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Distance and perceptions of risk in internationalization decisions[☆]



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ABSTRACT

This study examines top managers' risk perceptions in internationalization decisions. 126 CEOs and top managers responsible for internationalization in companies with headquarters in Germany, Switzerland, or Austria took part in our experiment. Applying random utility theory in a conjoint choice experiment enables the measurement of top managers' preferences for target countries and entry modes. Country-specific measures of geographic, cultural, economic, and political distances serve as covariates to explain country preferences and to quantify the effect on internationalization decisions. Our results show that distance dimensions are the primary drivers of risk assessment, whereas entry-mode choice is secondary. Internationalization may therefore be a hierarchical decision in which managers choose target market (and risk profile) and view entry-mode choice as subordinate to other environmental factors.

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1. Introduction

International business (IB) literature is so replete with studies on location choice and international entry mode that Shaver (2013) questions the value of further research in this field. Although different theoretical streams highlight a variety of explanations for location decisions (Dunning, 1981; Johanson & Vahlne, 1977), the most notable explanation of what drives such decisions is risk perception.

Perceptions of varying risk between countries—mainly in terms of psychic distance (Bouncken, Cesinger, & Kraus, 2014; Johanson & Vahlne, 1977; Kogut & Singh, 1988) and differences in market development (Brouthers, 1995; Whitley, 1992)—affect internationalization and location decisions. Scholars debate and criticize the measurement and unidimensionality of the psychic distance construct (Håkanson & Ambos, 2010; Shenkar, 2001; Zaheer, Schomaker, & Nachum, 2012). The second major driver of risk in internationalization is entry-mode choice because more equity-intensive entry modes usually imply greater risk (Brouthers, 2002; Hennart, 2009). Although distance and entry-mode choice are theoretical representations of the risk in location and entry decisions, little evidence exists on how these combined risk perceptions drive managerial decisions.

Despite considerable research on international location choice, entry modes, and distances, results regarding the risk of internationalizing to a particular country remain inconclusive. These results may reflect the conflicting theoretical assumptions, as well as the limitations inherent in prevailing methodologies, because choice decisions are methodologically complex. Aharoni, Laszlo, and Connelly (2011) call for new methodologies (e.g., experiments) in IB research.

This study examines internationalization decisions in an experimental setting. In the experiment, managers select the riskiest option from a set of internationalization alternatives (i.e., target countries and entry modes). Country-specific covariates (i.e., measures of geographic, cultural, political, and economic distance) explain country preferences and quantify these preferences' effect on the internationalization decision. Empirical results reveal the primary role of distance dimensions in risk perceptions and the secondary role of entry-mode choice.

2. Choice of location and entry mode

Managers address a multitude of variables when considering internationalization (Cesinger, Fink, Madsen, & Kraus, 2012; Mitter, Duller, Feldbauer-Durstmüller, & Kraus, 2014). These managers often make decisions on the basis of conflicting criteria and trade-offs (Brouthers & Brouthers, 2001; Nielsen & Nielsen, 2011). The desire to minimize liabilities of foreignness (Zaheer, 1995), to increase the probability of legitimacy (Kostova, Roth, & Dacin, 2008) and to maximize chances of survival (Delios & Beamish, 2001), drives internationalization decisions. Thus, such decisions aim to maximize international expansion's utility.

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The target country consists of different geographic, demographic, economic, and institutional attributes. Because managers are unequally familiar with these contextual variables, they have to make decisions using imperfect information and considering the relative position of their home market. Cross-national differences influence perceptions of risk. Hence, when modeling internationalization decisions, scholars must consider the multidimensionality of distance (Aharoni et al., 2011; Håkanson & Ambos, 2010).

The other critical aspect of internationalization decisions is market-entry mode, which typically entails considering the amount of resources to invest, the control level, and the risk that internationalization implies. Multinational companies often seek to minimize risks in international expansion by implementing tight control over foreign operations (Brouthers, 2002).

IB literature reflects different schools of thought and theoretical perspectives. These perspectives comprise classical location theory (Vernon, 1966), foreign trade theory (Heckscher, 1919), transaction-cost theory (Teece, 1981), the OLI paradigm (ownership–location–internalization-specific advantages) (Dunning, 1980), the Uppsala model (Johanson & Vahlne, 1977, 1990), institutional theory (Kostova et al., 2008), and real options theory (McGrath, 1999). With the exception of real options theory, which provides a relevant decision-making framework under conditions of uncertainty (Driouchi & Bennett, 2012), all theories explain the location and entry-mode choice as deliberate decisions that depend on differences in factor endowments and environmental characteristics in international markets.

Given their complexity, internationalization decisions often represent trade-offs between competing alternatives. Because of information asymmetries and uncertainty in internationalization decisions, managers might delay their decisions or decide not to internationalize at all.

3. Development of hypotheses

3.1. Cultural and geographic distance

Typically, IB scholars conceptualize and measure differences in the informal environment by cultural distance (Kogut & Singh, 1988; Shenkar, 2001). Cultural distance refers to the extent to which shared norms and values in one country differ from those in another (Drogendijk & Slangen, 2006). By inducing a lack of understanding regarding cultural norms and values, cultural distance increases misunderstandings, creates difficulties in conforming to informal institutions, and raises risk in managerial decision-making (Slangen & van Tulder, 2009). Furthermore, cultural distance increases the cost of foreign-market entry and hampers the transfer of core competencies to foreign markets (Bartlett & Ghoshal, 1989; Palich & Gomez-Mejia, 1999). As a result, the organization's ability to operate effectively and gain operational benefits decreases.

H1a. Greater cultural distance between the home country and the target country has an association with greater perceived risk in internationalization decisions.

Despite substantial reductions in long-distance communication and transport costs (Cairncross, 2001), geographic distance maintains a powerful role in internationalization decisions (Kraus, Meier, Eggers, Bouncken, & Schuessler, in press; Leamer & Storper, 2001; Nachum & Zaheer, 2005). McCann's (2011) empirical results indicate that space and scale remain important because these cost reductions do not affect overall costs relating to distance. Several empirical studies confirm that geography remains a barrier to trade and foreign direct investment (FDI) (Berthelona & Freund, 2008; Gripsrud & Benito, 2005; van Bergeijk & Brakman, 2010) and that geographic distance increases the perceived risk of a foreign market because of information asymmetries.

H1b. Greater geographic distance between the home country and the target country implies greater perceived risk in internationalization decisions.

3.2. Economic and political distance

Economic distance is likely to induce risk in internationalization because of misunderstandings and problems in accessing foreign stakeholders (Ghemawat, 2001). Economic development is a pull factor in internationalization (Ambos & Ambos, 2011) because internationalization to more economically developed economies is a utility-maximizing opportunity. In contrast, greater volatility in less economically developed and emerging economies increases the perception of risk (Estrin & Meyer, 2004). Another prominent consideration is whether an international market country offers access to a highly qualified labor pool (Manning, Massini, & Lewin, 2008) and yields knowledge spillovers stemming from intense competition in local industry (Almeida, 1996).

H2a. Lower economic development in the target country than in the home country has an association with greater perceived risk in internationalization decisions.

Several studies confirm that political systems with predictable rules minimize the risks of internationalization and increase the likelihood of FDI (Gelbuda, Meyer, & Delios, 2008; MacCarthy & Atthirawong, 2003). Thus, organizations tend to maximize their utility and minimize risk by internationalizing into more politically developed countries.

H2b. Lower political development in the target country than in the home country has an association with greater perceived risk in internationalization decisions.

3.3. Entry-mode choice

Chang and Rosenzweig (2001) and Samiee (2013) classify the extensive literature on entry modes into three broad groups: ownership and control issues, country risk and development levels, and cultural distance. Each of these streams presents entry-mode choice as a means of managing—or as a reflection of—international risk because each entry mode is consistent with different levels of control and resource commitments. Despite the debate about the most suitable entry mode for distant and unfamiliar environments (Brouthers, 2013; Brouthers & Brouthers, 2001), managers perceive more equity-intensive entry as riskier because this entry mode involves greater financial exposure. More equity-intensive entry modes also entail more control mechanisms and mechanisms with greater complexity.

Ahmed, Mohamad, Tan, and Johnson's (2002) research on Malaysian public firms demonstrates that managers opt for entry modes with lower resource commitment and lower control. Moderate international risk relates to joint ventures, and only low international risk leads to foreign direct investments with high control and high resource commitment.

H3. An association exists between more equity-intensive entry modes and greater perceived risk in internationalization decisions.

4. Method

4.1. Random utility theory and conjoint choice experiments

Random utility theory (Manski, 1977; McFadden, 2001) reports that decision-makers (managers m) choose the alternative (internationalization strategy i) that offers the highest utility from a set of options. Utility U is a latent construct that consists of a systematic component V and a random error component ε ; that is, $U_{mi} = V_{mi} + \varepsilon_{mi}$.

In this research context, the overall systematic utility consists of part-worth utilities β for different target countries C and remaining factors X such as market-entry mode. Eq. (1) expresses this relationship:

$$V_{mi} = \beta_{mC}C_i + \beta_{mX}X_i. \quad (1)$$

The target countries C are a combination of geographic distance GD_i and the manager's perceptions of the target countries' cultural distance CD_{mi} , economic distance ED_{mi} , and political distance PD_{mi} , such that $C_i = f_m(GD_i, CD_{mi}, ED_{mi}, PD_{mi})$. This relationship extends the utility function to Eq. (2):

$$V_{mi} = \beta_{mGD}GD_i + \beta_{mCD}CD_{mi} + \beta_{mED}ED_{mi} + \beta_{mPD}PD_{mi} + \beta_{mX}X_i. \quad (2)$$

The multinomial logit (MNL) model (Islam, Louviere, & Burke, 2007; Louviere, Hensher, & Swait, 2000) can accommodate this utility function. The MNL model represents manager m 's choice of strategy i from the set J of internationalization alternatives in terms of choice probabilities $prob$, as in Eq. (3):

$$prob_m(i|J) = \frac{\exp(V_{mi})}{\sum_j \exp(V_{mj})}. \quad (3)$$

The estimated part-worth utilities β indicate the distance's effect on the utility of manager m 's internationalization strategy and, consequently, how this utility affects the probability of choosing the focal internationalization strategy.

In the conjoint experiment, managers selected their preferred strategies from systematically varied choice sets (Eggers, Eggers, & Kraus, in press; Louviere et al., 2000). Thus, decisions (i.e., manifestations of managers' systematic utility component V) served as the dependent variable. The internationalization options in the choice sets consisted of experimental factors, which were the independent variables. Covariates measured (perceived) distances between home and target countries (Section 4.4).

4.2. Dependent variable

To create a decision context, participants assumed that they managed one of the companies in the choice sets. All companies had their headquarters in the same home country, were active in the same industry, and operated only in the national market. Therefore, the decisions focused on the company's initial market entry. Respondents pursued internationalization strategies for the fictitious companies. These strategies differed in market-entry mode and target country (e.g., exporting to France or a joint venture in Russia). In their roles as managers, respondents had to select the riskiest internationalization strategy for the company.

4.3. Independent variables

Target country and market-entry mode were experimental factors. Secondary data yielded the top ten recipients of exports from Germany, Switzerland, and Austria (i.e., the home countries of the target sample). The final sample comprised data for 16 target countries: Germany, Switzerland, Austria, the Netherlands, Belgium, France, the UK, Italy, Spain, Czech Republic, Poland, Hungary, Russia, the US, Japan, and China.

This study includes equity (i.e., joint ventures and subsidiaries) and non-equity (i.e., exports, franchising, and alliances) modes. These two categories differ considerably regarding investment requirements and control, which affect risk (Pan & Tse, 2000).

The experiment covered 15 target countries (after excluding the home country from the 16 countries listed above) and five entry modes, yielding 75 potential internationalization options. To avoid straining their cognitive capacity, managers did not evaluate all options.

Instead, the software randomly selected 11 choice sets with four internationalization options. The random selection process met the efficiency criteria of balance, orthogonality, and minimal overlap (Huber & Zwerina, 1996). On average, each manager evaluated each target country 2.9 times and each entry mode 8.8 times.

In addition to experimentally varied alternatives, each choice set included a static option that represented the no-choice option (i.e., non-internationalization). Respondents choosing this option indicated that they perceived no option to be riskier than focusing on the home country.

4.4. Country-specific covariates

Scholars criticize empirical IB research on distances (Dow & Karunaratna, 2006; Håkanson & Ambos, 2010) primarily because most studies used the Kogut and Singh (1988) index to measure cultural and psychic distances interchangeably (Trabold, 2002). Distance is multidimensional and includes distinct aspects such as economic, political, cultural, and geographic distance (Berry, Guillén, & Nan, 2010). Thus, to account for multidimensionality, several constructs reflected distance in this study.

The measurement of geographic distance relied on two variables: a variable that equaled (log) distance in kilometers between the centers of the home and target countries and a dummy variable that indicated whether the target country bordered the home country. The measurement of cultural distance focused on the manager's perception of differences regarding task-completion and time-use routines, context orientation, communication directness, power distance, and attitude toward risk. The measures for economic and political distances between the home and target countries followed the work by Dow and Karunaratna (2006). The items covered differences in language, religion, education, political systems, and industrial development.

Exploratory factor analysis reduced the number of items to four factors, which explained 71% of the total variance. The analysis of eigenvalues greater than 1 initially pointed to a three-factor solution in which items for economic and political distance loaded on the same factor. However, this factor had a low value of Cronbach's α (0.36). The four-factor solution separated these items. The four factors were geographic distance (eigenvalue = 1.21, Cronbach's α = 0.62), cultural distance (eigenvalue = 3.25, Cronbach's α = 0.77), economic distance (eigenvalue = 1.16), and political distance (eigenvalue = 0.75). The resulting factor scores for each manager constituted covariates in the choice models.

4.5. Sample

The target group consisted of 126 German-speaking CEOs and top managers responsible for internationalization in companies with headquarters in Germany, Switzerland, or Austria. A professional panel provider recruited the sample from this group and for the online survey in 2013. The survey covered 1386 internationalization decisions.

5. Results

In the estimation of the benchmark model (Eq. (1)), effect codes represent market-entry modes and target countries (excluding country-specific covariates). Table 1 presents the results.

Unlike target countries, market-entry modes do not significantly affect perceived risk of internationalization ($p = 0.16$). Thus, in this decision context, the risk relating to target countries is more relevant than the risk relating to market-entry modes. Austria (AT), Germany (DE), the Netherlands (NL), and Switzerland (CH) have the least perceived risk. This finding is plausible because these countries border the sample countries (i.e., Germany, Switzerland, and Austria). Russia (RU), China (CN), Spain (ES), and Italy (IT) have the greatest perceived risk. Interestingly, managers assess the non-internationalization option as carrying

Table 1
Estimation results for market-entry modes and target countries.

Log likelihood	– 1973.1	
Attributes	B	p-Value
<i>Market-entry mode:</i>		
Export	– 0.15	0.16
Joint venture	– 0.05	
Franchising	0.00	
Strategic alliance	0.07	
Subsidiary	0.12	
<i>Target country:</i>		
AT	– 1.72	<0.01
DE	– 1.21	
NL	– 1.12	
CH	– 0.92	
GB	– 0.69	
BE	– 0.46	
FR	– 0.07	
US	– 0.02	
JP	0.21	
PL	0.28	
HU	0.43	
CZ	0.50	
IT	0.85	
ES	0.94	
CN	1.01	
RU	1.09	
Non-internationalization	0.92	

significant risk. Thus, managers perceive internationalization to be less risky than concentrating solely on the home market. Only when the non-internationalization option exceeds the estimate do managers perceive internationalization to the target country to be riskier than a domestic strategy. Thus, managers prefer a home-market strategy to investment in Russia, China, and Spain. For Italy, managers prefer a home-market strategy only when combining Italy as a target country with an equity entry mode such as a subsidiary. Table 2 shows the combined utility of entry modes and target countries: although target countries are the primary drivers of risk, market-entry modes can change preference order (e.g., although managers rate Russia as the riskiest country, only some least attractive combinations include Russia).

To decompose utility values for target countries and explain managers' preference order, the second estimation model replaces parameters for target countries with target countries' distance measures (factor scores) (Eq. (2)). Table 3 presents the results of this estimation model.

Cultural and geographic distances significantly affect risk ($p < 0.001$). Thus, managers view spatially distant countries or countries that score highly on cultural difference as riskier. Economic and political distances have significant negative effects ($p < 0.001$). These distances include both positive and negative measures. This finding implies that positive distances (i.e., a better economy or simpler political conditions) decrease perceived risk, whereas negative distances (i.e., negative differences in economic development or complicated political conditions)

Table 2
Most and least risky combinations of entry mode and target country.

Most risky combinations	Utility	Least risky combinations	Utility
Subsidiary in Russia	1.21	Exports to Austria	– 1.87
Strategic alliance in Russia	1.16	Joint venture in Austria	– 1.77
Subsidiary in China	1.13	Franchising in Austria	– 1.72
Franchising in Russia	1.09	Strategic alliance in Austria	– 1.65
Strategic alliance in China	1.08	Subsidiary in Austria	– 1.60
Subsidiary in Spain	1.06	Exports to Germany	– 1.36
Joint venture in Russia	1.04	Exports to the Netherlands	– 1.27
Franchising in China	1.01	Joint venture in Germany	– 1.26
Strategic alliance in Spain	1.01	Franchising in Germany	– 1.21
Subsidiary in Italy	0.97	Joint venture in the Netherlands	– 1.17

Table 3
Estimation results for distance measures.

Log likelihood	– 1983.5	
Attributes	B	p-Value
<i>Market-entry mode:</i>		
Export	– 0.16	0.17
Joint venture	– 0.01	
Franchising	0.00	
Strategic alliance	0.09	
Subsidiary	0.10	
Cultural distance	0.45	<0.01
Geographic distance	0.20	<0.01
Political distance	– 0.27	<0.01
Economic distance	– 0.49	<0.01
Non-internationalization	0.78	<0.01

increase perceived risk. Collectively, these findings support the first four hypotheses.

The conversion of estimates into importance weights (Table 4) reveals that differences in target countries' economic distance is the most important determinant of whether managers perceive a country to be risky (36.1%). Other important determinants are cultural distance (28.5%), political distance (20.8%), and geographic distance (11.0%). Market-entry modes are less relevant regarding perceived risk (3.7%).

6. Discussion, limitations, and conclusions

This research responds to calls from IB scholars (Aharoni et al., 2011) to apply an experimental design to the study of internationalization. Results of the conjoint experiment confirm most hypotheses (H1a/H1b and H2a/H2b) and show that different facets of distance are the primary drivers of risk perceptions in internationalization decisions. In contrast, choice of market-entry mode (H3) is not a significant predictor of risk perceptions. This finding may be surprising because of extensive literature on entry-mode choice. Yet, previous studies show mixed results on distances' influence on entry-mode choice (Brouthers, 2013; O'Grady & Lane, 1996). Internationalization may therefore be a hierarchical decision in which managers choose target market (and risk profile) and view entry-mode choice as subordinate to other environmental factors. Alternative modeling approaches (e.g., a nested logit model) would account for such hierarchical decisions. However, this study's experimental structure hinders such modeling approaches. Studying the hierarchical structure of decision-making in internationalization and using alternative models to study internationalization present two opportunities for further research. Nevertheless, this study contributes significantly by simultaneously modeling location and entry mode.

Another noteworthy finding relates to overall risk perception. Results show that managers also consider non-internationalization as risky. Although this study does not adhere to a single theoretical paradigm, real options' thinking posits risk as an opportunity rather than as a threat, thereby reflecting managers' perceptions of non-internationalization as risky (Fisch, 2008). Findings also provide insights on the Uppsala model of internationalization (Johanson & Vahlne, 1977). Although the Uppsala model refutes the idea that non-internationalization is riskier than internationalization, results reflect

Table 4
Importance weights.

Factor	Importance
Market-entry mode	3.7%
Cultural distance	28.5%
Geographic distance	11.0%
Economic distance	36.1%
Political distance	20.8%

the importance of psychic distance as a multidimensional construct, as per the Uppsala model.

Nevertheless, analysis in this study covers only risk relating to target countries and entry modes. When managers consider investing in a foreign country, however, risk may be but one driver of their decisions. Another important driver might be the likelihood of success in the target country. This additional consideration highlights a potential area for future research. Finally, greater heterogeneity of future samples is advisable because variances in perceptions of cultural or economic distances among respondents may impede the generalization of this study's results.

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