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From uncertainty to risk—A risk management framework for market entry☆

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ABSTRACT

This paper contributes to entry mode theories by proposing to integrate the distinction between uncertainty and manageable risk (Knight, 1921). Acknowledging firms' ability to diversify, transfer and mitigate certain sources of risk provides an additional layer of analysis, improves empirical modelling and managerial practicability of entry mode research. We provide a framework of instruments including capital structure, contractual and network-based risk management. We illustrate the theoretical and empirical value of our framework using a large sample of project financed infrastructure investments. Finally, we position project finance as a risk-motivated, cooperative market entry mode complementing existing categorizations.

1. Introduction

Entry mode choice is one of the most thoroughly researched strategies in international business (Brouthers and Hennart, 2007). Throughout the various theories that have been applied, the role of uncertainty stands out as an important determinant of entry mode choice. Despite their agreement on the importance of uncertainty, there is considerable disagreement across theories on its effect. Transaction cost-based research, for example, associates high uncertainty with ownership-based entry modes that allow for high organizational control (Anderson and Gatignon, 1986). Real options theory, on the other hand, predicts that firms avoid ownership in risky environments in order to increase their flexibility (Crook, Combs, Ketchen, & Aguinis, 2013; Li and Rugman, 2007).

Given this disagreement, it is not surprising that the extensive body of research on market entry has produced contradicting results. In their review of 308 empirical papers, David and Han (2004, p. 52) found as much support for a positive as for a negative relationship between ownership-based entry modes and uncertainty. In a similar vein, Brouthers and Hennart (2007, p. 419) conclude their review emphasizing a need to *"develop better and more realistic models of mode choice"* that account for the *"multilevel nature"* of the entry mode decision.

This paper addresses these two concerns by integrating the well-established distinction between uncertainty and risk (Knight, 1921) into entry mode frameworks. Most recently, Liesch, Welch, and Buckley (2011) applied the distinction to the context of internationalization. Their pioneering works linked risk and uncertainty to international business constructs but left empirical testing to future research. They concluded that *"uncertainty and risk and their effects have been treated in a relatively simplistic fashion to date, with little meaningful differentiation between these concepts"* (Liesch et al., 2011, p. 868). Because of the prominent role of uncertainty in entry mode research, the Knightian distinction adds a valuable layer of theorizing to existing entry mode frameworks, potentially closing an important gap. It contributes to a more nuanced, multilevel understanding of entry mode choice and allows us to explain some of the inconsistent findings.

According to Liesch et al. (2011), risk and uncertainty coevolve but differ fundamentally in their effects on internationalization. This is because risk, as opposed to uncertainty, is in part manageable by entering firms. Acknowledging the existence of manageable sources of risk helps to develop a more realistic model of entry mode choice. It extends our scope of analysis towards down-stream risk management (RM) strategies and improves the managerial practicability of existing frameworks.

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In this paper, we build on the work of Liesch et al. (2011) but complement the distinction of uncertainty and risk with a systematic RM framework of market entry. According to our framework, MNEs are capable of diversifying, transferring or mitigating identifiable sources of risk. RM instruments include capital structure, contractual and network-based instruments. Our RM framework provides a theoretical blueprint of nine premises scholars and practitioners can use to apply a risk perspective to entry mode strategies. In addition, our framework helps to explain some of the inconsistent empirical findings in market entry research. It shows that, when uncertainty is composed in large parts by manageable sources of risk rather than true uncertainty, RM allows MNEs to enter foreign markets without the cost associated with hierarchical means of internationalization.

Finally, we illustrate the applicability of our RM framework using international project finance as a special setting (PF). Our empirical results support our premises in the context of project finance. Extending the conceptual contributions of Liesch et al. (2011), we provide empirical evidence that uncertainty and risk affect entry mode strategy in different, sometimes even opposing ways. We also provide evidence for the practical use of RM instruments in market entry using our RM framework. Our results support the theoretical and empirical value of our RM perspective. They point to promising avenues for future research to increase the managerial practicability of entry mode research (Doh, McGuire, & Ozaki, 2015; Ghoshal and Moran, 1996; Rugman and Verbeke, 2003). Finally, we proceed to theoretically position project finance within existing entry-mode classifications, which is a novelty, and discuss its differences to alternative entry modes. We conceptualize project finance as a RM-based form of market entry that can potentially substitute internalization in situations in which a large part of uncertainty is in fact manageable risk.

The paper is structured as follows: First, we emphasize the theoretical value of a RM framework by pointing out the common role of uncertainty across all major entry mode theories. We then introduce the distinction between uncertainty and risk (Knight, 1921) before developing our systematic framework of RM instruments in market entry. Our theoretical contributions to all entry mode theories are highlighted along nine premises. In a second step, we apply our framework to the particular setting of international project finance. We illustrate differing, sometimes opposing effects of risk and uncertainty on project structuring and we provide empirical evidence on the use of RM. Concluding, we theoretically position project finance as an entry mode.

1.1. Theoretical perspectives on entry mode choice

Entry mode research is dominated by five theoretical perspectives: Transaction cost theory, resource-based view, institutional theory, real option theory, and the eclectic framework (Brouthers and Hennart, 2007). These theories differ fundamentally in their foci, assumptions and conceptualizations. Apart from the dependent variable, the only common covariate throughout all of these perspectives is uncertainty.

According to transaction cost theory (Hennart, 1982; Rugman, 1981; Williamson, 1976, 1979, 1996), MNEs choose hierarchical entry modes when external uncertainty is high and when transaction-specific assets are involved. This prediction, however, has produced conflicting results. Real options theory uses the construct of risk, but results in predictions opposing those of transaction cost theory (Crook et al., 2013). It predicts that organizational integration (hierarchy) is avoided in high risk situations as it reduces the flexibility of the entering MNE (Brouthers and Hennart, 2007). The resource-based view (Barney, 1991; Barney, Busenitz, Fiet, & Moesel, 1994) builds on the premise that entry mode choice depends on how firms can deploy their firm-specific resources and capabilities in the most profitable way. While not explicitly incorporating risk or uncertainty, the resource-based view acknowledges the existence of risk-related capabilities and resources that allow some firms to carry out projects that would be too risky or unprofitable for other firms (Das and Teng, 1998). The eclectic framework or OLI paradigm (Dunning, 1988) combines *"the insights from resource-based (firm-specific), institutional (location), and transaction cost (internalization) theories"* (Brouthers & Hennart, 2007, p. 407). It creates strong synergies between the theories but, as with all of its components, it does not distinguish systematically between risk and uncertainty. Finally, institutional theory comes closest to recognizing particular sources of risk of an investment. Focusing on country-related uncertainty, it is based on the premise that a country's institutional context and the sources of risk associated with it affect entry mode strategy (North, 2004; Scott, 1995).

Across entry mode theories, there is broad agreement on the important role of risk or uncertainty but none of them systematically distinguishes between the two. This illustrates the multi-theoretical value of integrating RM theory into market entry research.

1.2. Risk, uncertainty and risk management in market entry

> *"Uncertainty must be taken in a sense radically distinct from the familiar notion of risk [...] It will appear that a measurable uncertainty, or 'risk' proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all."* Knight (1921, p. 19-20)

Based on the seminal conceptualization of Knight, economists have distinguished uncertainty and risk for quite some time. True uncertainty, as referred to it in this paper, is unmeasurable, random, and unpredictable. As such, it is impossible to account for in contracts or to price appropriately in order to make it transferable ex-ante. Because of these properties, true uncertainty is not manageable a-priori.[1]

Unlike true uncertainty, risk is to some degree measurable. It *"has an unknown outcome, but we know what the underlying outcome distribution looks like."* (Mauboussin, 2013, p. 36; Silver, 2012). Risks can often be traced back to a specific source (i.e. cause); they can be priced and are partly transferable to other parties using contracts. Depending on the source, risks can also be addressed through other means than contracts. If, for example, a source of risk is related to the behavior of a particular economic actor, it can be mitigated through social pressures (Emerson, 1962; Pfeffer & Salancik, 1978).

Despite its long history, the Knightian distinction between risk and uncertainty has not been sufficiently integrated into international business theories. Liesch et al. (2011) provide a conceptualization in which risk and uncertainty coevolve in the internationalization process. Based on their resources, context, and managerial oversight firms can accommodate to risk (Liesch et al., 2011). According to this framework, all that has been conceptualized in entry mode literature as uncertainty involves in fact two very distinct elements: unmanageable, true uncertainty and (partially) manageable risk. We build our first premise on this model:

Premise 1: When entering foreign markets, firms face true uncertainty and risks.

In colloquial use, sources and consequences of risk are used interchangeably, but for the purpose of our paper, they need to be

[1] Without knowledge of the source of uncertainty, firms can minimize risk exposure only by minimizing its potential financial consequences (sunk cost).

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