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Evaluating foreign market entry mode theories from a hotel industry perspective

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ABSTRACT

This is a qualitative examination of the theories of new institutional economics (NIE) in the context of choosing between franchising and management contracts in the international hotel industry. In-depth semi-structured interviews were conducted with eight high-level hotel executives. The primary objective of this study is to empirically examine which of the predominant theories of NIE are the most appropriate for examining the specific choice between franchising and management contracts when internationalising a hotel or hotel chain. Transaction cost economics and the resource-based view emerged as the most appropriate theories, according to the executives interviewed. Moreover, several other important considerations were suggested by the respondents, including the size of the organisation, the importance of intangible assets and the level of investment into these assets. Finally, host country factors, such as legal and political risk, as well as the availability of capable local partners, were suggested as important considerations.

1. Introduction

International entry mode research commenced with Hymer's (1960) seminal insights in deconstructing the complexity of the internationalisation phenomenon into several comprehensive concepts. The foundations of this literature were further laid by Stopford and Wells (1972), who examined the different types of entry modes used by multinational corporations (MNCs). However, no theoretical explanations were given in these publications for the various modal choices of MNCs. Theory-based entry mode literature gained momentum relatively recently in the late 1980s and early 1990s with fundamental studies, including those of Anderson and Gatignon (1986); Gatignon and Anderson (1988); Gomes-Casseres (1989); Hennart (1991). These articles were both theoretical and empirical in nature, and all used transaction cost economics (TCE) as their theoretical foundation. Since then, several theories have been proposed through which to examine the entry mode choice of MNCs (Brouthers and Hennart, 2007; Canabal and White, 2008). However, a consensus has not been reached in the literature as to which theoretical perspective, or which combination of them, is the most effective in explaining the entry mode choices of MNCs (Sanchez-Peinado et al., 2007).

In comparison with studies focused on the entry mode choices of manufacturing firms, service firm focused studies are underrepresented in the literature (Bouquet et al., 2004; Brouthers and Brouthers, 2003; Canabal and White, 2008; Pla-Barber et al., 2010; Werner, 2002). Recently, researchers in the field have pointed out that there is merit in adding to the body of entry mode literature with service firm oriented research (Bouquet et al., 2004; Brouthers and Brouthers, 2003; Leon-Darder et al., 2011; Pla-Barber et al., 2010). This is because manufacturing firm oriented entry mode literature cannot be effectively transferred to service firms (Brouthers and Brouthers, 2003; Leon-Darder et al., 2011; Pla-Barber et al., 2010). The reason for this is that in traditional entry mode literature, ownership was seen as being equal to control (Agarwal and Ramaswami, 1992). Therefore, it was assumed that there is a linear relationship between increasing ownership and control in MNCs. However, this rationale does not apply to the service sector as the competitive advantage of service firms is not directly impacted by not owning the building in which the service is delivered. The reason for this, is the distinction between 'de jure' control and 'de facto' control (Erramilli et al., 2002). De facto control can be achieved through non-equity modes at a much lower resource commitment and this largely explains the popularity of non-equity modes in the service sector. This is supported in the literature with several relatively recent studies having concluded that non-equity entry modes have become increasingly popular among service firms (Brown et al., 2003; Contractor and Kundu, 1998a; Martorell-

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Cunill and Forteza, 2010; Dev et al., 2002; Erramilli et al., 2002; Sanchez-Peinado and Pla-Barber, 2006a, 2006b; Sanchez-Peinado et al., 2007).

Alon et al. (2012); Contractor and Kundu (1998a) state that owing to cost efficiency concerns, hotel organisations specifically prefer the use of non-equity entry modes and the non-equity expansion strategy is now the most popular in the international hotel industry. In fact, non-equity entry modes constitute 65.4% of all the entry modes used by hotel organisations to internationalise (Contractor and Kundu, 1998a) – a trend that has been increasing over the past two decades (Alon et al., 2012; Contractor and Kundu, 1998b; Martorell-Cunill and Forteza, 2010). This has resulted largely from the hospitality industry's capital-intensive nature in regard to the ownership of physical assets such as real estate. More simply put, it is very common to separate industry knowledge and managerial expertise from the ownership of physical assets, in particular, real estate (Brown et al., 2003; Contractor and Kundu, 1998a; Martorell-Cunill and Forteza, 2010; Rodrıíguez, 2002) – a practice called the 'split of bricks and brains' in the industry.

This study focuses on the two most commonly used non-equity entry modes in the hotel industry: franchising and management service contracts, or branded management contracts (management contracts) (Contractor and Kundu, 1998a,b; Pla and Leon, 2002; Sandman, 2003; Zeng, 2010). Industry practitioners refer to these two entry modes as 'asset-light' modes. Leasing is not included in the analysis because, although it is non-equity in nature, it is not asset light. The key difference between franchising and management contracts is that although both are collaborative modes, franchising is a quasi-market transaction, that is, an inter-firm transaction that crosses firm boundaries. Management contracts, conversely, are a quasi-internalised transaction, that is, an intra-firm transaction that remains within the firm boundaries (Contractor and Kundu, 1998a; Dev et al., 2002; Erramilli et al., 2002; Fladmoe-Lindquist and Jacque, 1995). Therefore, franchising, while having lower levels of resource commitment, also has a lower level of control for the foreign entrant. The degree to which the control is shared between the parties involved in the contract is referred to as the governance structure and is defined as an "institutional framework in which the integrity of a transaction or related set of transactions is decided" (Williamson, 1996, p. 11)). Although both franchising and management contracts are non-equity modes, the management contract offers more strategic and operational control for the entering firm than franchising, but at the cost of being more resource intensive (Contractor and Kundu, 1998a,b; Pla and Leon, 2002).

In order to highlight the contribution of this study to the academic conversation on entry modes in the hotel sector, the most closely related articles in the field will now be briefly reviewed in chronological order. The initial research highlighting that ownership and control in the hotel industry are not necessarily correlated with each other, is that of Dunning and McQueen (1982). Later, Contractor and Kundu (1998b) were the first to apply the so-called syncretic theory, combining TCE, agency theory, corporate knowledge theory and the organisational capability perspective (OCP) (closely related to the RBV), to examine entry mode choice in the hotel industry. This publication was followed by Rodrıíguez (2002) who also employed the syncretic theory. Erramilli et al. (2002) was the first study to focus exclusively on the choice between non-equity modes, and as such, their study represents the origins of the specific research stream this study aims to contribute to. More recently, Martorell-Cunill and Forteza (2010) further built on hotel franchise literature and Alon et al. (2012) showed in their research how critical the number of franchises and the experience an organisation has in franchising is in influencing the time it takes to expand internationally through franchising. Martorell-Cunill et al., 2012 found that non-equity entry modes have become by far the most popular entry modes in the hotel industry compared with equity and leasing modes. In terms of the theories examined, Villar et al. (2012) highlighted the compatibility of TCE and the OCP in determining entry mode choice and in the following year, Martorell-Cunill et al. (2013a,b) confirmed that the choice of foreign market entry mode cannot rely solely on host-specific factors, but must also rely on the principles of syncretic theory, proposed initially by Contractor and Kundu (1998b).

This aim of this study is to empirically examine, which of the predominant theories of NIE are the most appropriate for examining the specific choice between franchising and management contracts when internationalising a hotel or hotel chain. In order to achieve this, a qualitative approach using in-depth semi-structured interviews was deemed appropriate due to the exploratory nature of the research aim. The expected contribution of this study is threefold. Firstly, this study fills a gap in the entry mode literature by building on non-equity entry mode research, which, is vastly under-represented in the literature in relation to how extensively non-equity modes are used in the industry. Secondly, the contribution of this study lies in the calibre of the research sample, which in this study consists of high-level hotel executives, that is, the individuals at the strategic level as opposed to hotel general managers, who are at the operational level. Finally, this study provides currently sought empirical evidence on the decisive factors in the choice between management contracts and franchising in the hotel industry.

2. Literature review

2.1. The conventional theory of the firm: neoclassical economics

The traditional view of the firm or 'the theory of the firm' arises from neoclassical economics. From this perspective, firms are seen as production units (Klein, 2000). In other words, neoclassical economics views the firm as a production function or as production possibilities. This view of the firm is referred to as the 'black box model', in which firms are seen more as 'plant' in which inputs create direct outputs. From the production perspective, management decisions are relatively quantifiable, revolving around input levels and employment levels and how they relate to the firm's output levels, considering economies of scale and scope (Spulber, 1989). This view of the firm has brought about several insights on pricing and output decisions through analysing factors such as input prices, demand schedules and technology in order to maximise firm profits (Spulber, 1989). However, the arguments of this school of thought are more appropriate when the firm is seen as a single actor; that is, there is little insight in this paradigm about the boundaries of the firm, which is a central consideration in this study.

2.2. New institutional economics

New institutional economics (NIE) has its roots in the work of Coase (1937) which was the first study to examine the boundaries of the firm, and the reason why this school of thought is also referred to as the Coasian view of the firm. From the Coasian perspective, firms are seen as legal entities and as governance structures. The work of Coase (1937) highlighted that theory needs to focus not only on production but also on the cost of transacting business. These ideas were then expanded and further developed, most notably by Williamson (1975, 1985); Klein et al. (1978); Grossman and Hart (1986); Hart and Moore (1990), and thus NIE came into being, the term coined by Williamson (1975). NIE is fundamentally concerned with the question of how to organise 'transactions' hierarchically (within the firm) or through market mechanisms