ENTRY MODE STRATEGIES OF FINNISH FIRMS ENTERING THE MALAYSIAN MARKET

By

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ABSTRAK

Pengantarabangsaan firma merupakan topik yang telah dikaji secara meluas; pilihan keputusan yang kompleks sering dihadapi oleh syarikat-syarikat dalam usaha untuk mencari peluang perniagaan baru melalui penerokaan ke pasaran asing.

Kerangkakerja yang mengandungi faktor khusus-firma, faktor khusus-pasaran dan faktor khusus-negara, diterapkan ke dalam kajian ini. Kajian ini membentuk dan menguji model yang menyelidik perhubungan di antara pembolehubah yang dikenalpasti, iaitu pengkhususan aset, pengalaman antarabangsa, risiko negara, perbezaan budaya, potensi pasaran, ketidakpastian permintaan, tahap persaingan, dan pilihan mod ‘entry’ syarikat. Kajian ini juga menguji peranan saiz firma sebagai penyederhana.

62 respon telah diperolehi daripada syarikat-syarikat Finland yang telah dikumpul melalui penyebaran soal selidik, menyumbang kepada kadar respon sebanyak 41.9%. Keputusan daripada analisis regresi mendapati bahawa firma-firma di Finland cenderung untuk memilih mod ’entry’ kawalan-tinggi untuk memasuki Malaysia apabila pengkhususan aset adalah tinggi, apabila syarikat mempunyai persepsi bahawa pontensi pasaran adalah baik dan apabila ketidakpastian permintaan di negara hos adalah rendah. Sebaliknya, risiko negara, perbezaan budaya dan tahap persaingan tidak memainkan peranan besar dalam proses pembuatan keputusan. Pada masa yang sama, saiz firma didapati menyederhana perhubungan di antara perbezaan budaya dan pilihan mod ’entry’. Saiz firma juga didapati menyederhana perhubungan di antara tahap persaingan dan pilihan mod ’entry’.

ABSTRACT

Firm's internationalization is a topic that has been widely researched; complex option decisions are faced by companies attempting to seize new business opportunities through foreign market expansion. In this study entry mode strategies are researched from the point of view of Finnish companies.

A framework consisting of firm-specific factors, country-specific factors, and market-specific factors is adapted for this study. The paper develops and tests a model that investigates the association between identified variables, i.e. asset specificity, international experience, country risk, cultural distance, market potential, demand uncertainty, competitive intensity, and the company's choice of entry mode. This paper also examines the role of firm size as a moderator.

Responses from 62 Finnish companies were collected through distribution of questionnaires, contributing to a response rate of 41.9%. The results from the regression analysis found that Finnish firms tend to adopt a higher-control entry mode to enter Malaysia when the asset specificity is high, when the firm's international experience is wide, when the company perceives the market potential good and when the demand uncertainty in the host country is low. On the other hand, country risk, cultural distance and competitive intensity do not play a major part in the decision making process. At the same time, firm size is found to moderate the relationship between cultural distance and the entry mode choice. Similarly, firm size moderates the relationship between competitive intensity and the entry mode choice.

Chapter I

INTRODUCTION

1.1 Background of the Study

Firm's internationalization is a topic that has been widely researched from the point of view of for example management, marketing and also entrepreneurship. There are many ways to approach the topic; in this thesis international business will be researched from the point of view of Finnish companies. Seeking opportunities from abroad is important for companies in Finland due to the country's relatively small domestic market size and this thesis attempts to make pursuing those opportunities easier.

According to Agarwal and Ramaswami (1992), "a firm seeking to enter a foreign market must make an important strategic decision on which entry mode to use for that market". Complex option decisions are faced by companies attempting to seize new business opportunities through foreign market expansion. The entry mode decision is important and thus complex, because wrong choices lead to lost market potential and loss of important committed resources such as management time and money (Rajan & Pangarkar, 2000). Because dramatic differences exist between the entry modes (Pan & Tse, 2000) and because different entry modes offer different benefits and risks, the company's decision on the foreign entry mode is one of the most important issues of the internationalization process.

The proposed thesis will concentrate on the factors that affect the choice of the entry mode for a Finnish company when it is targeting the Malaysian market. The current study concentrates on Malaysia, because Malaysia is thought of as competitive, not least because, according to the Finnish Embassy in Kuala Lumpur, the Malaysian economy has grown approximately 6 per cent yearly for the past five years. Furthermore, the Forbes financial magazine has ranked Malaysia as the 25th best country for business in 2009 among the 127 countries studied, up thirteen spots from the previous year. There are nearly 50 Finnish companies based in Malaysia, and many more who export to the country. As a comparison, there are 74 Finnish companies in Singapore and 45 in Thailand.

When a company is attempting to establish activities in a foreign market, it needs an entry strategy. An entry strategy is a plan for the firms internationalization, and it consists of several decisions; the choice of a target product and target market, the objectives and goals for the target market, the choice of an entry mode to penetrate the market, and the marketing plan for the target market (Root, 1994). The concentration of the thesis will be the third section: the selection of the mode of entry for a foreign operation. A foreign market entry mode is an institutional arrangement that facilitates the entry of a company's products, technology, human skills, management, or other resources into a foreign market and thus enables the company to operate in the foreign country (Root, 1994).

1.2 Purpose of the Study

In light of the previous research on the topic, the general purpose of this study is to provide an empirical investigation of the relatively untouched research area of Finnish firms' entry mode decisions for international expansion, specifically so for Malaysian market. The research will be done through hypotheses testing.

Finnish companies are rather untouched regarding research on their internationalization and the entry modes chosen. However, there is a need for such a research, because the number of Finnish firms doing business internationally is increasing. Doing business in Malaysia is increasingly more interesting and the trade between Finland and Malaysia has been on the rise as well; according to the Embassy of Finland, the trade between Malaysia and Finland has increased 10-30 percent yearly for both export and import before 2008, when the global economic slowdown hit worldwide. Therefore, detailed information on the entry decisions and options are needed.

Thus, this study will investigate findings of previous studies and explore several key determinant factors that may affect the foreign market entry choice. The right entry mode will be discovered in order for the Finnish companies to establish operations in the target market. The study will investigate how the determinants affect Finnish firms' entry mode choices when entering Malaysian market and therefore will attempt to make the managers' decision-making process easier. The research should be able to increase the understanding of the internationalization processes of Finnish firms in general.

1.3 Problem Statement

The problem statement of the thesis will be the following:

- What are the factors that affect the choice of entry mode for a Finnish firm entering the Malaysian market and how do the factors affect that choice?

1.4 Research Questions

The main problem will be approached through narrower research questions, which also determine the research's main areas of emphasis. The problem statement leads to the following research questions:

(i) What are the factors that affect the choice of the mode that the Finnish company will employ to go to the Malaysian market?

(ii) How do firm characteristics (asset specificity, international experience) influence the Finnish companies' entry mode choice?

(iii) How do country characteristics (country risk, cultural distance) influence the Finnish companies' entry mode choice?

(iv) How do market characteristics (market potential, demand uncertainty, competitive intensity) influence the Finnish companies' choice of entry mode?

(v) How does firm size moderate the relationship between asset specificity, international experience, country risk, cultural distance, market potential, demand uncertainty, competitive intensity and the entry mode choice?

1.5 Research Objectives

Besides trying to enhance previous research findings on the companies' entry mode choices, this research attempts to find the answer whether such behavior exist among the Finnish firms. Furthermore, this research will try to strengthen the findings of previous studies on whether asset specificity, international experience, country risk, cultural distance, market potential, demand uncertainty, competitive intensity, and firm size are the contributing factors affecting the entry mode choice of Finnish companies. Therefore, the research objectives are:

(i) To identify the main factors influencing Finnish firms' entry mode choice to Malaysia

(ii) To examine the relationship between firm characteristics, country characteristics, market characteristics and the choice of entry mode

(iii) To examine whether firm size moderates the relationship between asset specificity, international experience, country risk, cultural distance, market potential, demand uncertainty, competitive intensity, and the entry mode choice

Thus, by relying on previous literature and available information about the internationalization process and entry mode choices, the basic idea of the proposed study is to find out how Finnish companies choose among different entry modes and what factors affect the selection of the entry mode.

1.6 Central Concepts of the Study

To fully understand the factors affecting a firm's choice for its foreign market entry mode we have to study the internationalization process in general as well as the different entry modes chosen for this research.

1.6.1 Internationalization

There are many definitions of internationalization as a concept. Wind, Douglas and Perlmutter (1973) consider internationalization as a process in which specific orientations are associated with successive stages in the evolution of international operations. Another interpretation of internationalization that is often cited in the research literature is by Welch and Luostarinen (1988), who state that internationalization is a process in which the firm's involvement in international operations increases. A more general definition of internationalization is that it is a process with which a firm expands its conduct of business outside its domestic market.

1.6.2 Entry Mode

An entry mode means the way a firm expands into and operates in international markets. A firm has to make a choice of how and where the products meant for international markets are manufactured and how are they made available to the customer (Äijö, 2001).

Rhoades and Rechner (2001) state that entry modes are believed to vary in terms of investment required (resource commitment), control as level of ownership, and risk related to the level of resources committed and to the environment entered. The authors continue that the greater the firm's resource commitment in the international venture, the higher the resulting control over operations (Rhoades & Rechner, 2001). Control refers to the level of authority the company has over systems, methods, and decisions in the foreign operation (Ekeledo & Sivakumar, 2004). Generally, the entry mode with the highest amount of control requires the highest commitment of company resources and allows the highest return on investment (Anderson & Gatignon, 1986; Ekeledo & Sivakumar, 2004). However, greater control exposes the company to a higher level of business risk (Anderson & Gatignon, 1986), thus raising the level of risk associated with operating in a foreign environment (Rhoades & Rechner, 2001). Risks are also assumed to be higher in proportion to the responsibility for decision-making and higher resource commitment (Agarwal & Ramaswami, 1992).

Companies planning to enter foreign markets often choose from exporting, licensing or franchising, contract manufacturing, equity joint ventures, wholly owned subsidiaries, and other forms of governance for their international expansion (Gao, 2004). This study concentrates on exporting, licensing and franchising, joint ventures, and wholly-owned subsidiaries, and all these operational modes are discussed further in chapter 2.1 on page 9.

1.7 Significance of the Study

This study will provide relevant information on the Finnish firms' internationalization processes towards the Malaysian market by arguing that firm-specific factors, country-specific factors, and market-specific factors affect the entry mode decision. Based on previous studies, empirical evidence determined that asset specificity, international experience, country risk, cultural distance, market potential, demand uncertainty, and competitive intensity are the variables studied to determine the optimal entry mode decision. The current study is the first one to consider so many variables when it comes to Finnish firms' internationalization, and also the first one to study which factors affect the entry mode choices of the Finnish companies towards the Malaysian market.

This study contributes to the current body of knowledge in the area of firms' internationalization by combining variables from several theoretical frameworks, namely internationalization theory, transaction cost theory and eclectic theory, which are together assumed to be important drivers for the internationalization of firms.

Practically, this information is useful for a Finnish firm's management, since managers can better understand the importance of each variable affecting the entry mode choice. Thus, it is easier for them to evaluate different alternatives for entering the Malaysian market and thereby making their decisionmaking process easier. It also saves time and resources, because the findings will allow managers to concentrate on the most relevant variables when making the entry mode decision. The study therefore provides guidance for managerial consideration.

In addition, the research can prove useful for companies wishing to penetrate the Malaysian market, as they will have general understanding on which entry mode choice would suit them and which mode would be the best for operations in Malaysia.

1.8 Organisation of the Thesis

The proposed thesis will have five main chapters in addition to executive summary and abstracts. The chapter one, which is the introduction to the topic, will present the background of the study. The chapter introduces the purpose of the study, central concepts of the study and explains the significance of it. It also presents the research objectives and problem statement supported by research questions. Also explained is the structure of the thesis.

The second chapter of the study is the theoretical part of the thesis. The chapter reviews the literature on previous studies carried out on the subject of internationalization and entry modes. The supporting literature is evaluated to find the central concepts that are relevant to the current study. The theory of internationalization and different entry mode options will be introduced as well as factors that affect the selection of the foreign entry mode. The second chapter lays down the groundwork for the following chapters.

Chapter three will present the theoretical framework of the study. It explains the variables used and how they will be measured. The research hypotheses will be constructed and defined. The chapter also further explains the research design, basis of sampling and the method for data collection.

Chapter four will discuss the findings from the data analysis. The factors that affect the entry mode selection are evaluated from the Finnish firms' perspective. Finally, the findings are analyzed and brought into context of the study, to find the suitable entry mode for the Malaysian market and to know which factors the Finnish companies need to take into consideration when making that decision.

The fifth chapter will summarize the findings and conclude the study. The fifth chapter will also compare the findings to previous studies, discuss the limitations of the proposed research and give suggestions on future studies in the area.

Chapter II

LITERATURE REVIEW

Internationalization and export behaviour as well as the various entry modes chosen by companies have been the focus of a large amount of previous literature. Wind et al (1973) describe internationalization as a process in which specific attitudes or "orientations" are associated with successive stages in the evolution of international operations. Others have considered internationalization as a sequential process of increased international involvement and the associated changes in the organizational forms (e.g. Bilkey & Tesar, 1977; Johanson & Vahlne, 1977).

Previous research on internationalization process of companies has stressed that a foreign expansion is mostly concerned with the organization of the company's overseas operations and the various costs and benefits that the company faces with each foreign market entry mode (Pinho, 2007). Root (1994) defines an entry mode 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. The entry mode choice is an essential element in global strategy formation (Anderson & Gatignon, 1986; Hill, Hwang & Kim, 1990; Kogut & Singh, 1988), because wrong entry mode choice can lead to lost market potential and loss of committed resources such as time and money (Rajan & Pangarkar, 2000). Therefore, the entry mode should be strategically selected for the purpose of achieving organizational goals.

2.1 Modes of Foreign Market Entry

The choice of entry mode strategy is a major issue in international business, because the method a company uses to supply the market will have a major influence upon its success overseas (Wind et al, 1973). To achieve superior performance, the strategic entry mode choice should correspond to the company’s internal resources and capabilities (Root, 1994), strategic goals and objectives (Hill et al, 1990), and various external environment forces (Anderson & Gatignon, 1986; Erramilli & Rao, 1993).

There are a wide variety of international business arrangements classifying the foreign operations, and according to Gao (2004), companies planning foreign market entries can often choose from exporting, licensing or franchising, contract manufacturing, joint ventures, wholly-owned subsidiaries, and other operational forms. The most common modes for entering a foreign market are exporting, licensing, joint venture, and sole venture (Agarwal & Ramaswami, 1992). In line with the past research, entry modes can be classified into two categories of non-equity entry modes, such as exporting, licensing, and franchising, and equity entry modes, such as joint ventures and wholly-owned subsidiaries (Pan & Tse, 2000; Pinho, 2007).

It is generally acknowledged in the international business literature that as a firm moves from licensing to joint venture to wholly-owned subsidiary, control, investment, and risk all increase accordingly (Agarwal & Ramaswami, 1992; Root, 1994). When a company is thinking of different market entry alternatives, a central consideration is the level of control it will have over the foreign operation (Taylor, Zou & Osland, 2000). Control has been defined by Anderson and Gatignon (1986: 3) as “the ability to influence systems, methods, and decisions” and by Hill et al (1990: 118) as “authority over operational and strategic decision-making”. Each entry mode is thus consistent with different level of control and is often categorized according to the amount of control it gives the company. Therefore, a company’s management has to balance the control it wants over the foreign operation with the resources it is willing to invest to achieve that control (Aulakh & Kotabe, 1997).

The chosen entry mode has a major impact on the level of control the company has over the foreign venture (Taylor et al, 2000), because the level of resource commitment of the firm is related to the amount of control the firm enjoys over the foreign operation. Because the level of equity share determines the degree of control the company has over its foreign operations, exporting and contractual agreements are frequently termed low-control modes; wholly-owned subsidiaries are often called full-control modes; and joint ventures are generally considered as shared-control modes (Agarwal & Ramaswami, 1992; Anderson & Coughlan, 1987; Gao, 2004). This means that low-control modes "minimize resource commitment (hence risk) but often at the expense of returns" (Anderson & Gatignon, 1986: 3) where as higher control modes entail additional risk (Taylor et al, 2000). Thus, when a company assumes control over the operations it also assumes some form of risk. It is agreed that exporting represents the lowest risk / lowest control option where as wholly-owned subsidiaries represent the highest risk / highest control option, and thus it is believed that non-equity modes have lower risk at the cost of lower control (Rhoades & Rechner, 2001). Entry mode literature focuses on control because it's the most important determinant of both risk and return (Anderson & Gatignon, 1986). The discussion of high-low control entry modes is summarized in the Table 2.1 below.

Table 2.1 *Characteristics of firms entering foreign markets*

Entry mode	**Form**	**Control**	**Relational friction**	**Commitment**
Wholly-owned subsidiary	Subsidiary	High	Low	High
Partly-owned subsidiary (joint venture)	Minority/ majority ownership	High/ moderate	Low/ moderate	High/ moderate
Contract	Relationship	Moderate	High/ moderate	Low
Market	Exports	Low	High	Low

Sources: Adapted from Blomstermo, Sharma & Sallis 2006, p. 214

Of empirical interest in this study are the four distinct types of international entry modes, which are consistent with the literature reviewed in this area. They are exporting, contractual agreements (licensing and franchising), joint ventures, and wholly-owned subsidiaries. Even though there are many other entry modes in addition to the above-mentioned ones, these four modes of entry have often been the focus in the previous studies (for example see Agarwal & Ramaswami, 1992; Brouthers, 2002; Pan & Tse, 2000; Taylor et al, 2000).

2.1.1 Exporting

According to Taylor et al (2000), exporting involves a company selling its products manufactured in the home country to the customer in the target country. Because exporting requires a significantly lower level of investment than other modes of international expansion (Agarwal & Ramaswami, 1992), it is the most commonly used approach employed by companies starting their internationalization processes due to the reason that the financial risks can be minimized (Cateora & Graham, 2007). Consequently, the lower risk of exporting typically results in a lower rate of return on sales compared to other modes of international market entry (Agarwal & Ramaswami, 1992).

Despite the low risk and low resource commitment approach, there are often more advantages in producing in the foreign country than in exporting to it. The advantages occur in situations where production abroad is cheaper than in the home country, when transportation costs are too expensive, when a company lacks domestic capacity, or when the company's products and services need to be substantially altered to attract sufficient demand in the target country (Daniels, Radebaugh & Sullivan, 2007).

The current study follows the conceptualization by Taylor, Zou and Osland (1998); exporting involves a company selling its products which are manufactured outside the target country to the target country. Therefore, exporting is the entry mode choice without investment of assets in the host country (Agarwal & Ramaswami, 1992).

Table 2.2 Export from Finland to Malaysia between 2000-2009

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Amount (in RM million)	488	512	548	410	691	825	953	990	929	993

Source: Bank Negara Malaysia

2.1.2 Contractual Agreements

Contractual agreeements involve “nonequity associations between an international company and a party in the host country in which technology or management systems are transferred” (Taylor et al, 1998; 392). For the purpose of this study, contractual agreements consist of both licensing and franchising.

2.1.2.1 Licensing

A means of establishing presence in a foreign market without large capital outlays is licensing (Cateora & Graham, 2007). Licensing typically involves the purchase of production or distribution rights and the technological information and know-how required to exercise those rights (Maskus, 2004). Such purchase usually involves the rights to trademarks, patents, and production techniques. Therefore, licensing can take several forms; licenses may be granted for production processes, for the use of a company’s name, or for the distribution of imported products (Daniels et al, 2007).

In exchange for the rights to use the intangible property and possibly also for technical assistance, the licensee can compensate the licensor via a one lumpsum fee and/or through royalties based on the income earned by the licensee (Park & Lippoldt, 2005).The rights may be for an exclusive license in which the licensor can’t give rights to any other company for a specified area, or nonexclusive in which it can give away the rights (Daniels et al, 2007).

Licensing has several advantages. According to Root (1994), the most obvious one is avoiding import barriers. Another advantage of licensing as an entry mode is that it is a fast and easy way to enter a foreign market and it requires little capital investment (Cavusgil, Ghauri & Agarwal, 2002) and it also saves marketing and distribution costs. With licensing the company doesn’t have to undertake costly research and development, and thereby it can capitalise on the licensor’s reputation and expertise (Park & Lippoldt, 2005). The cost of the licensing arrangement can be much cheaper compared to the licensee company developing the new product or process on its own (Daniels et al, 2007). Furthermore, licensing enables the licensee to get insight of licensor's market knowledge, business relations, and cost advantages.

The risks of licensing include choosing a wrong partner, quality and other production problems, problems with payments, contract enforcement, and loss of marketing control (Cateora & Graham, 2007). Furthermore, according to Cavusgil et al (2002), the licensor will lack control over the production processes and marketing.

Therefore in this study, following Rajan and Pangarkar's (2000) definition, licensing is defined and conceptualized as a contract in which the licensor provides the licensee an access to its technologies or know-how in return for financial compensation. "Licensing ventures are operationally defined to be ventures with 0% to 5% equity stakes by the multinational parent" (Rajan & Pangarkar, 2000: 50).

2.1.2.2 Franchising

Franchising is a form of licensing in which the franchisor company not only sells the independent franchisee the use of a trademark essential to the franchisee's business but also assists the business operationally on a continuing basis, such as through sales promotion and training (Daniels et al, 2007). The franchiser generally provides the products, systems, and management services, and the franchisee provides market knowledge, capital, and personal involvement in managing the franchise business (Cateora & Graham, 2007). According to Anderson and Gatignon (1986: 5), "franchising offers medium control because the typical agreement includes incentives to adhere to the system's rules and allows a high degree of monitoring of the franchisee's activities".

Franchising is an attractive form of international market entry for companies that are looking for quick expansion with low capital investment. The combination of the skills of both licensor and licensee permits flexibility in dealing with local market conditions and yet provides the licensor company with a reasonable degree of control. Foreign laws and regulations are friendly towards franchising as an entry mode because it tends to increase local ownership, operations, and employment. (Cateora & Graham, 2007)

In this study franchising is conceptualized as a contractual agreement in which one party (the franchisor) sells to an independent party (the franchisee) the use of a trademark and also operationally assists the business continually (Daniels et al, 2007).

2.1.3 Joint Venture

According to Cateora and Graham (2007), international joint ventures are partnerships between legally incorporated entities such as companies and not between individuals. Therefore, a joint venture takes place when the international firm shares equity and control of the venture with another company from the host country (Taylor et al, 2000). It is “a special type of ownership sharing in which equity is owned by two or more companies” (Cavusgil et al, 2002: 100) “that have joined forces to create a separate legal entity” (Cateora & Graham, 2007: 329).

According to Karhu (2001), joint venture is usually determined to be a limited or a joint-stock company that is started for a specific purpose. Joint venture involves sharing of assets, risks and profits, and the parent’s equity stake ranges from 5% to 95% (Rajan & Pangarkar, 2000). Therefore, the level of control in the joint venture is dependent on the ownership split and the number of the involved parties (Hill et al, 1990). By combining companies’ know-how and resources, a more efficient entity can be created than would be possible without the co-operation (Karhu, 2001). Also, a joint venture can offer the possibility to gain special knowledge from the other company or to use the available resources more effectively (Immanen, 1986).

However, the selection of the joint venture partner is crucial, because the interests of the co-operating parties are rarely alike. This might bring several problems, such as dividing cost and the amount of work between the parties, and all kinds of co-operation induced difficulties. The choice of the partners and the qualities of the relationships between the executives are important factors leading to success (Cateora & Graham, 2007).

In this study, joint ventures are conceptualized following the definition by Taylor et al (2000: 147); “a joint venture is an arrangement whereby the firm is required to share equity and control of the venture with a partner from the host country”.

2.1.4 Wholly-Owned Operations

Another market entry alternative is a full ownership of facilities in the target country, whereby the parent company takes a 100 per cent equity stake in the operation in the foreign country (Taylor et al, 2000). According to Cavusgil et al (2002: 102), a foreign direct investment “can be made by acquiring an existing operation or by constructing new facilities”. Thus, an international company wanting to choose an investment entry mode can do so either by buying an already existing company in the target country or by starting a company from scratch. According to Karhu (2001), the task of the foreign unit can be for example procurement, distribution, sales, service, research and development, technology transfer, financing operations, or assembling.

In the case of a wholly-owned subsidiary, the company has to bear all of the costs of opening the new subsidiary and serving the foreign market. The company owns all of the revenue-generating assets and therefore the level of resource commitment is correspondingly high. (Hill et al, 1990). Therefore, wholly-owned operation as an entry mode requires the most resources from the company, but in return, this entry mode brings the highest degree of control over the operations.

Control through self-handling of operations is called internalization, a concept that comes from transaction cost theory, which holds that companies should choose the lower cost option between handling something internally and contracting another party to handle it for them (Daniels et al, 2007). Taylor et al (2000: 148) add that a firm will “internalize operations that it can perform at a lower transaction cost than would be the case if the firm exported or entered into a contractual arrangement with a local partner”.

According to Immanen (1986), a foreign unit can assist the company in avoiding entry barriers such as customs duties and limitations, take advantage of the financial benefits of the target country, and achieve a central position. There are also savings in transportation and customs duties and probably lower manufacturing costs due to using the less expensive local labour and raw materials (Cavusgil et al, 2002). Through a wholly-owned subsidiary it is also easier to create a local image for the company.

All in all, wholly-owned operations are the most demanding entry mode of all, because it means that the company has to establish a permanent presence in the target country. It also requires sizable investments and the company has to bear all the risk, and there might also be difficulties in hiring workforce and in forecasting the demand potential (Karhu, 2001). Because of the size of the investments required, the likelihood of establishing wholly-owned subsidiaries is higher for larger companies and is a good option after the company has gained some experience from international operations (Erramilli, Agarwal & Dev, 2002).

The selection of the international market entry mode is a critical decision because the nature of the company’s operations in the target country is affected by and depends on the choice made. The entry mode chosen affects the company’s future decisions because each entry mode has a different level of resource commitment, and changing from one entry mode to another is difficult without considerable loss of time and money. (Cateora & Graham, 2007)

Wholly-owned subsidiaries in this study are operationally defined to be ventures with 100% equity stake in the operation held by the multinational parent company in the host country (Taylor et al, 2000).

2.2 Theories of Firm's Internationalization

With regards to literature, several approaches can be used to explain a firm's entry mode choice. Several studies have explained the relationship between operating characteristics and the entry mode from different theoretical perspectives such as the internationalization theory (Johanson & Wiedersheim-Paul, 1975; Johanson & Vahlne, 1977), transaction cost theory (Anderson & Gatignon, 1986), and eclectic theory (Dunning, 1980).

Andersen (1997) stated that it would be insurmountable to discuss all the conceptual frameworks and theories that have been presented previously concerning the foreign entry mode decision, and thus the current study will be based on the above-mentioned theories of firm's internationalization. They are perceived to be the most important contributions to explain the different entry modes (Andersen, 1997). The following table (Table 2.2) highlights the key issues of the different frameworks, which will be further explained in the following sections.

Table 2.3 *Comparison of different frameworks for studying foreign entry modes*

	Internationalization Theory	**Transaction Cost Theory**	**Eclectic Theory**
References	Johanson & Wiedersheim-Paul, 1975; Johanson & Vahlne, 1977	Anderson & Gatignon, 1986	Dunning, 1980 and 1988
Basic Theory	Resource-based theory	Transaction cost theory	Transaction cost theory, internat'l trade theory, resource-based theory
Unit of Analysis	Firm	Transaction	Firm
Main Arguments	Internationalization of a firm is a long, slow and incremental process of cultural and geographical expansion and commitment	Companies' goal is efficiency maximization, and to achieve that they adopt entry modes which minimize transaction costs	The choice of entry mode determined by ownership, location and internalization advantages; the more advantages a company has, the more likely it adopts a high equity entry mode
Explanatory Variables	Firm's experiential knowledge	Transaction characteristics (asset specificity, uncertainty)	Ownership (size, international experience, asset specificity), locational (market potential, country risk), and internalization advantages
Decision Criteria	Trade-offs between growth and risk	Transaction cost minimization	Trade-offs between return, risk, control, and resources
Modes of Entry	Entry mode according to establishment chain: a) no export, b) export via independent representative, c) sales subsidiary, d) manufacturing abroad	Several classifications, e.g. contractual transfer, joint venture, wholly-owned operation	Several classifications, e.g. independent mode, co-operative mode, integrated mode

Source: Adapted from Andersen 1997, p. 31

2.2.1 Internationalization Theory

Johanson and Wiedersheim-Paul (1975) and Johanson and Vahlne (1977), who studied Swedish firms' international activities, proposed the internationalization theory explaining the internationalization process of the firms over time. The theory aims to explain the "pattern and pace" of companies' international expansion activities (Johanson & Vahlne, 1977: 23). The authors argue that in their course of becoming international, companies follow an evolutionary process where the increased commitment is largely due to incremental learning and psychological distance.

Johanson and Vahlne (1977: 24) observed that the Swedish companies often develop their international activities "in small steps, rather than by making large foreign production investments at single points in time". According to Johanson and Wiedersheim-Paul (1975), the incremental process, the "Establishment Chain", has four stages:

(i) No regular export activities
(ii) Direct exporting via independent intermediary
(iii) Establishment of a foreign sales subsidiary
(iv) Foreign production/manufacturing plants

In a typical case, a firm starts to export to a country via an agent, later establishes a sales subsidiary in the host country, and eventually begins local production (Johanson & Vahlne, 1977).

The internationalization theory is one of the most widely adopted concepts in the field because it has introduced several factors that affect the process of the firm's internationalization. The theory uses the concepts of psychic distance and experiential knowledge to explain the internationalization process of a firm over time. Sharma and Erramilli (2004) explain that psychic distance influences a firm's market selection and experiential knowledge affects its pattern of resource commitment. The establishment chain of the internationalization theory is explained by the concepts of market commitment and market uncertainty (Johanson & Vahlne, 1977; Sharma & Erramilli, 2004).

The establishment chain model starts from the provision that a lack of experiential knowledge about foreign markets is the dominant barrier to internationalization and creates uncertainty. Increased market knowledge increases the company's market commitment, which in turn further increases the market knowledge a company has (Ellis, 2008). The risk of operating in foreign market is diminished through a time-consuming experiential learning process, because it makes the company more confident in foreign markets (Johanson & Vahlne, 1977). This experiential knowledge is gained through personal experience, and it governs the pace and pattern of commitment to foreign market operations (Johanson & Vahlne, 1977). Whitelock (2002) considers the experiential knowledge to be the critical kind of knowledge for companies doing international business. The establishment chain resembles Dunning's eclectic theory (1980) concerning the emphasis on a firm's knowledge, which is part of the firm specific skills, i.e. ownership advantages (Andersen, 1997). More will be discussed about the eclectic framework later.

Another key feature of the "Uppsala model" is the concept of psychic distance. Psychic distance represents the factors that delay or prevent the effective flow of information between the firm and the foreign market, such as language and cultural differences (Johanson & Wiedersheim-Paul, 1975). Ellis (2008: 4) explains that "psychic distance reflects individual perceptions, which may vary even within the firm". In this study, psychic distance is considered to be the same as cultural distance between the firm's home and host country.

A company's early internationalization activities will be constrained by the psychic distance separating the home and foreign markets (Ellis, 2008). Firms develop foreign activities over time and in an incremental way based on their knowledge development of the markets. However, Johanson and Vahlne (1977, 2003) argued that because the acquired knowledge is market-specific, the establishment of operations in different markets would reflect a pattern of increasing psychic distance. This means that companies "start out by invading ‘neighboring’ (in the cultural sense) markets and later, as experience grows, more distant markets will be entered” (Johanson & Vahlne, 1990: 17). As the company’s operations cover more distant markets and its experience grows in the international arena, psychic distance is predicted to decline. Therefore, as explained by Johanson and Vahlne (1990), psychic distance is not fixed, but instead it diminishes with increasing international experience and organizational learning.

According to Anderson and Coughlan (1987), the psychic distance affects the choice of a particular entry mode in foreign markets because companies seem to prefer indirect export to direct export in countries associated with high psychic distance. Accordingly, it is argued that the greater the cultural difference is between the countries, the lower the degree of control is that the company demands (Anderson & Gatignon, 1986; Kim & Hwang, 1992), mainly due to the uncertainty perceived. Because companies can restrict their resource commitment and therefore reduce the risk in culturally distant markets, Kim and Hwang (1992) argue that there is a negative relationship between cultural distance and entry mode choice. Furthermore, local partner’s knowledge can effectively compensate for the loss of control that a firm faces when choosing a lower-control entry mode for culturally distant market (Tihanyi, Griffith & Russell, 2005).

However, there is a controversy in previous entry mode literature because some studies show that companies’ reaction to increasing psychic distance is to demand more control (Blomstermo, Sharma & Sallis, 2006; Taylor et al, 1988). They argue that firms would be better off having a higher level of ownership in an unfamiliar environment. Through higher equity ownership, a company is able to establish greater control of international operations while mitigating the differences in culture (Tihanyi et al, 2005). “Presence abroad through a high control entry mode may buffer the consequences of culturally distant markets” (Blomstermo et al, 2004: 217), which include for example increased exposure to risk.

One important factor determining companies' success in foreign markets is the level of the company's market commitment (Cavusgil, 1984). The model of internationalization stages supposes that the establishment chain implies larger resource commitment as the company expands its operations abroad (Johanson & Vahlne, 1977; Johanson & Wiedersheim-Paul, 1975).

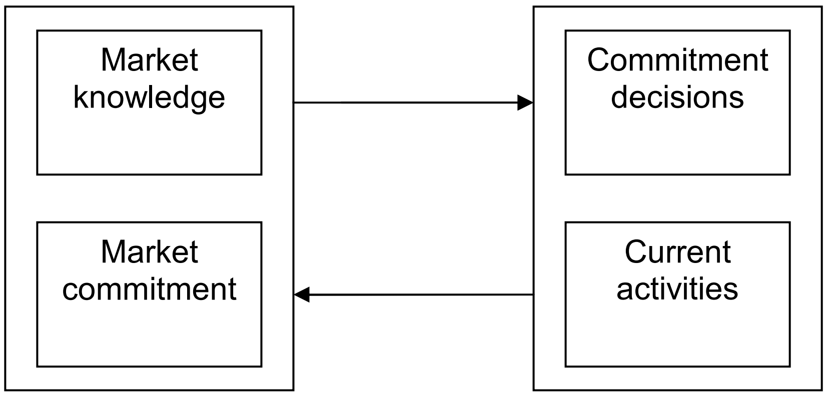

Figure 2.1 *The basic mechanism of internationalization*
Source: Johanson & Vahlne 1977, p. 26

Thus, according to figure 2.1, increased market knowledge leads to increased market commitment. Johanson and Vahlne (1977) assumed that market knowledge and market commitment affect both the company's commitment decisions and the way it performs its current activities. The state of a firm's internationalization affects perceived opportunities and risks which in turn also influence its commitment decisions and current activities (Johanson & Vahlne, 1977). The authors further state that unless a company has very large resources, market conditions are stable and homogenous, or the company has much experience from other markets with similar conditions, it will make additional commitments to a foreign market in small steps. Johanson and Vahlne (1977) conclude therefore that in case the market is risky and the company doesn't have previous international experience, it will follow the establishment chain.

However, Tihanyi et al (2005) found no significant relationship between cultural distance and entry mode choice, and they also mention the difficulty in formulating the measurement instruments for the concept. As markets become more homogenous, it seems to be increasingly irrelevant to use psychic distance as a factor explaining the firm's internationalization, especially when taking into consideration the easiness of getting information and the increasing fragmentation of markets (Tihanyi et al, 2005). Another disadvantage is that Johanson and Vahlne (1977) didn't include co-operative modes of market entry in their establishment chain and according to Andersen (1997) this is a weakness considering the frequent use of such entry modes.

The internationalization model has been criticized as being deterministic (Andersen, 1997). Therefore, "it does not follow that the initial market entry will always be by export through an independent middleman, nor is it always the case that production abroad is the ultimate goal for all firms in all markets" (Whitelock, 2002). Knowing the limitations of the internationalization theory, most empirical studies on foreign entry modes have been based on the transaction cost theory and the eclectic theory (Andersen, 1997).

2.2.2 Transaction Cost Theory

Transaction cost theory of entry mode choice emerged from Anderson and Gatignon's (1986) research on the transaction cost theory of the firm to entry mode choice analysis of U.S. companies. Transaction cost theory claims that a firm will "internalize operations that it can perform at a lower transaction cost than would be the case if the firm exported or entered into a contractual arrangement with a local partner" (Taylor et al, 2000: 148). Transaction cost theory has been used in several empirical studies of Western companies' entry mode choice (see e.g. Anderson & Coughlan, 1987; Anderson & Gatignon, 1986; Erramilli & Rao, 1993; Brouthers, 2002). Because international business crosses cultural, political, and regulatory boundaries, transaction costs have been considered one of the key issues in a company's decision to enter a foreign country (Rhoades & Rechner, 2001).