

GREENFIELD VS ACQUISITIONS: DETERMINANTS OF CHOICE IN EMERGING ECONOMIES

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ABSTRACT

This paper aims at finding the determinants of entry mode choices for MNCs that enter emerging economy nations as wholly owned subsidiaries. Existing literature suggests that this area of international business literature is relatively understudied and reasons for conducting more research exist. In this paper, I test three hypotheses using a logistic regression model. More specifically, this paper looks at the role of contributed assets; and organizational learning and experience in determining the choice between greenfield entry and acquisitions. The results suggest that host country experience and past entry experience has an impact on the current entry mode choice.

Key words: Entry Mode, Acquisitions, Greenfield, Emerging economy, MNC

I. INTRODUCTION

Generally most firms start as purely domestic companies. However, after operating as domestic companies for some period, firms may decide to go international. Typically firms start exporting to a country via an agent, later establish a sales subsidiary and eventually begin production in the host country (Johanson and Vahlne, 1977). The findings from the monopolistic advantage theory (Hymer, 1960) and the internationalization theory (Buckley and Casson, 1976) suggests that firms get motivated to go abroad with the hope of generating higher rents from the utilization of firm specific assets which cannot be replicated by other firms; and to create their own supply, production, or distribution streams when external markets for supplies, production, or distribution fails to provide efficiency. Firms become multinational through foreign direct investment (Chang, 1995). These investments can take various forms depending on the level of control an MNC wants to exercise over its international operations (Anderson and Gatignon, 1986). The entry modes may be equity-based (e.g. acquisition) or non-equity-based (e.g. licensing). From the view point of internationalization theory, MNEs are hierarchical response to imperfections in international market and when these imperfections are significant, it may be more beneficial for companies to establish a wholly owned subsidiary instead of entering into

arms-length transactions. In the absence of market imperfections, a firm would always choose licensing over wholly owned subsidiary as an option (Hill and Kim, 1988). Emerging market nations are rife with market imperfections. This makes the possibility of entering via an equity mode a feasible choice. The three kinds of equity-based entry modes pursued by the MNCs include joint ventures, acquisitions, and greenfield investments. Of these three modes, joint venture offers less control and acquisition and greenfield investments offer more control. However this higher level of control means more risk in the form of higher level of resource commitments as well. In addition, a direct entry is typically more risky as it offers no guarantee of achieving an ongoing business of the required size or level of profitability (Yip, 1982).

The focus of internationalization is shifting towards the emerging economies as developed markets are becoming saturated and MNCs have turned to emerging markets for future growth (London and Hart, 2004). As defined by Hoskisson et al (2000) - "emerging economies are low-income, rapid-growth countries using economic liberalization as their primary engine of growth". Specific research into emerging markets is necessary because most of the works in international business research were conducted keeping the developed markets in mind. The unique characteristics of emerging

economies may prove many of the findings in such settings invalid in an emerging economy setting. The past studies were very much concerned with MNCs entering the developed market such as the US or Western European countries. However, there were reasons why studies on emerging market were not common in the past. The inappropriateness of theories developed based on developed economies, sampling and data collection problems and lack of homogeneity in emerging economies generally made it difficult for researchers to conduct study on emerging economies (Hoskisson *et al.*, 2000). Emerging economies pose greater theoretical and practical challenges than developing markets since the rapid changes they undergo heighten uncertainty (Luo *et al.*, 2001). One reason behind this is the fact that in such economies stable institutions have not been fully developed, while the old order is being eroded at the same time (Choi *et al.*, 1999). Also, unlike many developed markets, the policy that the state formulates has a very significant effect on access to resources in an emerging economy (Haggard, 1990). However, the importance of international business research keeping the emerging economy context in mind is becoming increasingly important as the emerging economies are assuming more and more prominent position in the world economy (Wright *et al.*, 2005). The total capital flows to developing economies have increased from \$104 billion in 1980 to \$472 billion in 2005. (*source: Federal reserve Bank of Dallas*). These economies have become lucrative destinations for MNCs because of the recent reforms and economic developments taking place in those countries (Cui and Lui, 2005). So, there is definitely a requirement to move on with research that is specifically focused on MNCs' operations in the emerging economies.

As argued by Wright *et al.* (2005), there is a need to consider the extent to which theories and methodologies used to study strategy in mature, developed economies are suited to the unique social, political, and economic contexts as well as firm characteristics of emerging economies. The paper is motivated from this argument and aims to look at one important area in the international business literature in an emerging economy context, the entry mode choice of the MNCs. Entry mode selection is a very important decision as it involves varied level of resource commitments and often it is difficult to change a firms' initial particular choices of modes without considerable loss of time and money (Agarwal and Ramaswamy, 1992). The

choice of mode of entry has an influence on the foreign affiliate's likelihood of success and possibility of survival; and thus is a critical determinant of the ultimate success of the foreign operation (Stopford and Wells 1972; Li, 1995; Root, 1987; Davidson, 1982; Killing, 1982). In this study, I have decided to confine my focus to one specific choice of entry mode, greenfield versus acquisition, a relatively understudied area in entry mode literature. The specific research question that I would like to try to find an answer for is - "What are some of the factors that determine the choice between an acquisition and a greenfield start-up while MNCs enter emerging economy markets?"

II. LITERATURE REVIEW

Although some studies have been conducted on entry mode choice of MNCs in the emerging economies, a very limited number of them (e.g. Kogut and Singh, 1988; Hennart and Park, 1993; Brouthers and Brouthers, 2000) have specifically looked at the choice between greenfield start-ups and acquisitions. Yip (1982) was one of the pioneers in research in this area. In his study of the entry outcome of 59 entrants in 31 markets, he found that higher barriers to entry enhanced the possibility of acquisition whereas greater relatedness enhanced the possibility of direct entry. However, the setting of his study was not international in nature. Kogut and Singh (1988) conducted a study on international entries looking at entry via joint ventures, greenfield investments and acquisitions. Their sample included all foreign direct investments made in the US from 1981 to 1985. The authors found that both cultural distance and uncertainty avoidance tendency of the investing firms had influence on the choice of entry mode for investing firms. Hennart and Park (1993), looking at Japanese entry into the United States, found that the mode of entry chosen by Japanese investors were driven by firm strategic and target market characteristics. Brouthers and Brouthers (2000) in their study of Japanese firms entering Western Europe found that organizations with strong intangible capabilities such as technology and international operations might be able to more readily leverage these capabilities through greenfield start-ups. Zejan (1990), in his study of Swedish multinational firms, found that the degree of industrial diversification of the parent company and host country's per capita income positively influences acquisition decision compared to starting a totally new venture, while the rate of

growth of industrial production in the industry entered seemed to have a negative effect.

However, none of the above mentioned studies looked specifically at an emerging market scenario. The emerging market scenario was covered in broader studies that looked at the choice between joint ventures and wholly owned subsidiaries (e.g. Pan and Chi, 1999; Pan and Tse, 2000; Meyer and Nguyen, 2005), not the choice within wholly owned subsidiaries. The study by Cheng (2006) is the closest one on this issue as it looked specifically at the choice between greenfield and acquisition from an emerging economy perspective. This study was conducted over regions around the globe and in doing so covered some emerging economy nations. Although he compared three modes (including brownfield) instead of two, his findings did suggest something on the determinants of acquisition and greenfield investments. Still, the setting of the study was quite different from a setting that looks specifically at entry mode choices of MNCs entering emerging economies. The incorporation of data from developed markets such as Japan, EU and NAFTA (two of the three NAFTA member countries are considered developed nations) has surely diluted the results and needs refinement if it is to remain useful in the specific scenario that my research is aiming to look at.

So, there is a research gap here. Filling this gap is important for a number of reasons. First, the decision to enter as a wholly owned subsidiary is a very important one as it requires significant amount of resource commitment from the part of the MNCs. So choosing the correct entry mode is very critical. Second, the number of such investments is on the rise in the emerging economies. For example, the number of M&As in South-east Asia rose from only 2 deals in 1987 to 179 deals in 2000, and 339 deals in 2006. The value of cross-border M&A sales by developing economies increased from only 643 million USD in 1987 to USD 127 billion in 2006. (Source: www.unctad.org). So, there is a clear trend that more and more MNCs are interested to operate as wholly owned subsidiaries in the developing and emerging economies. There is no doubt that looking at the reasons behind the choice between the modes of entry under a wholly owned subsidiary scenario merits attention and that is exactly what this paper aims to do.

III. HYPOTHESES DEVELOPMENT

III.1 Contributed Assets

A firm would always like to make sure that it gets good value for the investment it has made over the years in building up its expertise. Two such areas are expertise in R&D and expertise in advertising. The previous studies on greenfield versus acquisition were more or less unanimous on the role R&D investment plays in the choice between these two modes of entry. However, the findings on advertising were inconclusive. Considering the emerging economy context is very different compared to the US or European Markets where the earlier studies were situated, it is worth testing the effect of advertising intensity on the choice of the preferred entry mode. High level of advertisement on a continual basis can mean significant investment from the part of the foreign company. While entering a market, the firm would like to make sure that this investment made is not wasted and results in proper outcome. Although, through acquisition, foreign entrants can acquire local brand names and combine them with their firm-specific marketing skills (Hennart and Park, 1993), acquisition also reduces the possibility of gain from proprietary knowledge and increases the risk of dissemination of this knowledge (Brouthers and Brouthers, 2000). A company that spends heavily on advertising is also better prepared to make the consumers aware of their brand in the new market. Thus high advertising intensity is likely to encourage direct entry regardless of the scale of the operation at the host country, advertising campaigns can be mounted quickly (Yip, 1982).

H1: More advertising intensity of the parent firm will lead to a lower probability of entering via acquisition.

III.2 Host Country Experience

The benefit of entering via acquisition is likely to be more when an MNC enters a host country for the first time. Greenfield ventures might require assets to be acquired from the local markets, and the availability of resources in the local markets can not be taken for granted in the host economy. The case is more likely to be true in an emerging economy setting as the market is often underdeveloped and efficient flow of resources may be absent. This may result in investors

choosing acquisitions instead of a greenfield investment as their preferred entry mode (Meyer and Estrin, 2001). There is also a potential for increase in competitive pressure as a greenfield investment adds new capacity and a new competitor (Hennart, 1991). This view was also supported by Meyer (2004). An early entrant would try to avoid such a situation as it might create fierce response from the already existing players in the market, and in some cases might result in conflict of interest with the host government as they are likely to be under pressure from the incumbent firms to maintain a viable level of competitiveness in the respective business sectors. In addition, through acquisition, an inexperienced investor can get access to local managers who know how to operate in the host country and possess valuable information (Hennart and Park, 1993).

However, this benefit of entering via acquisition reduces as the MNC operates in the host country over a period of time and learning takes place. The learning allows the MNC to find feasible ways to acquire the resources necessary to start a greenfield venture. An experienced MNC is also likely to be more confident of fending off any problems that may rise due to the reaction of existing companies as a result of the MNC opting for a greenfield investment mode of entry. The support for this argument can be found in the work of Dubin (1975) who found that the tendency to acquire fell as the firm acquired more foreign experience.

H2: The more experience a parent firm has of operating in the host country, the lesser the probability that the firm would enter through acquisition.

III.3 Past Entry Experience

Every organization constitutes a bundle of knowledge (Gupta and Govindarajan, 2000). This knowledge may constitute, among others, learning from past acquisition experiences, experience of operating as a multinational company, and experience of operating in emerging economies. These sorts of organizational learning may give more confidence to a firm regarding its competence in operating under certain environment and may influence the decision of entry mode. Organizations may be seen as learning by encoding inferences from history into routines that guide behavior and amongst these routines we may find forms, rules, procedures, conventions, strategies,

and technologies around which organizations are constructed and through which they operate. Generally, the frequently used routines are more easily evoked than those that have been used infrequently (Levitt and March, 1988). So, it is quite probable that a firm that has prior experience of entry through acquisition in an emerging economy nation would feel more comfortable with this mode of entry compared to a greenfield investment in a similar context. This leads to my final hypothesis -

H3: The probability of entering via acquisition will be higher if the MNC has past acquisition experiences in emerging economy nations.

IV. METHODOLOGY

IV.1 Sample

The study looked at entry mode determinants specifically for MNCs entering emerging economy countries. If we look at the previous studies on mode of entry into emerging economies, the data collected were almost always based on one specific country. In my study, this was extended by incorporating a number of countries. I hope that it would enhance the generalizability of the research findings. As the emerging economy nations from different regions are quite different from each other, I decided to use one specific region from where to pick the countries. So I looked at Japanese investments in four countries located in South-East Asia – Indonesia, Malaysia, Taiwan and Thailand.

The data was collected from Richard Ivey Business School's database of Japanese foreign direct investment¹. This database is based on materials published in Toyo Keizai's annual directory of information on the foreign subsidiaries of Japanese firms. The initial finding showed a total of 1,155 entries (acquisition and greenfield) made by the Japanese firms in the four countries mentioned above. The time period was between 1964 and 2000. However, more than 30% of these entries were made by private limited companies. Since the database only had data for publicly listed companies, those entries had to be omitted from the final list. After taking care of the missing variables, the final sample included 538 entries with almost

¹ I am grateful to Professor Andrew Delios for providing me with the access to this database.

one-fifth of them being acquisition entries. Details of the sample are provided in Table 1.

Table 1: The sample

Country	Greenfield	Acquisition
Taiwan	144	37
Thailand	96	22
Malaysia	150	25
Indonesia	51	13
TOTAL (538)	441	97

IV.2 Variables and Measures

Dependent variable. For this paper, the entry mode choice was the only dependent variable. It was assigned 1 when the entry was by acquisition and 0 when the entry was made as a greenfield investment.

Independent variables. Advertising intensity, host country experience, and acquisition experience in emerging economies were the key independent variables. The advertising intensity (*adint*) of the firm was calculated by using the ratio of firm-level expenditures on advertising to total sales. The five-year average advertising intensity was used for this study. The host country experience (*exp*) was calculated from the year the MNC started its first affiliate of any kind in the host country to the date of the entry of the specific affiliate in consideration. Acquisition experience in emerging economies (*acq_en*) was measured looking at previous acquisition entries of the parent firm in other emerging economies. If the MNC had previous acquisition experience in the emerging economy markets at the time of entry, it was assigned 1. Otherwise it was assigned 0.

Control variables. A number of control variables were used. Parent company size (*psize*) was measured by the number of total employees the parent firm had. Parent Company age (*page*) was measured by the number of years the parent firm was in operation during the time of entry. Parent Company Performance was controlled using Return on Asset (ROA) of the parent firm as a variable (*pperf*). ROA is a standard measure of operating performance in organizational research (Baliga *et al.*, 1996). Previous studies (Hennart and Park, 1993; Brouthers and Brouthers, 2000) have found that R&D intensity has impact on the choice between greenfield and acquisition. So, I decided

to control for this item. This variable (*rdint*) was measured as the ratio of firm-level expenditures on R&D to total sales. A five year average R&D intensity measure was used for this purpose. Firms in a particular industry may have their own unique preference regarding the choice of entry modes. This was controlled by creating four broad industry variables – agriculture, forestry, and fishing (*agr*); manufacturing (*mfg*); services (*ser*); and wholesale trade (*wst*). Previous studies have indicated that cultural distance may impact the choice of entry mode. So I controlled for this impact by creating an index using the formula introduced by Kogut and Singh (1988). The raw data was collected from the website of Geert Hofstede (www.geert-hofstede.com). Then the index (*cultdist*) was manually calculated using the following formula –

$$CD_j = \sum_{i=1}^4 \{(I_{ij} - I_{ij})^2 / V_i\} / 4$$

Here I_{ij} represents the index for the i th cultural dimension and j th country, V_i represents the variance of the index of the i th dimension, J indicates Japan, and CD_j is the cultural difference of the j th country from Japan.

IV.3 Estimation Methods

For testing the hypotheses, a binomial logistic regression model was used. The logistic regression method is designed to estimate the probability of occurrence of a given event considering the values of a set of quantitative and/or qualitative descriptive variables x_j (Menard, 2001). This method is widely used as it is seen as the appropriate method while working with a dichotomous dependent variable (Reddick, 2007).

V. RESULTS AND DISCUSSION

The correlation table (See Table 2) of the independent variables suggested that the correlations present among the independent variables were largely acceptable. Only two of the industry variables, wholesale trade and manufacturing were found to be strongly negatively correlated with each other. For the logistic regression part (See table 3), I constructed three models. The first model incorporated all the control variables except the industry variables. In the second model I added the independent variables and in the third model I added the industry variables. Model 1 shows that parent size has a

significant impact on the choice of entry mode. Larger parent organizations tend to prefer acquisition more than greenfield entries. This may be due to the fact that larger organizations are generally more experienced in dealing with complex operations and thus might find handling acquisitions comparatively easier. The model also shows that R&D intensity is negatively correlated with acquisition choice. This is in line with previous studies that found similar impact of R&D on entry mode choice between acquisition and Greenfield. The cultural distance was also found to

have a significant impact on the entry mode choice and had a negative impact on the possibility of entering via acquisition. This is not unnatural as acquisition often involves adjustments between the parent firm and host firm. A high level of cultural distance may make this task difficult and may sway the choice in favor of a greenfield mode of entry. The other two variables, parent age and parent performance, did not have any significant effect. The results found in model 1 were consistent in model 2 and model 3.

Table 2: Correlations between the independent variables

	adint	Exp	acq_en	psize	page	pperf	rdint	culdist	mfg	agr	ser	wst
adint	1.000											
exp	-0.052	1.000										
acq_en	-0.094	0.237	1.000									
psize	-0.048	0.325	0.165	1.000								
page	-0.091	0.183	0.088	0.137	1.000							
pperf	0.217	0.125	0.059	0.041	0.213	1.000						
rdint	0.115	0.176	0.028	0.418	0.093	0.060	1.000					
culdist	-0.010	0.035	0.054	0.133	0.069	-0.115	0.155	1.000				
mfg	0.102	-0.060	0.070	-0.0004	0.012	0.064	-0.015	0.119	1.000			
agr	-0.067	-0.067	-0.032	-0.048	-0.008	-0.020	-0.114	0.041	-0.256	1.000		
ser	-0.048	0.037	-0.077	0.023	0.005	-0.015	0.111	0.047	-0.297	-0.040	1.000	
wst	-0.060	0.075	-0.027	0.009	-0.012	-0.053	0.010	-0.166	-0.832	0.113	-0.131	1.000

Table 3: Logistic Regression models

Variables	Coefficients		
	Model 1	Model 2	Model 3
intercept	-0.62	-0.51	-0.64
Advertising intensity		-8.78	-9.74
Host country experience		-0.0275*	-0.0235
Acquisition experience in emerging nations		1.0471***	1.0036***
Parent size	0.00003***	0.00003***	0.00003***
Parent age	0.0022	0.0019	0.0016
Parent performance	-1.1346	-0.5051	-1.8356
R&D intensity	-24.85***	-22.53***	-23.30***
Cultural distance	-0.2620*	-0.3050*	-0.4452***
Manufacturing			0.94
Agriculture			0.81
Whole Sale Trade			-0.31
Chi-square	21.99***	39.97***	57.38***

*** p<0.01; ** p<0.05; * p<0.1

Positive signs indicate a higher likelihood of acquisitions; negative signs indicate a lower likelihood of acquisitions.

Model 2 incorporated the independent variables. The advertising intensity had the predicted sign but was not found to be significant. Thus in line with previous studies conducted on the developed markets, this factor proved to be not important while choosing between Greenfield and acquisition. So Hypothesis one was not supported. However, support was found for the other two hypotheses. The experience factor did seem to play a role in the choice of mode of entry in case of wholly owned subsidiaries. Host country experience had a negative impact on the possibility of entering via acquisition as per the prediction. This is not surprising as more experience increases the confidence of the MNCs in starting a fresh venture, from the scratch. Past acquisition experience in emerging economies was positively related with possibility of entering via acquisition. The high level of significance of this result suggests that organizational learning that takes place from previous ventures play a key role in future entry modes.

In Model 3, I incorporated the industry variables. Two noticeable changes occurred due to the incorporation of these variables. The significance level for host country experience fell slightly below the 90 percent confidence interval, weakening the support for hypothesis two. The significance level of cultural distance increased significantly, enhancing the importance of this item in the choice of entry mode for wholly owned subsidiaries. The model chi-square consistently increased as the analysis moved from Model 1 to Model 3; reinforcing the requirement of incorporating additional variables to improve the fit and predictability of the model. Overall, findings show that one of the three hypotheses tested were not supported, while one of the two hypotheses that were supported found only weak support.

VI. CONCLUSION

In this paper I aimed to test a relatively understudied phenomenon in International Business Literature. The context was purely emerging economy markets which was a first time in conducting a research in entry mode choice while entering as a wholly owned subsidiary. Although the contributed assets related outcomes did not provide anything new when compared to studies that were set on the developed market, the study did find good support for the role of host

country experience and organizational learning in the choice between greenfield and acquisition mode of entry. Many of the earlier studies also used Japanese data as their sample; and this might have played a role in the resemblance found in this research with previous researches conducted in this area. However, the role of organizational experience and learning was largely ignored in previous researches, and I believe the result from this study can open an interesting avenue for further research in this area.

Overall, I believe the current study made some important contributions to the international business literature and reinforced the need for conducting more research on the emerging economy setting. There were some limitations to this study. The data used was not very current as the latest data available was that of year 2000. Future research may incorporate more recent data to make this study a more updated one. Some of the variables could not be tested due to data limitation. Future researchers may look at those variables and may make this study more comprehensive in nature. Considering the vastness of International Business literature, this study was just a small effort to add something extra to the existing knowledge. If the findings of this study prove beneficial to future researchers in some way, I will consider this endeavor a successful one.

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