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• Conceptual framework
Emerging Countries

The term emerging market economy can mean different things, and there are several and not commonly accepted definitions. An Emerging Economy can be defined as a country that satisfies two criteria: a rapid pace of economic development, government policies favouring economic liberalization and the adoption of a free market system (Arnold and Quelch, 1998). Most analysts argue that an EM can be defined according to its size, growth rate and length of time it has opened to global markets. Khanna and Palepu (2007, p.42) claim: “the most important criterion is how well an economy helps buyers and sellers come together”. Moreover, a political scientist, Ian Bremmer (2008), defines the EMs: countries where politics (e.g. institutions, public organizations) are as important as the market itself. That is the reason for the importance of the institutional view in a strategy elaboration step (as it is explained later in the text).

Arnold and Quelch (1998) identify the pillars by which any definition of an emerging market should be based:

1. Average GDP per capita and relative balance of agrarian and industrial/commercial activity
2. GDP growth rate
3. Extent and stability of the free market system, namely, the openness and reliance of the market.

To better identify such countries, we have considered Morgan Stanley Capital International\(^1\) (trading as MSCI Barra), and Dow Jones Total Stock Market Index\(^2\) (Emerging Market Segment).

Coleman (2007) reports that when Deloitte asked manufacturing executives about their prospects in emerging markets compared with those coming from developed economies, 58% were expecting a substantial growth coming from the firsts, while just the 23% were optimistic for the second.

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\(^1\) the list tracked by The Economist is the same except Singapore, Saudi Arabia and Hong Kong included.

\(^2\) Cme Group Index Services, “Dow Jones Total Stock Market Index”, (May 2010)

** South Korea is excluded**
Entry barriers

From a “on ground” perspective, EMs hide several difficulties. As London and Hart (2000, p.18) wrote: “Scalability, flexibility, decentralization, knowledge sharing, local sourcing, fragmented distribution, non-traditional partners, societal performance and local entrepreneurship” appear as the elements that should be taken into account. Aspects that can match with the different patterns of evolution that characterize these heterogeneous countries. There are several classes of entry barriers that imply disadvantages for entrants. From the classification of Porter (1980):

- Scale effects (here the entrant may need substantial volume in order to attain low costs)
- Product differentiation (this creates preferences and loyalties among buyers and sellers)
- Switching costs (customers who want to switch from one supplier to the other)
- Access to distribution channels (available channels might be dominated by competitors)
- Costs independent of scales (such as access to raw materials, or innovations etc)
- Government policies and regulations (interventions might be required)

Moreover, some researchers (Zhang et al. 2007; Luo, 2002; etc.) reported that uncertainties in EMs can be classified at three levels: culture specific (e.g. cultural distance); country specific (e.g. policy environments); and market specific (e.g. property rights, suppliers).

MNCs can overcome liabilities of foreignness through internalization, leverage or sharing existing products and resources within the firm’s boundaries: in order to capture EMs opportunities the MNC strategy can either exploit economic global efficiency (economies of scale) or encourage the adaptation to local needs and conditions (local responsiveness). In this strategic mix, the suggestion made by International Management Scholars is to develop different strategies for different market segments among the different countries. “To enter into the base-of-the-pyramid, beyond the adaptive skills of national responsiveness, MNC should import business models based on past global practices and capabilities, extracting knowledge, protecting and controlling resource flows”. (London and Hart, 2000, p. 6).
Strategies and Emerging Markets

Whereas “western companies can lower costs by setting up manufacturing facilities and service centres in EMs, where skilled labour and trained managers are relatively inexpensive; […] several emerging-country transnational corporations have entered North America and Europe with low-cost strategies” (Khanna and Palepu, 2005, p.64). From this point of facts, being active and delocalizing in ECs becomes a compulsory counter-Strategy for western companies. As Khanna and Palepu (2005) argue, western MNCs cannot avoid engaging across their value chains with developing countries, since they cannot remain competitive for long time. This can be explained by the progressive upgrading of the product quality and market knowledge of the EC’s based companies, combined with the indisputable advantage coming from a huge domestic market potential that can provide Economies of scale and competitive advantages basically due to huge domestic margins.

Seeking low-cost factors: a model for the fragmentation of production

One of the reasons that pull a MNC toward EEs is the factor of low-cost: delocalization of production and fragmentation. As transport costs fell for intermediate goods, firms started to fragment their production, becoming either vertical (if upstream activities are labour intensive), or horizontal (if downstream activities are labour intensive) (Venables 1999). Venables builds up a model in which two economies, Home and Foreign, are endowed with two factors (K; L), and there are two industries X (produce in both the economies) and YZ (it has an upstream and a downstream activity producing intermediate good Y and final output Z). It is then demonstrated that fragmentation of production may lead to the development of either vertical or horizontal MNCs. Demirbag (2008) argues, that comparative cost advantages in a host country influence the foreign investor’s entry mode choice, vertical or horizontal fragmentation in EEs becomes a crucial step in building successful global strategies. If upstream production is relatively labour intensive, then vertical MNCs develop and trade flows increase. Fragmentation of production starts when t(Y)³ is low enough to make Y production convenient in a Foreign country. But if downstream production is labour intensive then firms become horizontal MNCs, just by moving some of their final assembly to

³ Trade costs of moving the Y production to Foreign country
the country in which it is sold. This reduces the value of trade, as trade in final products is replaced by trade in intermediates. Whether MNC activity is a substitute or a complement with trade therefore depends on the relative factor intensities of upstream and downstream production (Venables, 1999).

**Business Groups**

“According to the official definition by the Chinese government, a business group consists of legally independent entities that are partly or wholly owned by a parent firm and registered as affiliated firms of that parent firm” (Yiu et al., 2005,p. 193). Within the hosting environment, Business Groups are an active actor that can constitute an obstacle (opportunity too) for the MNCs’ penetration of the social and industrial context. Literature suggests that “government involvement has been particularly pertinent in the formation of business groups in most EEs, such as Pakistan, Latin America, Indonesia, Korea and China” (Yiu et al., 2005, p. 187). The capability of these groups in benefiting members-of-the-group companies are enormous in contexts such as those of the ECs: obtaining licenses, arranging for financing from shallow capital markets, identifying potential technology partners, setting up distribution chains to overcome infrastructure bottlenecks, and organizing skilled labour pools. These skills are believed to be fundamental requisites for successful entry across a broad spectrum of industries in EMs (Li, Rammasway and Petit, 2006). The following table summarizes which are the main “services” that Business Groups can provide in order to add value:

<table>
<thead>
<tr>
<th>Institutional dimension</th>
<th>Institutions that groups imitate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Market</td>
<td>Venture capital firm, private equity provider, mutual fund, bank, auditor</td>
</tr>
<tr>
<td>Labour Market</td>
<td>Management institute/business school, certification agency, head-hunting firm, re-locations service</td>
</tr>
<tr>
<td>Product Market</td>
<td>Certification agency, regulatory authority, extrajudicial arbitration service</td>
</tr>
<tr>
<td>Government regulation</td>
<td>Lobbyist</td>
</tr>
<tr>
<td>Contract enforcement</td>
<td>Courts, extrajudicial arbitration service</td>
</tr>
</tbody>
</table>

*Source: Khanna and Palepu (1997)*
Emerging Country Analysis

Country Portfolio Analysis
The CPA is the base by which the choice of an emerging country should start. Executives usually build up a picture of the country by using the main national indexes (GDP; per capita income; population composition and growth rates; exchange rates; past, present and projected PPP indexes. To complete this first approach to the country, “MNCs may consider: Global Competitiveness index; World Bank governance Indicators; International Transparency corruption ratings; weight in emerging market fund investments; and perhaps, forecasts of its next political transition” (Khanna and Palepu 2005, p.65).

5-Contexts Framework
The 5-Contexts Framework helps Executives in creating a map of the context of each country in such a way that the political and social system, the degree of openness to FDI, product, labour, and capital markets are shown to the extent by which they work or do not work. “A framework that places a superstructure of key markets on a base of socio-political choices” (Khanna and Palepu, 2007, p. 66). The 5 Contexts are: Political and Social System; Openness; Product Markets; Labour Markets; Capital Markets.
The methodology of the Khanna and Palepu’s framework requires managers to be able to find the institutional voids of each targeted country by first asking a series of questions. Secondly, the ability of the managers in taking advantage of this framework can be found in the accuracy through which information is collected and questions are answered.

Political Risk Assessment
Political Risk is not a statistical, computable element. It is better called political

4 The key questions for identifying institutional voids edited by Khanna and Palepu are attached at the end of the chapter (Attachment 1).
uncertainty, since it is not possible to calculate due to its unsystematic nature (Lindeberg and Morndan, 2000), we consider it as the probability that an event occurs times the magnitude of the possible loss. Political risk refers to the fact that politics decisions and enforcements, can heavily affect the business climate in such a way that investors lose money or do not make as much money as they expected when the investment was made (Kobrin, 1982). In general, when authors refer to such a risk, they are speaking about the extent to which a government may interfere for their own interest. According to Kobrin (1982), political contingencies include micro risks (changes in industry specific conditions) and non-macro risks (uncertainty to which all firms in a country are exposed) as several authors have categorised. Two other aspects that have been pointed out by scholars are the internal and external dimension of the political event, and the governmental and societal base.

**Strategy in EEs: theoretical perspectives**

“Many competitive advantages in EEs are based on network relationship and close business-government ties, with firms becoming effective monopolies in their home markets. As the institutional context changes, there are necessary changes on both “asset structures and orientations” of the firms (Hoskisson et al. 2000, p. 256). Because of institutional voids, managers must often rely more on their ties with the business community and/or government officials to conduct business (Li et al. 2008). Hoskisson et al. (2000) argued on the other hand, that the importance of an institutional field of research will slow down as the development of the ECs increase, “which means that as EEs move towards a market economy, firms should adopt more market-based strategies, such as market orientation, to improve performance” (Li and Zhou, 2010, p. 856). This last suggestion enhances the necessity of the inclusion of other theoretical frameworks for the near future, and integration with the institutional one.

**Institutional Theory**

Institutions are defined as collective and regulatory complexes consisting of political and social agencies (Child and Tsai, 2005). Treating ECs and indeed, the early stages of a market economy, authors find that IT is a pre-eminent vis-a-vis transaction cost, resource based view theories, in explaining impacts on enterprise strategies.
(Hoskisson et al. 2000; Khanna and Palepu, 1997, 2005; Wright, 2005; Estrin, 2010; Child, 2005; Peng, 2008). Even with the necessity of other theoretical patterns, the dominant theory guiding strategy elaboration in EEs is indeed, the Institutional perspective. The institutional effect on the performances of firms, however, varies across countries because institutions are developed and sustained in their paths by the dependent and highly localized processes in the country (Makino et al., 2004, p. 1032). As Oliver (2001) noted, the main response for a firm in an emerging host country should be an active behaviour, changing the institutional environment and developing strategies, instead of simply adapting to it passively. There are several documented researches concerning MNCs subsidiaries (Makino et al., 2004), arguing that country-effects in EEs (proxies for institutional differences) are crucial, while corporate-effects are more critical when explaining subsidiary performance in developed economies (Peng et al. 2008). “Institutions govern societal transactions in the areas of politics (e.g. corruption, transparency), law (e.g. economic liberalization, regulatory regime), and society (e.g. ethical norms, attitudes toward entrepreneurship)” (Peng et al. 2008, p. 922).

In an under-institutionalized environment like EEs, managerial ties may primarily matter in order to gain institutional advantage. Several empirical researches (e.g. Peng and Luo, 2000) demonstrate that personal ties with government officials possessed by a firm’s top managers are positively associated with steady performance, thus giving an institutional advantage. Even more so, a resource based perspective evaluates managerial ties as a valuable and intangible resource.

Peng (2006; et al., 2008) argues that the institution based view constitutes one leg sustaining a “strategy tripod”, in an integrated theoretical framework composed of Porter’s industry and Barney’s resource-based view. Peng, Wang and Jiang (2007) argue that the treatment of institutions as a mere background is insufficient and can rarely represent a source of advantage opportunities. Here we deal with the institutions as independent variables (Peng, 2006), the strategic options are outcomes of the interaction between these and the dynamism of the company.

Here the main frameworks we can integrate with the Institutional theory:

- Transaction cost theory (TCT);
- Resource-based view (RBV) (including Knowledge and Learning perspectives);
- Agency theory (AT);

**Entry Mode Choice**

Buckley and Casson (1998) list twelve entry strategies: Normal FDI, FDI in production, Subcontracting, FDI in distribution, Exporting, Franchising, Licensing, Integrated JV, JV in production, JV in distribution, JV in exporting. Six of them have several variants, while the "stages" of the strategy laid out are based on the following issues: (1) where production is located; (2) whether production is owned by the entrant; (3) whether distribution is owned by the entrant; (4) whether ownership is outright or shared though a JV; and (5) whether ownership is obtained through greenfield investment or acquisition (Buckely and Casson, 1998).

It is then distinguished linkages involving the flow of information from R (R&D) to P (Production) and M (Marketing) to D (Distribution), and linkages involving the flow of physical product from P to D, and from D to final demand.

To be consistent with the biggest part of the researchers on entry mode choices, almost exclusively based on the three reference entry forms (JV, Greenfield and Acquisition), we are going to investigate how they are determined by several crucial factors.

In general terms: “a JV is the most convenient way to acquire the resources of a local partner as well as minimizing environmental risk; Greenfield provides the greatest control over the local facilities but sometimes may not be related with policy privileges from governments; and finally, acquisitions offer the fastest means of building a presence in foreign market, but problems may be caused by overpayment and the challenge of cultural and national differences” (Zhang et al. 2007, p.756).

Below, the entry mode function of the main aspects that determinates the choice between JV/Acquisition/Greenfield, based on Bhaumik and Gelb (2005):

**Entry mode =** \( f: \text{(Growth of local industry, Technology-intensiveness of product, Competition in the local market, Resource needs of the MNC, Local institutions, governance, and business regulations, Prior operating experience in developing-country environments, Cultural distance} \)
between MNC’s home country and host country, Extent of liberalization of FDI regulations and industry-specific regulations, Perceptions about quality of host country’s managerial labour, Sector of operation of the MNC)

Table 19 – General entry mode choice determinants

<table>
<thead>
<tr>
<th></th>
<th>JV</th>
<th>Acquisition</th>
<th>Greenfield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cultural distance</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Competition</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Resource need</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Knowledge of the country</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Relative size of the investment</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Quality of local management</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technology intensiveness of the product</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Growth of local industry</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extent of liberalization of FDI regulations and industry-specific regulations</td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Future Expected Profitability of the industry</td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

One of the investing firm specific factors for EC entry, is the MNC’ *input dependency*. Demirbag et al. (2008) argues that this aspect can be explained by both the Resource Dependence Theory and the RBV: the first considers the firm facing a complex set of resource dependencies, thus, in general terms, MNCs would choose a greenfield mode of entry to avoid agency concerns and costs coming from partner-relationships. RBV instead (resources are inimitable and imperfectly substitutable), considers a greenfield investment as preferable because it protects such resources, allowing a more efficient knowledge transmission between parent and subsidiary. *Diversified companies* could prefer acquisitions instead of greenfields, in this way getting all the advantages coming from such mode of entry, and exploiting their sophisticated management practices, minimizing transaction costs (Brouthers and Brouthers, 2000).

*Cultural distance* is a widely used determinant to elaborate entry strategies for MNCs (Harzing, 2002), as we have already seen. However, Demirbag et al. (2005), integrate it with TCT: as cultural distance (or dissimilarity) increases, investment in non-redeployable assets in the EC becomes riskier. So, we might hypnotize higher efficiency levels of a greenfield investment, since strong differences in the host country contexts could create concerns in the management practices, between MNCs

---

5 The table is based on the results of a multinomial logit regression model based on responses from a sample of 114 observations in South Africa.
and partners. Indeed, an higher cultural distance facilitates partnerships (JV or acquisitions), in order to avoid lack of environment/market knowledge (Brouthers and Brouthers, 2000). Finally, it can be argued that there is a relationship between the size of the parent firm and the entry modes. The greater is the size of the parent organization, the greater the likelihood of a greenfield entry (Demirbag et al. 2005). Scholars have also sustained the opposite argument: since larger firms have managerial resources and capabilities to facilitate integration and transaction costs, they may tend to prefer acquisitions.

Table 20 – Investing firm specific determinants

<table>
<thead>
<tr>
<th>The higher is…</th>
<th>Acquisition</th>
<th>Greenfield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Input dependency</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Extent of diversification</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Previous commercial association</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Cultural distance</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Parent size</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

Now we will illustrate the main findings made combining Institutional and resource-based view:

- **H1 - The stronger the market supporting institutions in an emerging economy, the less likely foreign entrants will enter by JV (as opposed to greenfield or acquisition).** (Meyer et al. 2009)

Even though Bhaumik and Gelb (2005, p. 20) confirm Meyer’s finding, he argues the opposite: “in South Africa, a low perceived quality of the institutions, is associated with a lower probability for acquisition and with a higher probability for JV relationships. In Egypt, on the other hand, a high value of institutions is associated with a lower probability for JV and a higher (though not statistically significant) probability for acquisition. The results suggest hat, ceteris paribus, a low quality of institutions increases restructuring cost in South Africa and agency costs in Egypt”.

In EEs, investing firms usually require specific context resources to achieve competitive advantages. They come in two forms: 1) network and relationship-based strategies (since law and property rights enforcements are weak). 2) Local sources of strategic capabilities that enable the firms to build and maintain networks and relationships.

---

6 The table is based on the Demirbag et al. (2005) research on 145 foreign affiliates formed by MNCs from 15 different countries. The method is the binomial logit analysis.
H2a - The stronger the need to rely on local resources to enhance competitiveness, the less likely foreign entrants are to enter in EEs by greenfield (as opposed to acquisition or JV); and H2b - this effect is stronger when requiring intangible assets compared to tangible assets. (Meyer et al. 2009)

Finally, to understand how the two dimensions of institutions and resources interact, Meyer et al. (2009) built the following table:

Table 21 – Resources, Institutions and entry modes

<table>
<thead>
<tr>
<th>Institutional framework</th>
<th>Extent of market failure</th>
</tr>
</thead>
<tbody>
<tr>
<td>weak</td>
<td>strong</td>
</tr>
<tr>
<td>Local resources acquired</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td>Tangible</td>
</tr>
<tr>
<td></td>
<td>Intangible</td>
</tr>
</tbody>
</table>

\[ \text{Sensitivity to market failure} \]

|                | Greenfield | Greenfield  
|----------------|------------|
|                | \( \downarrow \text{H2a} \) | Greenfield  
| JV             | Greenfield  
| Jv             | Acquisition  

Source: Meyer et al. (2009)

More specifically, by the integration of the institution and resource perspective:

H3 (a) – Under conditions of strong institutions, the greater is the need of foreign entrants for intangible resources, the more likely they are to use acquisition or joint venture rather than greenfield; and (b) – under conditions of strong institutions, the need for local tangible resources will not influence the choice of entry mode. (Meyer et al. 2009)

---

7 Meyer et al. used a Multinomial logit regression model over a collection of data coming from 613 responses received among 4 countries (Egypt, India, South Africa, and Vietnam).
8 except when asset specificity is high, when acquisition or JV may be appropriate.
9 except when market failure is bilateral and takeover is infeasible (e.g., due to scale issues).
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