Master of Arts in International Accounting

Case Study of Splash Designs Limited

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What is the most suitable mode of entry for expanding a sales representative function in England?

1. Introduction and background of study

Globalization has become a long term and recurring part of the business. It gives different companies and organizations a lot of challenges and opportunities (Luo, 1999). Entry mode choice has been a hot topic but there are very few studies (Chen & Hu, 2002) that examine the performance link on the entry mode choices (extent of control) made basing on the transaction costs theory. The authors considered a longitudinal study on the current case an interesting one as the performance of the company using this entry mode choice logic can be measured and evaluated subsequently.

Transaction cost analysis has been used widely by researchers to investigate the best choice of mode entries to a different country (Chen and Hu, 2002). Some researcher also explored on the importance of bargaining power (Palendzuela and Bobilo, 1999) with the help of transaction costs theory to help organization determine on entry mode choice to a new market.

For the firm based in foreign markets, control is the central factor in the organizational-financial pattern. Control also entails strong commitment of resources and the action of the firm abroad implies important modifications within its organization, methods and job related systems (Palenzuela and Bobilo, 1999).

Splash Designs Limited is a trading company found about 2 years ago. The founder of the company has been dealing with local trading companies (e.g. Li & Fung) for exporting orders. Upon receipt of orders from local trading companies ("Hong"), back-to-back subcontracting orders will be placed to China factories through his personal networks.

Stanley Lau, the younger brother of the founder has been employed as a consultant in the capacity of marketing director for the companies in giving advice on business strategies. The company has been successfully expanding the exporting business of the company by running shows and exhibitions locally and overseas.

Over the past two years, Splash Designs has been grown in a very rapid speed. The turnover for the first year was HK$9 million mainly attributed to its major customer from a Hong Kong trading. This year the company has traded with 9 new customers connected from various exhibitions (e.g. Hong Kong and England). The total orders on hand now come to almost HK$20 million. Splash Designs Limited has such a rapid growth from zero with only two staff from the beginning and grown into a company of 30 staff (China: 20, Hong Kong: 10) in about 2 years time. The turnover for the first fiscal period ended 31 December 2001 of the company was HK$9 million with a small profit of around HK$200K. From January to April 2002, the company has already commitment sales order of around HK$19 million. This evidenced that the growth has been tremendous and incredible.

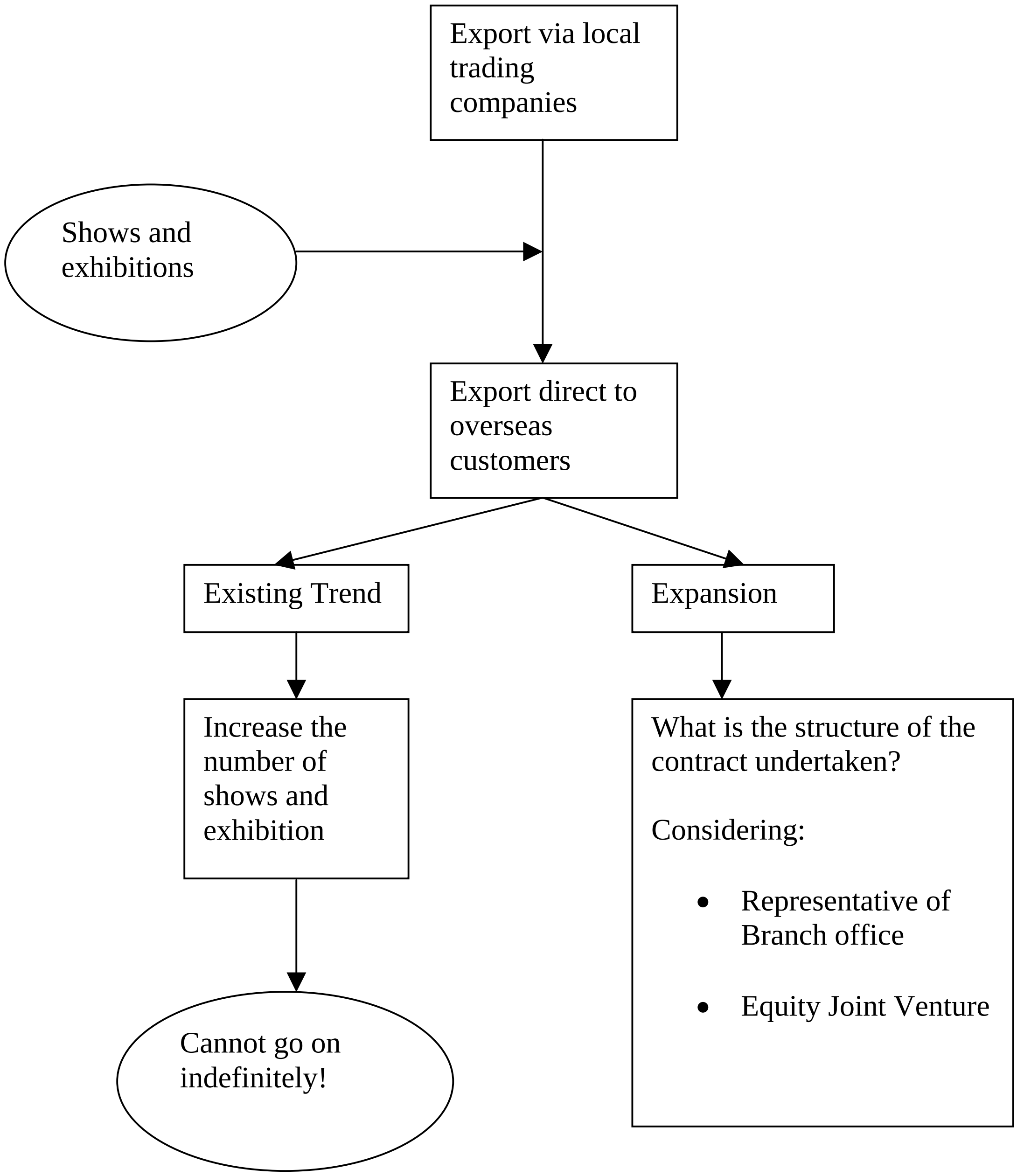
It has always been strategy of the company to solicit clients from US and Europe markets for business. By leveraging on the inexpensive labor cost of China factories, only a small portion of the margin can survive the business and growth. To gain more confidence of overseas buyers, exhibition is held regularly (3 times a year, Hong Kong – 2 times, London – 1 time) to obtain publicity. Also, overseas trips by the marketing director will be made twice a year to solicit business in major markets (such as Merchandise Mart in Atlanta, Jervis Center in New York etc.).

For the supporting side, a workshop comprising most of the features of a sample factory is established to control the intellectual information of customers and products. Also, specialized technical staffs are employed to organize and execute sampling process. During the sampling process, important production technical information and costing information can also be generated. This is an important step to enhance the subcontracting process to be required at the manufacturing stage in a later period.

In order to secure the business and growth, more exhibitions and shows will be participated to increase the chances of reaching the potential customers of the company. However, the company found that it is impracticable to increase the resources indefinitely in exhibiting in all the trade fairs around the world. The company therefore found that an expansion of a sales representative function in a country satisfied with the firm specific demand and strategic factors become necessary. After determined to expand in England (please refer to theoretical framework for the reasons of choosing England), it is very important that the company should decide on the most suitable mode of entry for expansion. In the following section, you can see that theories of cooperative and entry to a market are discussed and applied to the current situation of the company.

Recently, the company found that the only way to expand more is to obey Dunning's (1981) OLI theory by migrating to a stage of owning overseas sales subsidiary. As England is the only place that Splash Designs has exhibited and management found that it is potential place for integration of sales function (There were 5 new customers found during the last 2 London exhibitions). Besides, England is believed to be an ideal place for reaching both the England and European buyers. Before implementing such plan, a case study is done in exploring the most suitable mode of entry for expanding a sales representative function to England.

Figure 1. Motivation of study



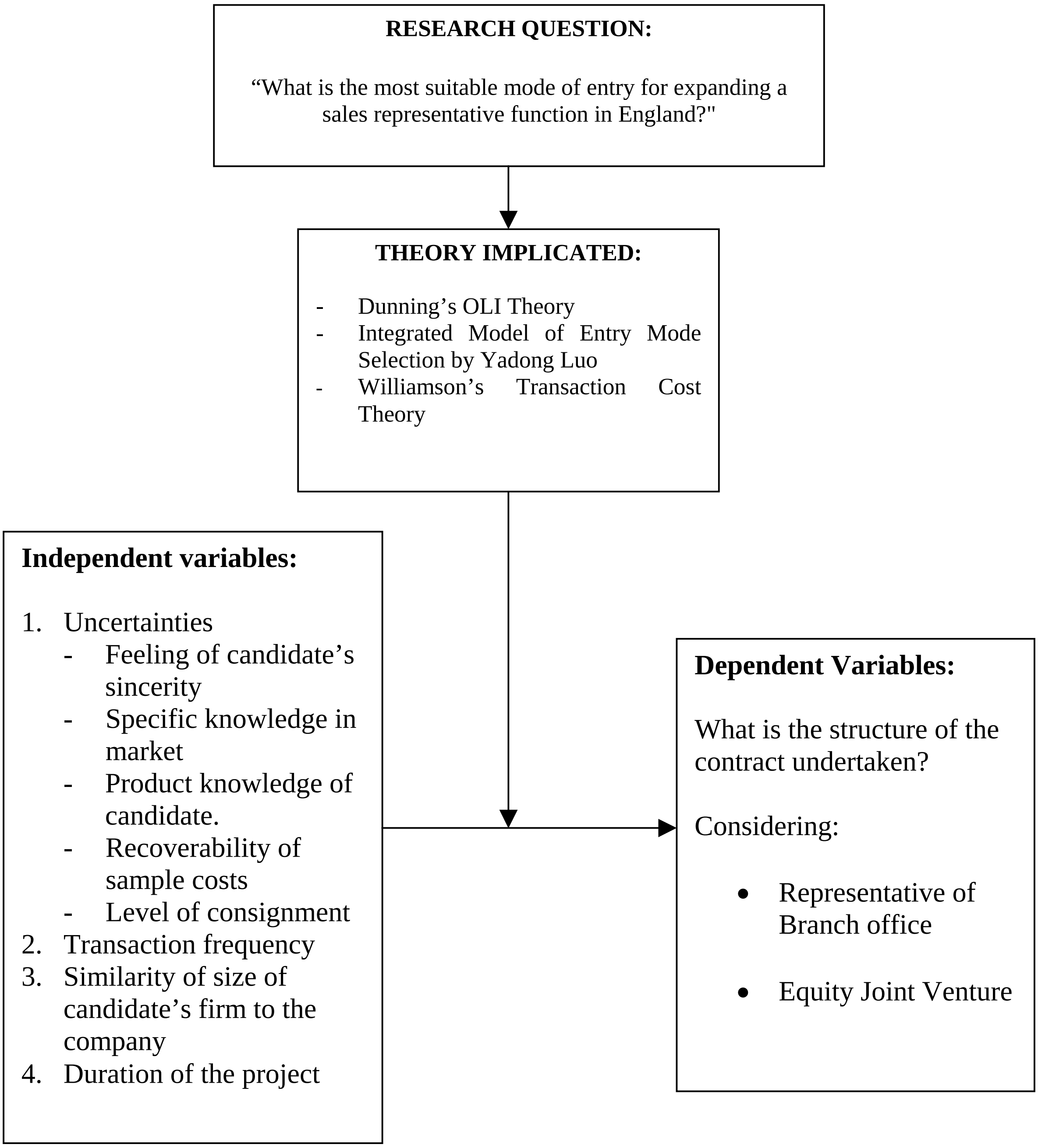
2. Theories and Framework of Study

There are a lot of literatures regarding transaction costs theories impact on entry mode choice to a new market. In Palenzuela and Bobilo (1999), when the firms focus on the entry modes in the choice of full control or the shared control, the transaction cost theory is appropriate to explain why the firms prefer full ownership vs. shared ownership. The transaction cost theory begins with the assumption that the competition within the markets discourages the supply side opportunistic behaviors and forces suppliers to perform efficiently. From the transaction-cost analysis, the most important determinant of market failures is the presence of specific assets in the transaction. The transaction cost theory indicates that while asset specificity is high, there will be a probability of high share of subsidiaries, and while the asset specificity is low there will be a probability of low share control.

In relation to the specific knowledge belonging to the firm, the transaction-cost theory recognizes that it is one of the most important types of specialized assets. Also the proprietary knowledge is difficult to codify and transmit, because, it is often subject to hazards of transmission and valuation (Palenzuela and Bobilo, 1999). It indicates that R & D investments, which generate proprietary knowledge, have a need of direct control instead of contractual market agreements.

In Zhao and Zhu (1998), we also found from the managerial perspective, this study will benefit foreign investors by providing them with relevant empirical information for selecting an adequate level of ownership. Based on the findings of the study, strategic choice of ownership level by foreign firms should focus on the market structure of a given industry. First, foreign investors under the high market concentration conditions should seek effective control of operations through high equity share in order to compete with local firms. Second, they should consider high equity share in IJVs if IJV are located in coastal areas or areas that already have large clusters of foreign businesses and high concentration of sales. Finally, the above decision factors should be coupled with the assessment of local industrial R & D capability. The empirical findings show that IJVs in low R & D intensity industries tend to choose lower equity share than those IJVs in high R & D intensity industries.

Figure 2. Framework of Study



In reviewing the literatures in this area, we have found a lot of articles regarding joint ventures and entry modes for examples in China (Zhao and Zhu, 1998, Zhang and Li, 2001, Chen& Hu, 2002). These are very useful to us in considering the factors affecting the entry mode choices in general, however some factors e.g. political and government preferences are not so relevant in our case would not be discussed here.

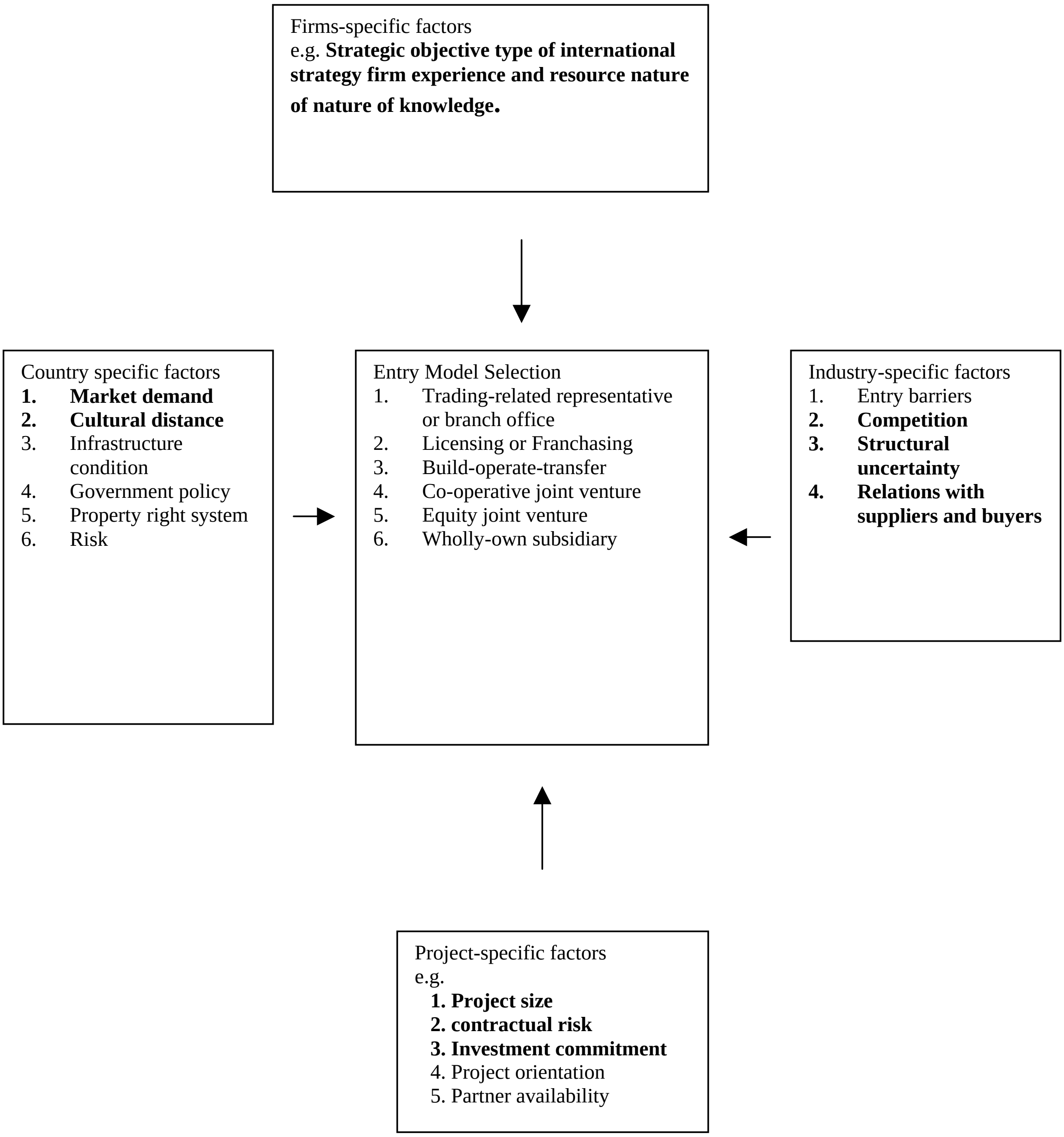
In this study, three major theories were applied namely Dunning’s (1981) OLI theory, Luo’s (1999) integrated model in entry mode selection and the transaction costs theory by Williamson (1981). In figure 2, the most important and relevant theory we reckon as Luo’s (1999) integrated model. Others we find them useful in supporting the rationale.

According to the eclectic theory of Dunning (1981), he maintains that the firm possessing ownership and location advantages uses them in conjunction with other factor inputs existing in the foreign country.

In addition, Luo (1999) held that location selection for an expansion of the business is critical because it affects both efficiently, and effectiveness of the investment.

These theories sound parallel to our choice of England as our location for expansion since the potential market size, growth, presence of customers under Demand factors are high in England for our industry. The population of England is very large and it evidenced that there are a lot of opportunities for the market. Strategic factors such as skilled human resources and market logistics are also present in England.

Figure 3. An Integrated model for entry mode selection in international expansion: by Luo, 1999 (items in bold are relevant to our case study)



When decide upon a suitable entry mode, Williamson (1981) suggested that transaction costs theory plays an important role. Transaction costs are associated with transacting business with other parties in the market, including the costs of writing up, negotiating and monitoring of the act of those who enter into the agreements. If the transaction costs are low, a reasonable firm will prefer market governance on its transactions. However, if the costs of adaptation, performance governing and prevention of opportunistic act of other parties are too high, the firm will prefer in an internal contracting structure.

In this paper, the concentration of the case study is to evaluate the determinants of using equity joint venture as a mode of entry for expanding a sales representative function in England. In figure 3 (by Luo, 1999), you can see that the four factors including firm-specific, industry-specific, project-specific and country-specific factors affect entry mode choice a lot. For firm-specific factors, it includes strategic objective, market orientation, organization competencies and global integration requirements. They are to be considered according to the type and nature of company. Together with the other three categories of factors in deciding entry mode, we have picked up for our framework of study (see figure 2) the factors that give better explanation for our case study.

In Luo (1999), he points out that firms' resources munificence in internationalization will influence the firm's ability to explore market potentials and earn a competitive edge in the global marketplace. It affects entry mode choices because it impacts resources commitment, control mechanisms, partner selection, and knowledge transfer. Luo (1999) also allotted that firms' choice of entry mode in a new market have a great bearing on the risk they are willing to take. In our study, firm-specific factors such as the specific knowledge of the candidate in the market, product knowledge of the candidate, recoverability of sample costs, size of candidate's firm and the level of consignment are all determinants to the choice of joint venture as entry mode in England. The authors think that the company wants to access the market by way of the local partner of the joint venture. Also, the higher the recoverability of sampling costs from the local partner, the lower the risk would be investing in the joint venture. Higher control seems to be unnecessary in this situation. In Luo (1999), he maintained that the level of control in a joint venture is dependent upon the ownership split and bargaining power; it lies somewhere between the case of licensing and wholly owned subsidiaries. Having said that, different entry modes require different resource commitment and control. By the same token, we think that the higher the similarity of the size of the candidate's firm with the company, the higher the suitability of using joint venture as an entry mode to England.

We included in Country-specific factors the feeling of sincerity of the candidate for cooperation (because of the cultural distance). According to Luo (1999), over time, MNEs learn how to overcome cultural barriers and migrate from low risk entry modes (e.g. representative or branch office) to high risk modes (e.g. dominant equity joint ventures and wholly owned subsidiaries) and move from culturally proximate countries to more distant countries. In our case, we consider, the higher the sincerity of the local partner to co-operate, the lower the risks would be and thus the entry mode would be more likely an equity joint venture type.

For project-specific factors, we will discuss on the duration of the cooperation and the transaction frequency that would likely be undertaken. According to Williamson (1981), the higher the transaction frequency, the higher the transaction costs would be, control would be set and high (i.e. higher equity participation). In Luo (1999), he claimed that the project-specific factors are associated with resource commitment, strategic orientation and transaction costs. He also stated that the longer the duration of the project, the stronger the involvement and investment of the company would be. In essence, there is a high relationship with the risk and duration of the project. Basing on the assumption that the longer the duration of the project, the lower the risk would be and the willingness to commit would be higher. Joint venture or even a wholly owned subsidiary will be preferable modes of entry for internationalization. In our context, we think joint venture is more relevant as we are concentrating on the duration of the co-operation. Also, Luo (1999) points out that if a project is local market oriented, the MNE may choose cooperative or equity joint venture mode because the local partner can provide distinctive supply and distribution channels, governmental networks and culture-specific business knowledge and experience. This conforms to our proposition in the Case Analysis section.

3. Case Analysis

In order to produce the feasibility study of the project, and to gauge the results more accurately, data will be obtained from two different sources. All the data collected will be compared and analyzed (see figure 4).

First channel: members of the management team including the managing director, marketing director and the exporting manager will be interviewed and surveyed on their expectation of the most suitable mode of entry to England and the factors they considered relevant for the decision.

Second channel: potential candidate for sales representative in England will be recruited through exhibition (an exhibition in London, UK was held 8 Feb – 11 Feb 2002, three potential candidates were recruited). All of them will be interviewed and surveyed with a questionnaire on their expectation of the most suitable mode of entry to England and the factors they considered relevant for the decision of setting up a sales representative office in England.

Before commencing the case study, management and our case study team all sat down together and tried to predicate the most suitable mode of entry for the company and the following proposition was came up to for further consideration:

P1: The higher the sincerity of the candidate for sales representative, the more likely the company will go for a joint venture type of entry mode.

P2: The stronger the candidate in owning marketing channels, the more likely the company will go for a joint venture type of entry mode.

P3: The higher the candidate in product knowledge, the more likely the company will go for a joint venture type of entry mode.

P4: The higher the propensity of the candidate in investing the sampling costs, the more likely the company go for a joint venture type of entry mode.

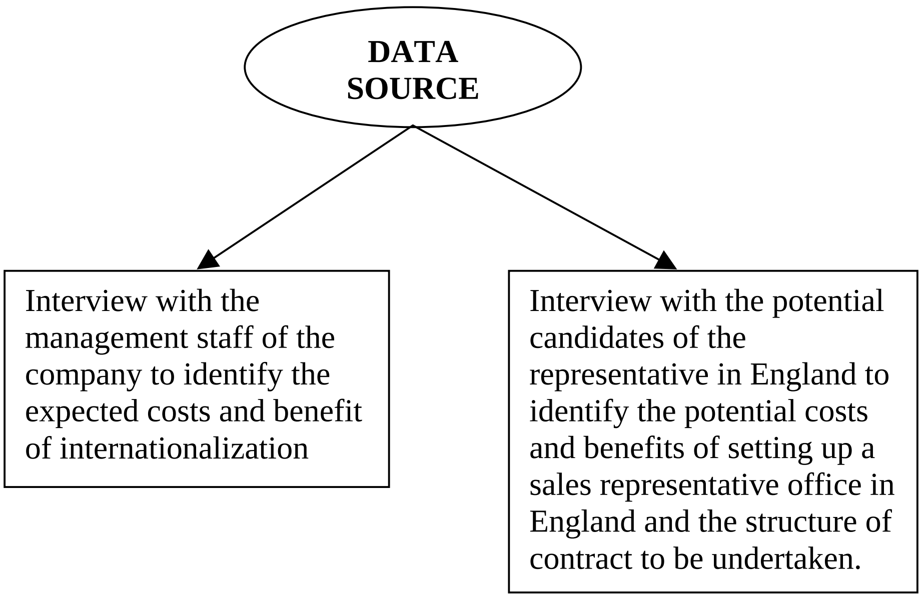
P5: The higher the similarity of the firm size of the candidate's firm and the company, the more likely the company will go for a joint venture type of entry mode.

P6: The higher the duration of the co-operation, the more likely the company will do for a joint venture type of entry mode.

P7: The higher ownership share of the company in the joint venture, the higher level of consignment of goods to the sales representative.

P8: The higher the transaction frequency, the more the likely the company will go for a higher share in joint venture type of entry mode.

Figure 4. Method of Study



4. Results and Discussion

Appendix 1 gives an interview protocol for the purpose of gathering information for evaluating of the case study. During the past two months up to the present date, the authors of the case study have interviewed 2 candidates for representative and all the three members of management team of the company including the managing director, marketing director and the export managers. Result of interviews have been recorded and discussed by the authors. In addition, two potential candidates had been recruited from the trade exhibition in England last February. These candidate have also been interviewed by the managing director and the marketing director of the company personally in order to determine their ability in taking up the project. Subsequently, one of the potential candidates was appointed effective 1 May 2002 as a sales representative for the company.

Figure 5. Results of the case study -Factors relevant to joint venture versus contracting or wholly owned Subsidiary

Relevance of factors	Exporting Manager	Directors	Candidate 1 & 2	Overall
Sincerity of candidate	High	High	High	High
Ownership of marketing channel	High	High	High	High
Product knowledge of candidate	High	High	High	High
Recoverability of sampling costs	High	Medium	High	High
Similarity of size of candidate's firm and the company	High	High	Medium	High
Transaction frequency	Low	Low	Low	Low
Duration of project	Longer /High	Longer/ High	Longer/ High	Longer/ High
Level of consignment to ownership	Positive	Positive	Positive	Positive

After the interviews with management team of Splash Designs Limited and the potential candidates of the sales representatives, it is found that the factors mentioned in figure 5 are most relevant to the entry mode choice of the company for expanding to England. The results also supported the propositions that we made before the case study interviews.

Although the results from the interviews are only the perceived importance of those factors with respect to the entry mode choice, they seems conform to the integrated model created by Luo. Since the project is going to be executed by the company after the approval from the board of directors is obtained, the company has appointed one of the candidates as a representative in England for initial stage of implementing the project. The English candidate shows very high enthusiasm in forming the joint venture with the company. However, the company thinks that the appointment of the candidate in this beginning stage pertinent and crucial before leading to a joint venture project as all of four factors regarding entry mode choice are yet to be ascertained. Management also believe that with a trial period of not less than 3 to 4 months, the ability (firm-specific factors) and location specific factors will become clearer before the actual going ahead of the joint venture.

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Appendix 1 – Interview Protocol

The following will be served as guiding interview route map for the collection of information necessary for assessing the most suitable mode of entry for expanding a sales representative function in England.

Interview questions for staff of Splash Designs Limited

1. What is your position held?
2. Do you approve an expansion of a sales representative function to England now?
3. What factors you considered important for evaluating a potential candidate to be the England representative?
4. What factors you considered important for selecting the mode of entry to England as a sales representative?
5. What is your preferred mode of entry to the region? Give reasons.

Interview questions for candidate of Sales Representative for Splash Designs Limited in England:

1. Do you think you will honestly cooperate with Splash Designs Limited in expanding a Sales Representative function to England?
2. Do you think you possess a very strong network in selling the items of Splash Designs Limited?
3. Do you think that the sales volume (transaction frequency) in England justified for setting up a sales representative office?
4. Do you think that your firm size has a positive bearing on the control of the joint venture?
5. Do you think that your choice of the control of the joint venture has a positive bearing on the duration of the co-operation?
6. Do you think your knowledge of the English market gives you more confident in owning a higher share of the joint venture?
7. Do you think that if you are willing to pay for sampling costs if you own higher share of the joint venture?
8. Do you think that if you own lower share of the joint venture, you consider more consignment of goods to you is expected?

Appendix 2 - Literature review table

Article	Theory and Model	Basic research question	Sample Nations implicated, sectors compared, time frame etc.	Results
1. Determinants of ownership preference of international joint venture: new evidence from Chinese manufacturing industries Hongxin Zhao, Gangti Zhu (1998)	Basically applying transaction costs theory and bargaining power theory.	What factors affect the decision of ownership preference of IJV.	Data were mainly collected from official statistical books by the Chinese government. 818 IJVs were picked from the total database of 835 JV projects.	It was found that scale, duration, location, proximity to coastal areas, industry concentration, requirement of R&D, skill intensity, productivity, cultural distance, foreign agglomeration and market potential of the location all have a bearing on the ownership preference.
2. An analysis of determinants of entry mode and its impact on performance Haiyang Chen, Michael Y. Hu (2002)	Basically applying transaction costs theory but tried to relate the entry modes selection to the outcome (performance) of the entry.	What factors affect the outcome (performance) of the entry with respect to different entry mode selected?	Data were mainly collected from official statistical books by the Chinese government. Data sets are derived from different sources to support entry mode choices and impacts on performance.	It was hypothesized that a high control entry mode will be favorable for transfer of product knowledge to local partner, transfer marketing skills, brand names, enter to geographic region with high potentials, industrial sections with high potentials and projects with long and stipulated duration but less likely to be favorable to capital-intensive projects. Choice of entry mode is also found to be related to cultural distance. In addition performance are also conformed to transaction costs theory.

Article	Theory and Model	Basic research question	Sample Nations implicated, sectors compared, time frame etc	Results
3. Transaction costs and bargaining power: Entry Mode choice in foreign markets. Valentin Azofra Palenzuela, Alfredo Martinez Bobilo (1999)	Integrated model of transaction costs theory and Bargaining Power in order to explain entry mode choice.	How transaction costs and bargaining power affect entry mode choice in a foreign market?	Published data were used and in course of statistical model, a test was realized based on the normality of variables and also an analysis of correlation matrix in order to avoid multicollinearity problems.	Five major variables are inspected and found to be related with the entry mode choices: Capital intensity, firm size, level of foreign independence, country risk and cultural distance.
4. An investigation of Market Entry Strategy Selection: Exporting vs Foreign Direct Investment Modes- A Home-host Country Scenario Henry Chung, Peter Enderwick (2001)	By elaborating on Dunning's OLI theory, the author held out that there are four location related factors concern most to the entry mode choices, namely international business experience, immigrant effect, service requirements and market size.	What factors affect the market entry strategy from Exporting to Foreign direct investment modes?	The data were obtained via a self-administered questionnaire mailed to a sample of 580 New Zealand companies with business experience in Taiwan.	Three factors were found with very significant influence on the entry mode choice of a new foreign market namely Product types, immigrant effect and international experience.