INTERNATIONAL RISK AND ENTRY MODE STRATEGY

OF MALAYSIAN PUBLIC LISTED COMPANIES

by

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DEDICATION

This thesis is dedicated to

Mallyssa Cheah and

my parents.

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ABSTRAK

Firma - firma Malaysia dewasa ini semakin giat dalam penceburan perdagangan antarabangsa, maka mereka perlu memahami dan mengetahui peranan risiko antarabangsa dalam pilihan strategi. Persepsi risiko antarabangsa memainkan satu peranan yang penting dalam proses pemilihan strategi memasuki pasaran antarabangsa. Berlainan dengan kajian yang telah dilakukan dahulu, di mana fokusnya mengutamakan risiko antarabangsa yang spesifik, kajian ini menguji pengaruh risiko antarabangsa ke atas pemilihan strategi cara kemasukan. Responden kajian ini terdiri daripada syarikat - syarikat yang tersenarai dalam Bursa Saham Kuala Lumpur di mana mereka telah meneroka pasaran antarabangsa baru - baru ini. Firma - firma yang memilih strategi cara kemasukan yang berlainan boleh diperbezakan dari segi persepsi mereka terhadap risiko antarabangsa. Adalah dijangkakan kesemua variabel risiko antarabangsa, dan bukan hanya satu atau dua risiko antarabangsa yang spesifik akan mempengaruhi pemilihan kaedah memasuki pasaran antarabangsa. Dapatan kajian ini menunjukkan bahawa firma - firma yang mempunyai persepsi tahap risiko antarabangsa yang tinggi memilih strategi cara kemasukan yang memerlukan kurang komitmen sumber and kawalan, manakala firma - firma yang mempunyai persepsi tahap risiko antarabangsa yang rendah memilih strategi cara kemasukan yang memerlukan lebih komitmen sumber dan kawalan.

ABSTRACT

As firms continue to turn towards international expansion as a strategic alternative, they must become increasingly aware of the role that international risk plays in strategic choices. The perception of international risk plays an important role in the firm's foreign market entry strategy. Different from earlier studies that have focused mainly on specific international risks, this study proposes an integrated model of international risk, and will test the influence of international risk perception on the choice of entry mode strategy. The respondents are Malaysian public listed companies who have ventured overseas in recent years. Firms will choose different entry mode strategy based on their perception of international risk. It is expected that all the variables of international risk, and not just one or two specific international risks influences the choice of entry mode strategy. The findings show that firms perceiving higher levels of international risk pursued entry mode strategies that require lower resource commitment and control, while firms perceiving lower levels of international risk pursued entry mode strategies that require higher resource commitment and control.

Chapter 1

INTRODUCTION

This chapter explains the background of the present study and its importance to international business. It also defines the significance of the study to ensure that the value of the study will be better appreciated.

1.1 Introduction

Domestic companies which internationalise their business operations to prepare for global changes have been advised to manage international risks. Local firms must manage risks to go global (The Star, June 3, 1997). Going international presents the firm with new environments, entirely new ways of doing business, and a host of new problems. There is a wide range of problems associated with international business. They take the form of strategic considerations such as service delivery and compliance with long term government regulations, or start up issues such as how to find customers and communicate with them effectively. In addition, firms must also worry about operational matters, such as information flows and the mechanics of carrying out an international business transaction, as well as country risks such as political risk, ownership risk and transfer risk (Czinkota et al, 1994).

As the business world becomes more global and the level of international competition continues to increase, managers will find themselves facing increasingly complex strategic decisions. Perhaps first and foremost among these decisions are the decisions relating to methods of expanding the firms' international operations. This concerns the choice of entry mode strategy. However, as one considers the prospects of international

expansion, one cannot help but be aware of the many and varied risks facing firms in these *strange new lands* (Brouthers, 1993).

International business may be described as business transactions between citizens, companies, or governments of two or more nations (Jackson & Musselmen, 1987). International business holds out a promise of large new market areas, yet firms cannot simply jump into the international marketplace and expect to be successful. They must adjust to the need and opportunities abroad. In order to adjust to the international environment, firms must first assess their perception of international risks. Ghosal (1987) has postulated that managing risks is one of the primary objectives of firms operating internationally.

However, Miller (1992) have suggested that the integration of a more comprehensive *international risk* may be related to the strategic choice of entry mode. It was suggested that by looking at individual international risks, such as exchange rate risk or political risk, in isolation of the other international risks results in an incorrect analysis of the internationalisation question and can lead to an incorrect entry mode strategy. Nevertheless, current treatment of risk and uncertainty in the international management literature vary in their use of these terms and tend to look at particular categories of risks to the exclusion of the risks mentioned elsewhere in management literature.

1.2 Scope and Significance of Study

The purpose of this thesis is aimed at examining the influence of international risk on the entry mode strategy of Malaysian Public Listed Companies. Researches have only recently viewed international risk from an integrated risk-balancing perspective. Most

previous risk research have concentrated on one specific type of risk, such as political risk (Simon, 1982; Akhter and Lusch 1988) or finance risk (Stone 1989). There were also studies being done on the relationship between international risk perception and strategic choice (Vernon, 1985). In a study done by Brouthers in 1993 which extends the integrated international risk framework developed by Miller (1992), the relationship of international risk to entry mode strategy was empirically tested.

To focus in on the risk-strategy relationship, we first identify key components of the international risks involved in strategic decision making and then we explore ways in which management can minimise the impact of these risks on the firm through the entry mode strategy selected. With a theoretical base formed, we will present the results of this study to test the influence of international risk on entry mode strategy, using a small sample of companies listed in the Kuala Lumpur Stocks Exchange (KLSE). It is hoped that this study can contribute towards a better understanding of international risk - entry mode strategy relationships from the view point of the Malaysian public listed companies.

This study will empirically test an integrated model of international risk and will test the influence of risk perception on strategic choice. This is a departure from earlier studies that have focused mainly on specific international risks. This study extends the integrated international risk framework developed by Miller (1992) and tests its applicability among the Malaysian public listed companies. This study develops an alternative to the sub-optimal approach to treating uncertainties in isolation from one another. This alternative - the *integrated international risk perspective* takes a general management view giving explicit consideration to numerous uncertainties.

1.3 Definitions of Key Terms

In the following paragraphs, the key terms used in this study will be defined. The key terms defined are *international risk* and *entry mode strategy*, which will provide a better understanding of this study.

1.3.1 *International Risk*

Risk is the uncertainty associated with an exposure to loss. It is caused by some unfavourable or undesirable event. The key word in the definition of risk is uncertainty. The uncertainty arises because it is impossible to know in advance whether losses will occur. Risk is also the variability in the possible outcomes of an event based on chance. This means that the larger the number of likely outcomes that might occur, the greater the risk. The degree of risk depends on how accurately the results of a change event can be predicted. The more accurate the prediction, the lower the degree of risk (Jackson & Musselman, 1987).

The strategic management field lacks a generally accepted definition of risk (Miller, 1992). The major uses of the term *risk* are in reference to unanticipated variation or negative variation i.e. downside risk in business outcome variables such as revenues, cost, profit, market share etc. Managers generally associate risk with negative outcomes (March & Shapira, 1987). Therefore, international risks generally can be defined as the danger firms face of limitations, restrictions, or even losses when engaging in commercial activities of international business.

Miller (1992) provides details of a three part integration of international risk variables. The three parts consist of:

(1) general environment,

(2) industry, and

(3) firm specific risks.

General environmental uncertainty refers to those variables that are consistent across all industries within a given country. Included in the factor are such variables as political risk, government policy uncertainties, economic uncertainties and social uncertainties. Industry risks contains the risk associated with differences in industry or product specific variables. Among these variables are the input market uncertainties associated with production inputs, special material and labour supply availability, product and market uncertainties, and competitive rivalry. These uncertainties can be created by shifts in supplies or changes in demand within a specific country. Finally, firm-specific risks includes specific types of risk such as operating uncertainties related to labour and employee issues, liability uncertainties associated with harmful effects of products to users, credit uncertainties arising from uncollectability of accounts receivables and so on.

The use of the term *international risk* refers to the uncertain environmental variables that causes unpredictability in international business (Miller, 1992). The term *uncertainty* as used in strategic management and organisational theory refers to the unpredictability of environmental or organisational variables that impact corporate performance (Miles & Snow, 1984). Uncertainty about the international environment and organisational variables related to international business reduces the predictability of corporate performance, and thus increases international risk. In the international environment, firms face the totality of risks, that is, they face what Miller (1992) terms as the general environmental, industry and firm-specific risks.

1.3.2 *Entry Mode Strategy*

The term *entry mode strategy* refers to the method the firm selects in its conduct of international business. Although something of a simplification, many of the international business literature focuses on these entry modes, and suggests that each of these entry mode is consistent with a different level of control (Calvet, 1984; Root, 1987) and resource commitment (Vernon, 1979). Control here means authority over operational and strategic decision making, and resource commitment means dedicated assets that cannot be re-deployed to alternative uses without loss of value (Kim and Hwang, 1992). In this study, the entry mode strategies are classified into three groups, which is consistent with the literature reviewed on this topic (Brouthers, 1993; Kim and Hwang, 1992; Hill et al, 1990) The three entry mode strategies refers to:

(1) Non-equity / indirect exporting mode

(2) Joint-venture mode

(3) Wholly-owned subsidiary mode

Hill et al (1990) suggests that while a wholly owned subsidiary can be characterised by a relatively high level of control and resource commitments, the opposite can be said of indirect exporting. However, with joint-ventures, although the levels of control and resource commitment admittedly vary with the nature of ownership split, their extent of levels of control and resource commitment can nevertheless be said to lie between that of wholly-owned subsidiaries and the non-equity / indirect exporting modes. Therefore, in selecting the appropriate entry mode strategy, firms have to answer two questions:

(1) What level of resource commitment are they willing to make?

(2) What level of control over the operation do they desire?

These two questions can often be evaluated in the context of the international risk that management thinks it may encounter in the country being considered for entry. In high risk countries, firms may not be willing to commit resources. In countries that they perceive as low risk, they may desire control over the operation, assuming that they can do as good in the running of the foreign operation as they do with the domestic operation. Therefore, it is risk perception that shapes the evaluation to our two questions, which in turn leads to decisions regarding the choice of entry mode strategy (Brouthers, 1993).

1.4 Design of Investigation

This research entails the study of the influence of international risk on the choice of entry mode strategy selected by Malaysian public listed companies. For the purpose of this study, a public listed company in Malaysia is defined as any company listed in the Kuala Lumpur Stocks Exchange (KLSE) as of 1 June 1997. The companies range from new Second Board companies to very large conglomerates listed on the Main Board. Questionnaires were administered by mail to all the 642 listed companies. The researcher does not control or manipulate the variables involved and no artificial setting is created for the study. It is also cross-sectional in nature as it is a one - time study where data is gathered just once from the sample involved. The units of analysis are companies.

1.5 Organisation of the Chapters

The succeeding chapters in this thesis have been organised in the following manner.

- Chapter 2 of this study reviews the literature on studies carried out on international risks, and the influence of international risk on entry mode strategy.

- Chapter 3 presents the theoretical framework, explains the variables used in this study, presents the hypothesis statement, research design, the basis of sampling and method of data collection.
- Chapter 4 discusses the detailed findings derived from the analysis of data.
- Chapter 5 concludes the thesis with a summary and conclusion of research findings, a comparison of research findings to previous studies, and discussions on the limitations of this study with suggestions for future research.

Chapter 2

REVIEW OF LITERATURE

This chapter introduces the literature review on the influence of international risks on entry mode strategy selection, and the findings from previous studies which will be helpful to the present study.

2.1 Studies on International Risk: Background and Importance

Treatments of risk in the international business management literature largely focus on particular international risk specifically, i.e. political risk, ownership risk or transfer risk (Akhter and Lusch, 1988; Ting, 1988), to the exclusion of other interrelated risks. Decisions in one international risk area effect the magnitude of risks and effect the decisions in other risk areas. A significant shortcoming in many of the existing risk and uncertainty literature is the emphasis on particular uncertainties rather than a multi-dimensional treatment of uncertainty. This perspective, which can be labelled the particularist view, isolates specific uncertainties to the exclusion of other interrelated uncertainty elements (Miller, 1992).

Many of the risk literature in the international management field has focused on either political (Simon, 1982; Akhter and Lusch 1988), or foreign exchange uncertainties (Stone, 1989). Studies that look at only one international risk variable, such as studies of political risk, or financial risk, may lead to incorrect entry mode decisions because other related risks have been ignored (Brouthers, 1993). However, international risk has not been ignored in previous entry mode strategy studies. In fact, of many empirical papers published to date, many have included a risk variable in some form or another and found

a significant relationship between the international risk variable and entry mode strategy (Kim & Hwang, 1992). Some of these empirical studies have defined risk, either as dissemination risk (Kim and Hwang, 1992; Anderson and Gatignon, 1986; Agarwal and Ramaswami, 1992) or country specific risk (Anderson and Gatignon, 1986; Erramilli and Rao, 1990; Kogut and Singh, 1988).

Dissemination risk is defined as risk of exposing a firm's proprietary know-how, skills or technology to actual or potential competitors. Dissemination risk has been operationalised in a variety of ways in the literature, including looking at the level of research and development spending (Kim and Hwang, 1992), marketing and advertising spending (Anderson and Gatignon, 1986), contract enforcement cost-risk if misuse of proprietary knowledge or quality standards (Agarwal and Ramaswami, 1992), and brand and reputation strength (Kim and Hwang, 1992) among others. For the most part of these approaches, they assume that higher investments in these variables translates into higher proprietary content and thus increased dissemination risk. While these findings are interesting, they do not address the issue of handling multiple types of risk in entry mode decisions.

Country specific risk is defined as the external uncertainties (environmental unpredictability) in a given country (Anderson and Gatignon, 1986). Country risk has been operationalised as environmental volatility (Erramilli and Rao, 1990), socio-cultural distance (Kogut and Singh, 1988), clusters of countries (Anderson and Gatignon, 1986), or risk of expropriation, stability of political, social and economic conditions (Agarwal and Ramaswami, 1992). In summary, previous entry mode research have addressed many issues of international risk (political risk, cultural differences, financial risk and

foreign exchange risk), but not many of these empirical studies have looked into international risk as a whole.

2.2 Influence of International Risk on Entry Mode Strategy

Managing international risks can be accomplished through the choice of appropriate strategies, however perception of these risks may vary from firm to firm, and country to country. If risk perception varies, strategic choice may also vary. The remaining section of this literature review explores the relationship between perceived risk and strategic choice. We shall describe how the risk-strategy framework is developed.

2.3 The Risk-Strategy Framework

The study conducted by Brouthers in 1993 developed an integrated risk-strategy framework that describes the relationship between perceived international risk and the choice of entry mode strategy. If the world were a simpler place, management could choose which type of risk to face and set their strategy based on the limited number of risks. Unfortunately, management does not have the choice of simply facing only *control risk* and *market complexity risk*. Instead, management must base their entry mode decisions on the total international risk perceived in entering new markets. The interaction of risk in the international strategic risks outlined creates a total perception of risk, upon which strategic choices must be made. A firm must adjust its entry mode strategy based on management's perception of total international risk. For markets where total perceived risk is perceived as being low, firms will use strategies that involve a high level of resource commitment. However, in markets that have high total perceived risk, management must adjust its strategy to minimise the effect of risks on the firm's performance and will likely use low resource commitment strategies.

The next sections describes how the Risk-Strategy Framework has been extended to include previous entry mode selection research, and develops a number of propositions. First, we shall review the components of total perceived risk. The components of international risk were outlined by Miller (1992) and Brouthers (1993). For the purpose of this study, the components of international risk - strategy is adapted from the study by Brouthers (1993) which studies the influence of international risk on entry mode strategy in the United States computer software industry. This study by Brouthers (1993) simplifies and extends the integrated risk framework of Miller (1992).

2.4 Control Risks

Often, firms involved in international business wish to minimise risks associated with international expansion by controlling (internally) as much as possible the expansion and the operations of the international business unit. This is perceived so because many of them believe that if they have the ability to directly control the foreign operation, they can manage and reduce risks (Cyert and March, 1992). However, at some point where the absolute perception of risk gets too high, then management no longer believes that it has control over the risk. At this point, strategy must change and the firm will be anxious to relief itself of some portion of the control, sharing responsibility for control and shifting the risk management to another firm, either a joint-venture partner or licensee, whom they feel is better qualified to perform the tasks.

In the normal transaction of international business, these control risks are not simple black and white issues. In actual fact, when the risk versus control trade-off becomes blurred, a strategy of reduced control may be appropriate. Control risk variables are concerned with three issues:

(1) management's desire for control

(2) cultural differences

(3) the industry structure

Firms select their entry mode strategy based on their perception of control risks in the market (Brouthers, 1993). The following literature review suggests that there is a relationship between international risk and management's desire for control.

2.4.1 *Management Experience*

Previous international research have given attention on management experience as a measure of a firm's ability to exercise control and manage an international operation, thus influencing these entry mode choice. In the study by Anderson and Gatignon (1986) it was revealed that a lack of management experience in international business can have a dramatic impact on risk perception and the desire for control. Where management experience is low, management will perceive high levels of international risk (Vernon, 1985) and therefore the management is less sure of its abilities to control the international business unit. When this is the case, management will be biased to select an entry mode with low control attributes (Anderson and Gatignon, 1986).

However, Miller (1992) does not include management experience in his framework of integrated risk management in international business and therefore it is an extension to Miller's (1992) framework of international risk management. Nevertheless, the literature review shows that management experience has a direct impact on risk perception and thus, influencing management's desire for control. Management experience is included as part of the theoretical framework of this study.

2.4.2 *Cultural Differences*

The second component in control risk is cultural differences. Cultural differences refers to the similarity or differences between cultures of the customers in the home market versus that in the target foreign market, i.e. socio-cultural distance or market knowledge (Kogut and Singh, 1988). Cultural uncertainty results from the difficulties inherent in predicting the likelihood of collective action, and the direction of such an action when people are faced with discrepancies between their own values and those embodied in the institutions impacting their lives (Miller, 1992).

Culture affects the attitudes and beliefs of potential customers and may also impact their response to certain products and services. With small differences in culture, similar strategies can be adopted. Studies by Kogut and Singh (1988), Erramilli and Rao (1990), and Anderson and Gatignon (1986) have also revealed that as cultural differences increases, management's desire for control decreases. In highly different cultures, management will perceive increased levels of control risk because of their lack of market knowledge, and will select entry mode strategies that minimise management control.

2.4.3 *Industry Structure*

The third component of control risk is industry structure. Two different views were found in the literature with respect to industry structure, risk and entry mode strategy selection. The first group is of the opinion that where the industry is highly concentrated with only a few key players in the market (such as oligopoly), risk is perceived to be high because competitors can inflict greater damage to each other. In such a situation, firms will select entry mode strategies that provides high management control over the

international business unit to be able to manage the operations properly, defend themselves from competitors' attack, and to attack or threaten to attack their competitors (Casson, 1987).

The second group is of the opinion that the industry structure affects a firm by restricting new entrants into the industry, and this will reduce the rivalry between firms. In highly concentrated industries where competitors are few, firms are more likely to perceive low control risks. This is because where competitors are few, firms tend to know their competitors well. Because of this high concentration in the industry, firms tend to favour high control modes on international expansion, thus maintaining barriers into the market (Vernon, 1985). This study is based on the opinion of the second group. Miller (1992) addresses *industry structure* as *industry uncertainties* in his framework of integrated risk management.

2.5 Market Complexity Risks

Market complexity risks refer to market specific variables that affect a firm's ability to enter a market, distribute their products or services, and obtain or maintain a market share. Market complexity risks affect management's decision on the amount of resources they are willing to commit to a particular market. When the foreign market is similar to the home market, firms are more willing to invest resources, while in markets that vary significantly from the home market, firms will be more hesitant to invest and will therefore seek methods of reducing their investment of resources.

As with control risks, market complexity risks are based on management's perception of similarities and differences between home market and foreign target markets. In the risk-

strategy framework developed by Brouthers (1993), market complexity risk variables include the following:

(1) political risk

(2) transfer risk

(3) operating risk

(4) ownership risk

(5) marketing infrastructure

(6) customers' tastes

(7) competitive rivalry

(8) market demand and market potential.

2.5.1 *Traditional Risks*

Items (1) to (4) above which includes political risks, transfer risks, operating risks and ownership risks are termed as traditional risk factors by Root (1987), and the literature review explores further in this study.

2.5.1.1 *Political risk*

Political risks arise from the uncertainty of political stability and are created during periods of political turmoil (Root, 1993). Political uncertainty is generally associated with major changes in political regimes, and it also refers to instability in government policies that impact the business community (Ting, 1988). Political risk can be viewed as governmental or societal actions and policies originating either within or outside the host country, and negatively affecting either a select group or a majority of foreign business operations and investments (Akhter and Lusch, 1988). It can also be political instability