An Explanatory Model for the Decision to Enter Emerging Markets: A Shareholder Perspective

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This paper proposes an alternative framework for making the decision the to enter emerging markets. The approach takes the view of the shareholders of a multinational enterprise to analyze the entry decisions: whether or not enter an emerging market and how to enter the market. Emerging markets provide opportunities for multinational enterprises, and also pose great risks if a multinational enterprise enters. It is theorized that if excessive returns are less than the associated risk firms will choose not to enter. If potential returns are greater than the risk associated with entry into emerging markets, firm risk tolerance is a determinant of entry mode choice. Firms with low risk tolerance are predicted to enter through joint ventures or strategic alliances while those with a higher tolerance for risk are likely to enter through wholly owned enterprises.

1. Introduction

An emerging market (domestic market) provides growth opportunities for a multinational enterprise, which may find its existing business in a mature and saturated market. Multinational enterprises first need to make the decision whether to enter a particular emerging market or not. Then they need to choose the best entry mode to enter the market, that is, to form a wholly owned enterprise or find a partner to form a joint venture. Finally, they need to decide the percentage ownership if they choose to have a joint venture. Those decisions follow a chronological sequence and entry mode is selected after the decision to enter the market is made. However, in the existing literature, the entry mode decisions are isolated from the sequence of decisions. Entry mode decisions analyzed in the context of transaction cost theory (Sarkar and Cavusgil, 1996; Rindfleisch and Heide, 1997; Meyer, 2001; Nakos and Brouthers, 2002; Herrmann and Datta, 2002; Meyer, 2004 and Zhao and Decker, 2006) suggest that multinational enterprises select entry mode through the minimization of the transaction costs associated with each form of entry. North notes that firms try to minimize total cost, not just transaction costs (North 1987, 1990, North and Wallis, 1994) in the choice of entry modes. While Ie believe that cost minimization is critical in entry mode selection, it does not fully explain entry mode choice.

Risk management and the creation of shareholder wealth are critical factors in guiding foreign investment . Gordon, Hayt and Marton (1998) reported that 83% of firms with market values greater than $1.2 billion engage in risk management. The scope of risk management has increased. In the past risk management was limited to addressing the sufficiency of insurance for casualties and liabilities. Markowitz (2005) notes that political and operational risks account for about one-half of the total risk Recent studies of corporate governance (e.g. Gompers, Ishii, and Metrick, 2003) draw strong correlation between the type of corporate governance and the financial performance of the firm. Klapper and Love (2003) have found similar results in emerging markets. This study is

organized as follows. Section 2 explains the key factors considered in the entry decision into emerging markets. Section 3 describes the proposed approach to the entry decisions into emerging markets. Section 4 provides a discussion and concludes the paper

2. Key Factors in Entry Decision

Maximizing risk adjusted reward is the key aspect of investing in an emerging market (Ollson, 2002). Specifically, multinational enterprises estimate the potential financial reward if they enter an emerging market. At the same time, the multinational enterprises analyze the potential risks they will face if they enter. In other words, multinational enterprises estimate the risk-adjusted financial return of their investments in the emerging market. Thus, a multinational enterprise invests in the emerging market only if the risk associated with the emerging market can be properly compensated by the reward of the investment. Putting the entry decision question under the tradeoff between reward and risk, I link how management makes the entry mode decisions to the maximization of the shareholder value of the multinational enterprise. This view is able to answer why a multinational enterprise invests in some emerging markets but not others, why different firms choose different entry modes into the same market, why a multinational enterprise chooses a certain ownership percentage, and how firm characteristics affect the firm's entry mode decisions.

Entry Decision: Rewards and Risk

Entry mode selection cannot be divorced from the process used in making the decision to enter an emerging market. The factors that are used to decide if a particular market is worthwhile to enter will also play a key role with transaction costs in entry mode selection. The decision process concerning the possible entry into a new market is complex. . Potential rewards for entering the market are weighed against the risks of entering or not entering. A foreign estimates the return to its investment under a normal circumstance and also estimates the potential losses under worse scenarios. Multinational enterprises cannot skip the later step because of high risk in emerging market investments. The return on investment is dependent upon the resources makeup the firm, the skill that firm possesses in deploying those resources, the size of the investment and the risk that tempers the incoming stream of payments.

Reward: The Resource Based View (RBV) posits that firms are comprised of "unique bundle of resources" (Penrose, 1959; Wernerfelt, 1984; and Barney, 1991). According to RBV these resources can consist of valuable physical assets, intangible assets, human assets, organizational assets, competitive capabilities, etc. that are idiosyncratic to each. To the extent to which these assets are valuable, rare, inimitable and exploitable by the organization determines ability of firm to generate competitive advantage, parity or disadvantage in a market. Madhok (1998) found that the organizational capability was a key determinant of firm boundaries of multinational enterprises entering emerging markets. It is precisely this uniqueness and the multinational enterprise's ability to effectively and efficiently utilize those resources that differentiates the potential return on investments among multinational enterprises pondering market entrance given equal investments.

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Risk: Risks associated with market entrance can either be general or firm specific. General risks are connected to a particular industry or geographic region. These could include economic, financial, political, regulatory, cultural, currency exchange and others. However, these general risks can either be reduced or magnified by the factors that a make a firm unique. A proprietary technology that automates a manufacturing process could alleviate some of the cultural risk connected to a labor-intensive process. Likewise too much debt could increase the financial risk to a firm who has uncertain future cash inflows.

Firm risk tolerance: As discussed in the above, different multinational enterprises have different risk characteristics. Each firm needs to define its risk tolerance, which is the basis factor for the firm to make entry mode decisions. One of the approach to determine the firm's risk tolerance is "Value at Risk" approach (VaR). In words, VaR defines how much money a firm can afford to lose in a worst case scenario. Depending on the firm's unique capital structure and financial situation, a firm's risk tolerance is characterized by the total value loss allowance, eg what are the losses the firm can afford without throwing the firm into bankruptcy or financial ruin and what is the likelihood that the losses would happen. The risk tolerance constraints the size of the investment in an emerging market and it determines the percentage of ownership in a joint venture. We present our approach in the following section.

3. Entry and Entry Mode Decisions

Figure 1 shows a firm's entry and entry mode decisions and the key factors affecting the decisions. First, a multinational enterprise analyzes the potential return on investments in an emerging market and the potential risk if it enters the market. As discussed previously, the risk the firm will face depends on the entry mode it chooses. At this stage, the risk is analyzed based on an assumed entry mode, for example, a wholly owned enterprise. If the return on investments after adjusting for risk to the emerging market is higher than the normal return of the industry, then the firm should choose to enter the market.

The foreign analyzes the potential losses and controls the losses by choosing the best entry mode. Using VaR approach, the multinational enterprise determines its risk tolerance, or how much money it can afford to lose in a worst case scenario. If the multinational enterprise can take large losses under unfavorable conditions, the wholly owned enterprise may be the choice. However, if it cannot take large losses, it should consider finding a partner in the emerging market to share the risks. It should be noted that the risk taken by the firm is different if it chooses a wholly owned enterprise rather than a joint venture. Thus, the risk-adjusted return can be higher for a joint venture than a wholly owned enterprise. The multinational enterprise has to tradeoff between a bigger investment (wholly owned venture) with a lower return and a smaller investment (joint venture).

Finally, the multinational enterprise determines the percentage ownership in the joint venture if it chooses to have a partner. In this case, the larger the losses the firm can take, the higher percentage of ownership the firm should have in the joint venture. Under the constraint of risk tolerance, the size of the investment in a new venture or the percentage of ownership in a joint venture is determined.

The decision processes may need iterations. The risk a multinational enterprise faces if it enters an emerging market depends on the entry mode. In the first step, an assumption on the entry mode is made in order to estimate the risk and start the analysis. However, the entry mode assumed may not be the entry mode determined at the final step. Then, the processes can be repeated using the final entry mode decision as the assumed entry mode in the first step to check if the same results will be reached.

Table 1 summarizes the main predictions. For the emerging markets having high risk that cannot be compensated by their potential return, multinational enterprises will not enter (for example, Iraq). For the emerging markets having low risk that can be compensated by their potential return, multinational enterprises will enter the markets. For the firms with low risk tolerance, the firms will choose joint venture as the best entry mode. For the firms with high risk tolerance, the firms will choose wholly-owned enterprise as the best entry mode.

Figure 1. Flow chart of entry and entry mode decisions

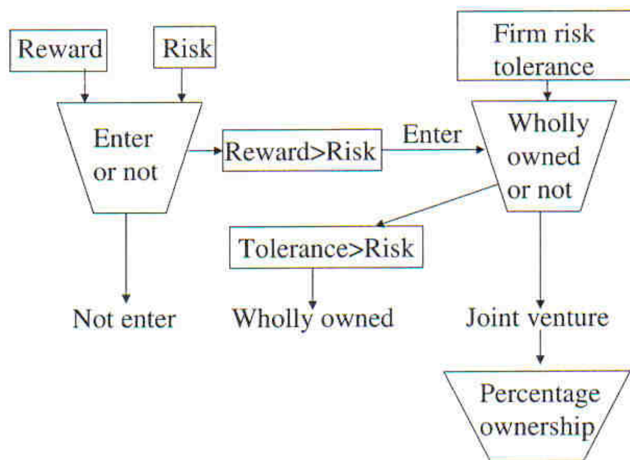

Table 1. Entry and entry mode decisions

	EXCESSIVE RETURN < RISK	EXCESSIVE RETURN > RISK
LOW RISK TOLERANCE	NO ENTRY	JOINT VENTURE
HIGH RISK TOLERANCE	NO ENTRY	WHOLLY OWNED ENTERPRISE

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4. Discussion and Conclusions

This paper attempts to move beyond transaction cost analysis in determining choice of entry mode in entering emerging markets. An alternative framework utilizing risk management is proposed. The proposed approach determines the entry decisions and the optimal entry mode choice by tradeoff between potential return and risk of an emerging market under the constraint of the multinational enterprise's risk tolerance. In brief, given both the characteristics of an emerging market and a multinational enterprise, the entry and entry mode choice is mainly determined by return and risk of an emerging market and the firm's risk tolerance.

In the proposed approach, given the characteristics of a foreign and a potential foreign partner, the multinational enterprise's demand for control is higher if one of following is true while all else being equal: (1) the emerging market has a higher potential growth rate; (2) the emerging market has a lower risk; (3) the multinational enterprise can tolerate higher losses.

The paper theorizes that, by incorporating risk management and shareholder value, the alternative approach can explain entry mode choice by multinational enterprises investing abroad. By incorporating risk management the model is specifically relevant to investing in emerging markets due to their risk characteristics. Furthermore, the new approach answers some questions the transaction cost model has not been able to answer, particularly, why multinational enterprises enter some emerging markets but not others. Empirical testing would be the next step.

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