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The Choice of Market Entry Mode: Cross-Border M&A or Greenfield Investment

Aiwei Wang
School of International Trade, Southwestern University of Finance and Economics
Chengdu 610074, China

Abstract

Multinationals may enter a host market by different modes of foreign direct investment (FDI). Two are widely used: Cross-Border M&A and Greenfield Investment. In practice, M&A transaction has increased dramatically in China over the last several years. This paper examines the choice of FDI modes, and makes a comparison between the two modes from the external and internal impacts. Then get the conclusion that we should choose the right mode according to the different situation about the firms in the international market. The purpose of this paper is going to analyze the two entry modes specifically and helps us better understand the two modes.

This article consists of four parts. Part1 is a short introduction to China today. Part II briefly introduces the current status of M&A and Greenfield Investment. Part III compares the two entry modes from their implementations, cost, external and internal sides. At the last part, we get the conclusion and make the suggestions to our investors.

Keywords: Foreign direct investment, Multinational firms, Merger and acquisition, Greenfield investment

1. Introduction

In China, there is a very famous proverb that says "Xi Bian Bu Liang, Dong Bian Liang". This proverb describes a celestial phenomenon, but it can also be used to vividly depict a true picture of the world economy. In 2008, it is very unusual for whole world. Our China suffered from so many disasters, while most places of the world are also experiencing an economic slowdown this year. China, which is also involved into the finance tsunami to some extent, however, on the whole the economics of China is balanced.

After its accession to the WTO and further opening to the outside world, China has been one of the most important countries to receive an increasingly strong flow of FDI, with 40,772 million USD in 2000; 46,846 million USD in 2001; 52,700 million USD in 2002; and 53,505 million USD in 2003. (See Exhibit 1) After 2003, until 2007, China continuously maintained this strong momentum in assimilation of FDI inflows. China, with total FDI inflows surpassing 53 billion USD, is one of the world's two largest recipients of FDI. (UNCTAD (2007) *World Investment Report 2007*)

FDI has occupied a lofty position in China, however, in my view, because of this year's finance crisis, the next following years; the trend of FDI inflows to China may be influenced. Therefore, I suppose it is the time for us to expand our investments to international market. In order to enter into the international market, there is no doubt we will also adopt the strategy of FDI. Next, we should choose the specific model. There are two common models: Greenfield Investment and Cross-border Mergers and Acquisitions. Before making a right choice, the enterprise should firstly understand the characteristics of these two models from the internal and external impacts. As soon as we understand the two modes, then we can make a right choice.

2. Current status of M&A and Greenfield Investment

According to the *World Report 2003-2005 of FDI,* we get the fact that before 1980s; majority of multinational companies entered the host country by the way of Greenfield investment (See the Exhibit 2). After 1980s, firms increasingly enter foreign markets by acquiring a local producer (*acquisition*) instead of opening a new subsidiary (Greenfield investment). In 1987 to 2000, M&A had increased for 14 years continuously. The amount of M&A had been accounted for more than half of the total FID since 2000 and the ratio was as high as 82.11 percent. In 2001, due to the bubble busted of the global stock market, the Cross-border M&A experienced the cold current and fall off 48.21%. The investment capital even accounted for less than 50%. (See the Exhibit 3) With the world economic recovery in 2004, M&A also resumed again, the accounting for the proportion of multinational investment rose to 58.73 percent.

3. The Comparison between M&A and Green-field Investment

3.1 The Comparison from their Implementations

A firm can establish a wholly owned subsidiary in a country by building a subsidiary from the ground up, the so-called green-field strategy, or by acquiring an enterprise in the target market. That is M&A. From their definitions we can see that Green field investment is one of the most typical ways of internal growth and M&A is the one of external growth. Both internal growth and external growth have advantages. Each of the investment way could bring different outstanding achievements and can develop and expand the company, but there are also some differences between the two entry modes.

The basic difference between M&A and Greenfield Investment is the implementation differences. M & A is an investment model by expanding the internal organization of firms through the external market trading, which regards the enterprise as a special commodity. At first the acquiring firms often overpay for the assets of the acquired firm. What is more, in the beginning, it will not increase host country's production capacity. This point may let the host country worry about their industry market's structure and competition. Especially to developing countries, it may cause the adverse concern whether this mode of investment way can influence the host country's economic sovereignty. Greenfield investment attaches importance to make good use of the capacity of the enterprises' internal organization and resources, then in order to establish the new production capacity and obtain the scale, purchasing land, machinery and means of production from the market. In the model of Greenfield, the behavior of market transactions have been replaced by the behavior of trading in the enterprises' internal organization, although this way can eliminate some cost caused by market transactions, the internal management also exists cost of the same page. (Zhou 523) The differences between the internal organization management cost and market transaction cost is determined by the capacity of the enterprise and resources. As a result, the substance of M&A and Greenfield Investment is going to make a choice between the market and internal organization according to the cost and return.

In addition to the cost, M&A and Greenfield Investment also show some differences in the effects of external factors and internal configuration. With the development of the strategic theory, enterprises are not only pursuing short-term interest, in order to achieve long-term strategic objectives, they have to consider the effective and efficient investment behavior from comprehensive sides. They aim to achieve a strategic business activities and access to sustainably competitive advantage at the core. As I mentioned above, so the ultimate option between M&A and Greenfield Investment should focus on business development strategies. (Bjorvatn, 14) I would like to set Lenovo as an example, which spend almost 20 years to grow into regional company through Greenfield Investment, however, it became a global company in a short period of time through M&A. Lenovo completed its expansion by external growth which internal growth cannot be achieved or have to take for a long time to accomplish its strategic goal. From it, we can know that every company should make a right decision according to the actual situation. Next, I will analyze from the internal and external side.

3.2 The Comparison from the External Impacts

3.2.1 Intensity of Market competition

To this point, the difference between the two is that M&A is an adjustment to the market's present firms in an industry, while Greenfield Investment adds the new supply to the market. In the market-oriented environment, weak competition often accompanied with high profits of the industry. At this time, FDI is inclined to Greenfield Investment to enter into the market. When the effective supply on the market is far from meeting the demand; then Greenfield Investment may be able to grab a place in such a situation, which can gain its competitive advantages. Due to the promising market prospects, it will be attracted a large number of investors, but the appropriate acquired firms will be very scarce and at the same time the cost will be very high. As a result, wise investors would prefer Greenfield Investment rather than M&A. On the contrast, with enhancing the supply by the market, the market is becoming saturated. As a result, the new investors have almost zero return from the entry and the competition is becoming more and more intensive as the supplies have surpassed the demands. In order to survive, companies cut the price for market shares. In such situation, M&A won his position again, a rapid increase in M&A can gain market share and production capacity reduce the cost at one time.

The degree of competition in the market is often accompanied by the development of the industry cycle. Most of the development of the industry experienced four processes: start-up, development, maturity and the decline. With the appearance of new products and new technologies, the industry began to experience a new developing cycle. In the initial stage of the development, because of less competition, Greenfield Investment is the mainstream during this period. As the industry maturing and competition increasing step by step, enterprise started to pursue economies of scale and excess production capacity. Our Greenfield investment model should be replaced by M&A. Under the influence of competition, M&A will become the mainstream of the FDI.

3.2.2 Resource constraints

Company's core competitiveness lies in its main product and the form of the product depends on some specific resources. Different enterprises have different investment performances according to the characteristics of the resources. From another perspective, the choice of investment models is constrained by the objective conditions which are caused by specific resources. Sometimes, good resources bring the competitive advantage to the enterprise. However, some resources are limited to the number or location of the binding nature. In this case, in order to obtain advantages of resources, M&A may be the only way. Recently, china carries out M&A frequently in the international energy market, such as CNOOC's acquisition of JUNIK, this aim was making up the shortage of domestic resources.

3.2.3 Transferability of resources

M&A and Greenfield Investment is essentially expanding their own companies' ability and resources. Companies expand and spread the core competencies within the enterprise through the way of Greenfield Investment. The way through M&A is a part of the strategies that the enterprise transplants other companies' core competencies or core resources as a whole. Therefore, M&A or Greenfield Investment is determined by whether the resources and capabilities own the ability of transferability.

We have learnt that if it is the capital centralized, and then the investment tends to Greenfield Investment. If it is the human capital centralized then the investment tends to M&A. Human capital belongs to implicit asset. It is very difficult to transfer of the asset such as knowledge and technology even within the same country not mention to cross-border. But we can obtain the acquired firms' technology, patents and related professional and technical personnel directly by the way of M&A, which will save the cost of research and technology development, reduce the risk of time and the risk of failure and achieve the pace of upgrade. In addition, the core products which have formed by the human capital centralized enterprises are difficult to catch up with. New recruits are required to spend a lot of energy to overcome the existing household brands. Mergers and acquisitions can solve the problem quickly by establishing operating advantages and avoiding risk.

3.2.4 Changes in the demand for industry

In general, if we are going to enter into an industry in which the demands change constantly, we would prefer to M&A. Because the constantly changes request the enterprise should have the foresight to the high-risk operation in the near future. M&A which can better respond to the changes will enable new entrants occupy the market quickly. On the contrary, the demand for the industry is stable, then companies are often able to form a more effective and predictable plan through Greenfield Investment.

3.3 The Comparison from the Internal Impacts

3.3.1 Quick to Execute

By acquiring an established enterprise, a firm can rapidly build its presence in the target foreign market compared with Greenfield Investment. When face the business expansion, majority of enterprises would regard M&A as a short cut. In terms of economic globalization, the pace of corporate is not only the key to accessing to relevant market, but also has a bearing on the survival and development of enterprises. To the point about speed, M&A is often the first choice for decision-makers. Through M&A, the company can significantly reduce the project's construction period. Acquiring firm can access to the local market with a high speed; and gain a head start in the market among the fierce competition. If we choose Greenfield Investment, we have to prepare enough time to face the complicated procedure. It related to the general argument, the examination and the official approval, infrastructure, equipment installation and so on. There are the numbers of uncertain factors waiting for the investors. Research shows that the creation of Greenfield Investment from business to business negotiations have to take 2-3 years to the general. Most have to wait for another 3-5yeats when it reaches a certain size. In contrast, M&A only need a few months time. (Friedman, 78)With the development of science and technology, compared with Greenfield Investment, M&A saves from trouble brought by the pressure of time and risk. When the German automobile company Daimler-Benz decided it needed a bigger presence in the U.S. automobile market, it did not increase that presence by building new factories to serve the United States, a process that would have taken years. Instead, it acquired the number three U.S. automobile company, Chrysler, and merged the two operations to form Daimler-Chrysler. Firms make acquisitions because they knew that is the quickest way to establish a sizable presence in the target market.

3.3.2 Corporate culture

Culture is the embodiment of a system of an organization and the performance. Although the corporate culture is intangible, it is the reflection of enterprise and is driven by the business activities of companies. Corporate culture accumulates in business operation. It is very difficult to change once it has been formed. Not mention to copy or transfer it. U.S. International Joint Company had tried to imitate the success of the cost strategy from Southwest

Airlines. However, they failed; the reason is that they cannot copy the company's culture rather than the aircrafts, routes or the rapid way of turnover.

When a company acquired another company, it is a long way to go due to their culture different. These differences can be formed by different countries or different industries. From the perspective of corporate culture, Greenfield Investment is much better than M&A because enterprises can build a new one and implant the new culture into the new body. So the investors can maintain a high degree of consistency. However, to the companies whose culture is less distinct and more likely to achieve diversity, M&A does matter under this culture.

3.3.3 Management

There is a wide range of enterprise operates in a low efficient not just because they are in a low degree of resources, but also due to their inefficient management. Therefore, one of intrinsic the motivations for M&A is the different level of management. As the different degree of the composition of each enterprise management, enterprises' management efficiency of each page is different. For illustration, there are two companies A and B, when A's management is more efficient than B's, A can gain more if he implant his management to B. Then A has the motivation to acquire B. Through M&A, the Company A's management resources can make maximal return. However, to some extent, enterprises with low management level had better choose Greenfield Investment to circumvent the high level of risk of management.

4. Conclusion

The choice between M&A and Greenfield Investment is not an easy one to make. Both modes have their advantages and disadvantages. In general, the choice will depend on the circumstances conforming the firm. If the firm is seeking to enter a market where there are already well-established incumbent enterprises, and where global competitors are also interested in establishing a presence, it may pay the firm to enter via an acquisition. In such circumstances, a Greenfield Investment may be too slow to establish a sizeable presence. However, if the firm is going to make an acquisition, its management should be cognizant of the risks associated with acquisitions that were discussed earlier and consider these when determining which firms to purchase. It may be better to enter by the slower route of a Greenfield Investment than to make a bad acquisition.

If a firm is considering entering a country where there are no incumbent competitors to be acquired, then a Greenfield Investment may be the only mode. Even when incumbents exist, if the competitive advantage of the firm is based on the transfer of organizationally embedded competencies, skills, routines and culture, it may still be preferable to enter via a Greenfield Investment. Things such as skills and organizational culture, which is based on significant knowledge that is difficult to articulate and codify, are much easier to embed in a new venture than they are in an acquired entity, where the firm may have to overcome the established routines and culture of the acquired firm.(Charles, 342)

In a word, if the investors choose the right way to enter into the target market, it can save cost and reduce the risk. However, if they choose the wrong way, they cannot live up to their expectation. Therefore, I suggest that all the investors should think over the two entry modes before taken action.

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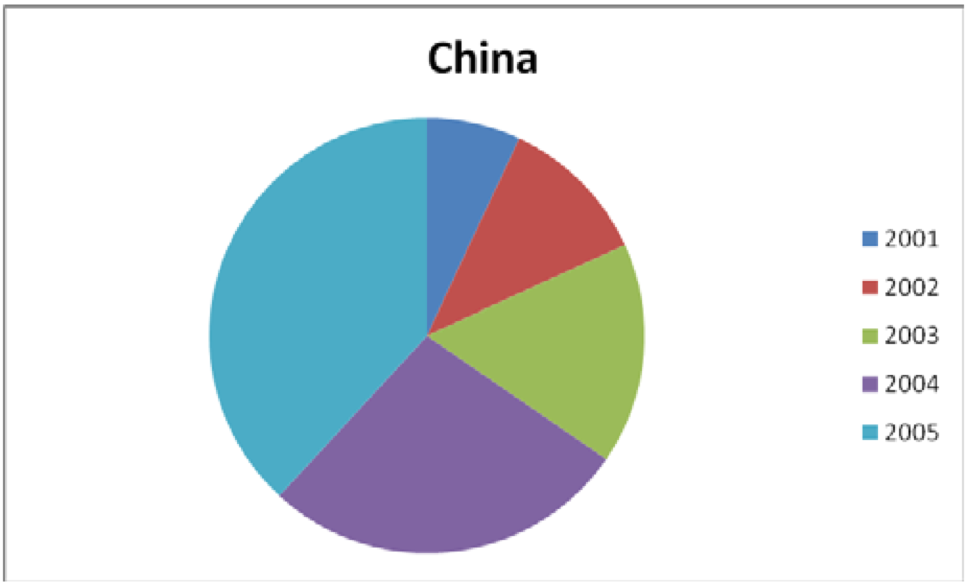
Appendix

Exhibit 1



The share of M&A in FDI from 2001 to 2005

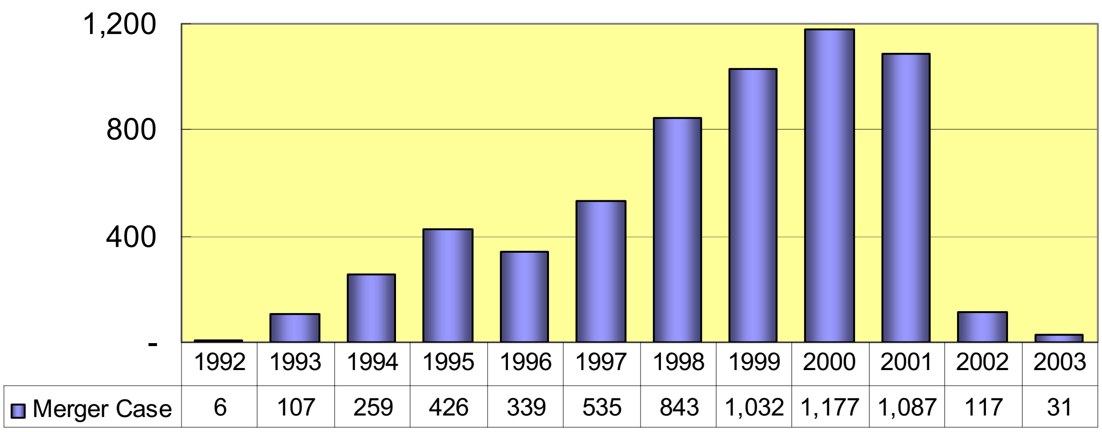
Exhibit 2

Types of FDI	Elasticity on total fixed capital formation	Contribution to the increase of total fixed capital formation (billion US dollars)
Greenfield investment	0.11	8.72
Cross-border M&A	−0.04	−3.19

The impacts of FDI on capital formation of aggregated Chinese Industry

Source: www.ite.poly.edu/people/brao/cross-border _case.htm

Exhibit 3



Merger Case Statistics

Source: www.17stu.com/lunwen/77/165/lw_17223.html

Exhibit 4

Types of FDI	Industrial sectors	Correlation coefficient with capital formation	Correlation coefficient with employment
Greenfield investment	Manufacturing	0.36	0.35
	Wholesales & Lodging Services	0.42	0.54
	Entertainment & Cultural Services	0.09	−0.34
Cross-border M&A	Manufacturing	−0.23	0.00
	Wholesales & Lodging Services	−0.31	−0.60
	Financial & Insurance Services	−0.28	−0.61

The impacts of FDI on Different Industries IN China

Source: www.sasac.gov.cn/n1180/n2429527/n2438790/4945132.html

Exhibit 5

Merger Motivation