

**A Decision Model to Aid Entry-Mode Strategy Selection**

by

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**(ABSTRACT)**

With the phenomenon of internationalization gaining in importance, it is crucial for companies to be aware of what the internationalization process involves. An important part of the process is selecting optimal entry modes for foreign target markets. The objective of this research has been to develop guidelines to aid in such a selection.

A theoretical decision model was first developed based on existing research literature. The literature however, did not adequately address the influence of company objectives on the entry-mode selection process. To overcome this deficiency, the theoretical model was super-imposed with real-world data gathered via interviews with industry personnel actively involved in the entry-mode decision making process. This yielded the final decision framework. This framework approaches the selection process in three steps--1) elimination of unfeasible entry modes, 2) selection of objective and factor concordant entry modes, and 3) selection of the optimal entry mode for a given target market.

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# Chapter 1: Introduction

## Background

Improvements in electronic connectedness and advances in telecommunications over the last fifty years have brought us closer than ever to other parts of the globe [Wysocki, 1990]. The economy of today's shrinking world is characterized by enormous flows of products, capital, labor, and technology among countries including the European Economic Community [Yip, 1989]. In such an economy, foreign competition threatens industries from telecommunications to commercial banking and from machine tools to consumer electronics.

But if the global economy is a threat to domestic firms, it is also an opportunity to exploit bigger and faster growing international markets [Yip, 1989]. A way to defend against foreign competitors at home is to attack the same competitors in international markets [Genturk and Shimanski, 1987].

Not all companies must go international, but all companies should plan for growth and survival in a world of global competition and explore the possibilities abroad [Genturk and Shimanski, 1987]. However, though such a global perspective is important, the complexities involved in effecting such a perspective cannot be overstated. The international landscape is volatile and can change drastically almost overnight. The Tiananmen Square incident transformed China's image suddenly from

one of stability to one of fragility and riskiness. On the other hand, Eastern Europe, after being a "backward bulwark of socialism," is evolving as one of the great economic growth areas of the 1990s. In the Middle East, after the Iraqi invasion of Kuwait and the subsequent declaration of war by the US, oil prices turned suddenly volatile, threatening for a while to toss the world's economies into recession [Wysocki, 1990].

With the phenomenon of internationalization gaining in importance as well as complexity, an in-depth understanding of the internationalization process becomes important. This process for a firm basically involves three steps :

- 1) Selecting which markets to enter.
- 2) Deciding on the mode of market entry for each target market.
- 3) Formulating a marketing strategy to follow in a target market.

Although the importance of each one of these steps cannot be over-emphasized, the decision involving the choice of entry-mode is particularly critical to success [Root, 1987; Anderson & Gatignon, 1986; Baranson 1990; Becker & Thorelli 1989; Erramili & Rao 1990]. This decision-making process forms the main focus of this research.

## **Problem Statement**

In order to develop effective entry strategies, a firm must be able to identify the best means of entry (exporting, contracting, investing, etc.). This development is dependent on a number of factors, both external and internal to the firm, as well as a

company's objectives for a target market. Consequently, the firm must also have a comprehensive understanding of which entry strategies work well under what circumstances and why? Research in this field, however, has been inadequate and there is a lack of decision models to aid such an understanding. Particularly lacking is a model that integrates theoretical and practical aspects of the decision process.

## **Research Objective**

In an attempt to answer the problem stated above, this research focused on developing a model to aid a firm in selecting an appropriate entry-mode for a given situation. The intention was to achieve at least the following goals:

- 1) Identify the various market entry modes.
- 2) Develop a comprehensive understanding of the various parameters that need to be considered in the entry-strategy development process.
- 3) Develop a theory based decision model to select the best entry-mode in a given situation for a target market.
- 4) Study how firms make the entry-mode decision for any target market.
- 5) Study how firms integrate their company objectives for a specific target market into the decision process.
- 6) Incorporate the practical knowledge gained from steps 4 and 5 above in the theory-based decision model to develop a model that can be used by firms as a guideline when making entry-mode decisions.

## **Research Significance**

The entry-mode decision is vital because it lays the foundation of a firm in a target market. It has been called a frontier issue in international marketing [Anderson & Gatignon, 1986]. Yet, despite the potential impact of these entry-mode decisions on the very success of a firm's foreign operations, research so far lacks key constructs and systematic evaluation of the pertinent factors. Consequently, this research attempts to bridge a vital gap in the internationalization process. It provides a better understanding of the entry strategy formulation process. Also, it is a step toward fulfilling the need for a decision model incorporating both theoretical as well as practical aspects to aid firms in formulating more informed and effective strategies to enter international markets.

## **Research Parameters**

The current research was conducted within the framework of the following parameters:

- 1) The home country was assumed to be the United States.
- 2) Within the United States, the practical aspects were derived from a study of only firms in and around Virginia. This parameter was because of limitations of time and financial resources.
- 3) The thrust of the research was to offer broad guidelines rather than specific solutions as these tend to be company, country, and market specific.

4) The guidelines were developed assuming they were to be used by a company entering a specific country for the first time.

5) The simplifying assumption was made that the company was committing resources only to the country in question and consequently no division of resources among different countries was involved.

## **Outline of the Research**

The document consists of six chapters. Chapter 2 contains a literature review of the previous research relating to strategies for U.S. multinational companies attempting to enter markets in other countries. Some previous studies dealing with entries into foreign markets are reported and the findings from these studies are discussed. A theory-based decision model is developed in Chapter 3 for selecting an appropriate entry-mode for a target market. Chapter 4 presents the means employed to gather information from companies already involved in international ventures. The survey instrument, sampling design, and method of data collection are described. A discussion of the interviews conducted is also presented in Chapter 4. This knowledge is then used to overlay the theory-based model presented in Chapter 3, to develop a broad set of guidelines in the form of a new model in Chapter 5. Finally, Chapter 6 presents concluding remarks on the research, and recommendations for future research.

# **Chapter 2: Literature Review**

## **Introduction**

The entry-mode strategy decision as a subset of the internationalization process has seen considerable research. Even though there is a need for a comprehensive model to aid this decision making process, the research conducted in related areas cannot be ignored. This chapter presents some important research conducted in areas related to the present research. The review starts with an overview of internationalization as a whole and its importance in present times. The discussion then proceeds to entry modes. Various classifications of the entry modes from existing literature are presented. Expert opinions on the factors affecting entry-mode decisions are then discussed. Finally, some approaches to entry-mode strategy development presented in the past are discussed. The review presented in this chapter provided a foundation block for the current research.

## **Internationalization**

### **Importance of Internationalization**

During the past two decades, the involvement of U.S. based and foreign firms in multinational business operations has proceeded at a rapid pace [Mufson, 1985; Root,

1987; Sewell & Tucker, 1988; Yip 1989]. An increasing number of firms are entering international markets. Root [1987] attributes this to several reasons. He says some firms may go abroad because markets at home are stagnant or foreign markets are growing faster. Others may simply follow their domestic customers who are going international. Some firms in oligopolistic industries go abroad to match the market entry of a domestic rival or to counter foreign firms penetrating domestic markets. Or, companies may go abroad in search of greater sales volume in order to reduce unit costs of manufacturing overheads and thereby strengthen their competitiveness at home as well as in foreign countries.

Mufson [1985], Souza & McDougall [1989], and Baranson [1990] agree with Root in that U.S. firms may be going abroad because markets at home are saturated. Connolly [1984] suggests that the reason may be the availability of cheaper resources abroad. Porter [1986] is in agreement with Root and he suggests that additional reasons may be emerging new markets in developing countries or the formation of safety nets during business downturns. Genturk and Shimanski [1987] propose that going international is a way to defend against foreign competitors at home and a way to plan for growth and survival in a world of global competition.

Yip [1989] suggests that the reason may be the falling trade barriers worldwide. He cites the recent United States/Canada trade agreement and the impending 1992 harmonization in the European Economic Community as two dramatic examples. He says that Japan also is gradually opening up its long barricaded markets. Yip also shares the belief of the above mentioned authors that foreign markets are relatively unsaturated and are growing rapidly. He suggests that an additional reason may be

the improvements in electronic connectedness and telecommunications which has served to bring different parts of the globe closer than ever before. Wysocki's [1990] views are concordant with those of Yip. He also believes that improvement in communications across the world is a major contributing factor to the increase in internationalization activities of firms.

Other reasons offered by experts include taxation at favorable rates, reduction of distribution and transportation costs, diversification of the risks of suppliers and distributors for the products, and political considerations.

All the reasons offered by the above mentioned authors for this trend toward internationalization are fairly comprehensive. However, it seems that the three primary reasons are improved electronic connectedness all over the globe, saturation of the U.S. markets, and availability of cheaper resources in other parts of the world. The fact that electronic connectedness has served to make the world smaller may in fact be the single biggest reason for generating a world wide awareness of products available in different countries. A natural consequence of such awareness is the generation of new global markets for these products. On the other hand, the improved connectivity also acts as a catalyst to the satisfaction of this market demand. The net result: the world has become a global marketplace, providing an alternative to the saturated markets at home. In addition the lowering of import barriers by different countries serves as considerable motivation for firms to participate in this global market place.

## **The Internationalization Process**

The trend toward increased international activities of firms has lead several researchers to study the mechanism of internationalization. A number of authors have explained the internationalization process in the light of the behavioral factors facing the firm [Johanson and Vahline, 1977; Cavusgil, 1982; Kogut and Singh, 1988]. These authors adopt an evolutionary perspective of the internationalization process.

Their explanation of the internationalization process focuses on a firm's acquisition and use of knowledge about foreign markets and the growth of involvement overseas. They propose that the internationalization process is gradual, involving incremental commitments to overseas markets rather than major foreign investments at a single point in time. At the start no regular export activities are performed by a firm in a target market, then export takes place via independent representatives, later through a sales subsidiary, and eventually manufacturing may follow. This sequence of stages indicates an increasing commitment of resources to the market. It also indicates current activities which differ with regard to market experience gained. The first stage gives practically no market experience. The second stage sees a firm as having an information channel to the market and receiving fairly regular but superficial information about market conditions. The subsequent business activities being performed in the market lead to a more differentiated and wide market experience.

The authors also propose that firms enter new markets with successively greater psychic distance. Psychic distance is defined in terms of factors such as difference in language, culture, political systems, etc., which disturb the flow of

information between the firm and the market. These authors believe that firms start internationalization by first going to markets they can most easily understand, and then gradually enter markets with greater psychic distance.

This evolutionary perspective of the internationalization process has recently come under criticism from several authors. Reid [1983] criticizes the focus on only one factor (i.e., the firm's knowledge) to explain the internationalization process of firms. He says that the model ignores a firm's relation to other bodies on the foreign market. He also argues that any firm has the option of making a strategic choice as to modes of entry and expansion and such a choice is contingent on market conditions.

Dunning [1988] criticizes that the model says something important only about the early stages of internationalization when lack of market knowledge and market resources are still constraining factors. When the firm already has activities in several countries, these factors are no longer a problem. In that situation, the firm can allocate resources to international operations on the basis of the real market conditions rather than in response to the unknown. In addition, there has been a general internationalization of industries and markets so that the lack of market knowledge is no longer a factor limiting the pace and pattern of internationalization of firms.

Ohmae [1989] questions the claim that firms first approach markets which have less psychic distance. He argues that the world has become much more homogeneous and consequently psychic distance has decreased. Other environmental changes such as improved supply and more efficient means of transmitting information, less

fragmented markets, and increased emphasis on R&D all have an impact on the internationalization process.

A more critical analysis of the objections raised by the above mentioned three authors to the evolutionary perspective does indicate that there are some shortcomings to this explanation of the internationalization process. It seems that although the theory provides an adequate explanation of the internationalization process in the 60s and 70s, more recent developments indicate a more complex pattern of internationalization.

Considerable advances in communications and transportation over the last decade have brought different parts of the world closer. All over the world people are increasingly becoming aware of the values, cultures, social practices, tastes, etc. of those in other parts of the world. With information flow significantly more facilitated in comparison with the previous decades, product demand is becoming global. This is especially true in the triad of North America, Europe, and Japan. Within this triad information flow is free to such an extent that goods made available in one part are generating an awareness and subsequently demand in other parts almost immediately. Consequently, Ohmae's assessment that psychic distances continue to have a decreasing influence on the internationalization of firms seems fair. In addition, like Dunning says, with this facilitated flow of information across national borders knowledge of target markets can easily be attained in ways other than personal experience.

All this does not go to say that the explanation offered by the evolutionary theory no longer holds. It seems that the theory still provides an adequate explanation

of the internationalization process of small firms or firms which are new entrants to the global market place. Large firms or firms with surplus resources, however, can be expected to make larger internationalization steps, especially if the consequence of the commitments are perceived as small by these firms.

An important aspect of internationalization, not addressed by the above mentioned authors of the evolutionary perspective, is the formulation of strategies for going into international markets. Forming a comprehensive strategy for international markets is crucial for a number of reasons. "Initial entry into a foreign market is often very unsystematic, resulting from an unsolicited export order from a foreign buyer, an order from a domestic customer for his overseas operations, or interest expressed by an importer or potential business partner in a foreign market. Consequently, it is important to lay down objectives with regard to a target market, especially in terms of level of involvement and degree of risks, as part of a systematic evaluation of opportunities worldwide. Otherwise, international activities will lack direction, resulting from creeping commitment and sporadic efforts, and will not necessarily be targeted to the most attractive opportunities for the firm in world markets" [Douglas and Craig, 1989].

Some studies have been conducted which stress strategy formulation for international markets [Root, 1987; Becker and Thorelli, 1989; Douglas and Craig, 1989]. These studies provide insight into the planning and strategic aspect of internationalization. Becker and Thorelli [1989] proposed that successful internationalization of any firm has to involve a lot of planning because the international marketplace is heterogeneous and contains far more unknowns than the domestic

markets. They define two dimensions in the process of internationalization--planning steps and decision steps. According to them, the way to approach the internationalization process is by combining the general planning steps with the major international decisions that must be taken.

The general planning steps defined by them are 1) situation analysis, 2) problem/opportunity analysis, 3) definition of objectives, 4) forecasting of sales and estimating cost and profit contribution, 5) designing the marketing program, and 6) budgeting. The important decision areas pointed out by them in the process of internationalization are:

1) The commitment decision: This involves examination of the firm's resources, objectives and philosophy, reasons to enter markets abroad, preliminary analysis of various candidate countries, and the type and extent of the commitment.

2) Selection of target country: This involves examination of candidate countries by means of a comparative framework that comprises both the international and local environments. At the international level the analysis should include relationships between host country and home country, tariffs and non-tariff barriers in the target country, currency stability and currency controls. At the local level the country analysis should include the government, business culture, marketing infrastructure, and demand analysis. The country specific financial requirements and time dimensions must also be considered.

3) Specifying mode of market entry and operations: This involves determining the appropriate mode of entry, the first and most crucial part of the international operations plan. As this step lays the foundation of the operations in a target market a thorough and in-depth analysis of the company objectives, resources, international environment, local marketing environment, and market structure should be performed again at this stage.

4) Defining marketing strategy and program: This numerates the strategic aspects in the overall marketing plan. It involves tailoring the marketing mix to the chosen country and the mode of local market entry.

5) Defining the marketing organization: This includes among organizational factors the type and nature of coordination between headquarters and international units, scheduling, performance evaluation, and preview of subsequent planning periods.

Becker and Thorelli's view of internationalization, as a process involving joint consideration of general planning steps and major international decision areas, is very enlightening. It seems to provide a planning framework for managers involved in international marketing. They do not offer details on how to combine the planning steps with the major decisions to come with a sound strategy for internationalization. In spite of that, their work provides managers with a framework which helps identify crucial points needing consideration and important decision areas.

A similar approach to internationalization is adopted by Root [1987]. He proposed that the implementation of an effective internationalization process involves

five main strategic decisions. These decisions are: 1) selection of target market; 2) defining the objectives and goals in the target market; 3) the choice of an entry-mode to penetrate the target country; 4) the marketing plan to penetrate the target market; and 5) the control system to monitor performance in the target market.

While Root, Becker and Thorelli address only one target market in their strategic approach of internationalization, Douglas and Craig [1989] offer a full fledged explanation of the firm's total foreign operations. They proposed that the internationalization of a firm involved three main strategic decisions. The first and most important decision is on the initial international market entry. They consider this step crucial, because a false move at this stage may result in withdrawal from international markets. Mistakes made in initial entry can damage a firm's reputation and be difficult to surmount. Careful formulation of initial entry strategy is thus crucial in shaping the pattern of international market evolution. In this phase the key decisions relate to selecting of target country and choosing an entry-mode.

The next decision is on market expansion. Here the focus shifts to penetration of target markets more fully, and building on knowledge, experience, and contacts established in the initial phase of entry. The third decision is on global rationalization. It involves the firm's movement toward the adoption of global orientation in strategy development and implementation. Attention focuses on developing a global strategy. Focus is on improving the efficiency of operations world wide and developing mechanisms for improved transnational coordination of operations and for integration of strategy across countries.

The above mentioned studies seem to offer a well rounded perspective of the process of internationalization. The evolutionary perspective as well as the strategic perspective of the internationalization process help in the understanding of the different phases in internationalization and point out the important decision areas in this process. The view point of the experts who adopt the strategic focus of internationalization indicates that the internationalization process must not only be very structured but that the choice of appropriate entry modes is critical for its success. This choice is, however, dependent on a number of different factors. Many experts have presented their viewpoints with respect to these dependencies. The next section presents a review of the different types of entry-mode, their importance, and the factors which need to be given consideration while making the entry-mode decision.

## **Entry Modes**

Many experts have stressed the importance of selecting an appropriate entry-mode on the success of foreign operations. Anderson and Gatignon [1986] have identified the choice of entry-mode as one of the "frontier issues" in international marketing. It has been defined as an institutional arrangement that makes possible the entry of a firm's products, technology, human skills, management, or other resources into a foreign country [Root, 1987]. Erramili and Rao [1990] consider it the most important factor in determining the success of foreign ventures. Important as the decision is, it is not an easy one to make. This decision is fraught with complexity. There are two main reasons for this complexity--the diversity of the entry modes and the numerous factors (often conflicting) affecting the entry-mode choice. A number of companies however make this decision blindly or have a pre-determined entry-mode for

any and every market. It is doubtful though that these companies are exploiting the opportunities offered by the international arena to the fullest. To lend an insight into the complexity involved in this decision the various entry-mode options and the numerous factors affecting the decision are presented in the following sub-sections.

## **Types of Entry Modes**

A wide variety of modes of entering foreign markets are possible. These include the different types of exporting, contracting, and investing. These modes vary in terms of the level of resources or equity commitment to overseas market [Root, 1987; Douglas and Craig, 1989; Baranson, 1990]. Each of these modes are discussed in detail in the subsequent sections.

### **Export Entry**

Export entry modes are those which are limited to physical products only. The product is manufactured outside the foreign target market and then transferred to it. Exporting can be of two kinds: indirect and direct.

1) Indirect exporting involves the use of middlemen located in the company's own country, who do the actual exporting.

2) Direct exporting can be done either by a) using target country middlemen to market the product (direct agent/distributor exporting), or b) via the company's' own operating units in the target country (direct branch/subsidiary exporting).

These modes entail minimum risk and commitment, but at the same time afford little control and limited returns [Douglas and Craig, 1989]

## **Contractual Entry**

Contractual entry modes are those in which an association is formed between an international company and a target country company. The association is non-equity based and involves the transfer of technology, knowledge, and skills from the former to the latter. This entry-mode can be of several types:

1) Licensing: Under this arrangement an international company gives a target country company the right to use its patent, knowledge, trademark, etc., for a certain amount of time. In exchange the international company gets some compensation.

2) Franchising: Under this arrangement (intended to be permanent) the international firm, in addition to licensing a patent, a trademark, etc., helps the target country firm with organization, marketing and general management.

3) Other: Other contractual entry modes involve the transfer of services directly to foreign entities in return for monetary compensation (technical agreements, service contracts, management contract and constructional/turnkey contracts) or in return for product manufactured

from those services (contract manufacture and co-production agreements).

The contractual entry modes offer slightly more control than export entry modes. They provide limited returns but the advantage lies in the fact that they entail minimum risk and commitment.

## **Countertrade**

Countertrade is an arrangement in which businesses take the compensation for products provided in the form of goods. Various forms of countertrade are possible:

1) Counter-purchase: This refers to a set of parallel cash agreements in which the supplier sells a service or product and orders unrelated products to offset the costs to the buyer.

2) Switch Trading: Additional parties are brought into the picture whereby part of the exchanged goods is shifted to the new party. When one party has an unwanted balance of goods to be received from a second party, a third party in need of the goods offered by the first party is found to purchase the available goods, with the proceeds going to the second party.

3) Clearing Agreement: Its objective is to balance the exchange of goods over time between two governments without having to transfer funds, by using an agreed-upon value of trade, tabulated in nonconvertible

clearing account units. The contracting parties establish an exchange ratio of their respective currencies to determine the amount of goods to be traded.

4) Buyback Barter: One party's purchase of capital equipment is paid for through the output made feasible by the capital equipment.

Recently, many experts have stressed the importance and advantages of barter dealings [Kaikati, 1985; Root, 1987; Schaffer, 1990]. They say it is an important marketing practice for both developing and developed countries. Various reasons have been cited by them for the resurgence of international countertrade deals. A brief summary of these reasons follows:

1) Rupture in the East-West Trade: The increasing debt of Eastern Europe including the former Soviet Union countries to the IMF coupled with the suspension of Soviet access to the Export-Import Bank facilities in 1975 reveals that the communist block might be compelled to rely more heavily on barter deals.

2) Reliance of Less-Developed Countries on Barter Deals: Less-developed countries favor barter dealings because these do not involve the use of scarce foreign exchange. There is a dearth of hard currency because of loans taken by non-oil-producing Third World countries to pay energy costs. The Third World prefers barter deals because it is a source of financial aid and allows some degree of planning.

3) Worldwide Inflation: The current worldwide inflation and recession have also boosted barter deals. Historically, barter deals usually do reappear during periods of economic distress. For example, after World War I as well as World War II, paucity of foreign exchange led to an upsurge of barter deals. Nowadays, a barter economy is reemerging for another time in the Western world as a result of the disturbing economic conditions of inflation, persistent recession, chronic balance of payments deficits and widespread shortages of raw materials.

## **Investment Entry**

Investment entry modes are those in which the international firm owns production units in the target country. There can be several kinds of investment entry modes.

1) Sole Venture: This involves full ownership and control by the firm. An international company can start a sole venture from scratch (new establishment ) or by acquiring a local company (acquisition).

2) Joint Ventures: This involves shared ownership and control between the international firm and a target country company. Since 1981 there has been a trend toward joint ventures. Even U.S. multinationals have preferred joint ventures over subsidiaries [Connolly, 1984]. This trend has been due to heightened global competition, increased risk, ever larger projects, and the fast pace of technological change [Contractor, 1990].

Third World countries which have shown consistent and rapid growth during the 1970s and 1980s ("Newly Industrialized Countries" such as Brazil, South Korea, and Taiwan), find joint ventures to be a viable and attractive alternative for economic development [Kumar and McLeod, 1981]. This is primarily because joint ventures provide them with many advantages, including control over the firm, a source of employment generation, and the possibility of technology transfer, all neatly wrapped in a single package.

One type of joint venture currently becoming popular is joint ventures between Third World multi-nationals and U.S. firms to enter other Third World markets. [Connolly, 1984]. United States firms face competition from Third World multi-nationals in the Third World markets in industries such as construction, service contracts, and manufacturing. Third World firms have advantages such as lower labor and management costs, lower input costs, a more appropriate technology for the Third World, and a greater familiarity with the business and working environment that is characteristic of the Third World nations. However, these companies lack capital, are often subject to exchange controls in their own country, and lack a flow of up-to-date and improved technologies in manufacturing. These are the complementary assets that firms from the U.S. can provide in a joint venture partnership as well as providing management and marketing skills and head office services that often are scarce resources for many Third World countries. There are situations in Third World countries where the combined advantages of the U.S. and

Third World firms make market entry or survival possible, where otherwise neither could go it alone.

Some researchers, however, argue that joint ventures are very likely to fail and provide many reasons for this [Harrigan, 1987; Kennedy, 1984]. The primary reason according to Kennedy is that parent companies tend to treat a joint venture as though it were a subsidiary, ignoring conflict of interest among parents. Harrigan agrees with Kennedy and says that many parent firms evaluate immature ventures too formally, with too much emphasis on financial criteria and not enough emphasis on input measures. This results in premature termination or a cutback in the commitment before a venture has time to realize its potential. Harrigan suggests that young joint ventures need a long leash. All too often, corporate parents recognize this at the time of creation but at the time of evaluation revert back to their familiar performance assessment procedures: formal, frequent, and financial. Another problem area according to Kennedy is the contract in joint ventures which reflects the understanding of cost, market, and technologies at the moment companies signed them. When things change, as they always do, partners don't really try to compromise and adjust. They look at the contract and start pointing fingers and show low tolerance for each other.

3) Transnational Strategic Alliances: The disadvantages associated with joint ventures have led to the advent of a new kind of entry strategy: transnational strategic alliances (TSA) [Baranson, 1990]. TSA's are

formed between two or more enterprises in two or more countries. They seek to integrate varying combinations of deliverable resources and capabilities (products, production facilities, marketing and distribution outlets, and financing) in response to emerging market opportunities [Ohmae, 1989]. The philosophy behind alliances is to specialize in what one does best and out-source the rest. The logic behind this is as follows. First, products nowadays rely on so many different critical technologies that most companies can no longer maintain cutting edge sophistication in all of them. They need the technology and skills of others. Second, each company needs to rely on an army of external vendors and, in turn, each vendor needs to sell to a broad array of customers, causing rapid dispersion of technology. In short, nothing stays proprietary for long and no one player can master everything. Third, as manufacturing, R&D, building and maintaining brand-name, sales & distribution, and information technology are all moving towards being fixed costs, it becomes increasingly important for firms to reduce these costs. In a fixed cost environment, firms need partners/alliances to maximize contribution to these fixed costs [Ohmae, 1989].

TSA's provide an alternative to foreign investment in joint ventures without some of the disadvantages associated with joint ventures. Increasingly, firms are turning to forming transnational strategic alliances as a means of expanding their commercial outreach within a realistic time frame, without over-extending their managerial and financial limits. This trend has also been driven by the necessity to engineer and

produce simultaneously complex products in close conjunction with suppliers of materials, components, equipment, and software.

It can be seen from the above discussion that there are several modes of entry available to a firm desirous of going abroad. However, in a given set of circumstances all entry modes may not be feasible, and among those modes feasible, all may not be optimal. It is essential for a firm to be able to select an effective entry-mode in a given situation. Pundits in the field of entry modes, say that a number of factors need to be considered while making such a selection. These factors and the impact they have on the appropriateness of an entry-mode are discussed below.

### **Factors Affecting Choice of Entry Modes**

The firm's choice of a particular foreign entry-mode is a function of a large number of diverse factors. Erramili & Rao [1990] have classified these factors as non-behavioral and behavioral. Non-behavioral factors include internal ones such as product characteristics and firm characteristics, as well as external environmental factors such as home country and target country. Behavioral factors include cultural distance of the foreign market, experience of the firm in the foreign market, knowledge of foreign markets, and the perceptions, opinions, beliefs, and attitudes borne out of this knowledge (or the lack of it). A discussion on how these factors may effect the entry-mode decision follows.

## **Non-behavioral Factors**

Non-behavioral factors can be external or internal. A discussion of both types is presented below.

**External Factors:** These factors are those pertaining to the market, production, and environment in the home and target countries.

1) Home Country Factors: Government policies, competitive structure, size of the market, and production costs in the home country, etc., play an important role in determining the right entry-mode. If government policies are restrictive or even neutral to investment abroad, but offer tax breaks or other incentives for exporting, then entry modes such as licensing, contracting, exporting, etc. may be appropriate [Root, 1987; Anderson and Gatignon, 1986].

If the firm comes from an oligopolistic industry, then it may be biased toward equity investments. A firm from an atomistic industry might find exporting or licensing beneficial. Similarly, firms from big domestic markets either stay home because of the presence of ample opportunity or else favor equity investment; and firms from small domestic markets in search of economies of scale might prefer exporting [Bauerschmidt, Sullivan, and Gillespie, 1985; Root, 1987]. If the domestic market is characterized by high production costs or unavailability of raw materials,

then firms might prefer setting up local production in the target market country [Bauerschmidt et. al., 1985].

2) Target Country Factors: Target country factors can have a significant impact on the selection of an entry-mode. The nature and competitive structure of the target market, the political and economic situation of the target country, etc. need to be given consideration when deciding if and how to penetrate a market. Large target markets favor modes offering high sales potential. Thus, equity investment, branch/subsidiary exporting, etc. may be appropriate here. Smaller markets favor modes with low break-even sales volume, e.g. indirect and agent distributor exporting, licensing, contracting, etc. Atomistic markets favor exporting but oligopolistic and monopolistic markets favor equity investment. Availability of cheap labor and raw materials in the target market favors local production. Long distances coupled with high transportation costs in the target country discourage exporting [Root, 1987].

If the target country government policies are hostile toward foreign investment, then exporting might be appropriate. Alternatively if the target country has tariffs, quotas, or other barriers then direct investment may be a better choice. Several one-way changes in external economic relations indicate future changes in government policies on trade and international payments. The direction, composition, and value of exports and imports; balance of payments; debt service burden; exchange rate

behavior; etc. can send out important signals and hence should be studied closely.

Dynamics of the target country's economy, e.g. rate of investment, growth rate of GNP and personal income, employment trends, need to be given consideration too. A dynamic economy may encourage entry modes with high break-even points even when current market size is below the break-even point. A socialist or communist economy may not favor equity investment. Low political risks encourages equity investment and high political risk encourages exporting [Root, 1987]. If the target country has very different cultural values, languages, and social structure, then entering the market initially with a high level of commitment may not be advisable. This is because the firm is ignorant about the way of life in the target country and information is difficult and costly to come about [Root, 1987].

**Internal Factors:** These factors play a big part in how a company responds to the external factors in choosing an entry-mode. Some of the internal factors are:

1) **Company Factors:** They include the size, commitment level, target market knowledge, etc. of the firm. A small to middle sized company, because of limited resources, might be able to just consider exporting, licensing, etc. On the other hand, large sized companies have several entry-mode options available to them. A high commitment firm may prefer equity entry modes, whereas a not so committed firm may rather

export. Firms with a high level of target market knowledge and awareness would probably use a high commitment entry-mode. On the other hand, firms with little or no knowledge of the target market may enter slowly, increasing commitment with increased awareness of the market [Root, 1987; Johanson and Vahlne, 1990].

2) Product Factors: These factors include the nature and requirements of the product the firm wants to take abroad. For a technologically intensive firm, licensing is a good choice of entry. For a product requiring a lot of servicing, proximity to the customers is important, hence branch/subsidiary exporting are suitable entry modes. If the product itself is a service then local service production is called for. Franchising, contracting, etc. are suitable for services. For a highly differentiated product that can demand its own price, export entry modes may be appropriate. Such a product can absorb high transport costs or high import duties, etc. and still remain competitive. Conversely, weakly differentiated products have to compete on the basis of price. To keep their prices low, local production (contractual or equity investment) may be necessary. If the product needs adaptation to the target country market, then proximity to the market is desirable. Branch/subsidiary exporting or local production are suitable modes in this situation [Goodnow, 1985; Anderson and Gatignon, 1986].

## **Behavioral Factors**

Proponents of the behavioral approach have suggested a generally positive relationship between the decision-maker's knowledge of foreign markets and the level and pace of the firm's resource commitments to these foreign markets [Cavusgil, 1982; Kogut and Singh, 1988]. The studies conducted by these researchers indicated that knowledge-deficient firms show a greater tendency to employ entry modes such as licensing, franchising, agent exports, and joint ventures. In markets highly similar to the United States (i.e., markets about which U.S. firms can expect to be very knowledgeable) such as Canada, United Kingdom, and Australia, firms resorted to licensing and joint ventures to a small extent, preferring wholly owned subsidiaries instead. However, the usage rate of licensing and joint ventures rose dramatically for entries into countries that were less similar to the United States. Kogut and Singh [1988] found that a cultural distance between the United States and the host country increased the probability of choosing a joint venture over an acquisition or a wholly owned subsidiary.

As the above discussion indicates, the choice of an entry-mode for a given target country is the net result of several, often conflicting forces. The variety of forces, difficulties in measuring their strength, and the need to anticipate their direction over a future planning period combine to make the entry-mode decision a complex process with numerous trade-offs among alternative entry modes.

Given the complexity involved in selecting an appropriate entry-mode for a foreign target market, and considering the tremendous impact this decision can have

on the success of a firm's international ventures, one would expect the literature to be rich in studies providing guidelines and/or frameworks to help managers in selecting an appropriate entry-mode. However, this does not seem to be the case. The literature lacks a comprehensive identification of key constructs and systematic evaluation of contingencies which may effect the entry-mode decision. Most of the work has been done in isolated pockets studying the impact of only one or two variables at a time on the entry-mode decision. The real-world environment however is comprised of a number of factors coming into play simultaneously. Any entry-mode decision has to be made taking into consideration all the factors together. In the recent years some studies have been done which adopt such an approach to some extent. These are discussed in the following section.

### **Existing Entry-Mode Strategy Development Approaches**

In 1986, Anderson and Gatignon offered a Transaction Cost Framework for investigating the entry-mode decision. They first ranked entry modes by the level of control these modes offered. Next, they offered propositions on the degree of control most efficient for a variety of conditions. Given a ranking of entry modes on control, it was then possible to recommend entry modes for a given situation. They suggested that four constructs 1) transaction-specific assets; 2) external uncertainty; 3) international uncertainty; and 4) free riding potential (i.e., ability of a company to reap short-term benefits from the good name of another company), determine the optimal degree of control, and offered propositions based on these constructs.

The Transaction Cost approach remains a useful way to structure the issues. However, an important dimension in the entry-mode decision that this model fails to address is the role company objectives for a target market play in determining a suitable entry-mode. In addition, it offers only propositions and does not provide any kind of a logical model to guide firms through the decision making process. The propositions, however, seem very sound and the model developed as part of this thesis will draw on these propositions. An in-depth discussion of Anderson and Gatignon's model is presented in the following chapter.

In the same year Chakravarthy [1986] and Porter [1986] suggested that the entry strategy should be a comprehensive plan which sets forth the objectives, goals, policies, time schedules, etc. that will guide a company's international business operations over a period long enough to achieve sustainable growth in world markets. They suggested that the plan should include an analysis of the target market, a description of the market environment, a competitive audit, a financial analysis, and a control system. Objectives may include those for sales volume, market share, profits, return on investment, marketing efforts, and so on.

These two authors address the importance of company objectives in the entry-mode decision. They also address the importance of a strategic approach to the selection of entry modes. However, they do not provide any guidelines to help decision makers actually select an optimal mode. They also do not identify any kind of logical process to follow when making the entry-mode decision.

In 1987 Root proposed a logical flow model to aid in deciding on the right entry-mode. He suggested that all entry modes should first be examined in light of the external and internal factors to obtain a feasible set of entry modes. From this feasible set the appropriate mode should be selected by using comparative profit contribution, risk, and non-profit analysis. The later portion of Root's model is very appealing. The approach Root offers of selecting the optimal entry-mode from a feasible set of entry modes seems very comprehensive and intuitively very logical. The model developed in the following chapters will draw on this aspect of Root's model. A detailed discussion of this aspect of Root's model is presented in the next chapter. The first part of Root's model, however, fails to provide adequate guidelines on the selection of a feasible set of entry modes in a given situation. Neither does it address the importance and the impact of company objectives in the entry-mode selection.

As can be seen from the review of the literature, there has been considerable research in isolated pockets with respect to the entry-mode decision. The approaches presented above are a rich source of concepts and propositions for entry-strategy decisions. However, a more comprehensive decision framework is required to enable better entry-strategy decisions. A decision model that not only integrates theoretical aspects of the entry-mode decision, but also incorporates practical perspectives is not available today. Such a model would serve to guide a firm in a logical and strategic manner through the decision making process, taking care of all the critical parameters. This research attempts to develop such a decision model.

## **Summary**

This chapter presented the literary foundation for the current research. The existing work was reviewed and presented so as to gradually narrow the focus from the basic tenets of international marketing to specific aspects of entry modes.

Expert opinions on the importance of internationalization and the process of internationalization itself were presented. This was followed by a discussion of the different types of entry modes and the factors affecting their selection. Existing approaches to the entry-mode selection process were presented. Finally, the need for a decision model incorporating theoretical and practical aspects of the entry-mode selection was discussed.

The next chapter presents the methodological techniques used in this research study. An integrated theoretical model for the entry-mode decision is developed and then the means employed to overlay the model with practical insights are discussed. The practical knowledge was gained essentially via interviews with companies already involved in international ventures.

# Chapter 3: Methodology

## Introduction

The entry-mode decision has been shown to be one fraught with complexity. This can be attributed to an often conflicting combination of factors, tangible or intangible, external or internal. In addition, each company has a unique set of objectives for a target market which also influences the entry-mode decision. Consequently, the decision process can be reduced neither to a formula nor to a rigid set of rules, not even to a complex computer model. What can be done is to develop a model that lays down broad guidelines in a structured yet flexible manner to aid a firm in the decision-making.

This chapter presents the methodology adopted in the evolution of such a model. A decision framework for the selection of an optimal entry-mode has been developed on the basis of the literature review. Ideas from some previous models have been integrated to yield some parts of this framework. It was found that a crucial aspect, company objectives, was not accounted for in the models developed so far. In order to incorporate them, interviews with industry personnel were conducted.

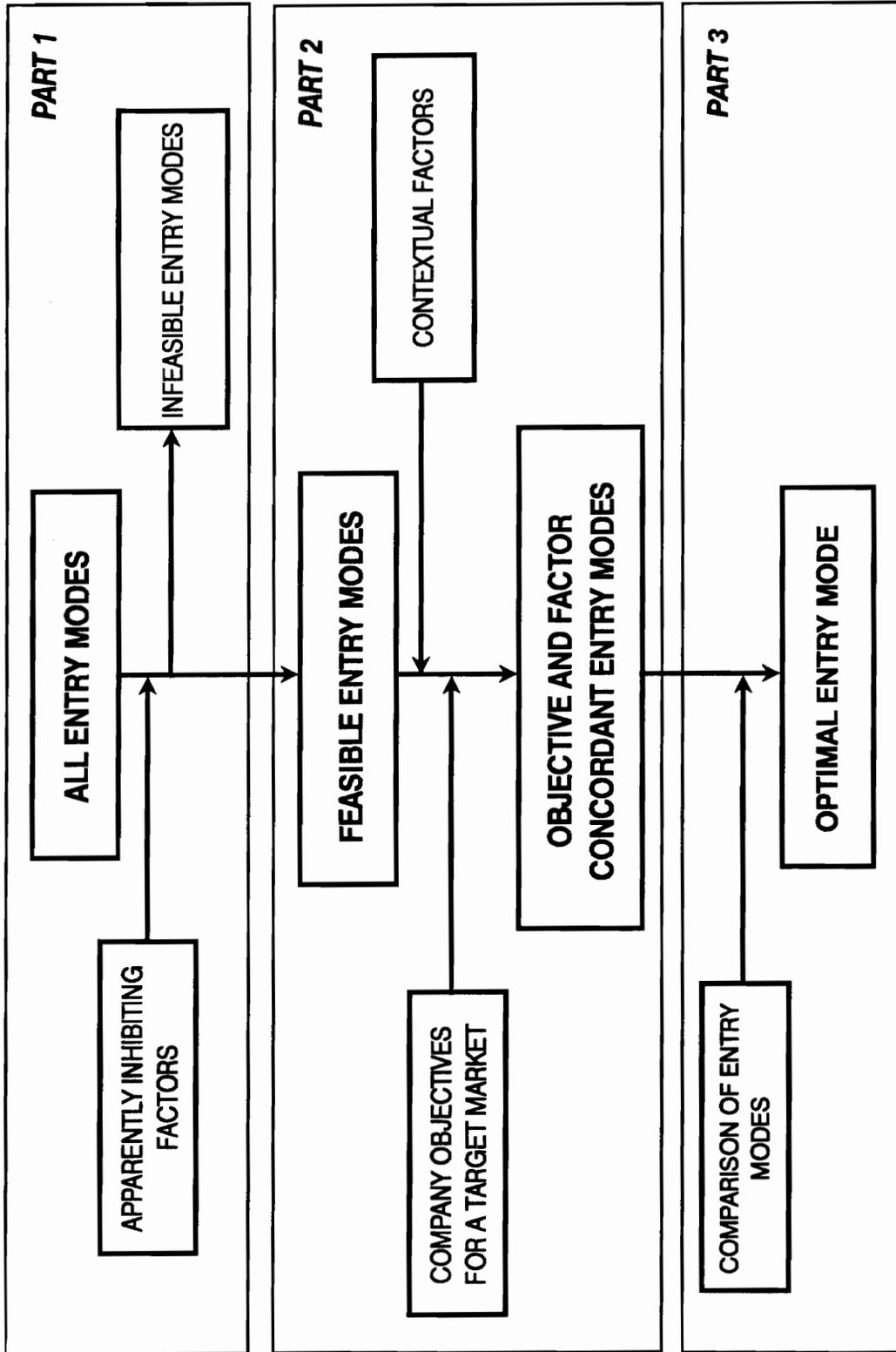


Figure 1: The Entry Mode Decision Process

## **Overview of the Decision Framework**

Based on the literature survey, a framework has been developed to aid decision makers in the selection of optimal entry modes for target markets. Broadly speaking the entry-mode decision process can be divided into three parts--elimination of infeasible modes, selection of modes concordant with company objectives and contextual factors, and identification of the optimal entry-mode. The framework proposed is accordingly divided into these three parts. Figure 1 shows a graphic description of the decision process and its three parts. These three parts of the framework are discussed below.

### **The Decision Framework - Part I**

The first part of the decision framework, proposes three steps that decision makers should take before they can do a comprehensive analysis of entry modes for a specific target market. These three steps are--1) knowledge of entry modes, 2) knowledge of pertinent factors, and 3) elimination of infeasible entry modes.

#### **Step 1: Knowledge of Entry Modes**

The first step that a decision maker needs to take is to gather information on all possible means of entry. This calls for an awareness of all the entry-mode options possible, along with a sound knowledge of each mode's advantages and disadvantages. Such a knowledge allows companies to run comparisons between

entry modes and then identify the mode which is most suited for a given situation faced by a firm with respect to a target market.

Expert opinions on the types of entry modes and their advantages and disadvantages are summarized in Chapter 2. Hence, they are not reiterated in this section.

## **Step 2: Knowledge of the Pertinent Factors**

Once a company has developed sound background knowledge of all the entry modes the next step in the decision framework is to develop an understanding of all factors that may have an impact on the entry-mode decision. Many factors in the environment facing the firm place stringent requirements on the entry vehicle that a firm can use for a target market. Some of these factors are company resources, international experience, product characteristics, target market competitive environment, manufacturing costs, etc. to name a few. Only an entry-mode which best fits the contextual factors facing the firm can be considered optimal. Consequently, the importance of a knowledge of these factors cannot be over emphasized. Expert opinions on the various factors that effect the entry-mode decision has been presented in Chapter 2 and hence are not reiterated in this section.

## **Step 3: Elimination of Infeasible Entry Modes**

Equipped with the background knowledge of the possible modes of entry and the relevant factors, the decision maker is in a position to address the specifics of a

target market. In this step of the decision process, the intent is to reduce the possible set of entry modes so as to simplify the subsequent process of identifying an objective and factor concordant set of entry modes and finally an optimal entry-mode for a target market. This "weeding out" process can be done by eliminating those entry modes which can be considered not feasible due to one or more immediately apparent inhibiting factors prevalent in the decision environment. For example, if a target country's government policy bans the import of a company's product, then export can be eliminated. Also, if a company has limited resources, then high investment entry modes are ruled out.

Although numerous experts have addressed this aspect of the decision process, a structure to it has not been proposed, and in fact such a structure may not be feasible. The reason for this is that circumstances dictating the infeasibility of a given entry-mode can be innumerable and varied. In spite of the lack of a structured means of dealing with this aspect of the decision process, it is not a complex one. This is because the cause and effect scenarios dictating this aspect are easy to spot. For a detailed discussion of how the various factors effect the entry-mode decision refer to Chapter 2. Numerous cause and effect relationships have been pointed out in that chapter.

Having eliminated the entry modes which are apparently not feasible for a target market the decision maker needs to examine in detail the remaining entry modes. These entry modes have to be analyzed in light of the two important dimensions in the entry-mode decision--the company objectives in the target market and the factors

facing the firm. Such an analysis is addressed in the second part of the decision framework presented below.

## **The Decision Framework - Part II**

The second part of the decision process proposes a detailed examination of the entry modes not eliminated as infeasible in part one. If the remaining entry modes are all feasible for the firm, they warrant a more in-depth evaluation. This part of the framework proposes two dimensions--pertinent factors and company objectives--along which the entry modes should be evaluated. These dimensions are important because only entry modes which allow the firm to meet its objectives in a target market as well as satisfy the requirements of the factors in the working environment of the firm can be considered suitable for a specific target market.

The first of the two dimensions that comprise the decision process, factors, has been previously discussed. A number of studies have addressed the importance of the contextual factors on the suitability of an entry-mode. One such study 'Transaction Cost Framework' offers a comprehensive analysis of the impact of the various factors on the entry-mode decision. This study done by Anderson and Gatignon is incorporated into the current framework and is presented in detail below.

The second dimension, company objectives for a target market, should also play a major role in determining an optimal entry-mode for a target market. It would seem that companies would want to use entry vehicles which can lead to the achievement of their objectives in a target market. In fact, this should be a major

### High-Control Modes: Dominant Equity Interests

- \* Wholly Owned Subsidiary
- \* Dominant Shareholder (many partners)
- \* Dominant Shareholder (few partners)
- \* Dominant Shareholder (one partner)

### Medium-Control Modes: Balanced Interests

- \* Plurality Shareholder (many partners)
- \* Plurality Shareholder (few partners)
- \* Equal Partner (50/50)
- \* Contractual Joint Venture
- \* Contract Manager
- \* Restrictive Exclusive Contract  
(e.g. distributor agreement, license, etc.)
- \* Franchise
- \* Non-Exclusive Restrictive Contract
- \* Exclusive Restrictive Contract

### Low-Control Entry Modes: Diffused Interests

- \* Non-exclusive, Non-restrictive Contracts  
(e.g. intensive distribution, some licenses, etc.)
- \* Small Shareholder (many partners)
- \* Small Shareholder (few partners)
- \* Small Shareholder (one partner)

Source: Anderson, E., and Gatignon, H., "Modes of Foreign Entry: A Transaction Cost Analysis and Propositions," *Journal of International Business Studies*, Vol. 17, No. 3, Fall, 1986, pp. 1-26.

**FIGURE 2: Classification of Entry Modes by the Degree of Control Offered**

consideration in the mind of the decision makers. Unfortunately, it seems that no work has been done which studies the impact of company objectives on the suitability of entry modes. Hence, to develop an understanding of this aspect, interviews were conducted with several companies involved in international ventures. The methodology adopted for this process is presented in Chapter 4.

## **The Transaction Cost Framework**

In 1986 Anderson and Gatignon offered a Transaction Cost Framework for investigating the entry-mode decision. The authors stressed the importance of considering the various factors facing the firm when making the entry-mode decision. Their framework provides a comprehensive picture of the interactions between entry modes and the contextual factors. It offers propositions showing the relationship between the two.

The authors first clustered entry modes according to the degree of control each mode provides the entrant. Figure 2 shows the clustering used by them. Control is given considerable focus as the appropriate degree of control enables the firm to coordinate actions, carry out strategies, and pursue interests. Higher levels of resources committed usually lead to greater control of a foreign enterprise by the investor. Yet a higher degree of control generates a higher level of risk. Thus the firm must manage resource commitments in the hope of maximizing expected return and minimizing risk.

Next, the authors offer propositions on the degree of control most desirable for a given set of conditions. Given a ranking of entry modes on control, it is then possible to recommend entry modes for a given situation. They suggest that four factors determine the entry-mode/degree of control appropriate in a given situation. These factors are 1) Transaction-specific assets; 2) External Uncertainties; 3) Internal Uncertainties; and 4) Free Riding Potential. Based on these factors they offer propositions to aid in the selection of entry modes. These propositions are presented below and are used in this study as ideas to build upon .

### **Propositions for Transaction-Specific Assets**

Transaction-specific assets are those investments (physical or human) which are specialized to one or a few uses or users, e.g. "a stamping machine to make parts to the specifications of one manufacturer or working relationships and knowledge of the idiosyncrasies of a firm and its activities." These assets develop over time and can significantly contribute to performance. The partner who acquires these assets then becomes hard to replace. Anderson and Gatignon propose that in such a situation the firm is better off integrating (direct investment) to get maximum control. The other option could be to redesign the tasks so that general purpose assets will suffice and integration won't be necessary.

Four situations leading to the development of such transaction-specific assets are elaborated below.

- 1) If the product or process is highly proprietary then an entry-mode offering greater control is more efficient. The reason for this is two-fold.

One, such knowledge often poses transmission problems across company boundaries. Two, valuation of such information is a problem because a buyer cannot know what the knowledge is worth unless the knowledge is disclosed, at which point the acquirer need not pay for it.

2) For unstructured, poorly understood products and processes the costs of the firm's first transfer across national boundaries is higher than the costs of subsequent transfers. This is because the transfer is ill-understood. Thus, development personnel must interact heavily with production personnel to solve inevitable unforeseen problems. For such products as first transfers of technology, high control modes are preferable to preserve and extend the common code of understanding.

3) For products highly customized to the user, modes offering higher degrees of control are more efficient. Such products demand that the entrant work actively and closely with a local entity to know the needs of the local people. This leads to a strong reliance on the current contractee, which creates a human transaction-specific asset. Team effects are created and control is needed to preserve them.

4) The more mature a product class, the less control a firm should demand of a foreign business entity. When a product class is immature it has high proprietary content which gives rise to the earlier mentioned valuation and transmission problems. Hence, high control is needed. However as a product class becomes mature these problems dissipate making void the reason for high control. Also, the likely gains decrease with mature products. Consequently, a low commitment and hence a lower control mode would suffice.

## **Proposition for External Uncertainty**

External uncertainty is the volatility of the firm's environment. It typically refers to political instability, economic fluctuation, currency changes, etc. Anderson and Gatignon propose that in volatile environments, entrants should use low control entry modes. This avoids resource commitment and frees entrants to change partners or re-negotiate contract terms and working arrangements relatively easily as circumstances develop and change. Low-control modes allow firms to retain flexibility and shift risk to outsiders. Further, in volatile environments, a product or technology may be obsolete by the time a high control administrative mechanism is in place. Hence, firms may be better off using low control entry modes.

However, if transaction-specific assets accumulate such that the entrant becomes locked in to a partner in a shifting environment then flexibility, the major reason not to integrate in the face of uncertainty, is lost anyway. Further frequent shifts mean frequent negotiation of new arrangement, presenting the agent with many occasions to behave opportunistically and inflexibly. In short, uncertain environments aggravate the normal difficulty of working with irreplaceable agents. Anderson and Gatignon propose that given some degree of asset specificity, control becomes more desirable as uncertainty increases. They propose that more the combination of country risk (economic fluctuation, political instability, etc.) and transaction-specificity of assets (proprietary content, poorly understood products, customization, product class immaturity), the higher the control desirable.

## **Propositions for International Uncertainty**

Internal uncertainty exists when the firm cannot assess its agents' performance by objective, readily available output measures. This makes control essential in order to impose subjective judgment and to monitor inputs. This, however, is subject to the condition that the management knows how the people should behave and how to judge hard to quantify results, i.e. the management is familiar with that environment. However, if the management lacks international experience (i.e., experience in that foreign country) then a low level of control is desirable.

In addition, a significant socio-cultural distance between the home and host cultures magnifies the perceived uncertainty. In such a situation, a firm could choose one of two paths. One path could be to carry on its own operating procedures and methods, which then requires heavy training of agents. The agents consequently acquire transaction-specific assets in the form of valuable knowledge and relationships of little use to other firms in that country. The management problem now is aggravated by specifics, making a high level of control desirable. A second path could be to go along with the local or general purpose operating methods and ways. With specifics out of the way, the problem of socio-cultural distance can be managed by transferring risk to external agents and keeping low control.

If the host country has a large foreign business community, as a consequence of which the country's technical capabilities increase and multinational management skills are widely available, then contracting or licensing become efficient modes with control being maintained with threat of replacement.

## **Proposition for Free Riding Potential**

Free Riding Potential is said to occur when one party can "free ride" on the efforts of others, i.e., receive benefits without bearing costs. When this potential is present then entry modes offering a high degree of control are efficient. This suggests that for brand names of high value, where the local partner has opportunity to have short-term gains at the expense of long-term gains, a high level of control is appropriate.

## **Shortcomings of the Transaction Cost Model**

The Transaction Cost approach is a useful way to structure the issues. It offers propositions which are intuitively very appealing. However, there are some shortcomings to this model. One drawback is that the authors apply the propositions to the whole range of entry modes, rendering unnecessary complexity to a user. In a given situation some entry modes may be completely infeasible and a simple preliminary step to identify and eliminate from consideration these modes could be very helpful to a user of this model. The theoretical model proposed as part of this research, incorporates this step right at the beginning so as to simplify the subsequent process of identifying workable and finally optimal entry modes.

Another shortcoming of the model is that it does not address Transnational Strategic Alliances (TSAs), an entry-mode concept that has gained considerable prominence. This entry-mode has been incorporated in the final framework developed as part of this research.

Finally, the model does not explicitly address the impact of company objectives for target markets on the selection of an entry-mode. It would seem logical to assume, that any company would give considerable attention to achieving objectives in target markets when designing strategies for these markets. Any entry-mode selected consequently, would have to offer the potential of meeting these objectives.

### **Purpose of Interviews**

Because the literature available does not sufficiently address the relationship between company objectives and entry modes, an attempt has been made to gather this information from companies involved in international ventures. Real-world data are gathered from several companies to develop an understanding of the impact this dimension has on the choice of entry modes. The real-world data has also been used to enhance the theoretical model overall. The final model developed is presented in Chapter 5. The methodology used to gather the data are discussed in the following chapter.

### **The Decision Framework - Part III**

The third and the final part of the decision framework focuses on selecting an optimal entry-mode for a target market. Once the company objectives and other pertinent factors have been accounted for and a suitable set of entry modes has been identified by the firm, it must be able to analyze the entry modes further to determine the optimal mode for the given set of circumstances. Such an analysis must involve a systematic comparison of the feasible entry modes because they are all possible ways

to penetrate the target market within the given factors and company objectives. There must be a means to decide on trade-offs among the several entry modes under consideration. Typically, this means ranking and weighing the entry modes on various qualitative bases. More importantly, however, this stage of the decision process must include a quantitative analysis and comparison of the various entry modes included in the objective concordant sub-set. The associated projected costs and benefits over a future period of time must be accounted for. Moreover, different entry modes are subjected to different markets and political risks and, therefore, the expected benefits and costs must be adjusted for risk.

This step of the model accounts for this aspect of the decision making process. The model proposed by Root [1987] provided the basis for developing this analysis phase. In 1987 Root proposed a logical flow model to aid in selecting the optimal entry-mode from a feasible set of modes. He suggested that all entry modes should first be examined in the light of the external and internal factors to obtain a feasible set of entry modes. From this feasible set the appropriate mode could be selected using comparative profit contribution, risk, and non-profit analysis.

### **Comparative Profit Contribution Analysis**

The profit contribution of an entry-mode is the net revenue it will earn for a company over the period of the strategic plan. Estimation of the profit contribution requires that managers project all costs and revenues that will result directly or indirectly from using an entry-mode for a target country. Different entry modes will have different time profiles for revenues and costs. To standardize time profiles for

comparative analysis it is necessary to calculate the present values of estimated profit contributions over the same number of years. Finally, the feasible entry modes should be rank-ordered by the size of their net present values.

## **Comparative Risk Analysis**

This analysis involves adjustment of expected cash flows associated with each of the feasible entry modes for political risk. Political risk is created by the international firms' uncertainty over the continuation of present political conditions and government policies in the foreign country that are critical to the success of a selected entry strategy. There can be four classes of political risk:

- 1) General Instability Risk: This arises from uncertainty about the future viability of the host country's political system. It may not always cause abandonment of an investment project, but it will almost certainly interrupt operations and lower profitability.
- 2) Ownership/Control Risk: It proceeds from the management's uncertainty about host government actions that would destroy or limit the investor's ownership or effective control of his affiliate in the host country.
- 3) Operation Risk: This type of risk arises from uncertainties about policies that would constrain the investors' operations in the host country.
- 4) Transfer Risk: This arises from uncertainties about future government act that would restrict ability to transfer payments or capital out of the

host country, i.e., risk of inconvertibility of the host country's currency. A second type of transfer risk is depreciation of the host country currency relative to the home country currency of the investor.

The firm's periodic cash flow has to be adjusted period by period for specific political risks. This approach requires assessing the sensitivity of the project's cash flows to possible political events or situations in the host country. Managers can estimate the probability of a specific political event for each year of the planning period, and then weigh the period's cash flow by these probabilities to get their expected values. To improve probability judgments, managers could use decision trees, Bayesian analysis, computer simulation, etc.

## **Non-profit Contribution**

The feasible set of entry modes also needs to be compared and then ranked on the basis of a company's non-profit objectives. These objectives can vary from company to company, depending upon the establishment of a reputation, the reversibility (degree to which an entry-mode can be undone if a mistake is made), the desire to maintain a presence in the long run, innovative learning and adaptation, and so on.

## **Ranking by Overall Comparative Assessment**

In the final stage the results of the analysis of profit contribution, risk, and non-profit objectives should be analyzed together and an overall comparative assessment

of the feasible entry modes should be performed. There can be no objective procedure to capture the three analyses in a single number. Therefore, managers must use their own subjective judgment in making an overall assessment of the entry modes.

For one reason or another, managers may fail to carry out the quantitative analysis to the degree suggested in this part of the model. But, even so, the approach presented here should help them in making better entry decisions. Its key advantage is the forcing of a comparison of feasible entry modes so that decision makers do not accept a workable mode when a better mode is available. A crude use of this approach will still encourage managers to raise the necessary questions about entry modes, and thereby will guide them in the direction of the right entry-mode for a target market

## **Summary**

A theoretical model for the development of entry mode strategies has been presented. It incorporates established concepts from other models suggested in the literature previously, such as the Transaction Cost Framework suggested by Anderson and Gatignon and the model suggested by Root. The model developed leaves room to be further developed using real-world knowledge. The real-world knowledge gathered is presented in the following chapter. In Chapter 5, the final form of the decision framework developed as part of this research is presented.

# **Chapter 4: Interviews**

## **Introduction**

The literature reviewed contributed significantly to the understanding of the important dimensions in the entry-mode strategy development process. It also aided in the development of a theory based decision making model to guide managers in the selection of suitable entry modes. However, no mention of the impact of company objectives on the decision process was found. Consequently, to develop an understanding of this dimension, information was gathered from companies involved in international ventures.

This chapter presents the methodology used for gathering information from various companies. Discussion of the sample design, data collection scheme, and the analysis techniques used is presented. The chapter also presents a report of the interviews conducted. Representatives of six companies were interviewed. The responses to the questions posed to the companies' representatives are discussed collectively. These interviews provided insight into how the decision on entry modes is made in the real-world environment and provided a means of incorporating real-world knowledge into the decision framework.

## **Methodology for the Interviews**

### **Sample Design**

In this research, the population from which the sample was drawn is U.S. firms involved in business ventures with the other countries. The population was limited to firms in and around Virginia. A list of 20 firms in this region was obtained from the U.S. Department of Commerce. A convenience sample of 6 firms was then selected for the research. The selection procedure was based on the following factors :

- 1) Distance from Blacksburg.
- 2) Cost of travel.
- 3) Time limitations.
- 4) Willingness of the firm to cooperate.

### **Data Collection**

Case studies of the firms were conducted. This method of data collection was used because it allows for an in-depth examination of a unit of interest. As the objective of the data collection was to develop a thorough understanding of the procedure firms followed in entering a target country, this method seemed appropriate. In addition, because the research was primarily exploratory in nature, case studies seemed to be best suited.

First, a broad outline of the topics to be covered in the interview was prepared. This was done to keep the interviews focused on the area of the research. Next, the selected firms were contacted by phone to enlist their cooperation. Interviews were set up with representatives of each firm who were involved actively in the decision making process for entry strategies for international markets. The interviews were conducted in the offices of the representatives and were tape recorded. The questions posed were open-ended to allow the interviewees freedom to answer in detail. Confidentiality was promised to the interviewees. The focus of the interview was on the company objectives, how they interacted with the various factors present in the decision environment and how they influenced the choice of market entry strategy. The aim was to find out how companies in the real world make the entry-mode decision. The interviews provided an insight into the more practical aspects of the strategy formulation process.

## **Data Analysis Techniques**

After the data were collected, they were analyzed to determine how company objectives in conjunction with the various prevalent factors affect the choice of entry mode. First, the interviews with each company's representative was thoroughly studied. Next, each question was taken up individually, and the responses of the companies' representatives to the question was studied. This question by question examination of responses is presented below. Such an examination led to a better understanding of how the companies made the entry-mode decision, what factors they considered, and the impact of these factors on the decision.

On the basis of this analysis, the guidelines on how company objectives interact with the prevalent factors and how they influence the entry-mode choice were developed and are presented in Chapter 5. As will be explained in the chapters to come, the practical data yielded the fact that the entry-mode decision is a two-dimensional decision incorporating company objectives and the various external and internal factors facing a company.

## **Companies Interviewed**

The companies interviewed were promised confidentiality. Hence, the names of the companies are not disclosed. However, the companies have been labeled to be able to refer to them in the discussion. The labeling scheme is as follows:

- A) A large sized company in the automotive industry.**
- B) A large sized company involved in the manufacturing of electrical components and products.**
- C) An industry leader in the United States in the food and beverage industry.**
- D) A medium-sized firm in the food processing and packaging industry.**
- E) A small-sized firm in the used textile machinery industry.**
- F) Once a successful large-sized U.S. company in the food industry, but now has come under severe financial stress.**

## **Questions and Responses**

**Question: Since when have you been involved in international ventures (exporting, franchising , joint ventures, etc.) ?**

**Responses:** Companies A, B, and C have been involved in international operations for over 20 years. Companies D, E and F are relatively new entrants to the international arena. They have been involved in international operations for about 4 to 6 years.

**Question: What are your primary reasons for being involved in these international operations?**

**Responses:** For the companies interviewed two reasons came up most often. These are:

- 1) Potential for increased sales offered by the foreign markets.
- 2) Lower manufacturing costs due to availability of resources, cheaper labor, etc.

Company A and B cited both reasons for going abroad. The two companies have the capacity to expand and are interested in foreign markets. In addition, product development is very expensive. In order to stay competitive they need to spread costs over more volume: therefore, they need more markets. Also, to stay competitive, they

need to avail themselves of the cheaper manufacturing options offered by some foreign countries.

Company C is involved in international markets to increase the sales volume of its products. The company has the capacity and the resources to expand. It is an industry leader in the U.S. market and is interested in increasing market share globally.

Company D is involved in foreign ventures in order to find markets for its excess capacity. Company E deals in used textile machinery which has mostly been replaced by more updated technology in the U.S. and Europe. Consequently, it is in search of markets in other countries where there might be demand for this machinery. Company F is involved in international ventures for the reason of increased sales potential. It is motivated by falling trade barriers and the opening up of markets world-wide.

**Question: How do you identify the foreign markets you want to operate in (i.e., your target markets)?**

**Responses:** Companies A and B responded that there are three kinds of foreign markets they consider having dealings with. The first kind includes those markets that allow the company to reduce its manufacturing and other input costs and offer potential for increased sales. The second kind includes those markets that allow the company to reduce its manufacturing and other input costs but do not offer potential for sales. The third kind includes those markets that only offer potential for increased sales.

Both Companies A and B have research teams for identifying and studying foreign markets. The research teams scan the environment for potential target markets. Consideration is given to the size of the country, the price the product can demand, sales potential, political/legal restrictions, and manufacturing costs.

Company C has a research team which continuously monitors the environment to identify potential markets which might show demand for its products. Consideration is given to political restrictions, market size, and potential product demand.

Company D, initially had hired a consultant to identify foreign markets for its excess production capacity. The consultant introduced the company to a country in which he had a lot of business and, consequently, with which he was familiar. The company since then identifies foreign target markets based on a number of dimensions. Distance is an important consideration as its products have a short life span. Distance also increases shipping costs. Second, demand for its product category and the ability of consumers to afford its product have a significant impact on the selection of a target market.

Company E is in search of markets for its product but has no systematic way of doing so. It is registered with the industry trade organization, and once in a while this organization refers inquiries from interested buyers (from either the home country or foreign markets) to the company. Sometimes the company gets interested buyers from the recommendation of friends.

Company F considers two prime factors when selecting a target market. First, it identifies markets which pose no legal or political barriers to its entry. Next, these markets are evaluated in terms of availability of distribution channels for the company's products.

**Question: What do you perceive are the different ways a company can enter its target markets?**

**Responses:** Companies A, B, C, and F identified many entry options possible for a company. They cited the entire range from exporting to investing along with the different types of these modes. These companies however, said that the entry strategies feasible for any company depend on a number of factors which are country and company specific. The responses of Companies D and E primarily were focussed on export entry modes.

**Question: What do you perceive are the different ways you can enter a target market?**

**Responses:** Companies A and B felt that they could select from a wide range of entry modes. The entry modes they consider feasible are the ones which are compatible with the target market under consideration as well as the company's working environment. For example, Company A eliminates franchising as an option because the nature of the product it manufactures is incompatible with the concept of franchising. Both companies cited the example of not being able to pursue investment

based entry modes in certain countries because of government regulations in that country on foreign investment.

Company C's product involves a guarded technology and consequently in its search for an appropriate entry-mode it begins by eliminating modes which involve possible disclosure of technology aspects.

Companies D and E responded that exporting was the most appropriate entry-mode for them. While Company D could not provide justification for elimination of all other modes from consideration, Company E, which did not manufacture any goods, was able to eliminate other modes based on the product it was marketing.

Company F said it was not in a position financially to consider high investment entry options and therefore eliminates such options from consideration in the very beginning of the decision selection process.

**Questions: What steps do you take for entering your target markets?**

**Responses:** Companies A, B, and C approach their target markets in a very systematic and organized manner. Through the target market identification process these companies gather a good background knowledge of the overall environment of the target country. The information gathered, as mentioned above, indicates whether the market offers sales potential or lower manufacturing costs potential, or both. Based on this information the companies define their objectives for specific target markets. On the basis of these objectives and a more in-depth understanding of the overall

environment of the target market the companies decide upon the level of control they wish to exercise in a target market. Next, the companies study the various entry options to identify the entry-mode offering the desired level of control in the given situation.

Having identified its target market, Company D searches for established local distributors to carry its product. Its primary focus is on finding distributors conversant with its product categories. Based on the abilities of the distributor, the company then lays out its objectives for that target market.

Company E has no definitive plan laid out for its target markets. At this point, it does not even identify target markets as such. If and when the company gets an order from a buyer from another country, it simply sells its machinery to the buyer.

Company F first conducts a study of the target market. Based on the information gathered, it lays out its objectives for the market. Next, the company searches for distributors familiar with its product lines. It then selects the distributor that it perceives is most capable of helping it meet its objectives in the target market.

**Question: What kind of objectives do you define for your target market?**

**Responses:** Companies A, B, and C have two objectives in common. First, for some target markets the companies may pursue the objective of attaining profitability and selling as much volume as possible. Second, in other target markets the companies may have the objective of creating an image and establishing a long run

presence, even at the cost of short-term losses. In addition, however, Companies A and B in some markets may pursue the objective of learning and gaining experience so as to develop diverse capabilities to be able to innovate and adapt to future changes in that market and thereby become integral to it.

Company D's objective for any target market is based on the local distributors' abilities. Its goal is to supply to the distributor as many units as he/she can sell in the target market.

Company E's objective in any target market is simply to sell as many units as possible. Company F's main objective in its target markets is to be competitive. Currently, it is not competitive in many of its overseas markets, because its financial condition does not permit opting for relatively more efficient entry modes besides exporting. The company has been attempting to increase sales and expand its presence in the target markets without much success.

**Question:** Do these objectives have any influence on the entry modes you choose for a target market? If yes, then how do these effect the entry-mode decision?

**Responses:** All the six companies said that the objectives defined for a target market are given a lot of consideration when deciding on an entry strategy.

Companies A, B, C, and F, said that the company objectives determine to some extent the amount of control they want to exert in a target market. However, the

selection of an entry-mode is not based solely on company objectives. A number of factors external and internal to the company also play an important role in the selection. An entry-mode is selected which satisfies both the company objectives and the constraints placed by the contextual factors.

Company D said that its objective significantly influences the entry-mode selection process. According to its current objectives, low control entry modes are most favorable. Company E responded that its company objectives does influence the entry-mode selected, but this influence is limited due to the nature of the product it carries.

**Question: What factors do you consider are significant toward the determination of an entry-mode for a target market?**

**Responses:** Companies A, B, and C look into a number of factors in the target country, in the home country, and within the company when deciding on an entry strategy for a target market. Specifically, these companies indicated that they look at factors from three angles - company related, product related and target market related.

Company D's selection of an entry-mode for a target country is primarily determined by its internal factors. First, the home market for the company is not saturated. Hence, it has potential for expansion domestically. Second, it is a middle-sized company with limited resources. Finally, the company has very little international experience.

Company E's product characteristics play a major role in determining a suitable entry-mode. Company F's internal company factors play an important role in determining a suitable entry-mode, but it also considers factors relating to the target market as important to the selection process.

**Question: Can you enumerate how the various factors relating to your company and your product influence your choice of entry-mode?**

**Responses:** Company A classifies its products offerings into three categories 1) vehicle parts, 2) vehicles, and 3) servicing of its vehicles. The vehicle parts seem to lend themselves to any mode of entry. Hence for these products the entry-mode selected depends on the objective for a market and the other pertinent factors facing the company for that target market.

The vehicles however, need to be customized to the needs of the local people in certain target markets. This requires active interaction with a local entity of the target country to better understand the requirements of the target country consumers. This leads to a strong reliance on the local contractee. Team effects are created and control is needed to preserve them. Hence modes of entry allowing a certain level of control are used.

Also the vehicles have a high demand for service after sale, which necessitates proximity to the customers. For these servicing needs the company offers dealerships to local dealers in the target market. Because the company has a strong image in the market, and would not like the local dealers to reap short-term benefits by poor to

average performance they maintain a strong control over these dealers. The company provides intensive training to the dealers and maintains a rigid contract with them.

For Company A, a major consideration in terms of company factors is its name and what it stands for. Over the years this company has invested substantially to build up a good name and image. Protecting its name is imperative to the company. The entry-mode it selects for a country may not be directly affected by this factor. However, any mode it uses is accompanied by a high level of commitment on the part of the company.

Company B makes electrical parts and supplies. These products are of high quality but they mostly compete on the basis of price as there are competitors with similar high quality products in target markets. To keep prices low, a form of local production (contractual or equity investment) is used. In addition, the products need a lot of adaptation to the target country market. Therefore, the company likes to maintain proximity to the market and uses branch/subsidiary exporting or local production.

With respect to company factors, Company B reported that two factors are considered in the entry-mode decision: 1) resource availability; and 2) experience and knowledge of the target market. If it has enough capital, management, and marketing skills available for a target market it is willing to consider any entry-mode option. Also, if it has knowledge of the target market and has experience in markets similar to the target market then it is willing to consider any entry-mode. However, if the company has a shortage of resources due to commitments in other markets or if it lacks

experience in a particular kind of market, then low involvement entry modes offering low control to the company are preferred.

Company C is in the food products and beverages industry. Its product is highly proprietary in nature, and the composition of the product is a closely guarded company secret. This poses restrictions on some entry modes. Because transmission of this knowledge becomes difficult across company borders the company sets up its own units in target markets.

With respect to company factors, Company C listed the protection of its valuable brand name an important consideration in the entry-mode selection process. From the perspective of both product and company factors, Company C is therefore inclined toward high control entry modes.

Company D is in the food products and packaging industry. The company adapts its products to a limited extent to suit the tastes of the local customers in the target markets. Consequently, to know what the local tastes are, the company conducts small scale research in the target market, involving either getting the desired information through the distributor or through surveying some local residents.

With food products, quality control is a very important consideration. The company feels that modes such as licensing are ruled out for its products as these modes do not offer the company enough control to maintain quality. However, the company is middle-sized with limited resources and lacks experience in the international arena. Consequently, it is unable to consider high control entry modes.

As a result, the company produces the product in the home country and then exports the finished product to the target markets.

Company E sells used textile manufacturing machinery. It believes that exporting is the only suitable mode of entry given the nature of its product. In addition, its a small firm and lack of experience in international ventures provides further reason to prefer exporting over other entry modes.

Company F is in the food industry. Its products pose no restrictions on entry modes feasible for the company. The company has a strong and popular brand name and is well known for quality. Maintaining the brand name and the quality of its products is hence an important consideration for the company. While this situation favors high control modes such as manufacturing in the target market, such an option is currently not possible due to the company's lack of funds.

**Question: How do target market conditions effect your selection of an entry-mode?**

**Responses:** Companies A, B and C said that the more favorable the economic environment of the country the wider the range of entry modes they are willing to consider. If the industrial structure and the income distribution is favorable the companies are willing to use an entry-mode which offers a high level of control. Also, for politically stable environments the companies are willing to take on a high control mode. However, if governmental policies in the home country are restrictive or even

neutral to investment in a particular target market, then entry modes offering medium to low control such as licensing, contracting, exporting, etc., are considered.

Company A, however, also said that it is generally more inclined towards high control modes in a competitive environment in as much as its main objective for entering that market includes a long-term commitment. It studies both the home market and the target market. For parts or processes which are characterized by high production costs or unavailability of raw materials at home, it sets up local production in those target market countries which offer potential for lower costs. For large target markets offering high sales potential equity investment, branches/subsidiaries exporting, etc., are preferred.

On the other hand, Company B said it opts for low control modes in highly competitive environments if it determines that the main objective it wants to pursue in the target market is short-term profitability through large sales volumes. With this aim the main competitive weapon on which the company relies is low price. Low prices are difficult to achieve in a competitive environment where competitors may have been entrenched for a long time. Company B thus looks for independent international intermediaries with whom to operate in the attractive foreign market conditions.

For Company C, competition in the target market is not of much concern. This is because given its brand name it automatically generates a competitive edge over the local or other companies with similar product lines. However, it is concerned about sales volume that may be generated in the target market in as much as its profit lies in economies of scale.

All three companies A, B and C indicated that if the market environment is unattractive, then low control modes are used when the company is pursuing the objective of increasing sales as these allow the companies to retain flexibility, avoid resource commitment, and allow the option of changing or re-negotiating contracts with changing circumstances. The companies feel that they need not integrate but can let the competitive market mechanism operate to generate returns.

Companies D, E, and F do not give consideration to competitive factors in the target market when selecting an entry-mode.

Because company E's product is so restrictive and it is essentially bound to export oriented entry strategies, market conditions in the target market have no meaning as such for it.

Company D said that because its product is perishable, distances between production facilities and retail outlets cannot be significant. This indicates the necessity of entry modes that incorporate production facilities in the target market. However, because this company is not favorably inclined toward production facilities in the target markets, it essentially means that the target market for this company must have close proximity to the home country. Another very important market factor for Company D is the socio-cultural environment in the target market. This is because its product is so closely related to personal likes and dislikes, which in turn may be dictated by religious beliefs or customs. In effect, Company D says that it must make a comprehensive market survey of whether its products would be acceptable in the target market or

would require adjustments. This in turn has an effect on the entry-mode selection process because the volume of production required for these customized products is an important parameter.

Company F, being in the food industry, has to incorporate agricultural and health restrictions in the target market into its entry-mode decision process. For example, in one country, if it had not been for its financial dilemma, it would have opted to produce in the target market because import of any food products was forbidden by the target country's government.

**Question: Do you perform any kind of quantitative analysis for selecting an entry-mode?**

**Responses:** Companies A, B, and C performed intensive quantitative analysis for each market to aid in selecting a suitable entry-mode. However, the companies were not willing to discuss this aspect of their strategy. Nevertheless, they indicated that the quantitative analysis involved comparing the feasible entry modes on profitability and sensitivity to political and financial risk.

Companies D, E, and F did not perform any quantitative analysis for selecting an entry mode.

**Question: Have you been successful in your international ventures?**

**Responses:** Company A has never withdrawn from any of its international markets. Currently it has international operations all over the world. It has gone through good and bad phases in its business, but it was never due to poor planning. It attributes the "not-so-successful" phases primarily to economic fluctuations and lack of commitment in its partners.

Company B initially had failed or performed poorly in some of its international ventures. It attributes this to the company's short-sighted perspective at that time, and to the lack of proper planning and structured decision making.

Company C has withdrawn from some of its target markets and has consequently suffered high switching costs. It feels that the primary cause of these situations was poor research and the volatility of various factors in the target market.

Company D is not satisfied with its current performance in international markets. So far, the company has not been able to identify the reason for its poor performance. At the same time however, Company D is not very committed to its international operations or success in as much as it feels that the domestic market has enough potential for its sustained growth.

Company F has not been successful in most of its international operations. The company attributes this to the fact that its international operations are based on an inappropriate entry-mode, i.e., exporting. Although it has attempted and continues to attempt to overcome this situation, it is bound by severe financial constraints. It emphasizes its continued commitment to internationalization.

## **Summary**

This chapter presented the knowledge gathered in the form of interviews with six companies involved in international ventures. The knowledge is utilized to modify and enhance the decision framework developed in Chapter 3. These modifications are discussed in the following chapter. The final framework developed as part of this research is also presented in Chapter 5. Chapter 6 addresses the significance and practical utility of the model developed. It also discusses the limitations of the model and suggests areas for future research.

# **Chapter 5: The Final Decision Framework**

## **Introduction**

The previous chapter presented the analysis of the interviews conducted with the various companies. The interviews yielded valuable information not only with respect to how companies incorporate their target market objectives into the decision making process for entry modes, but also about the decision-making process as a whole. This chapter presents the final decision framework developed to aid managers in the selection of optimal entry modes for target markets. This framework is developed by incorporating the real-world practical information gathered via the interviews into the theoretical framework developed in Chapter 3.

## **An Overview of the Decision Framework**

The basic flow of the decision-making process as suggested by the final framework developed, remains the same as that in the theoretical framework. However, incorporation of the data gathered from the interviews makes the framework more robust than the theoretical model. The framework is also more enriched, as it provides for the consideration of company objectives in the entry-mode decision process.

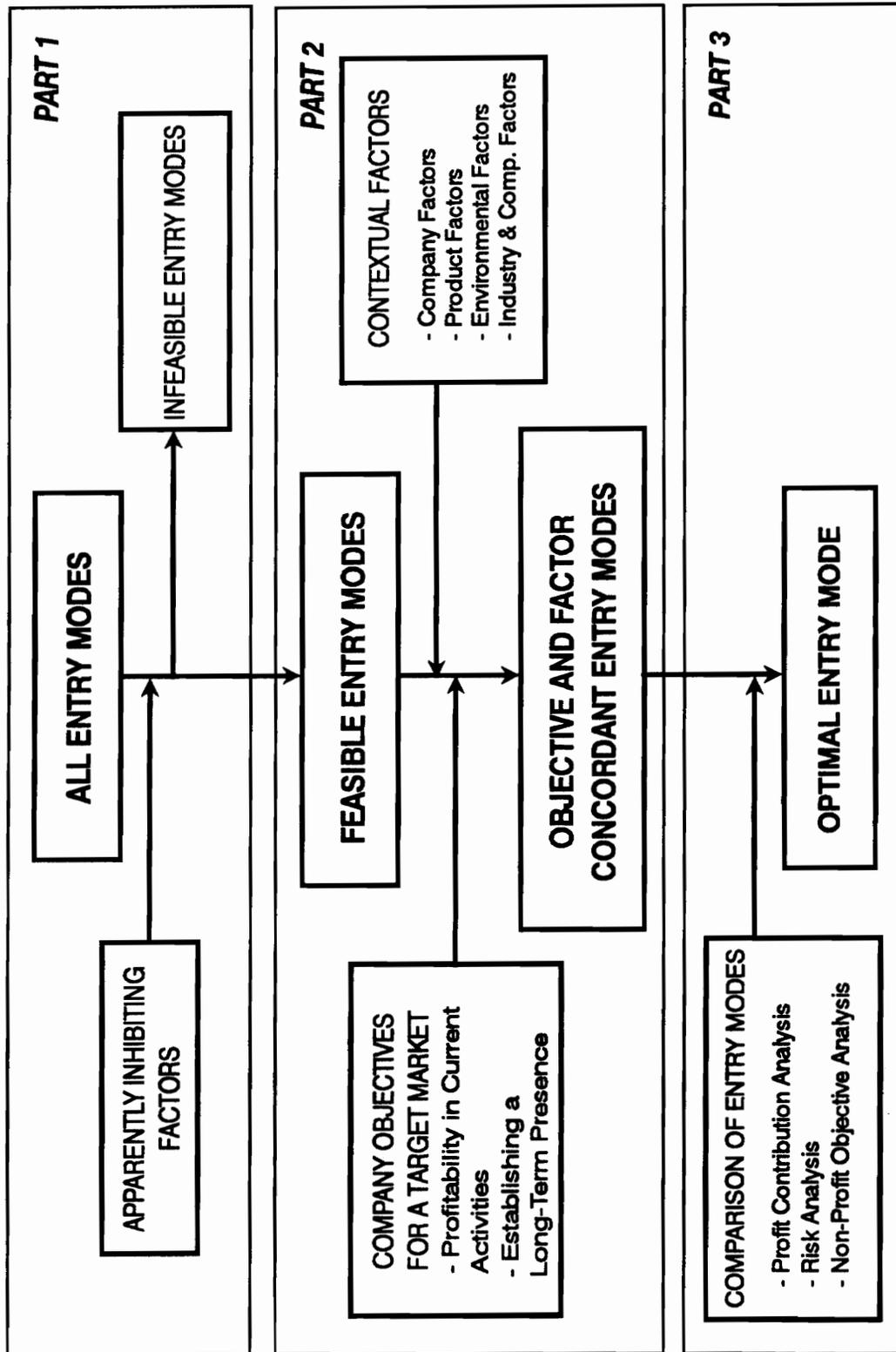


Figure 3: The Final Decision Framework

The decision framework developed divides the decision process into the following three parts:

- 1) Eliminating from consideration entry modes not feasible for a target market.
- 2) Choosing a suitable set of entry modes based on company objectives and factors.
- 3) Selecting the optimal mode of entry.

## **A Detailed Discussion of the Decision Framework**

Each of the three parts in the decision framework is explained in detail. The following sections elaborate upon these parts and enumerate the steps decision makers have to take in each of these parts. A graphical representation of the final decision framework is presented in Figure 3.

### **PART 1: Eliminating Entry Modes not Feasible for a Target Market**

The first part of the decision framework, proposes three steps that decision makers should take before they can do a comprehensive analysis of entry modes for a specific target market. These three steps are --1) knowledge of entry modes, 2) knowledge of the pertinent factors, and 3) elimination of infeasible entry modes.

## **Step 1: Knowledge of Entry Modes**

The first step that a decision maker needs to take to be able to select an optimal entry-mode for any target market, is gathering information on all possible means of entry. Most companies in the industry are unaware of all the entry options available to them and consequently fail to identify entry modes that would best match the company's capabilities with opportunities abroad. As a result these companies encounter high cost of lost opportunities. To avoid such a situation and to be able to fully exploit the opportunities offered by foreign markets, selection of an optimal entry-mode for a target market is necessary. This calls for an awareness of all the entry-mode options possible, along with a sound knowledge of each modes' advantages and disadvantages. Such a knowledge allows companies to run comparisons between entry modes and then to identify the mode which is most suited for a given situation faced by a firm with respect to a target market.

In addition, an understanding of the amount of control each entry-mode offers to an entrant is imperative. The reason for this is two-fold. First, control enables an entrant to coordinate actions, carry out strategies, and pursue interests, all of which in turn can lead to higher returns. Second, control demands responsibility for decision making, resource commitment and exposure, and creates switching costs, all of which increase the risk faced by an entrant. Because most companies would like to maximize expected returns and minimize risk in a target market, both of which are determined by the level of control a company maintains in a target market, an understanding of the entry modes in terms of the amount of control they offer is necessary.

The interviews indicated further that companies satisfied with their performance in international markets seem to look at entry modes from a control and commitment viewpoint. On the basis of the various factors and the company objectives, companies tend to decide upon a level of a control they wish to exercise in a foreign market and then on that basis choose an entry-mode.

Consequently, the entry modes have been classified according to the degree of control they offer. The various entry modes have been previously described in detail in Chapter 2 and are enumerated below as low, medium, or high control modes.

#### **Low-Control Modes**

- 1) Direct agent/distributor exporting
- 2) Direct branch/subsidiary exporting
- 3) Indirect exporting
- 4) Minority share holding with many partners
- 5) Minority share holding with few partners
- 6) Minority share holding with a single partner

#### **Medium-Control Modes**

- 1) Licensing
- 2) Franchising
- 3) Technical agreements
- 4) Service, management and constructional/turnkey contracts
- 5) Contract manufacture and co-production agreements
- 6) Counter-purchase

- 7) Switch trading
- 8) Clearing agreement
- 9) Buyback barter

### **High-Control Modes**

- 1) Sole ownership
- 2) Joint venture
- 3) Transnational strategic alliances

Once a decision maker has developed a thorough understanding of all the entry modes, he/she needs to identify all the pertinent factors that may have an affect on the entry-mode selection. This is addressed in the following section.

### **Step 2: Knowledge of the Pertinent Factors**

The choice of an entry-mode is a function of several factors. Many factors in the environment facing the firm place stringent requirements on the entry vehicle that a firm can use. Only an entry-mode which is the best fit to all these factors in combination can be considered optimal. Consequently, the importance of a knowledge of these factors and their impact on the entry-mode decision can not be over emphasized.

Once a company has developed sound background knowledge of all the entry modes the next step in the decision framework is to develop an understanding of all factors that may have an impact on the entry-mode decision. In Chapter 2 a detailed discussion of the various factors was presented. The immense variability of the

different factors indicated an obvious need to classify them in some fashion and then consider the factors as classes, to alleviate the adequate consideration of the effects of the various factors on the entry decision.

The interviews yielded a structured and simplified manner in which to classify the factors. It indicated that the factors can be clustered under four categories - 1) company factors; 2) product factors; 3) target country factors; 4) target industry and competition factors. The impact of these categories on the selection of a suitable entry-mode can then be evaluated. These categories are explained subsequently. A detailed discussion of the impact of each factor in each category independently on the entry-mode has been previously presented in Chapter 2 and hence here the factors are simply enumerated.

### **Company Factors**

Company factors refer to such factors as available resources, cost advantages, foreign investment experience, operational flexibility, and free riding potential.

Resources refer to the company position in terms of size, capital, and management, technology, production and marketing skills. Cost advantages are primarily attained by the combined effect of economies of scale and positions on the experience curve. In general, cost advantages enhance the likelihood of success of foreign ventures. Foreign experience refers to the experience the company has in ventures abroad. As a company gains experience in foreign markets, it gains confidence and becomes more aggressive in international markets. Flexibility refers to the ability of the company to alter its decisions and stand in a target market in case of

contingency circumstances. Flexibility also influences the potential for success in international markets by creating options that may turn uncertainties to the firm's own advantage. Free riding potential applies to companies which have a good brand name. This presents the danger that one party can receive short-term benefits by exploiting another party's name or image without bearing the related costs. An example may be to exploit a franchise name to reap quick benefits in a way in which the franchiser may be adversely affected with no effect on the franchisee.

### **Product Factors**

Product factors refer to the proprietary content, product complexity, customization, stage of product life cycle, service requirements, etc. of a product.

Proprietary content refers to the proprietary nature of the products/processes that the company intends to market/produce in the foreign market. Highly proprietary products or processes pose transmission and valuation problems across company boundaries. Product complexity arises either because the product lines are new to the market, or are unstructured, or are very complex in nature. The higher the product complexity the more difficult these products are to understand, which poses problems of transmission. Product customization refers to the degree to which the products are customized to the needs of the individual or groups of end-users. A higher degree of customization demands that the entrant work actively and closely with a local entity to know the needs of the local people. Product life cycle stage refers to the relative age of the product in the host country market as well as in the home country market. Declining products in the home country market can be pushed as a growth product to foreign markets. Immature products in the target market due to high proprietary

content pose problems of valuation and transmission, whereas mature products have less likely gains associated with them. Service requirements refers to the amount of servicing before and after purchase the products require. For products requiring high levels of servicing, proximity to the customers is important.

### **Environmental Factors of the Target Country**

Previous studies as well as the interviews indicated that environmental factors are important for determining international entry strategies. The environment of any country comprises four major factors: economic environment, legal/political environment, socio-cultural distance, and technological strength.

Economic environment reflects the industrial structure and the income distribution within the target country. Industrial structure shapes the product and service requirements, income level, and employment level, whereas income distribution provides an indication of the purchasing power and market size of the country. Legal/Political environment includes factors such as political stability, and tax and monetary regulations of a country, as well as the government policies toward exporting and foreign investment. Socio-cultural similarity refers to the similarity of popular attitudes and values, languages, and social structure between the home and the target market. Technological environment focuses on the level of skills of the workforce, patent protection, etc. It includes the current state-of-the-art in the foreign country with respect to related technologies.

## Industry and Competition Factors

Industry and competition analysis focuses on competition intensity, industry attractiveness, industry growth and size, and distribution integration in a country.

Competition intensity concerns how intensely a competitive firm competes with the reference product and how similar a competitor's strategies are. Industry attractiveness is a measure of the degree of favorability of the industry for the firm and is usually affected by the extent to which firms hold key success factors in relation to competitors. Industry growth and size refers to the prevalent trends and potential of the industry to grow and mature in the future. It is essentially a measure of the current positioning of the industry in terms of its market maturity. Distribution integration refers to the availability of distribution channels that are under the control of the firm.

### Step 2: Elimination of Infeasible Entry Modes

Because the decision maker is equipped with the background knowledge of all the possible modes of entry and the relevant factors, he/she is in a position to address the specifics of a target market. For any given situation, it is possible that some entry modes may be infeasible for a specific target market. It is also possible that all entry modes may be infeasible for a specific target market, i.e., a target market itself may be infeasible. This situation, however, must necessarily be considered a part of the decision process to identify a target market and will therefore be assumed not to exist for the purposes of this model.

In this step of the decision process, the intent is to reduce the possible set of entry modes so as to simplify the subsequent process of identifying an objective-concordant and factor-concordant set of entry modes and finally an optimal entry-mode. This "weeding out" process can be done by eliminating those entry modes which can be considered completely infeasible due to one or more immediately apparent inhibiting factors prevalent in the decision environment. For example, if a target country's government policy ban the import of a specific item, then export can be straight away eliminated.

Although numerous experts have addressed this aspect of the decision process, a structure to it has not been proposed, and in fact such a structure is infeasible. The reason for this lies in the fact that circumstances dictating the total infeasibility of a given entry-mode can be innumerable and varied. In spite of the lack of a structured means of dealing with this aspect of the decision process, it is not a complex one. This is because the cause and effect scenarios dictating this aspect are easy to spot. For a detailed discussion of the how the various factors effect the entry-mode decision refer to Chapter 2. Numerous cause and effect relationships have been pointed out in that chapter.

Having eliminated the entry modes which are apparently infeasible for a target market the decision maker needs to examine in detail the remaining entry modes. These entry modes have to be analyzed in light of the two important dimensions to the entry-mode decision--the company objectives in the target market and the factors facing the firm. Such an analysis is addressed in the second part of the decision model presented below.

## **PART 2: Choosing a Suitable Set of Entry Modes Based on Company Objectives and Factors**

The second part of the decision framework addresses the two major dimensions--factors and objectives, which have an impact on the suitability of entry modes for a target market. Only entry modes which allow the firm to meet its objectives in a target market as well as satisfy the requirements of the factors in the working environment of the firm can be considered suitable for a specific target market. This part of the model offers propositions which can aid managers in the identification of such suitable entry modes. The first of the two dimensions that comprise the decision process, namely factors, has been previously discussed. The second dimension, namely company objectives for a target market, is presented in the following section.

### **Company Objectives for a Target Market.**

The objectives of a company for a target market play a major role in determining an optimal entry-mode for that market. As stated during the development of the theoretical model in Chapter 3, an understanding of the objectives companies have in target markets and the impact of these objectives on the entry-mode decisions was developed primarily using the real-world data gathered via interviews with the various company personnel. The interviews indicated that two company objectives--1) profitability in current activities, and 2) establishing a long-term presence, are most influential in determining the optimal entry-mode. Consequently, these two company objectives are discussed in greater detail below.

### **Profitability in Current Activities**

One type of objective a firm can define for a target market is maximizing profitability in current activities. The primary goal of the firm in this case is to maximize the ratio of organizational outputs to the inputs employed to produce the outputs. The profitability objective is usually one that is adopted by companies with a short-term perspective.

### **Establishing a Long-term Presence**

In contrast to the first objective, for some target markets a firm may adopt a longer term objective. Such an objective could be to focus on the long-term survival and success of the firm in the target market. The vagaries of the international arena subject a firm to many kinds of risk, such as fluctuations in interest rates, exchange rates, and wage rates, changes in government policies, competitive risk, technological risk, resource risk, etc. Coping with these risks and reducing its susceptibility to them can be an important long-term objective of the firm. In a related sense, a firm may sometimes opt to enter a market with the objective of learning and gaining experience. The logic for this is that the diversity of foreign markets exposes a firm to multiple stimuli, allows it to develop diverse capabilities and provides it with a broader learning opportunity. Consequently, the enhanced learning that results allows the firm to be able to innovate and adapt to future changes. This improves the probability of a firm's survival by enhancing the chance that the firm will be in possession of the capabilities required to cope with an uncertain future state.

Although the first objective of profitability discussed above is more inclined toward recovering the investment and generating return on it, the other objective is less

focused on this issue. Irrespective of which objective a firm defines for a target market, the choice has a bearing on the level of commitment and consequently the level of control that a firm may desire in terms of its entry strategy for a foreign market. However, it is not possible to directly correlate a specific level of commitment or a specific entry-mode with a specific company objective. An important consideration in the entry decision is also the numerous factors discussed above. Any decisions regarding entry modes must therefore be based on the joint consideration of both the objectives and the pertinent factors. The following section presents rules to enable such a joint consideration.

### **Rules to Aid the Selection of Entry Modes**

Once a company has laid down its objectives for a particular target market and identified the pertinent factors with respect to a target market it needs to understand the interactions between the two and how these interactions influence the entry-mode decisions. The interactions and their influence on entry modes is presented below in the form of rules. These rules govern how each class of factors interact with each of the two company objectives to yield suitable entry modes for a target market. These rules however, only solve the purpose of providing guidelines. They adopt a very broad and general purpose approach. The reason for this being the numerous factors which impact the entry-mode decision and the interactions between these factors in any given situation. Consequently, only managers facing a specific situation can be the final judge of which entry-mode is optimal. The rules only are a means to aid in the decision. The final decision ultimately involves subjective judgment on the part of the decision maker.

## **Rule Set 1: Company Factors**

Factors within a company can pose restrictions limiting the entry-mode options available to a company. These internal factors such as company resources, international experience of the firm, and brand name may impose constraints within which the company would have to make its entry-mode selection. The effect these constraints, in conjunction with the company objectives for a target market, have on the suitability of entry modes is presented below.

If a company is internationally inexperienced and its objective for a target market is short-term profitability then low control entry modes are suitable. This is because an inexperienced firm is unlikely to know how to manage well in the international setting and high control modes accompanied by high resource commitment may result in high prices without yielding high profits. However, when a firm is pursuing long-term objectives as those stated earlier, it is advisable to start with a low control mode and gradually move to high control modes as international experience is accumulated.

Firms that are well known and carry a valuable brand name normally adopt a long-term perspective in any target market. In fact, for such firms to have a short-term objective for a target market may be a poor strategic choice. A major area of concern for these firms is the possible existence of free-riding potential. If these firms want to standardize their product's design, style, quality, and name then assurance of all that the brand name connotes demands quality control and free-riding can be especially damaging.

Even though valuable brand names can be efficiently marketed via low control modes, especially if they are unsophisticated consumer goods, the associated problem of free-riding potential makes control more desirable. By taking control a firm can protect its brand from degradation by free-riders who could otherwise have short-term gains at the expense of the long-term objective of the firm.

Firms should add more restraints, i.e., demand higher control as brand value increases. Beginning from low control modes, a firm is advised to exert more control for valuable brand names. Hence a firm is better off franchising its high value brands rather than merely licensing them in a non-restrictive, non-exclusive fashion. However, the firm may not need to go so far as a joint venture or majority-owned affiliate.

If a company has limited resources then it is for the most part restricted to a low control entry-mode such as exporting, irrespective of the company's objective in a target market. Alternatively, if company resources are in plenty, they no longer pose a constraint on the level of control that the company must choose. In this situation low, medium, as well as high control modes are available to a firm.

## **Rule Set 2: Product Factors**

The characteristic of the product a company is planning to take abroad has a significant effect on the entry-mode choice. Two propositions govern the relationship between product factors, company objectives, and entry modes. First, if the product classes are in the introductory/growth stage, are proprietary, complex, ill-understood in the foreign market, or customized to each end user, then high control modes become imperative, because success in these product classes usually requires a long-term

perspective with respect to managing risk, learning and adaptation. Second, if the products are in the mature stage, functionally simple and easy to use, familiar in foreign markets, standardized, then the objective of achieving profitability in current activities is usually preferable and therefore entry modes offering low levels of control are more suitable. These two propositions warrant a more detailed discussion which follows.

If the product or process is highly proprietary then a short-term objective is considered a poor choice and companies usually adopt a long-term perspective in their target markets.

On the surface it would seem that proprietary products or processes are appropriate for a low level of control such as licensing, because there is something of value to license. However, proprietary knowledge is subject to hazards of transmission and valuation. Such knowledge is often ill codified and difficult to transmit across organizational boundaries. Furthermore, valuation of such information is a problem because a buyer can not know what the knowledge is worth unless the knowledge is disclosed at which point the acquirer need not pay for it. This makes it important for information-holders to exploit such products themselves, and consequently high level of ownership (and hence control) of a foreign business entity is desirable.

Therefore, with products or processes that are proprietary, a firm should aim for establishing a long-term presence in a target market and use high control entry modes to fully exploit as well as protect its proprietary knowledge from others. Wholly owned subsidiaries and joint ventures are good choices in this situation.

For unstructured, poorly understood products and processes to succeed in international markets it is crucial for a firm to adopt a long-term perspective. A short-term objective, given such products, would be a poor strategic choice because these products may not show any returns in the short run. However, as consumers become more and more familiar with the product, demand is generated, thereby increasing the chances of making a profit. Hence, firms should aim for surviving by managing the various risks and also continuously monitoring the environment in the target market so as to be able to adapt and innovate and consequently be prepared for any future situation.

A major consideration for unstructured, ill understood products is the high costs of technology transfer across national boundaries. This is because for such products the transfer is ill understood. Development personnel must interact heavily with production personnel to solve inevitable unforeseen problems. Hence, high control modes are preferable to preserve and extend the common code of understanding. For simple, and familiar products however, this is not a problem. Hence low or high control modes are suitable.

Thus for firms that have unstructured, ill understood, complex, products and have the objective of establishing a long-term presence in the target market, high control modes of entry are most suitable. However, as the firm moves down the learning curve by developing and codifying solutions that are applied to the subsequent transfer of this technology, the demand on control relaxes. Then, with a short-term objective, low control entry modes are a better fit.

For products highly customized to the user companies tend to give more importance to a long-term perspective. The firm's willingness to adapt and customize the product to the local users in a target country and a long-term objective of establishing a presence in the target market go hand in hand.

Customized products demand considerable local knowledge. On the surface, this presents no difficulty, because the entrant can contract with a local independent entity that has that knowledge. But the very nature of customization dictates that the entrant work actively with the local entity to tailor the product to the user. Accordingly, working relationships must be developed between personnel from each company. These working relationships constitute an asset specific to the contractor-contractee transaction. There is a strong reliance of decision-makers on such relationships when assessing other foreign opportunities, which underscores their importance. As these relationships exist only with the current contractee, the entrant is locked in. Team effects are created, and control is needed to preserve them. Thus, for customized products and a long-term objective, high control modes are crucial for success in a target market.

Alternatively, for standardized products, the above situation does not exist. Entrants are free to use entry modes offering any level of control that may be compatible with the company objective and other pertinent factors.

When a product class is immature it has high proprietary content which gives rise to the earlier mentioned valuation and transmission problems. Technological and market knowledge of a new product class is not yet common. Hence, only the

innovator's personnel know the product and its markets. To avoid becoming locked in to outsiders who acquire that knowledge, control is required. Thus, newer technology should be handled by wholly owned subsidiaries. At the same time for immature product classes, it is also easier to acquire higher levels of control. As the product is difficult to duplicate, host governments and local partners can be coerced into granting more ownership and control. Of course, this advantage diminishes as the product matures, creating pressure to relinquish some of the control.

As the innovation diffuses, specialized knowledge comes into the open market. Over time transaction-specific assets associated with an innovation become general purpose assets associated with a well-established product. As the diffusion occurs firms should use less integration, as less administrative control is needed. Hence, mature products should be licensed or some other low or medium control mode should be used.

### **Rule Set 3: Target Market Environment**

The economic, legal, cultural, and technological environment of the host country can also have a significant affect on the selection of feasible entry modes.

If the environment in the target market is attractive (i.e., the market has a stable and favorable economic, legal, and political environment, and is culturally similar to the home country and technologically strong) then the firm can use entry modes offering either a high, medium, or low level of control with any of the objectives of the company. In other words an attractive environment imposes no restrictions on the entry-mode selection.

However, if the market environment is unattractive (e.g. political instability, economic fluctuations, currency changes) then different levels of control may be appropriate based on the company objectives.

If a firm is pursuing primarily the objective of profitability then low to medium control modes are better suited for it. These modes allow a firm to retain flexibility, avoid resource commitment, and allow the option of changing or re-negotiating contracts with the changing circumstances. In addition, in fast changing industries technology or products may become obsolete by the time a company gets a high control administration working so it is better to license to generate return on investment before it becomes impossible to do so.

On the other hand, if the company objective is to achieve long-term effectiveness and adaptability then high control modes are justified to the extent that 1) the firm is ready to tolerate increased chances of short-term difficulty in the unfamiliar market, 2) there is a possibility that the market may improve over time, and 3) the firm's commitment of resources to the market is small enough not to put the firm's overall financial status in jeopardy in the case of complete failure.

#### **Rule Set 4 : Industry Size and Competitive Conditions**

If the target industry being entered has strong growth potential and has already attained a sufficiently large size, high control entry modes can enable the entering firm to move rapidly and take a pre-emptive position over the competition. In particular, this situation would facilitate the achievement of the strategic objectives of short-term

profitability and quick payback. A strong foreign industry would also provide a favorable condition for attaining long-term effectiveness, managing risk, and increasing adaptability, if the market is approached by way of high control entry modes and a high level of resource commitment.

In a highly competitive industry an entrant pursuing the objective of profitability must opt for a low control mode. When the aim is profitability the main competitive weapon on which the entrant must rely is low price resulting from low production and distribution costs. However, penetration of a foreign market where strong competitors already occupy entrenched positions can be very difficult and costly for the entrant aiming at reaping short-term profits. This is due to the inherent difficulty of maintaining a low price in such a situation. In this case efficient utilization of independent international intermediaries helps avoid price wars, while still taking advantage of attractive foreign market conditions. Therefore, if a foreign market is highly competitive, an entrant pursuing the strategic objective of efficiency should use low control entry modes.

However, given the highly competitive nature of the target industry, if the focus is on a long-term objective such as increasing market share, sales growth, customer satisfaction, and situational adaptability through product differentiation and innovation, then competition based on quality, improved service, and adaptation to foreign tastes is imperative. This needs strong technical and managerial guidance from the parent company, hence a high level of control.

If the target market has a large foreign business community then irrespective of company objectives, a lower level of control is easy to attain although situations may even make higher control modes easily attainable. Foreign businesses arouse international awareness and multinational management skills become widely available. Consequently, management of the foreign entity can possibly be contracted out to a pool of knowledgeable personnel who are not necessarily employees and who can be controlled by the threat of replacement.

### **Interactions Between Various Rules**

Although the four rule sets detailed above addressed the four major classes of factors that may affect the entry-mode decision, interactions between these rule sets do in fact exist and are an integral part of the decision in the real-world. However, enumerating these interactions is not possible due to the sheer number that may be possible. Of course, that is not to say that the decision maker ignore these interactions. Depending on the specific conditions, the decision maker must be able to recognize and consider them. As an aid to this, some of the important interactions are presented below.

If the foreign market environment is attractive, the industry being entered is attractive and competitive, the products are ill-understood by foreign consumers or are in the early stages of their life cycle or are proprietary, and the entrant is internationally experienced, the entrant pursuing long-term effectiveness and adaptability should use high control modes.

If the foreign environment is less attractive, the industry is unfavorable, less competitive, and the entrant is internationally inexperienced, then the entrant should use low control entry modes for short or long-term strategic objectives.

If the environment is less attractive, the market being entered is competitive, and the products are in the mature stage, are easy to use and familiar to the foreign consumer, and require little service, then the entrant pursuing short-term profitability is better off using low control entry modes.

On the other hand, the situation may be viewed differently if transaction-specific assets are present. Transaction-specific assets are investments, physical or human, that are specialized to one or a few users or uses. Specifically, if a volatile environment is coupled with transaction-specific assets then the primary advantage of flexibility, as discussed above, is lost due to these assets. In addition, the volatile environment serves to magnify the impact of each source of transaction-specific assets. Problems of managing irreplaceable agents is also magnified as the changing environment presents ample opportunity for agents to shirk and to re negotiate to their advantage. In such situations, since flexibility has been compromised anyway, high control modes are made more desirable.

### **PART 3: Selecting the Optimal Mode of Entry**

The third and the final part of the decision framework focuses on selecting an optimal entry-mode for a target market. Once the company objectives and other pertinent factors have been accounted for and a suitable set of entry modes has been

determined by the firm, it must be able to analyze the entry modes further to determine the optimal mode for the given set of circumstances. Such an analysis must involve a systematic comparison of the feasible entry modes because they are all possible ways to penetrate the target market within the constraints placed by the contextual factors and company objectives. Quantitative techniques must be employed for these comparative evaluations of feasible entry modes.

This part of the framework is derived from the model proposed by Root. Unfortunately, little input for this part of the decision framework could be obtained from the companies interviewed because they were reluctant to discuss any quantitative means or figures. What did unfold from the interviews was that most companies did in fact perform such an analysis in the final stages of their decision-making procedure, lending credibility to the basic structure of the final framework developed in this research.

The framework proposes that the suitable entry modes should first be compared along three dimensions. These dimensions are: 1) profit contribution, 2) exposure to risk, and 3) contribution to non-profit objectives. The results obtained on these three dimension should then be collectively considered to make an overall comparative assessment of these modes. The entry-mode which ranks highest overall in this assessment can be considered optimal for the firm for the given target market. This entire process is explained in detail in the following sections.

## **Comparative Profit Contribution Analysis**

This analysis calls for a comparison of the feasible entry modes in terms of their profit contributions. The profit contribution of an entry-mode is the net revenue it will earn for a company over the strategic planning period. The profit contribution calculation can be done in three steps.

- 1) Estimate all revenues that would be received by the company over its planning horizon-directly or indirectly, from the use of each feasible entry-mode. Perform the same estimation for all operating and startup costs, where startup costs include costs incurred to enter new markets such as learning about the new environment, hiring personnel with new skills, negotiating with foreign businessmen and government personnel, marketing research, development of distribution channels, etc.
- 2) Calculate the net profit contributions of the feasible entry modes for each year using projections from the first step. Adjust the expected profit contributions for the time value of money by calculating their net present values.
- 3) Rank-order the feasible entry modes by the size of their net present values.

The entry-mode which ranks highest is the optimal mode, provided only profit contribution is considered important. However, exposure to risk caused by using an entry-mode is also an important consideration. The suitable entry modes need to be compared along this criteria as well.

## **Comparative Risk Analysis**

This analysis involves adjustment of expected cash flows associated with each of the feasible entry modes for political risk. Political risk is created by the international firms' uncertainty over the continuation of present political conditions and government policies in the foreign country that are critical to the success of a selected entry strategy. Conventionally, political risks are distinguished from market risk which derive from uncertainty about future changes in cost, demand, and competition in the market place. However, so pervasive is the role of government today that conventional market risks are often more the consequence of political than economic forces. Given this interdependence between political and market phenomena, the analysis addresses only political risks to avoid unnecessary complexity. Decision makers may however, distinguish between political and market risk and address them separately.

Since the focus is on political risks, a more elaborate discussion of these risks is warranted. There can be four kinds of political risk--general instability risk, ownership/control risk, operation risk, and transfer risk. These are explained below.

**General Instability Risk:** This arises from uncertainty about the future viability of the host country's political system. It may not always cause abandonment of an investment project, but it will almost certainly interrupt operations and lower profitability.

**Ownership/Control Risk:** It proceeds from the management's uncertainty about host government actions that would destroy or limit the investors ownership or effective control of his affiliate in the host country.

**Operation Risk:** This type of risk arises from uncertainties about policies that would constrain the investors' operations in the host country.

**Transfer Risk:** This arises from uncertainties about future government act that would restrict ability to transfer payments or capital out of the host country, i.e., risk of inconvertibility of the host country's currency. A second type of transfer risk is depreciation of the host country currency relative to the home country currency of the investor.

The expected cash flows with each of the feasible entry modes needs to be adjusted for each of these political risks. Conceptually, this approach requires assessing the sensitivity of each entry-mode's associated cash flows to possible political events or situations in the host country. Decision makers can estimate the probability of a specific political event for each year of the planning period, and then for each entry-mode weigh the periods cash flow by these probabilities to get their risk adjusted expected values. To improve probability judgments managers could use decision trees, Bayesian analysis, computer simulation, etc. The mathematical depiction of such an analysis can be quite complex, and is beyond the scope of this research.

Once the risk adjusted cash flows for each entry-mode have been calculated for each year/period, they should be adjusted for the time value of money by calculating their net present values. The entry modes can then be rank-ordered by the size of their net present values. Such a ranking would identify the entry-mode which allows for the highest risk adjusted profit contribution. However, there is yet another dimension which

needs to be considered to identify the optimal entry-mode for a firm in a given target market. This being the non-profit objectives of a firm. This is addressed in the following section.

### **Comparative Analysis for Nonprofit Objectives**

Decision makers also needs to analyze entry modes in terms of non-profit objectives. Non-profit objectives vary from company to company. They could include target for sales volume, growth, and market share, control, reversibility (the degree to which an entry-mode can be undone if a mistake is made), establishment of a reputation, and so on. Decision makers should be clear about their non-profit objectives and the importance of those objectives to the company. The entry modes have to be analyzed and rank-ordered in terms of these objectives.

One approach to do such an analysis is by using a compensatory decision rule. This rule states that the entry-mode which rates highest on the sum of the decision maker's judgment of the relevant non-profit objectives is the best. This can be illustrated as:

$$\sum_{i=1}^n R_e = W_i E_{ie}$$

where

$R_e$  = Overall rating of entry-mode  $E$

$W_i$  = Importance or weight attached to non-profit objective  $i$

$E_{ie}$  = Evaluation of entry-mode  $e$  on the non-profit objective  $i$

$n$  = Number of non-profit objectives considered relevant

The entry-mode which has the highest rating is the most suitable if only the non-profit objectives are considered. In reality however, a firm seeks an entry-mode which best satisfies not only its non-profit objectives, but also its profitability objectives. Identification of such an entry-mode is discussed in the next section.

### **Ranking by Overall Comparative Assessment**

In the final comparison stage the results of the analysis of profit contribution, risk, and non-profit objectives should be analyzed together and an overall comparative assessment of the feasible entry modes need to be performed. There can be no objective procedure to capture the three analyses in a single number. Therefore a company must use its own subjective judgment in making an overall assessment of the entry modes.

For one reason or another, managers may fail to carry out the quantitative analysis to the degree suggested in this part of the model. But, even so, the approach presented here should help them in making better entry decisions. Its key advantage is the forcing of a comparison of feasible entry modes so that decision makers do not accept a workable mode when a better mode is available. A crude use of this approach will still encourage managers to raise the necessary questions about entry modes, and thereby will guide them in the direction of the right entry-mode for a target market.

## Summary

This chapter presented the final framework developed as part of this research for the purpose of making more structured and informed entry-mode decisions. The framework retained a substantial part of the theoretical structure that was developed as a foundation in Chapter 3. However, the final framework also incorporates knowledge derived from the real-world. This knowledge was used to develop complete parts of the final framework as well as modify or validate the other parts that were developed theoretically. The framework doesn't provide a rigid system that a company must necessarily follow to make such decisions. A rigid system cannot be developed for a decision so diverse and complex. The framework is simply a set of guidelines that are meant to enable a more informed, and structured decision.

# Chapter 6: Conclusions and Recommendations

## Conclusions

The decision framework developed as a result of this research effort is admittedly simplistic. Yet, it satisfies the objectives of the research. The framework provides a first step towards the development of a comprehensive model for aiding the internationalization process of companies. It focuses on a vital aspect of this process, that of selecting an optimal entry-mode for a foreign target market. It takes managers away from the common practice of using a simplistic approach to entering foreign markets, whereby managers use a workable entry-mode rather than search for an optimal entry-mode. The framework provides managers with a step-by-step logical approach for selecting optimal entry modes for target markets.

The decision framework developed first stresses the necessity for managers to have a sound background knowledge of all the entry-mode options possible and the various factors and their impact on the entry-mode choice. The model then focuses attention on a specific target market and recommends the elimination of those entry modes which can be considered completely infeasible due to one or more immediately apparent inhibiting factors prevalent in the decision environment. This elimination process yields a feasible set of entry modes for a target market. Next, the feasible set of entry modes is further narrowed down, by the joint consideration of the company objectives and the pertinent external and internal factors for a target market, to yield an

objective-concordant and factors-concordant set of entry modes. The entry modes in this set are then subjected to comparative analysis to identify the most optimal mode for the given target market.

The model developed is robust and useful, in as much as it incorporates sound theoretical concepts as well as practical concepts from industry. However, the model is not a panacea and enhancements to the model are possible and even desirable. There are many avenues for furthering the scope of this model or to develop newer, more sophisticated models. This model does provide a strong starting point for the development of enhanced and more complex and more significant decision frameworks. From this perspective, some recommendations for future research and development are discussed in the following section.

## **Recommendations for Further Research**

As has been discussed above, the model developed serves to satisfy the need for a decision framework to aid managers in the selection of an appropriate entry-mode for a target market. However, it is only one step in the right direction, but one that opens many promising possibilities for further research. Two areas for future research which come to mind are - 1) further development of the current framework to make it more sophisticated and significant, and 2) development of a similar framework for handling the entire process of internationalization. These two areas are discussed below.

## **Overall Development in the Model**

The model in its current form is somewhat simplistic based upon some of its assumptions. Future research should consider a more complex development of the overall structure of the model. Some suggestions are presented below.

One assumption made in the development of this model was that a international firm is a new entrant to the target market under consideration. That is, the firm is not already present in the target market but, is planning to enter that market for the first time. As a result of this assumption, costs of switching from one mode of operation to another was not given consideration. It would serve to enhance the significance of the model greatly, if such a switching cost could be considered as a factor and its impact on the entry-mode decision could be studied.

Another simplifying assumption made was that a firm is involved with and committing resources to only the target country in question and consequently no division of resources among different target countries is involved. As a result of this assumption the extremely complicated and involved task of analyzing several target markets simultaneously when deciding on an entry-mode for one target market was avoided. In the real-world environment, however, a target market is not independent of other target markets. Joint consideration of all the target markets for a firm would result in a far more realistic model. The complexity of the model would increase tremendously by the inclusion of such joint considerations, but it would serve to enhance the significance of the model.

Another limitation of the model is its static nature. The model implicitly assumes that a firm will restrict itself to the mode of operation it selects for a target market at a given point of time. In reality, however, the process is dynamic. A firm is (or should be) continuously adapting and changing in response to the changes in the environment. The model can be made more sophisticated if it could cater to the dynamic environment. A model which not only guides a manager in selecting an entry-mode in a given situation, but also provides for reevaluation of the suitability of the entry-mode by continuously monitoring the environment, can be very promising.

The sample of firms interviewed also present a limitation. First, the sample size of six is admittedly small. Next, the sample consisted mainly of large-size firms. Hence, the model may not be very sensitive to the needs of smaller firms. One avenue for future research may be to test this model on firms of all sizes and if needed to enhance it to meet the needs of different size firms.

### **Developing a Global Decision Framework for Internationalization.**

The model developed as part of this research limits itself to addressing only the entry-mode decision. This decision however, is only a small part of the internationalization process of the firm. Managers of firms operating in the international arena need to make several crucial decisions. These include selection of the target market, timing of the market entry, market expansion, performance evaluation, etc. A comprehensive framework which can incorporate guidelines to aid managers in making the correct decision in all these areas would be very desirable. Such a model providing a decision framework for the entire process of internationalization can be a big asset for

managers. The model developed as part of this research can serve as a starting point for the development of such a system.

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