Stock market reactions to entry mode choices of multinational hotel firms

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1. Introduction

As the hotel industry continues its global expansion, several organizational forms have appeared to be favored in entering foreign markets. Contractual agreements such as franchise and management contracts have for long been widespread means of entry (Dunning and McQueen, 1981). Joint-ventures, minority equity interests and wholly owned subsidiaries have also been used, yet to a lesser extent (Olsen and Zhao, 2000).

An increasing amount of studies have attempted to delve into the determinants of choice of entry modes in the hotel industry. For the most part, these scholarly endeavors have tried to provide answers to the questions of which mode is preferred, why it is preferred, and what determines that choice (e.g. Contractor and Kundu, 1998). These determinants appear to be well understood as the findings of these efforts consistently emphasized similar determinants, especially factors related the host country’s risk profile and to the need for control over the assets and operations (e.g. Dev et al., 2002).

What is less clear at this stage is whether the association between these determinants and the chosen organizational form is actually related to the performance of the foreign operation. Indeed, little attention has been paid to the performance consequences of entry mode choices in the general management literature, and no study thus far has ever investigated such relationships in the context of the hotel industry.

As the hotel industry faces an increasingly competitive environment, especially for capital and growth opportunities (Olsen et al., 2007), improving upon our understanding of market entry strategies and their influence on firm performance appears to be an important undertaking. Based upon the current understanding of the determinants of entry mode choices, and the lack of research on the influence of such modal choices on performance, an initial attempt to investigate how investors value entry mode strategies in developed and developing countries appears to be a worthy task. Thus, the present research effort was designed to answer the following questions:

1. Are the entry mode choices in the international hotel industry different for developed and developing host countries?
2. Are the combinations of entry mode choices and the development stages of the host countries valued by investors?

2. Review of literature

The advent of internationalization of business firms has sparked a fair amount of research on means of expansion in foreign markets. For the most part, studies on international development have attempted to investigate the determinants of entry mode choices (e.g. Blomstermo and Sharma, 2006). These efforts have essentially used theoretical arguments obtained from the general market entry literature (e.g. Dunning and McQueen, 1981), transaction cost economics (e.g. Anderson and Gatignon, 1986), the organizational capabilities theory (e.g. Chandler, 1992), or the agency theory (e.g. Shane, 1996) to explain such modal choices. A number of typologies have been suggested, but only a few works have tested the relationships between the mode of entry, its determinants, and the performance outcomes (e.g. Sharma, 1998).

A variety of organizational forms have been included in these studies, ranging from fully owned subsidiaries to licensing and franchising. Sharma (1998) suggested that entry mode strategies could be viewed along a continuum based on the degree of equity investment. Specifically, the range of entry modes can be
encapsulated by the following five organizational forms (from the lowest level of equity investment to the highest): (1) licensing/franchising, (2) management service agreements, (3) joint-ventures, (4) partially owned subsidiaries, and (5) fully owned subsidiaries (Cateora and Graham, 1986).

2.1. Determinants of entry mode choices

The choice between these organizational forms has been viewed as dependent on several factors. The initial works on the internationalization of business firms essentially concentrated on the choice between exporting goods from the home country and producing in the host country via foreign direct investment (FDI).

In these early works, a number of factors related to the host country, the companies themselves, as well as environmental conditions, have been presented as key determinants. McCarthy et al. (1993) surveyed 42 companies active in the former USSR, and reported that the entry mode choice (i.e. licensing versus FDI) was affected not only by the perceived level of risk, but also by the type of business activities carried in host nation. These findings were echoed by Shama (1995) who found that entry strategies were influenced by the perceived risks, companies past entry mode experience and activities, and perceived growth opportunities in the host market. The author also suggested that the timing of entry was an important consideration as the evolution of the host country’s political and economic environment alters the risk–reward relationship, making some entry modes more adequate in later stages of the development than in earlier stages.

Root (1987) proposed a generic framework of the factors affecting entry mode decisions. He suggested that the modal choice of entry was contingent upon three major factor groups: (1) company factors, (2) host country factors, and (3) host country environmental factors. Company factors included the type of products or services, the technological intensity, and the firm’s resources. Host country factors comprised variables such as market potential, degree of competition, production costs and the state of the labor market. Finally, the host country’s environmental factors encompassed economic, political and socio-cultural factors in addition to the geographical distance to the home country.

Shama (2000) empirically investigated the relative importance of a number of these factors on the choice of entry mode made by U.S. multinational firms in eastern European countries. Based on the responses of executives from 101 U.S. companies to a mailed questionnaire, the author found that the economic outlook of the host country, the level of competition, the year of entry of the firm in the host market, as well as the type of activities performed by these firms were the most important factors influencing the choice of entry mode. Specifically, he found that, as firms become more experienced in a foreign market they tend to adopt more risky organizational forms and make additional equity investments. His results also suggested that the type of activities conducted affected the choice between exporting and licensing versus joint-ventures and partial or full ownership. In particular, the degree of interaction with the consumers appeared to play a major role as firms offering services with a high degree of interaction tended to favor more equity investment modes in an attempt to ensure strict control over the service process.

2.2. Transaction cost perspective

A number of studies have concentrated on transaction costs as primary factors affecting the entry mode choice. The transaction cost economics (TCE) analysis framework suggests that firms will select the modal choice that minimizes the sum of their production and transaction costs to enter in new markets (Williamson, 1975). These costs essentially refer to the expenses incurred for preparing and enforcing contractual agreements. Anderson and Gatignon (1986) formalized the TCE approach in their theory of choice of entry mode. The authors made a series of propositions linking the mode of entry choice to the specificity of the assets being operated or transferred abroad, the external uncertainty in the host country, the internal uncertainty related to operating the assets in a foreign country, and the “free-riding” potential of the foreign operation.

Several empirical efforts have been made to test these proposed relationships. Anderson and Coughlan (1987) surveyed firms in the semiconductor industry and investigated the extent to which the specificity of the assets transferred abroad dictated the choice of internalization versus externalization of the companies’ distribution channels. Using logistic regression analysis, the authors found that high degrees of asset and product specificity were associated with highly integrated channels of distribution.

Contractor and Kundu (1998) used a number of TCE determinants in their study of the hotel industry. By means of mailed questionnaires, the authors surveyed 1131 hotel properties established in foreign markets. Using a generalized logit regression model, they investigated the determinants of choice between four entry modes: franchise, management contract, partly owned, and fully owned. The authors found that a majority of determinants were significantly different in the hotel industry than in manufacturing sectors. Yet, they also found similarities, principally with regards to the influence of external and internal uncertainties. Specifically, their results suggested that high external uncertainty, operationalized by a country risk index, favored the use of low equity involvement entry modes, such as franchising or management contracts. They also found that the low internal uncertainty, resulting from the control hotel chains could maintain over their key strategic assets, enabled hotel chains to expand without much equity investment. They argued that contractual relationships (i.e. franchise and management agreements) could effectively substitute for the increased control that normally results from equity involvement, and that the de facto control of the reservation systems and brand names sufficiently lowered internal uncertainties.

In their review of TCE studies on factors influencing entry mode choices, Zhao et al. (2004) examined the consistency of the results found in 38 TCE based studies on entry mode choice. The authors expressly considered the signs and significance of factors related to the four constructs of the TCE theory, which included variables such as the asset specificity, the country risk, the cultural distance, the international experience, and the advertising intensity. The results of their meta-analysis suggested a high degree of consistency amongst studies and with TCE theoretical arguments for the asset specificity construct. Findings on the influence of the other determinants were more ambiguous. The authors found high consistency when the modal choices were polarized (i.e. wholly owned versus licensing), but more conflicting evidences when intermediate modes (e.g. joint-venture, partly owned) were considered. They also found that a number of other factors not accounted for by the TCE theory moderated these relationships. For instance, they found that other industry and firm specific factors had an important moderating role.

2.3. Agency theory perspective

The TCE studies have for the most part attempted to investigate how firms were making the tradeoff between the risks and returns associated with various modes of entry under different circumstances captured by the specificity of the assets and the internal and external uncertainty. The notion of control has been viewed as one of the most critical elements to this tradeoff (Arora and Fosfuri, 2000).
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