



Unfavorable Market Conditions, Institutional and Financial Development, and Exits of Foreign Subsidiaries



Sangcheol Song*

Saint Joseph's University, College of Business, 5600 City Avenue, Philadelphia, PA 19131, United States

ARTICLE INFO

Article history:

Received 23 April 2012

Received in revised form 29 October 2013

Accepted 29 October 2013

Available online 10 December 2013

Keywords:

Multinational corporations

Foreign subsidiaries

Exits

Real options perspective

Institutional and financial development

Market demand uncertainty

ABSTRACT

In this paper, we examine how market conditions in host countries affect the entry and exit decisions of multinational corporations' foreign subsidiaries. Taking the real options perspective, we expect that smaller investments will be associated with more flexible entries and exits. We also predict that better-established host countries with greater institutional and financial development will facilitate the exits of foreign subsidiaries with smaller investments under unfavorable market conditions. We run a Cox proportional hazard rate model with a dataset of Korean foreign direct investments, and find that when market conditions become more unfavorable, foreign subsidiaries making smaller investments that were endogenously chosen under the influence of market demand uncertainty are more likely to engage in earlier exits than subsidiaries making larger investments. We also find that strong institutional and financial development positively moderates small subsidiaries' exits under conditions of unfavorably resolved uncertainty.

© 2013 Elsevier Inc. All rights reserved.

1. Introduction

The real options perspective (ROP) has been the subject of active study in international business research, as it sheds new light on how multinational corporations (MNCs) flexibly respond to unexpected changes in macro-economic conditions (Cuypers and Martin, 2010; Chung et al., 2010; Fisch and Zschoche, 2011; Kogut, 1991; Tong and Reuer, 2007). Under conditions of high uncertainty in foreign markets, it is typically better for firms to retain flexibility by maintaining lower levels of commitment that allow for easier entries and exits (Cuypers and Martin, 2010; Kogut, 1991; Tong et al., 2008). ROP literature accordingly finds that smaller investments are considered to carry more real options than larger investments such as majority ownership or acquisition (Cuypers and Martin, 2010; Kogut, 1991; Folta, 1998; Tong et al., 2008; Xu et al., 2010).

Real options, as future decision rights that are embedded within smaller investments, can enable firms to monitor the business situation in a particular market or industry at a relatively low cost. Smaller investments allow firms to preserve upside potential by acting as low-cost entry portals into new markets and industries and can be the basis for further acquisitions and investments when a business situation is found to have a great deal of economic potential (Chi, 2000; Chi and McGuire, 1996; Folta, 1998; Miller and Folta, 2002; Kogut, 1991; Kumar, 2005; Reuer and Leiblein, 2000). At the same time, smaller investments allow firms to limit their downside risks by enabling them to withdraw at a low cost from situations that hold little significant promise as business opportunities.

While the assumption that the real options characteristics of smaller investments generate additional value has been explicitly tested (Tong et al., 2008), the assumption that real options investments are less costly and easier to exit under unfavorable situations has not been objectively examined. As it may in fact be neither easier nor less costly to exit when uncertainty is unfavorably resolved, it is necessary to examine whether, as the ROP predicts, smaller investments can actually enable earlier exits from unfavorable situations than larger investments. Since smaller investment decisions are endogenously made based on the consideration of high uncertainty and other factors, the endogeneity problem in the relationship between a firm's decision and performance should be

* Tel.: +1 610 660 3138; fax: +1 610 660 1229.

E-mail address: ssong@sju.edu.

taken into consideration (Lee et al., 2008; Shaver, 1998). It is also necessary to examine whether or not firms can actually exit from unfavorable situations when they choose to. The timing of exits from investments may not be possible in the manner predicted by the ROP, due to exit barriers. Despite the need for further research in these areas, few studies have discussed the costs or ease of exits associated with exit barriers.

The purpose of this paper is to examine the exit conditions and barriers facing small-sized foreign subsidiaries exposed to unfavorable market conditions. It begins by examining the relationship between declining market growth rates in MNCs' host countries and the exit rates of their foreign subsidiaries with smaller investments. It then examines how easily these subsidiaries are able to exit, taking into account host countries' levels of institutional and financial development, which are considered to reflect the depth of their bankruptcy and capital markets, and the ease of exits.

This study contributes to existing literature in three ways. First, it contributes to literature on foreign exits by improving understanding of the specific conditions or barriers that prevent subsidiary exits from occurring in the manner proposed by the real options perspective. Second, it contributes to literature on the real options perspective by testing the impacts of unfavorably resolved exogenous uncertainty on the exercise of the option to exit. Finally, it contributes to institutional perspectives on foreign subsidiary exits by investigating the interplays between market conditions and degree of institutional development in host countries.

2. Theoretical underpinnings and hypothesis development

2.1. Uncertainty and investment size

The real options logic has been actively studied in the realm of international business over recent years, as multinational corporations face several macro-economic uncertainties including demand, institution, labor costs, and exchange rates (Chung and Beamish, 2005; Chung et al., 2010; Cuypers and Martin, 2010; Goldberg and Kolstad, 1995; Huchzermeier and Cohen, 1996). Under these circumstances, flexible responses to the environmental challenges associated with macro-economic factors in host countries are crucial to the performance and longevity of MNCs (Chung et al., 2010; Fisch and Zschoche, 2011; Lee and Makhija, 2009a, 2009b; Lee and Song, 2012). Therefore, it is more valuable for MNCs under the influence of macro-economic uncertainties to structure foreign direct investments (FDIs) in a manner that keeps options open, carrying more future decision rights but not the obligation to exercise them without incurring significant costs.

Given that real options embedded in FDIs allow firms to preserve upside potentials while limiting downside risks, the literature on real options argues that rather than committing to full initial investments, firms should begin with small investments, because these investment types provide firms with more flexibility in terms of minimal firm outlays (Cuypers and Martin, 2010; Kogut 1991; Folta, 1998; Marciukaityte et al., 2009; Reuer and Tong, 2010; Tong et al., 2008; Xu et al., 2010). This is also because the upside potential of small investments can be very high, while the cost of developing and managing them, including the cost of canceling them can be relatively low.

Real options embedded in small investments can enable a firm to monitor the business situation in a particular market or industry at relatively low cost. If it turns out that a situation offers little hope for significant business opportunities, then it is possible for a firm to withdraw from its investment at low cost. On the other hand, if a business situation has a great deal of economic potential, a firm can use its investment as a low cost entry portal into a market or industry, which can be done, among other ways, through further investment or acquisition (Chi, 2000; Chi and McGuire, 1996; Folta, 1998; Miller and Folta, 2002; Kogut, 1991; Kumar, 2005; Reuer and Leiblein, 2000).

2.2. Unfavorable market conditions, investment size, and subsidiary exits

Changes in the conditions of markets in which foreign subsidiaries operate significantly influence their operations (Cuypers and Martin, 2010; Kogut and Kulatilaka, 1994). In particular, future changes in market growth rates determine the level of market demand, thereby influencing a firm's production and sales volume. Therefore, for better performance and longevity, companies are required to respond to uncontrollable changes in market demand in a manner that they are able to exploit upside potentials in favorable situations and limit downside risks in unfavorable situations.

Host market conditions can change either favorably or unfavorably. Favorable changes in the market conditions of a host country can be beneficial, because they provide subsidiaries with more business opportunities to exploit the market's potential. A foreign subsidiary that manufactures or sells its products in a country with favorable market conditions may generate more profit and have a greater competitive advantage than those in other countries. A favorable situation also motivates a subsidiary to increase its local presence by making more investments. Studies have found that small initial investments within new foreign markets allow incremental strategy commitment (Xu et al., 2010), and facilitate future expansion (Chang, 1995). Once foreign direct investors' small investments are in place, if demand is stronger than expected, they are able to expand their operations in a country (Kogut and Chang, 1996; Kogut and Kulatilaka, 1994).

On the other hand, unfriendly changes in its host market conditions affect a subsidiary's profitability and longevity negatively. From its parent MNCs standpoint, the subsidiary in trouble may be the target for shrinkage or (Allayannis and Ihrig, 2001; Bartov and Bodnar, 1994). As such, when host market conditions become more unfavorable, MNCs' foreign subsidiaries are expected to exit.

This exit probability is influenced by the size of the investment involved. A small investment can be terminated at a relatively low cost if the market is less advantageous than originally envisioned (Slangen and Tulder, 2009). When the uncertainty level

Download English Version:

<https://daneshyari.com/en/article/1020294>

Download Persian Version:

<https://daneshyari.com/article/1020294>

[Daneshyari.com](https://daneshyari.com)