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Make-or-Break Decisions in Choosing Foreign Direct Investment Locations

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ABSTRACT

Firms have variable risk preferences in decision-making processes, but previous studies in the field of international management tend to view firms as inherently risk averse, and risky location choice as rare and exceptional. Drawing upon the arguments of problemistic search and slack search, we investigate the conditions under which firms make risky choices of location for foreign direct investments. Using longitudinal international expansion data on firms in the Japanese auto parts industry, we find that although firms generally avoid risk in choosing foreign direct investment destinations, they take risks when facing intense home-country competition and a lack of business group affiliation. Nonetheless, we find that small firms with business group affiliation are more likely to enter host countries with high political instability than are large firms with such affiliation.

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1. Introduction

International expansion is associated with high levels of risk, because it involves a considerable amount of resources under conditions of uncertainty. Risk is the “unpredictability or downside unpredictability of business outcome variables”, and uncertainty refers to “the perceived unpredictability of environmental and organizational contingencies” (Bromiley et al., 2001: 261). Specifically, the central premise in the international management literature is that although international expansion is certainly an important means to achieving competitive advantage, growth, and positive returns (Zahra et al., 2000), it requires firms to overcome various types of uncertainty arising from their lack of knowledge about local demand in foreign markets and the unpredictability of political, social, and economic systems (Ghoshal, 1987).

As such, studies on international expansion reflect the widespread assumption that firms are inherently risk averse and primarily consider risk reduction strategies in international expansion. Drawing from institutional theory, a number of previous studies have centered their efforts on the imitative behavior of firms. Firms reduce foreign investment risk by imitating the patterns of internationalization by other firms, because imitation not only grants legitimacy to firm decisions but also provides informational cues about the foreign market (Chan et al., 2006; Guillen, 2002, 2003; Henisz and Delios, 2001; Li and Kun, 2010; Martin et al., 1998; Xia et al., 2008). Moreover, a more straightforward strategy suggested in the literature is to avoid unfamiliar and politically hazardous countries as destinations for foreign investment (Globerman and Shapiro, 2003; Henisz and Delios, 2001; Henisz and Macher, 2004; Jones, 1984).

These studies have certainly advanced our understanding of organizational strategies for reducing risk in the processes of international expansion. However, the presupposition in the international management literature that organizations are inherently risk averse is not consistent with the view prevalent in other fields, such as strategy, that firms have variable risk preferences responsive to changing uncertainty and situations (March and Shapira, 1992). Firms do not always avoid risk but may engage in risk-taking behavior under some circumstances. A number of empirical studies have examined what accounts for variations in risk

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preferences and what motivates firms to take risks by using data on strategic change (Greve, 1998), investment in innovation (Greve, 2003), and diversification (Palmer and Wiseman, 1999). Unlike those in the international expansion literature, these studies have persistently considered risk taking as a foundational element of organizational changes and strategies that are essential for organizational success and survival.

This inconsistency obscures the mechanisms underlying the evident risk-taking behavior of firms in choosing foreign direct investment (FDI) locations. For example, despite uncertain market demand, the Honda Motor Company made the fortunate decision to establish its first plant in the U.S.A. in 1979, while all other Japanese automobile manufacturers, including Toyota and Nissan, hesitated. Similarly, rather than wait until the growth potential of India was realized and for its competitors to enter the country, the Japan Credit Bureau, a Tokyo-based credit card company, located its foreign investments in India in 1979. In the 1960s, Gulf Oil and Shell entered Nigeria, where risk was high because of political and social turmoil caused by the civil war and the overthrow of the government (Frynas and Mellahi, 2003). In 1995, the Ford Motor Company established a plant in Vietnam, which was fraught with political problems, and even the rule of law was not assured. In addition to these historical cases, Rose and Ito (2008) found that some firms prefer foreign markets with few or no rivals and tend not to imitate other firms' choices of FDI locations. Although we have such historical and empirical evidence of firms entering risky foreign markets, we lack theory that explains their actions in a coherent manner. This lack of theoretical models limits our capacity to understand the factors that influence firms' entry into risky foreign markets or to suggest strategies to attract FDI in such markets. We know little about which firms are more likely to enter foreign markets despite high levels of risk or how policy makers should allocate scarce resources to lure foreign investors.

In this study, we overcome these shortcomings and extend the existing literature by investigating the conditions under which firms make direct investments in foreign markets with high levels of risk. In developing our framework, we follow previous studies and focus on two types of risk: (1) the unpredictability of potential demand and the feasibility of doing business in the host country market (i.e., market opportunity risk), and (2) the unpredictability of legal, political, and regulatory conditions that may affect business activities in the host country market (i.e., political risk). Then, we argue that while firms avoid entering foreign markets characterized by high market opportunity risk and political risk, this aversion is reduced when firms face threats to their survival in the home market (i.e., problemistic search) and possess slack resources that allow exploration of emergent opportunities and afford firms the ability to react to potential crises or poor performance in risky markets (i.e., slack search).

We test our hypotheses using conditional logistic regression analysis of longitudinal data on the international expansion of Japanese auto parts manufacturers. The results support our theory and provide critical implications not only for managers who consider international expansion an important means to achieve higher performance and secure survival but also for policy makers who aim to develop competitive strategies to attract FDI in their country. Furthermore, our findings suggest different strategic requirements for risk takers and non-risk takers to expand into global markets.

2. Literature review

2.1. Market-seeking FDI

A major strand of international business literature on the determinants of outward FDI of MNEs is the eclectic paradigm developed by Dunning (1973, 1980, 1993). It suggests three determinants of outward FDI: advantages of ownership, location, and internalization. Ownership advantages are competitive advantages developed in the home country that are transferrable abroad. Location advantages are a wide range of a given host country's characteristics that can promote or reinforce an MNC's competitive advantages. Such characteristics include, but are not limited to, the presence of natural resources, low-wage labor, special taxes or tariffs, and the development of infrastructure that reduces production, logistics, and communication costs. Finally, internalization advantages refer to the greater advantage and value of internalizing economic activities compared with coordinating them externally through licensing and alliances.

Based on the eclectic paradigm, Dunning (1993) identifies four types of FDI: resource seeking, market seeking, efficiency seeking, and strategic asset seeking. The attractiveness of host country factors determines the opportunities for FDI. Host countries with abundant natural resources, significant market size, and low production cost are more likely to attract resource-seeking, market-seeking, and efficiency-seeking FDI, respectively. On the other hand, host countries with strong strategic assets such as technology and expertise are more likely to attract asset-seeking FDI (Makino et al., 2002; Rugman, 2010).

Of the four types of FDI, the theoretical arguments that we develop below concern the market-seeking type of FDI, which occurs when firms enter host countries to establish and extend their presence in new markets for their products and services. This is in large part because in our research context, Japanese parts manufacturers follow the patterns of international expansion of Japanese automobile manufacturers as their major buyers in making entry decisions, and tend to enter host countries that Japanese automobile manufacturers have already entered (Martin et al., 1998). This focus certainly creates a boundary condition for our arguments, but the prevalence of the market-seeking type of FDI indicates the validity of our focus (Luo, 2003). Regardless of this focus, we believe that the careful selection of control variables in empirical analyses will mitigate the potentially limited applicability of our findings to non-market-seeking types of FDI.

2.2. Risk and FDI

While the eclectic paradigm underscores the importance of determining the potential value of host countries, the literature on international expansion highlights the importance of considering host country risks when examining FDI location choice and

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