ENTRY MODE AND SUBSIDIARY PERFORMANCE IN EMERGING ECONOMIES

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Abstract: Based on Institutional Theory and the Resource Based View of the firm, this paper aims at finding a relationship between an MNC's choice of entry mode and the subsequent performance of the subsidiaries. There is a serious lack of work in the international business literature that looks at the influence of entry mode on subsidiary performance. Thus looking at this issue merits attention. The paper specifically looks at the choice between a joint venture entry, and a wholly owned subsidiary based entry and provides a number of testable propositions.

Key Words: Subsidiary Performance, Joint Venture, Wholly Owned Subsidiary, Host Country Experience, Institutional Theory, Resource Based View

Introduction

Generally most firms start as purely domestic companies. However, after operating as domestic companies for some period, firms may decide to go international. The findings from the monopolistic advantage theory (Hymer, 1960) and the internationalization theory (Buckley and Casson, 1976) explain why firms get motivated to go abroad. The monopolistic advantage theory suggests that a firm can generate higher rents from the utilization of firm specific assets which cannot be replicated by other firms. These assets generally include superior knowledge and economies of scale. The internationalization theory suggests that when external markets for supplies, production, or distribution fails to provide efficiency; firms can opt for FDI to create their own supply, production, or distribution streams. The four most common modes of foreign market entry are exporting, licensing, joint venture, and sole venture (Agarwal and Ramaswami, 1992). Typically firms start exporting to a country via an agent, later establish a sales subsidiary and eventually begin production in the host country (Johanson and Vahlne, 1977). The internationalization theory suggests that when external markets for supplies, production, or distribution fails to provide efficiency; firms can opt for FDI to create their own supply, production, or distribution streams. In addition, the prospective benefit from establishing R&D facilities abroad also plays a role in firms becoming international. The scope of foreign subsidiaries is increasingly becoming more international and often they are at the forefront of technological innovation (Nobel and Birkinshaw, 1998).

The focus of internationalization is shifting towards the emerging economies as developed markets are becoming saturated and MNCs have turned to emerging markets for future growth (London and Hart, 2004). This comes as no surprise as it is widely believed that this century will ultimately belong to the emerging economies and countries such as Brazil, Russia, India, and China are now seen as the next economic superpowers. The emerging economies have become lucrative destinations for MNCs because of the recent reforms and economic developments taking place in those countries (Cui and Lui, 2005). Specific research into emerging markets is necessary because most of the works in international business research were conducted keeping the developed markets in mind. The unique characteristics of emerging economies may prove many of the findings in developed economy settings invalid in an emerging economy setting. However, there were reasons why studies on emerging market were not common in the past. The inappropriateness of theories developed based on developed economies, sampling and data collection problems and lack of homogeneity in emerging economies generally makes it difficult for researchers to conduct study on emerging economies (Hoskisson et al, 2000).

Considering more and more companies are getting interested to invest in emerging economies (The total capital flows to developing economies have increased from $104 billion in 1980 to $472 billion in 2005, *source: Federal reserve Bank of Dallas*) due to their expected rise into dominance in the middle of the 21st century, it is very important to understand the reasons behind the different mode of entries taken by MNCs while entering these economies and what effect those mode of entries have on the subsequent performance of the MNC subsidiaries in those countries. The choice of mode of entry may have long term implications for the MNCs. It is difficult to change firms' initial choice of a particular mode without considerable loss of time and money (Root, 1987).

Although the work on the choice of Mode of Entry is quite abundant in the existing literature on international business, surprisingly there is a real lack of work that relates the mode of entry to the subsequent performance of the subsidiaries. This lacking is more acute if we consider entry into emerging economies specifically. I believe it would be very useful to take the studies in international business literature from a pre-entry to a post-entry level. The findings from such study may prove very useful as it will indicate whether what we assume to be the correct choice of mode of entry does in fact result in positive outcome for the subsidiaries.

The number of studies focusing specifically on emerging economies has always been few. However, we do see a change in the pattern and the number of studies focusing on emerging economies is certainly on the rise. Through this paper I would like to add to the existing studies conducted in the emerging economies context. In this study, I aim to look at the interaction between the choice of entry modes and subsequent performance of subsidiaries in emerging economies. More specifically I will look at the impact of the choice between joint venture modes of entry versus wholly owned subsidiary modes of entry on subsequent subsidiary performance. I chose these two modes for consideration as the level of resource commitment by the firms are much higher in these two modes compared to the other two modes of entry (exporting and licensing). As a result these modes require lot more careful attention as it is not as easy to get out of a situation of a joint venture or wholly owned subsidiary as it is with licensing or exporting. So the significance of the findings is likely to be lot more if the comparison is between these two modes.

One of the most common theories used in the existing entry mode literature is the transaction cost approach. It comes as no surprise as the earliest and most complete acceptance of transaction cost theory was amongst the international business and economics scholars (Barney and Hesterly, 1996). However, the use of economic models may not always be appropriate as it leaves out many other explanations. One such problem is that they ignore organizations and institutions almost completely, and even when considered, they treat them as a residual category required by some form of market failure or contracting problem (Pfeffer, 1997). As mentioned by Barney and Hesterly (1996), in the view of organizational economists the organizations exist in “seething caldrons” of competition where firms, individuals, institutions and governments are all seeking to obtain some part of the success that a particular firm may enjoy. It is improper to think of organizations as merely substitutes for structuring efficient transaction when markets fail; they possess unique advantages for governing certain kinds of economic activities through a logic that is very different from that of a market (Ghoshal and Moran, 1996). In light of these arguments, it may not be a bad idea to look at the entry mode impact on performance from other perspectives. So, in this paper I aim to use other organizational theories such as the institutional theory and the resource based view of the firm in building my arguments.

Literature Review

As mentioned before, although some studies (Delios and Beamish, 1999) have looked at other theories such as institutional theories, most of the existing work on international entry modes has largely been dominated by a transaction cost approach (Anderson and Gatignon, 1986; Hennart, 1991; Makino and Neupert, 2000). The transaction cost theory asserts that markets and hierarchies are alternative instruments for completing a set of transactions. (Williamson, 1975). In this approach, the emphasis is on opportunism, or self-interest pursued with guile and deceit. (Ghoshal and Moran, 1996)

The existing studies on subsidiary performance ranged from entry into developed markets to entry into transitional economies such as Russia and the East European nations. However, hardly any study looked specifically at entry into emerging economies, and even when looked at was looked at an individual country level. Often the studies were only concerned with one particular mode of entry and did not compare between entry modes. One such study was conducted by Isobe et al (2000). In this study of Japanese International Joint Ventures in China, they found a positive relationship between early entry and market performance. They further found that there was a negative relationship between the degree of a foreign firm's control over a joint venture and early entry. Japanese firms featured in other studies as well. Woodcock et al (1994) in their study of

Japanese firms entering the North American market found that new ventures outperform joint ventures and joint ventures outperform acquisitions.

A number of studies were conducted on European Union nations as well. In his study of foreign market entry mode and firm performance for European Union firms, Brouthers (2002) found that firms whose mode of choice could be predicted by the extended transaction cost model performed significantly better compared to those whose mode of choice could not be predicted. This study was based on survey data collected through questionnaires and the investments were made in all kinds of economies. Boruthers et al (2000) conducted a study on the 500 largest firms based in European community nations and found that firms which make perceived environment uncertainty (PEU) risk-adjusted entry mode choices are significantly more satisfied with their firm's performance than firms whose entry mode choices cannot be predicted using these measures. The data was also collected using questionnaire based survey.

In addition to looking at the performance of subsidiaries directly, some of the works considered the survival of subsidiaries as an indication of high performance and exit as an indication of low performance. In his study of foreign firms in the U.S. computer and pharmaceutical industries over the 1974-1989 period Li (1995) found a higher exit rate for foreign acquisitions and joint ventures than for subsidiaries established through greenfield investments. In his study on the offshore drilling industry, Mascarenhas (1992) found that first entrants and later entrants out survive early followers.

Other works on subsidiary performance were quite different from exactly looking at entry modes as one of the determinants of success and failure. These studies looked at different aspects such as human resource management practice, headquarter-subsidiary relations, the concentration level of firms in a certain industry, and market experience. In a study of 101 foreign-owned subsidiaries in Russia, Fey and Bjorkman (2001) found that different human resource management practices for managerial and non-managerial employees are significantly related to firm performance. Hewett et al (2003) found that the more closely headquarters and subsidiary roles in marketing activities are aligned with relational, industry, and market conditions; the greater market share tends to be. Miller and Eden (2006) examining the performance of U.S. subsidiaries of foreign commercial banks for the years 1995–1998 found that local density was negatively related to foreign subsidiary performance, and market experience was less beneficial in high-density environments.

As the findings from these studies suggest, the performance aspect of the firm were looked at from variety of ways. However, the relationship between entry mode and firm performance was not given much importance in most of the studies. When the specific study setting moved out of the developed nations, it only went as far as the transitional economies in most cases. Overall there is a need to conduct a study on the effect of entry modes in an emerging economy setting to fill in the gaps in the existing international business literature.

environment. The MNC might overcome this problem if it has extensive experience of operating in the host country via other projects and endeavors. However, the situation for those MNCs who have little or no experience of operating in that particular host country will not be as favorable when compared to the experienced MNC. This leads to my first proposition –

Proposition 1: In an emerging economy setting, an MNC with less experience in the host country will perform better if it engages in a joint venture instead of opting for a wholly owned subsidiary.

It is quite common for the new incumbents to follow in the footsteps of organizations that they perceive as successful in a particular industry. Following successful organizations can sometimes result in success for the follower firms. In an environment of uncertainty, this path may seem very lucrative. This may be even more useful in an emerging economy as the MNCs often lack the necessary knowledge of operating in such economies and the environment in general is more uncertain compared to those of the developed nations. As mentioned by DiMaggio and Powell (1983), organizations are rewarded for being similar to other organizations in their fields. The similarity can make it easier for organizations to transact with other organizations, to attract career minded staff, to be acknowledged as legitimate and reputable, and to fit into administrative categories that define eligibility for public and private grants and contracts. These rewards, and the subsequent high level of performance, are more likely to come if the incumbent subsidiary follows in the footsteps of the other foreign subsidiaries that have tested success in their approach. Although the risk of not being able to adjust to the host country environment properly remains in such a scenario, the idiosyncratic nature of the particular host country environment may help reduce this risk. In addition, following a tested path would provide the firm with some prior knowledge of the potential bottlenecks as well as areas of opportunity which might prove very useful for the new entrant. Thus I propose –

Proposition 2: In an emerging economy setting , an MNC will perform better under a joint venture mode if the earlier successful entrants in the industry followed this mode and will perform better under a wholly owned subsidiary approach if the earlier successful entrants in the industry entered via a wholly owned subsidiary approach.

The Resource Based View

The resource-based view of the firm adopts the resources and capabilities controlled by a firm as its primary units of analysis (Barney, 1991). This view suggests that it is the valuable, rare, and inimitable resources that a firm controls that gives it the competitive advantage to outperform other players in the market. These resources may include technology, marketing expertise, management expertise etc. While entering a market, firms may not always have the necessary resources. A firm that lacks the necessary resources may overcome this problem by relying on its partner for complementary assets.

However, there is no reason to believe that majority of the firms entering a host country will be lacking the necessary resources. In fact, sometimes it is the abundance of the necessary resources that prompts organizations to engage in an international venture. However, all these might change if the firm entering the foreign market is trying out a new industry, an industry where they have little or no previous experience. There is lot more uncertainty on the capability of the firm to actually perform at the desired level, and some additional support from already experienced partners are more than welcome. If there is a partner firm available with more experience, required technological know-how and the necessary marketing skills; the likelihood is stronger that the entrant would choose to collaborate with that firm. In an emerging economy, the confidence level of the entrant firm in such case would be even lower as the lack of experience is combined with lack of understanding of the economy as a whole. So I propose the following -

Proposition 3: In an emerging economy setting, an MNC will perform better under a joint venture compared to opting for a wholly owned subsidiary mode of entry when the MNC has no previous experience in the industry it is entering.

Although there has been substantial research on the topic of entry modes before, emerging market as a context was not generally considered. As we are moving more and more into a new era of global economic order, the importance of emerging market economies is on the rise. The future os many global companies now lie in their performance in these not yet fully developed but rapidly growing economies. Under this scenario, researches geared toward understanding idiosyncratic nature of these economies is definitely going to allow scholars to get a better grasp of the overall understanding of the business environment of these economies. In my study, I came out with three propositions grounded on theory. I earnestly hope that my small effort will be helpful in providing some headway for future researchers who are interested to work on the relationship between entry mode and firm performance in the emerging economies.

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