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K.V. MUKUNDHAN AND M.K. NANDAKUMAR

## **Stakeholder Influences on the Choice and Performance of FDI-Based Market Entry Modes**

A Conceptual Model

**Abstract:** *This article accounts for stakeholder influences on the performance of Emerging Market Firms (EMFs) entering developed markets through FDI-based market entry modes. Stakeholders, such as governments, regulators, customers, competitors, community/environmental interest groups, and industry associations, impose coercive and normative pressures of compliance on internationalizing firms. Firms respond to these pressures from their institutional environment by emulating the entry strategies of other firms in their environment. By conceptualizing stakeholder influences across two bases – one arising from regulatory influences and the other arising from normative influences -, we study the effects of these pressures and inducements in driving firms to internationalize through similar market entry modes. We conclude this article by proposing that although isomorphism negatively affects firm performance in the short run, firms can benefit from high reputation, high social status and future support for their actions from their stakeholders by adopting strategic behavior legitimated by their institutional environments.*

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International market entry mode is defined as “an institutional arrangement that makes possible the entry of a company’s products, technology, human skills, management or other resources into a foreign country” (Root 1987, 5). Selection of entry modes is one of the most critical strategic decisions facing an internationalizing firm (Agarwal and Ramaswami 1992). This decision becomes particularly important for emerging market firms (EMFs) entering developed economies (Pehrsson 2008). The choice of market entry mode is important for three reasons: (1) certain entry modes, such as the establishment of sales subsidiaries, require significant capital outlays and investments. The choice leaves a lasting impact on the firm’s international performance (Anderson and Coughlan 1987); (2) Building solid and durable partnerships with foreign partners is a time-consuming process, and, when established, involves significant costs for the entrant firm in switching over from one mode to another; and (3) Establishing a mode of entry goes beyond mere attention to marketing issues. It brings organizational and cross-cultural problems to the internationalizing organization.

Foreign direct investment (FDI)-based market entry modes, such as cooperative joint ventures, equity joint ventures and wholly owned subsidiaries, involve ownership of property, assets, projects and businesses in host countries. Though a majority of this outward FDI occurs in waves, early research on market entry modes had not looked at the phenomenon from an aggregate perspective (Agarwal and Ramaswami 1992; Chen and Hu 2002). When aggregate approaches to studying entry modes were employed, they were conducted on firms across industry boundaries, thereby ignoring broader social and cultural factors at work. Even today, a majority of research on market entry modes comes from the disciplines of finance and managerial economics that emphasize the concepts of economic efficiency and managerial agency (Hennart 2000; Teece 1981). However, recent evidence indicates that market failure and the pursuit of efficiency maximization do not provide a full account of why firms are motivated to pursue certain entry mode choices more than the others (Lu 2002). In addition, with costs imposed by tariffs, logistics, regulations and other non-tariff barriers declining worldwide, the importance given to transaction costs as determinants of entry mode choice has come under criticism (Duffy 1996). Alternative theoretical perspectives, such as organizational learning, inter-organizational networks and social ties, have not been sufficient to account for the observed phenomena of EMF internationalization.

Most importantly, the above mentioned approaches fail to explain how institutional practices and structures restrict an EMF's entry choices (Lu 2002).

Although firms from emerging economies had global operations in the late 1980s and early 1990s, it was not until the beginning of the 2000s that they started playing a dominant role at the international level. Owing to this laggard position in the global business scene, EMFs usually lack skills and abilities to manage risks associated with high resource commitments. When they enter developed markets, EMFs are likely to face discrimination by host country customers and governments and experience a lack of credibility within the organization for their internationalization program. EMFs can suffer from inappropriate organizational learning routines, lack of access to efficient capital markets and global managerial talent. Thus, the national origins of EMFs may engender legitimacy-based and capability-based disadvantages (Ramachandran and Pant 2010). In addition, an EMF's overseas investments are exposed to risks that may or may not be offset by higher revenues.

Since FDI entails substantial investments in capital and time, the consequences of failure for stakeholders can be high. When decision makers in EMFs make international market entry choices, stakeholders' evaluation of the firm's prospects influence their actions. Thus, the choice of FDI-based market entry modes is an interesting phenomenon to be studied from the perspective of stakeholder influences. In this study, we seek to investigate the following research questions governing the phenomenon of EMF entry mode choices: (1) what is the influence exerted by an organization's stakeholders in its choice of market entry modes?; (2) how does the quest of legitimacy drive a firm to adopt entry mode strategies ratified by its legitimacy providers?; and (3) What are the implications of stakeholder influences on an organization's entry mode choices?

## **Theory and propositions**

Both institutional theory and resource dependency theory offer explanations regarding why organizations adopt certain practices (DiMaggio and Powell 1983; Pfeffer and Salancik 1978). While these theories differ in their views of managerial discretion in responding to environmental pressures, a good number of prior studies have suggested the importance of both theoretical perspectives to explain the observed strategic behavior of firms (Bourgeois 1984; Judge and Zeithaml 1992; Oliver 1991). The proposed theoretical integration is based on the premise that firms exercise strategic choice within the constraints imposed on them by their institutional environments (Greening and Gray 1994).

### **Isomorphism as a response to institutional and inertial pressures**

DiMaggio and Powell (1983) suggest that organizations converge onto practices and behaviors that make them appear similar to other organizations over time. This similarity or homogeneity is explored through institutional theory that identifies the relative influence of three forces, namely, coercive, normative and mimetic in determining the adoption of behaviors and practices legitimated by an organization's field. A field is "a community of organizations that partakes of a common meaning system and whose participants interact more frequently and fatefully with one another than with actors outside the field" (Scott 1995, 56). The participants who interact with each other in the field are collectively called institutional actors. Organizations become isomorphic with their institutional context as a means to signal their social fitness and gain legitimacy from the institutional actors. In the process, they avoid social censure, minimize demands for external accountability, improve their chances of securing necessary resources and raise their probability of survival by appearing rational to these critical constituencies.

This isomorphic behavior can be categorized into three types depending upon the bases of stakeholder influences. Coercive isomorphism occurs when organizations are

motivated to avoid sanctions from stakeholders on which they are dependent. For example, a firm may be forced to conform to quality standards adopted by its suppliers and other channel partners. Normative isomorphism occurs when organizations are motivated to respect social obligations as professionals within the organization think the choices are superior. For example, people having similar educational backgrounds will approach problems in much the same way. The socialization people undergo on the job reinforces the conformities in organizational action. Mimetic isomorphism occurs when organizations are motivated by their interpretation of others' successful behaviors. Mimetic isomorphism can occur as a result of outcome salience or based on the frequency of adoption of familiar choices made by others in the firm's environment (Haunschild and Miner 1997). For example, firms can structure their organizations based on other successful firms or based on structures most frequently adopted by other firms in their environment.

In the growing volume of literature on isomorphism, a number of studies have investigated the choice of market entry modes from an institutional theory perspective (Davis, Desai and Francis 2000; Lu 2002; Martin, Swaminathan and Mitchell 1998). Martin et al. (1998) have examined mimetic isomorphism in the context of Japanese suppliers imitating the international expansion patterns of Japanese buyers. A few of these studies have examined isomorphic behavior in the context of EMFs entering developed countries (Li, Miller and Eden 2012; Mukundhan and Nandakumar 2013).

Next, we draw upon the resource dependency theory to indicate limitations that can constrain an organization's ability to take decisions in line with technical considerations. Hannan and Freeman (1977) identified structural inertia as a major factor affecting the adaptive flexibility of organizations. According to them, inertial pressures, arising from both internal structural arrangements and environmental constraints, significantly affect the flexibility of firms in choosing strategies dictated by technical considerations. Pfeffer and

Salancik (1978) explained the role played by customers and investors in controlling the flow of resources within a firm. Decision makers in firms may sensibly allocate resources to an overseas project or can award those resources in violation of their own policies. These collective actions cannot be evaluated for rationality in the absence of objective principles for their evaluation. This problem of collective rationality in organizations usually prevents managers from investing in projects that maximize technical utility. In such cases, the stakeholders of the firm become an integral part of its decision environment by dictating and influencing investment patterns. They wield political influence depending upon their perceptions of risk and return associated with a firm's overseas investments. If the firm's internationalization decision accentuates the perceived risk of its stakeholders, the affected parties will tend to impose legitimacy shocks and generate short-run costs on the organization. Thus, the extent to which the firms make investment decisions in line with their investor and customer expectations affects their legitimacy and determines their long-term survival. Over time, established companies end up building systems that are more responsive to customers and investors' needs. However, unlike institutional theorists, researchers adopting the resource dependence perspective have suggested that managers of firms mitigate external pressures by making decisions in constrained environments (Hrebiniak and Joyce 1985; Marcus 1988).

A good number of prior studies have demonstrated the flexibility that managers possess when dealing with social and political issues under structural inertia and other environmental constraints (Berrone, Fosfuri, Gelabert and Gomez-Mejia 2013; Crilly, Zollo and Hansen 2012). Although managers are not endowed with unbridled strategic choice as proposed by Child (1972), these studies indicate that they possess enough leeway to manage uncertainties stemming from resource dependency. In this study, we demonstrate how

managers deliberately adopt structures and behaviors that are isomorphic with other organizations as a response to stakeholder influences.

### **Regulatory pressures to organizational isomorphism**

The coercive, normative and mimetic forces present in an organization's field dictate the dynamics of institutionalization of organizational strategies. Together, these forces produce an environment whereby pressures to appear legitimate induces strategic conformity. Coercive forces are often conveyed through laws, regulations, and accreditation processes/outside agency requirements (Caravella 2012). Institutional logics is defined as "socially constructed, historical patterns of material practices, assumptions, values, beliefs, and rules by which individuals produce and reproduce their material subsistence, organize time and space, and provide meaning to their social reality" (Thornton and Ocasio 1999, 804). When faced with inconsistent demands of legitimacy from different actors, a firm faces uncertainty in comprehending the institutional logics. A firm may respond to such uncertainty by looking at its own prior experience or by looking outside its boundaries for models of behavioral inference. Emerging markets experience social and institutional changes over time and present different stakeholder expectations for internationalizing firms. In addition, developed host countries are wary about EMF's employing of lower domestic standards to the detriment of workers, local firms and the environment. Their governments respond to such fears by exerting coercive or regulatory pressures of conformance on these EMFs. Such pressures can be associated with competition, funding mandates, influential professional group, and network values. In addition, the EMF's customers in the host country can have product/service expectations that can make noncompliance costly to the firm (Deephouse 1996). EMFs are forced to conform to these standards and expectations and failing to do so raises questions about their legitimacy. Thus, EMFs undertaking international investments



have to take into account the interests of all principal stakeholders if they have to maintain their legitimacy. Since a set of collaborating organizations typically share a common resource base in terms of suppliers, customers and other stakeholders, firms operating in the same industry as that of the focal firm become models for behavioral inference for the latter. In the context of FDI-based market entry, we extend the arguments of Francis, Zheng and Mukherji (2009) to posit that when coercive institutional pressures play out at the host industry level, firms respond to them by adopting entry strategies adopted by other firms operating in the same host environment. Thus, we can expect decision makers in firms to respond to these coercive pressures by adopting the entry modes of firms in their industry.

*Proposition 1: EMFs entering developed markets are likely to choose market entry modes similar to that of other firms in their industry when regulatory pressures exerted by their stakeholders are high.*

### **Normative pressures to organizational isomorphism**

An organization is bound to its network through formal and informal ties, such as industry associations and other professional bodies. These channels work together on the issues of elaborating policies, guaranteeing equity among members, facilitating efficiency in the value chain and defending member interests. Normative influences to isomorphism arise from professional organizations and other focal social actors, who define appropriate behavior and standards for group members (Scott 1995). In the context of international entry, normative isomorphism occurs when professionals in a firm consider certain entry mode choices legitimated by the firm's institutional environment to be superior. For example, decision makers in an Indian Information Technology firm might consider entering the United States market through a wholly owned subsidiary a superior option when compared to establishing a joint venture because the former mode of entry provides a safe way to secure the intellectual

assets of the firm. This understanding, often implicit, is related to the issue of legitimacy. Decision makers within firms compare themselves with their peers and try to behave in accordance with standards or norms prevalent among members that share the same institutional field (Lounsbury, Ventresca and Hirsch 2003; Weber, Rao and Thomas 2009). This process leads to normative isomorphism in the choice of market entry modes.

*Proposition 2: EMFs entering developed markets are likely to choose market entry modes similar to that of other firms in their industry when normative pressures exerted by their stakeholders are high.*

### **Implications of stakeholder influences on entry mode choice**

The implication of entry mode decisions on organizational performance is an under-researched area in the field of International Business. Internationalizing firms derive benefits from: (1) exploitation of proprietary, firm-specific assets (Delios and Beamish 1999); (2) exploitation of market imperfections (Caves 1971); and (3) economies of global scale and scope (Buckley and Casson 1976; Hymer 1976). In this article, we argue that stakeholder support for a firm's future actions represents a fourth alternative through which firm's seek to derive benefits in the longer run. The literature about entry mode performance is replete with studies that compare the performance differential between two entry modes (Li and Guisinger 1991; Pan and Chi 1999; Woodcock, Beamish and Makino 1994). Some studies have compared the value-creation potential of cross-border acquisitions (Gubbi, Aulakh, Ray, Sarkar and Chittoor 2009) vis-à-vis domestic acquisitions (Reuer and Koza 2000). Some researchers have compared the performance of firms that made entry mode decisions based on theoretical rationale with firms that did not (Brouthers 2002; Kim and Gray 2008).

Brouthers (2002) concluded that an extended transaction cost model performed slightly better in influencing financial and non-financial aspects of performance when

compared to variables from institutional and cultural contexts. However, he found that many variables from the transaction cost, institutional and cultural contexts were not very good predictors of performance. Morosini, Shane and Singh (1998) studied the performance implications of institutional level variables on performance and found support to the claim that national cultural distance enhances cross-border acquisition performance. EMFs entering developed markets face an increased potential for conflict between the requirements of legitimacy from external and internal stakeholders (Kostava and Zaheer 1999). As a consequence, EMFs face greater challenges in establishing and maintaining legitimacy in developed markets when compared to entering other less-developed markets. EMFs typically seek legitimacy from a variety of external stakeholders who are guided by certain managerial and technical procedures. Since conformance to legitimated structures and actions increases an organization's probability of survival, we usually associate isomorphism with positive performance outcomes (DiMaggio and Powell 1983; Meyer and Rowan 1977).

At the same time, the likelihood of survival is obtained at the expense of financial performance as the firm trades off social legitimacy for technical efficiency (Barreto and Baden-Fuller 2006; Henderson 1999). Thus, we can see that certain legitimacy-seeking activities, although contributing negatively to organizational performance in the short-run, assure the future support of certain internal or external constituencies should the organization fall into particularly adverse circumstances. Such support becomes extremely important for the firm's survival. Conforming to institutionalized structures and practices also impacts certain non-financial aspects of an organization's performance. Reputation, for example, is a generalized expectation about a firm's future behavior or performance based on collective perceptions of past behavior on performance (Ferguson, Deephouse and Ferguson 2000). It represents the collective knowledge institutional actors possess about the firm in its institutional field (Ferguson et al. 2000; Rindova, Williamson, Petkova and Sever 2005).

Organizational Status is a socially constructed, intersubjectively agreed-upon and accepted ordering or ranking of social actors based on esteem or deference (Washington and Zajac 2005). An organization's status is a function of two factors, namely, past performance outcomes and the status of the organization's affiliates (Podonly and Phillips 1996). The concepts of reputation and status are drawn from different literature streams, the former from economics and the latter from sociology. Consequently, they represent different processes of seeking legitimacy, apply under different sets of conditions, require divergent approaches to measurement and, thus, imply different managerial responses (Sorensen 2014). When EMFs enter developed markets through FDI-based market entry modes, their stakeholders experience a high degree of uncertainty over the potential success of its proposed overseas investments. Firms can reduce stakeholders' uncertainty about its decisions by developing reputation, which, in turn, provides stakeholders with assurance about the firm's ability to create value (Rindova and Fombrun 1999). Firms build reputation over a period of time by investing persistently in a variety of relevant signals, such as resource deployment patterns, levels of financial performance and endorsements from high-status or prominent third parties (Roberts and Dowling 2002; Greenwood, Li, Prakash and Deephouse 2005).

In the choice of international entry, conformance to entry mode choices institutionalized by the firm's institutional environment reduces uncertainty for stakeholders and provides visibility to the focal firm's decisions in terms of its value-creating potential. Since international entry mode involves deploying resources in an overseas project or subsidiary, being isomorphic with institutionally-ratified patterns of resource deployment enhances the EMF's credibility in the eyes of its legitimating actors and paves the way for positive reputation building.

*Proposition 3: EMFs entering developed markets enhance their reputation by adopting the market entry modes of other firms in their industry*

When institutional actors are uncertain about a focal firm's worth, they rely on a firm's social status to make inferences about that quality (Podolny 2005). Thus, an organization's status serves as a signal to compensate for quality uncertainty (Piazza and Castellucci 2014). Although the social status of an organization is influenced in part by its past performance outcomes, a firm can boost its position within the status hierarchy when its affiliates have a high status. Prior research has indicated that an actor's status improves over time by relying on a network of high-status connections (Bothner, Smith and White 2010; Castellucci and Ertug 2010). In the context of Formula 1 racing, Castellucci and Ertug (2010) find that high-status firms extract greater effort from low-status partners, with the effort increasing proportionately to the difference in status between them. In the context of isomorphic market entries, the entry mode choices adopted by high-status industry affiliates of the focal firm, by virtue of the salience of their past performance outcomes, get legitimated in the organization's environment. When the focal firm adopts the entry strategies of these affiliate firms, its social status gets enhanced in the eyes of its legitimating actors. Thus, we propose that firms can improve their status by choosing entry modes that are adopted by affiliates in their industry environment.

*Proposition 4: EMFs entering developed markets enhance their social status by adopting the market entry modes of affiliate firms in their industry.*

We have captured the above discussion in the form of a conceptual model in Figure 1. In the figure, we have indicated coercive and normative pressures to positively influence the choice of an isomorphic market entry mode in the focal firm. Such a conformance is expected to provide legitimacy to the focal organization, which, in turn, is expected to positively

influence the collective perceptions of institutional actors about the organization (i.e., its reputation) and enhance its social status.

[Insert Figure 1 about here]

The pressures for regulatory conformance can be operationalized through variables reflecting the regulatory pillar of institutions. A composite measure, calculated on the basis of six dimensions of governance, is available with the World Bank (Kaufmann, Kraay and Mastruzzi 2005). This measure takes into consideration various aspects of political process, viz. civil liberties, political rights, media independence, government stability perceptions and the incidence of market-unfriendly policies. To operationalize normative pressures of conformance, we can rely on Hofstede's cultural dimensions to capture the strength of normative institutions (Giacobbe-Miller, Miller, Zhang and Victorov 2003). Corporate reputation is measured using either of the two indices documented in Van Riel and Balmer's (1997) corporate identity indices, namely, Balmer's affinity audit (BAA) or the Rotterdam Organizational Identification Test (ROIT). Organizational social status, on the other hand, is measured through past performance outcomes and the status of the organization's affiliates. Accordingly, the better the past performance outcomes of the focal organization, and the higher the social status of its industry affiliates, the greater will be the organization's growth in status (Podolny and Phillips 1996). Although we have explained the operationalization of the conceptual model to make it amenable to testing using empirical methods, the study can also be explored by adopting suitable qualitative research techniques.

## **Discussion**

The major objective of this study is to suggest a theoretical framework that captures the dynamics involved in international market entry decisions. Emerging Market Firms (EMFs) investing in advanced economies face pressures for conformance from their host country institutions and their internal stakeholders. The process of foreign direct investment (FDI) is inherently uncertain and decisions surrounding investments are influenced by fragmented environments that offer inconsistent evidence to decision makers (Francis et al. 2009). Thus, firms entering developed markets through FDI-based modes such as wholly owned subsidiaries and joint ventures face a great amount of risk while undertaking investments. Though extant research has focused on the impact of different types of uncertainty on entry mode strategies, and how these uncertainties lead to strategic behavior, there is a clear lack of understanding on how an organization's stakeholders influence entry-mode related decision-making. The theoretical framework detailed in this paper emphasizes stakeholder influences on mode choice and qualitative aspects of performance such as the value-enhancing potential of international entry (reputation) and revenue potential (social status).

Extant research on entry modes assumes that firms select modes that yield them the best return on investment (Brouthers, Brouthers and Werner 1999; Woodcock et al. 1994). However, in the presence of environmental uncertainty, firms lack the information required to estimate costs and return on investments. Alternatively, studies including variables from the cultural context have shown that firms utilizing wholly owned modes in high market potential countries achieve economies of scale that provide them with lower marginal cost, and as a consequence, better performance (Agarwal and Ramaswami 1992). Thus, by combining institutional theory with resource dependency perspective, we have intertwined social embeddedness of organizations with concepts such as power and politics to explore the complex theoretical nature of multinational corporations. We believe that this contingency

perspective provides a good representation of the decision environment facing managers in organizations. In the process, this study responds to the call for better theoretical integration to study emerging phenomena in international business (Kostava, Roth and Dacin 2008).

## **Conclusions and directions for future research**

The area of FDI-based entry modes is germane with ample research possibilities, especially in the context of EMFs entering developed markets. This study is an attempt to bridge this gap by proposing a conceptual model of EMFs entering developed markets. However, despite the novelty of its propositions, this paper is not without its limitations. First, we have assumed that the focal firm has sufficient reference firms in its industry for behavioral inference. In the absence of such firms to constitute reference groups, the focal firm may draw upon its own prior international experience while taking entry mode decisions. Second, we rely on prior literature to capture the essence of regulatory pressures at the industry level and normative pressures at the firm level. However, these are not the only levels at which institutional forces operate. There can be institutional forces operating at a dominant societal level and/or at a sub-national level (Francis et al. 2009). Thus, future research should attempt to conceptualize these interactions at multiple levels. Since emerging markets are defined in terms of economies undergoing institutional transitions, future research should continue to emphasize the institutional theory perspective. The changes in structure (entry mode) and orientation (motivations) of a firm's outward investments has to be studied from the perspective of changes in their respective home institutional environments. This study can also be extended to the context of EMFs entering other emerging and less-developed markets to understand whether stakeholders' influences on entry behavior will vary with the level of institutional development in the host country.



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