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The choice between greenfield investment and cross-border acquisition: A real option approach

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Abstract

The purpose of this study is to formalize the choice of market entry strategy for an individual multinational enterprise (MNE) from a dynamic perspective. It is argued that incorporating a suitable treatment of irreversibility, uncertainty and flexibility related to a MNEs investment decision gives further insights to the choice of cross-border acquisitions to greenfield investment as the preferred entry mode. In most cases, the initial entry strategy serves as a platform allowing the firm to make subsequent investments to exploit host-country advantages and capabilities. We allow for this by taking a two-step expansion strategy explicitly into account. The evolutionary process of the value of the foreign direct investment includes two stochastic elements as well as the timing that triggers the transition from export to foreign direct investment. The results suggest that uncertainty and future investment opportunities play an important role when it comes to transit from export to the first phase of the foreign direct investment commitment as well as have an impact on the choice of entry strategy.

JEL classification: D92; F23; G31; O32

Keywords: Foreign direct investment; Multinational enterprise; Sequential investments; Entry mode; Greenfield investment; Cross-border acquisition

1. Introduction

In todays' fast moving rapidly changing business and technological environment, the form of market entry in new foreign markets has become a crucial decision to most MNEs. Firms

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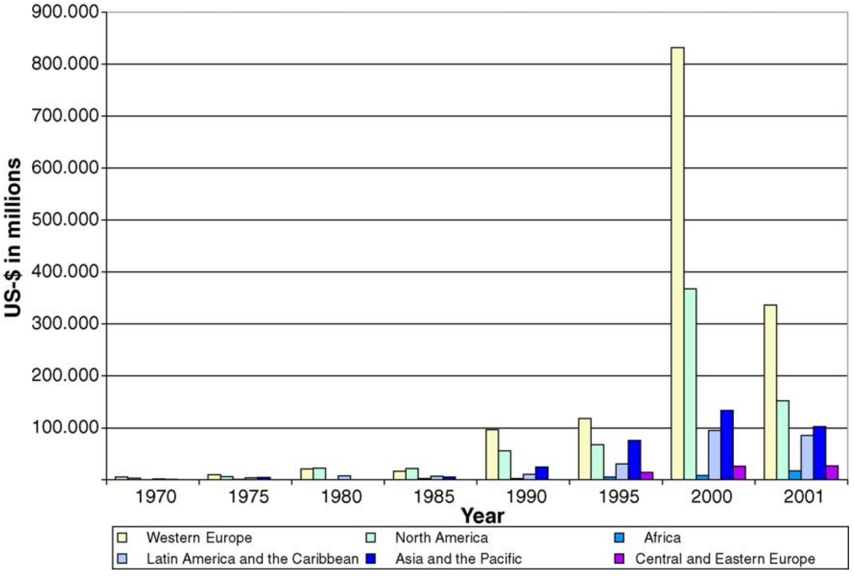

Fig. 1. FDI inflows, selected years and regions. Source UNCTAD (2001).

initially establish themselves in a foreign market through exporting. Although this entry strategy represents a low risk entry mode, it offers little control mechanism if market conditions change. Furthermore, export is associated with limited profits. Leaving other entry strategies, for example joint-ventures, disregarded, a firm will be faced with the decision to increase its resource commitment in the future in order to exploit further growth. Focusing on possible equity modes to enter a foreign market, greenfield investment, i.e. setting up a new plant, as well as the acquisition of an established company in the foreign market represent favorable foreign direct investment alternatives.[1]

Besides all other market entry modes and a perceived decline in 2001, worldwide foreign direct investment (FDI) continues to grow stressing the importance of equity based entry strategies (Fig. 1).

Furthermore, liberalization of foreign entry and ownership restrictions as well as the establishment of international accounting standards and shareholding systems have exponentially increased foreign investors' access to local markets and their ability to acquire assets within them. As a consequence, there exists a perceived worldwide trend of cross-border M&A as a preferred market entry strategy driving the upsurge in foreign direct investment. According to UNCTAD (2001), cross-border M&A accounted for 83% of worldwide FDI in 1999 especially driven by mega deals in telecommunication and media industries. Reasons for this are with no doubt advantages that arise from the resulting market power while reducing competition and from the possibility of speedy entry. The American internet auctioneer EBay for example used cross-border acquisitions in order to expand to thirteen countries within 100 days, leaving other possible entry strategies untouched. Besides this, foreign direct investment in form of greenfield investment becomes attractive for companies to expand in underdeveloped countries.

[1] See Pan and Tse (2000) who distinguish entry modes based upon equity or non-equity modes.