldwide recognised brand, sometimes complemented by the development of new brands for the Chinese market. As for the entry mode, the most common is management contracts while joint ventures and franchising are increasingly chosen (Guillet et al., 2011).

This entry of foreign hotel companies into the Chinese market has intensified competition, also providing the Chinese hotel industry with managerial knowledge from developed countries. Besides, it has helped to improve the productivity and efficiency of the market (Yu and Huimin, 2005). Hotels in China managed by multinational groups have higher profitability than those operated by national companies (Pine and Qi, 2004).

While foreign hotel multinationals continue to expand in China, the internationalisation of Chinese hotel industry is still in an early stage (Gu et al., 2012). Compared with these large multinational hotel chains, the internationalisation rate of the most important Chinese hotel chains remains very low. However, in the last few years they have begun to grow rapidly abroad, as will be analysed in the next section.

One of the critical decisions in the internationalisation process is the choice of an entry mode. While strategies applied by foreign hotel chains to enter the Chinese market have been analysed by experts, those used by Chinese hotel chains to enter markets abroad are not among the most studied topics by researchers (Andreu et al., 2010; Gross et al., 2013). Therefore, the aim of our paper is to fill this gap by analysing the entry mode choice of Chinese hotel companies in their internationalisation process. The analysis of the factors influencing entry mode choice is one of the most common in the international business literature. Although most studies focused on manufacturing firms, there is a growing interest in analysing the peculiarities of service firms when it comes to adopting this strategic decision. Some of these studies addressed the entry mode choice in the hotel industry (Brown et al., 2003; Contractor and Kundu, 1998; Driha and Ramón, 2011; Erramilli et al., 2002; Ivanova and Ivanov, 2013; León-Darder et al., 2011; Martorell et al., 2013; Pla and León, 2002; Pla-Barber et al., 2011; Quer et al., 2007; Ramón, 2002).

Within this framework, our paper seeks to complement the existing contributions by providing new empirical evidence about the way in which firm-specific factors influence the

entry modes used by Chinese hotel firms in their internationalisation process. The paper is structured as follows. The next section provides the theoretical review of the firm-specific factors that may influence entry mode choice. Then we will present the statistical analysis we performed and our main findings. Finally we will draw some conclusions and the main contributions of our work.

Theoretical framework and hypotheses

Entry modes in the hotel industry

Foreign market entry modes can be divided into three large groups according to the generic options that are available to an enterprise in order to compete beyond the domestic market: supplying foreign markets through commercial transactions (exports); transferring knowledge to the destination country through a contractual agreement; or moving productive or commercial capabilities, providing capital through foreign direct investment (FDI), either jointly (joint venture) or on its own (wholly owned subsidiary). These entry modes fall into two broad categories: non-equity entry modes (including exports and contractual agreements) and equity entry modes (including FDI modes). This classification is based on the degree of control (Contractor and Kundu, 1998). Considering the characteristics of each alternative, FDI implies better control of operations abroad and greater profit potential, but at the expense of committing more resources and consequently assuming a greater risk.

The hotel industry is considered as a soft service industry. One of the characteristics that has a direct influence on entry mode is the simultaneity between production and consumption. This is a ‘soft’ or inseparable service, i.e. it requires the proximity of both the supplier and the customer or the presence of the object on which the service is going to be delivered (Erramilli, 1991; Erramilli and Rao, 1993). This means permanent contact with the customer, as a result of which the latter becomes actively involved in the production process.

The constant interaction with the customer and the impossibility to store and transport the service, makes it necessary for the firm that has decided to internationalise to have a suitable, significant presence in each foreign market. Therefore, the hotel firm will not be able to 'export' a product, as manufacturing firms do, and it will have to choose any of the other entry modes: contractual agreements (management contract, franchising, etc.) or FDI (joint ventures or wholly-owned subsidiaries).

Firm-specific factors and entry mode choice

In the international business research, firm-specific factors have been extensively studied as determinants of entry mode choice. Firm variables, such as firm size, international experience, and intangibility and complexity of international assets may play an important role. Larger and more experienced firms typically favour full control entry modes (Sánchez-Peinado et al., 2007). Furthermore, the intangible assets are difficult to transfer to another firm without loss of value because market failures (Kogut and Zander 1993). These market failures may also lead firms to rely on full control entry modes.

Starting with firm size, Horst (1972) already argued that, considering the inherent risks and fixed costs, the proneness to invest abroad must increase with the dimension of the firm. The establishment of subsidiaries abroad entails significantly higher resource commitment and greater risk than other options. Consequently, larger firms have a greater ability to expend resources and absorb risks than small and medium-sized ones and thus they are more likely to select high-control and resource commitment modes (Sánchez-Peinado et al., 2007).

Moreover, greater size implies greater availability of financial and managerial resources, which makes it easier to set up full-ownership subsidiaries (Tallman and Fladmoe-Lindquist, 2002). In keeping with this, a large part of the empirical research has observed that firm size is positively associated with the degree of commitment assumed with the entry mode

(Agarwal and Ramaswami, 1992; Brouthers et al., 2003; Campa and Guillén, 1999; Driha and Ramón (2011); Osborne, 1996; Pla-Barbe et al., 2010; Ramón, 2002; Rialp et al., 2002; Stopford and Wells, 1972; Trevino and Grosse, 2002; Yu, 1990). This is why we can argue that larger-sized hotel firms will have better guarantees to assume the commitment derived from an FDI initiative, which leads us to expect that equity entry modes will be positively associated with firm size. Thus, we propose:

Hypothesis 1. Firm size is positively associated with the use of equity-based foreign market entry modes by Chinese hotel chains.

On the other hand, Agarwal and Ramaswami (1992) concluded that international experience is a key determining factor when the firm chooses an entry mode that requires a direct equity investment. The lack of knowledge about the foreign country could be an obstacle in the development of international activities (Johanson and Vahlne 1977). Firms prefer to start with methods of entry implying a low level of commitment and risk. Once the company has some experience abroad, the internal uncertainty about the internationalisation process will be lower and the firm assumes the possibility to manage its foreign operations. Therefore, as a company's international experience increases, it is more likely to choose an entry mode that calls for higher resource allocation (León-Darder et al., 2011). As a result, we propose:

Hypothesis 2. Firm's international experience is positively associated with the use of equity-based foreign market entry modes by Chinese hotel chains.

Finally, the intangibility of the assets may also influence the entry mode decision. Brand name, reputation, commercial skills, or firm's sales capabilities are key specific assets for international firms (Pla-Barber et al., 2011). It is thought that the larger the number of intangible assets in a hotel, the greater the control that a hotel chain needs to exert in order to meet quality standards. This is why the hotel chain may decide to choose an entry mode that allows for greater control, instead of a contractual agreement. Huang et al. (2011) proposed that firms will use entry modes characterised by higher levels of control in order to minimise the risk of deteriorating intangible assets. Equity entry modes could better protect intangible assets, namely brand value and a uniform customer experience. Thus, we hypothesised that:

Hypothesis 3. Asset intangibility is positively associated with the use of equity-based foreign market entry modes by Chinese hotel chains.

Methodology

Sample description

The companies analysed in our study were selected using *Hotels* magazine annual worldwide ranking. According to *Hotels* (2014), 33 Chinese hotel chains are among the 300 largest in the world. When the 33 chains included in this global ranking were examined, the sample was narrowed down to 15 chains that had one or more hotels outside China. These 15 chains studied by year 2014 amounted to a total of 185 hotels abroad.

Data were obtained from secondary sources, more specifically the websites of the 15 hotel chains and groups, as well as the websites of their hotels outside of China. The websites were used to gather information on the year the hotels were inaugurated, how they were managed, the chains' previous international experience in a specific country, the type of hotels

they opened abroad and their number of stars. Some of the main characteristics of the sample are shown in Table 1.

Insert Table 1

Measurement of variables

Entry mode

Following previous research on entry mode choice (Brouthers and Brouthers, 2003; Ekeledo and Sivakumar, 2004; Erramilli and Rao, 1993; Martorell et al., 2013; Pla-Barber et al., 2010; Quer et al., 2007), we created a qualitative dependent variable with two categories: (0) non-equity entry mode; and (1) equity entry mode. Non-equity entry modes include contractual agreements such as franchising, management and lease contracts, while equity entry modes cover different types of FDI (equity joint ventures, acquisitions and greenfield investments). Contractual agreements (category 0) call for lower resource commitment than investments (category 1).

Firm size

In order to measure firm size we used the hotel rooms' logarithm, available at *Hotels* magazine ranking (2014). This has been also used in previous research (Camisón, 2000).

Firm's international experience

This variable was measured using two different methods. First, using an entry-to-entry calculation of the number of years that had gone by since a company's internationalisation process began. This is a measure of firm's general international experience that has been applied in past research (Driha and Ramón, 2011; León-Darder et al., 2011; Martorell et al.,

2013; Pla-Barber et al., 2011; Pla-Barber et al., 2010). Second, the number of years operating in each country was used as proxy of the knowledge and the previous experience accumulated in each specific country, i.e., host country-specific experience (Delios and Henisz, 2000).

Asset intangibility

The number of stars of a hotel was used to measure the degree of intangibility of hotel's services. Within the hotel industry, intangible services grow as the number of stars increases (Brown and Dev, 2000). We designed a categorical variable where 1 stands for three-star hotels, 2 stands for four-star hotels, and 3 stands for five-star hotels. This variable had already been used by prior studies (León-Darder et al., 2011; Pla-Barber et al., 2011).

Results and Discussion

Descriptive analysis shows that equity investment modes (138 entries) prevail over contractual agreements (47 entries) among the Chinese hotel chains covered by our sample. As per yearly data, 2011 was the best year for Chinese hotels abroad, with a total of 23 new openings, followed by 2012 (19 hotels) and 2013 (17 hotels), which shows how internationalisation of Chinese hotel chains has been growing in the last few years.

With regard to the countries where Chinese hotel chains prefer to invest, Indonesia (36 entries) leads the ranking, followed by the U.S.A. and Malaysia (19 entries) and France (16 entries). Table 2 reports the top ten destinations¹.

Insert Table 2

In order to analyse the relationship between the entry mode used by Chinese hotel chains and the firms' determinants influencing this decision, we used the *Student's t-test*, the

Chi-square test and the *Standardised Residuals*. Table 3 shows the relationship between firm size and entry mode choice.

Insert Table 3

As we can observe, firm size presents a statistically significant negative relationship with equity-based entry modes, i.e., that large Chinese hotel firms prefer to use contractual agreements as entry mode. Thus, hypothesis 1 is not supported. This finding suggests that larger Chinese hotel chains may need to find new partners in order to be able to make the necessary investments to open a new hotel in a foreign market (Brown et al., 2003; Contractor and Kundu, 1998; Martorell et al., 2013). Besides, this supports that larger chains have greater capabilities to generate the necessary conditions and know-how that allow them to enter a foreign country using contractual agreements. This result is in line with that of some past research on hotel companies (Contractor and Kundu, 1998; León-Darder et al., 2011; Martorell et al., 2013; Pla-Barber et al., 2011). These authors confirmed that large hotel companies have greater capabilities to attain the conditions and knowledge needed to choose to enter a foreign market by means of a contractual agreement.

As for the international experience of the Chinese hotel chains, the results are shown in Tables 4 and 5.

Insert Table 4

Insert Table 5

The results reported in Tables 4 and 5 suggest a positive relationship between the international experience of the firm and the resource commitment in entry mode choice. This finding supports hypothesis 2. Therefore, the general international experience of Chinese hotel chains and the previous knowledge of the host country seem to reduce the uncertainty and increase the profitability of choosing equity modes. This result is in line with that of past research in the hotel industry (Martorell et al., 2013; Pla-Barber et al., 2010). This idea arises from the Internalisation Theory and agrees with the Uppsala Model (Johanson and Vahlne, 1977; 1990), where a gradual internationalisation process is proposed allowing the company to improve its experience and knowledge on foreign markets. According to this model, at the beginning of the process companies would rather use any method that entails low risks and resource allocation, and uncertainty decreases as international experience grows. Therefore, as a company's international experience increases, it is more likely to choose an entry mode that calls for higher resource allocation (León-Darder et al., 2011).

Regarding the relationship between asset intangibility and entry mode choice, Table 6 shows the results of the Chi-Square test and the Standardised Residuals (S.R.).

Insert Table 6

The Chi-Square statistic allows for concluding that there is a statistically significant relationship between asset intangibility and entry mode choice. This means that the observed frequencies are different from those that would be expected if they were unrelated variables. Moreover, the analysis of the standardised residuals shows that those cells where the standardised values are greater than 1 correspond to the 3 star hotels that opt for cooperation agreements and 5 star hotels that opt for FDI. Therefore, the number of stars is positively

related to entry mode choice. Whereas three star hotels show a greater tendency to use contractual agreements as entry mode, five star hotels make a more intensive use of FDI. This result supports hypothesis 3, thus suggesting that as the intangibility of the services offered by the hotel increases, Chinese hotel chains show a higher tendency to use equity-based foreign market entry modes. For that reason, as intangibility of the services offered by the hotel that a certain Chinese company wishes to open abroad increases (which is directly proportional to the number of stars), so does the company's interest in using an entry mode where more resources and control are allocated. This finding is in line with that reported in previous studies on international hotel chains (León-Darder et al., 2011; Pla-Barber et al., 2011).

Moreover, the contingency coefficient allows us to know the strength of the association between the variables. This coefficient takes values between 0 and a maximum level depending on the number of categories of variables which in this case is 0.707^2 . In our study we obtained a contingency coefficient of 0.332, so we conclude that there is a medium-high degree of dependence between the variables asset intangibility and entry mode.

Conclusions

In this paper we have analysed some firm-specific factors that may influence entry mode decisions of international Chinese hotel chains. As stated above, entry mode choice has been one of the topics most discussed in the international business literature. Nevertheless, there are few studies in the case of Chinese hotel companies. Therefore, this paper has tried to fill this gap, helping to analyse one of the most important aspects of internationalisation strategies applied to one of the sectors with greater economic projection in China.

The data show that the level of internationalisation of the Chinese hotel industry is still not very high. However, in recent years it is increasing the opening of hotels abroad, mainly in Asian destinations geographic and culturally close to China. In this process of

internationalisation, Chinese hotel chains seem to prefer entry modes involving capital investment versus contractual modes.

The results of our study and the available data do not allow us to state that Chinese hotel chains just copy the strategies followed by their American or European counterparts. Thus, we cannot conclude that there is no difference and it just comes down to investor preference regarding risk. In spite of this, we consider that risk aversion may have influenced entry decisions of Chinese hotel chains. They are still in an early stage of their internationalisation process. As stated above, the main destinations of Chinese hotel chains are Asian countries that are culturally close to China. As a consequence, they may be considered less risky destinations. For the same reason, Chinese companies may have chosen FDI as the entry mode. Cultural distance and the level of risk aversion of the firm can play a considerable role in determining the optimal entry mode. Cultural distance creates uncertainty, which ultimately results in additional costs. In order to reduce these costs, companies can seek cooperation with a partner (Contractor and Kundu, 1998; Hennart and Larimo, 1998; Pak and Park, 2004).

As Chinese hotel chains enter culturally more distant countries in the future, it is expected that they will choose contractual agreements (such as management contracts or franchising), as in the case of American hotel chains. Indeed, the number of franchised hotels has been increasing in the United States in the last years. However, franchising in branded hotel rooms (including both management contracts and franchises) is much less popular in Europe and Asia/Pacific (Xiao, O'Neill and Wang, 2008). Franchising is still in its infant stage in China's hotel industry. Anyway, it is reasonable to expect that franchising will become more widely adopted by Chinese hoteliers. As Heung, Zhang and Jiang (2008) point out, more of China's independent hotels are considering joining international hotel franchisors for development in the globally competitive environment. This may also happen as more

Chinese chains with hotels in lower and middle market segments become international, since past research reported that in the midscale and budget hotels, franchising is the prevalent mode of entry (Chekitan, Erramilli and Agarwal, 2002; Chen and Dimou, 2005).

Furthermore, our results show that firm size, firm's general international experience, its previous host country-specific experience and the level of intangibility of hotel services established abroad, are statistically significant factors affecting entry mode choice of Chinese hotel chains.

Nevertheless, the results should be interpreted with caution because of certain limitations of our study. On the one hand, we focused only on firm-specific factors. Future research should complement the analysis by including other environmental factors that may also influence entry mode decisions. Moreover, another statistical technique could be applied in order to analyse a more complex model of entry mode choice. On the other hand, since we only used secondary data, we were not able to consider managerial perceptions. Future research may overcome this limitation by using primary data sources based on surveys. In addition, our study focuses on the larger Chinese hotel chains that appear in world rankings. The results could vary if we expanded our sample to smaller Chinese chains with a lower availability of resources to undertake internationalisation strategies.

There are other promising avenues for future research on the internationalisation of Chinese hotel companies. First, to analyse whether the propensity to use equity-based entry modes continues in the future or, on the contrary, contractual agreements become more popular. Besides, it could be interesting to analyse if there are any differences between Western hotels' management agreements and Chinese hotels' hotels management agreements. If there is a different risk/reward relationship implicit in the way they are drawn up, this might also explain the preference over direct investments. Finally, the analysis of the link between

the determining factors, entry mode choice and firm performance could be another future research line.

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TABLES**Table 1: Characteristics of the sample**

| Characteristics of the firms | Mean | Standard deviation |
|-------------------------------------|-------------|---------------------------|
| Firms Size (number of rooms) | 40,764.33 | 70,046.02 |
| Number of hotels abroad | 28.45 | 15.54 |
| Age of the firm | 46.78 | 29.62 |
| Years of international experience | 20.59 | 23.82 |

Table 2: Top ten destinations of Chinese hotels abroad

| | Country | Number of entries |
|-----|----------------------|--------------------------|
| 1. | Indonesia | 36 |
| 2. | U.S.A. | 19 |
| 3. | Malaysia | 19 |
| 4. | France | 16 |
| 5. | Philippines | 11 |
| 6. | Japan | 9 |
| 7. | Australia | 7 |
| 8. | United Arab Emirates | 7 |
| 9. | United Kingdom | 6 |
| 10. | Singapore | 6 |

Table 3: T-Test for firm size and entry mode choice

| | Entry mode | N | Mean | Statistic F |
|------------------|-------------------------------|----------|-------------|-------------------------------------|
| Firm Size | Equity Investment | 138 | 4.11 | 127.52 (Sig. 0.000) ^a |
| | Contractual Agreements | 47 | 4.56 | |
| | Total | 185 | | |

^aLevel of significance after Levene's test for the equality of variances

Table 4: T-Test for firm's general international experience and entry mode choice

| | Entry mode | N | Mean | Statistic F |
|--|-------------------------------|-----|-------|------------------------------------|
| International experience (number of years abroad) | Equity Investment | 138 | 24.48 | 1.583 (Sig. 0.000) ^a |
| | Contractual Agreements | 47 | 9.17 | |
| | Total | 185 | | |

^aLevel of significance after Levene's test for the equality of variances

Table 5: T-Test for firm's previous experience in the host country and entry mode choice

| | Entry mode | N | Mean | Statistic F |
|--|-------------------------------|----------|-------------|------------------------------------|
| Previous experience in the country (number of years in the country) | Equity Investment | 138 | 9.36 | 3.703 (Sig. 0.018) ^a |
| | Contractual Agreements | 47 | 4.74 | |
| | Total | 185 | | |

^a Level of significance after Levene's test for the equality of variances

Table 6: Chi-Square for asset intangibility and entry mode choice

| Intangibility (number of stars) | | Entry mode | | Total |
|------------------------------------|-----------|---------------------------|----------------------|-------|
| | | Contractual agreements | Equity investment | |
| 3 stars | N | 19 | 15 | 34 |
| | Residuals | 10.3 | -10.3 | |
| | S.R. | 3.5 | -2.1 | |
| 4 stars | N | 14 | 39 | 53 |
| | Residuals | 0.5 | -0.5 | |
| | S.R. | 0.1 | -0.1 | |
| 5 stars | N | 14 | 83 | 97 |
| | Residuals | 10.8 | -10.8 | |
| | S.R. | -2.2 | 1.3 | |
| Total | | 47 | 137 | 184 |

Chi-Square: 22.772

(Sig. 0.000)^a^a 0 cells (0.0%) contain values less than 5. The minimum expected value is 8.68.

¹These countries are also among the top destinations attracting Chinese FDI. According to the Ministry of Commerce of the People's Republic of China (MOFCOM, 2015), Cayman Islands, the U.S.A., the British Virgin Islands, Singapore, the Netherlands, Australia, Kazakhstan, Luxembourg, Laos, Indonesia, Canada, and Brazil are among the top destinations for China's outward FDI in 2015 (excluding Hong Kong). Asia remains the largest recipient of Chinese FDI, given the region's geographical proximity and close trade links with China.

² $C_{\max} = \sqrt{\min(r-1, c-1) / 1 + \min(r-1, c-1)}$; r and c are the number of rows and columns, respectively.