The Impact of Institutional Distance on the Choice of Multinational Enterprise's Entry Mode: An Empirical Evidence in Vietnam

Vo Van Dut*, Nguyen Dinh Yen Oanh, Le Tran Thien Y, and Tran Thu Huong

Abstract

This paper aims to investigate the impact of institutional distance between home and host countries on the choice of multinational enterprise's entry mode in Vietnam. Based on the transaction cost theory, this study hypothesizes that a multinational enterprise (MNE) is likely to entry an institutionally distant country through merger and acquisition (M&A) rather than greenfield. Data of 258 MNE subsidiaries located in Vietnam from the data set of the World Bank are used to test the proposed hypothesis. Logit regression indicates that the hypothesis of the study is strongly supported with control of the characteristics of industry, of parent firm, and of subsidiary. The paper provides implications to international business literature.

Keywords: Institutional Distance, Entry Mode, Subsidiary, MNE

JEL Classification: F23, M16.

* Corresponding author. Vo Van Dut is a Lecturer/Deputy Head of Department of International Business, College of Economics, Can Tho University, Campus II, 3/2 Street, Ninh Kieu District, Can Tho City, Vietnam. E-mail: vvdut@ctu.edu.vn

Nguyen Dinh Yen Oanh is a Lecturer at Department of International Business, College of Economics, Can Tho University, Campus II, 3/2 Street, Ninh Kieu District, Can Tho City, Vietnam. E-mail: ndyoanh@ctu.edu.vn

Le Tran Thien Y is a Lecturer at Department of International Business, College of Economics, Can Tho University, Campus II, 3/2 Street, Ninh Kieu District, Can Tho City, Vietnam. E-mail: ltty@ctu.edu.vn

Tran Thu Huong is a Lecturer at Department of International Business, College of Economics, Can Tho University, Campus II, 3/2 Street, Ninh Kieu District, Can Tho City, Vietnam. E-mail: huongtran@ctu.edu.vn

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1. Introduction

The modes chosen by multinational enterprise's (MNE) to enter a foreign market, i.e. whether they take full ownership of their foreign affiliate or whether they share ownership with local firms, and whether they enter with a de novo investment (a greenfield subsidiary) or through an acquisition, have been a major topic in the international business (IB) literature over the past decades. The reason is that an appropriate entry mode generates MNEs' competitive advantages in the host countries and even in the international market (Veberke, 2009). Theoretically, transaction cost theory (Hennart, 1991) is one of the IB theories, which is mostly applied by several entry mode studies in IB literature (e.g., Hennart and Park, 1993; Cho and Padmanabhan, 1995; Brouthers and Brouthers, 2000; Slangen and Hennart, 2008; Brouthers, 2013). Transaction cost theory states that when entering foreign market by different entry modes, an MNE will incur a plenty of different costs because of liability of foreignness as operating in different business environments (Brouthers, 2013; Slangen and Hennart, 2008). Adapting transaction cost theory; many studies indicate that cultural distance, MNE manager's international experience and parent firm's age have related to the entry mode choice of MNEs (e.g., Hennart, 2009; Slangen and Hennart, 2008). These studies mainly focus on the sample observations in developed countries.

To our best knowledge, so far there is some news in daily newspapers or in magazines addressing merger and acquisition (M&A) in Vietnam (for example, see KPMG, 2013 for comparative review, 2013), a little piece of the study has been known about the role of institutional distance between Vietnam and foreign investors' (MNE) home country in their entry mode decision. The aim of this paper is therefore to study the relationship between institutional distance between Vietnam (host country) and MNEs' home country. In doing so, we enhance theoretical arguments to IB literature and add empirical evidences about the role of institutional distance between home and host countries in MNEs' entry mode choice in a developing country. Understanding this is important because the empirical findings of the study is a helpful reference for MNEs' top managers to choose the most suitable entry mode when entering an emerging economy (such as Vietnam) with a high uncertainty institutional environment. Additionally, the practical implication of the study can be a crucial message to the policy makers of Vietnam to improve better institutional environment that enables to facilitate the attraction of foreign investment in Vietnam. The rest of this article is organized as follows. Section 2 reviews related literature and develops hypothesis. Research method is described in Section 3, while empirical results are discussed in Section 4. Finally, Section 5 provides conclusion, practical implications and offers future research opportunities.

2. Theory and hypothesis

According to transaction cost theory (Hennart, 1991), when entering foreign markets through different entry modes, MNEs incur several different costs caused by liability of foreignness. IB scholars claim that the modes chosen by MNEs have related to the characteristics of internal and external environments (Brouthers, 2013; Eden and Miller, 2004). With regard to the internal environment, an MNE with the high level of international experience and the capacity of research and development refers to enter to the host country through greenfield rather than M&A because the cost of greenfield investment is lower than M&A. On the other hand, external environment is likely to affect the MNEs' entry mode strategy. In particular, the institutional country context differences between home and host countries are likely to decide the entry mode chosen by the MNEs. Studying this relationship is worthy for IB research because, to our best knowledge, a little is explicitly known about the role of institutional country context differences in MNEs' entry mode decision. In addition, institutional environment in each host country is different from home country and the measurement for institution is complicated (Vo, 2013). Our study develops hypothesis on the aforementioned relationship, combining insights from transaction cost theory with research on institution in IB literature.

Adapting transaction cost theory (Hennart, 1991) and previous studies' contributions, we argue that an MNE is likely to entry an institutionally distant country through merger and acquisition rather than through greenfield. There are two explanations for this argumentation. First, each country has its own institutional environment, this generates an institutional context difference as an MNE invests in a foreign country (Gaur and Lu, 2007). This difference becomes larger in the context between a developed country and developing country because institutional environment in developing countries still faces the high level of uncertainty. For example, compared to M&A subsidiary, greenfield subsidiary suffers many challenages as operating in a different institutional country. The MNEs need to adapt the requirements of local government and rules, regulations, norms of local markets or are discriminated by other competitors, such as non-governmental organization, commercial organization (De Jong, Vo, Jindra, Marek, 2015; Delios and Henisz, 2003). These challenges are likely to increase MNEs' entry expenses . In the meanwhile, M&A subsidiaries can avoid these expenses because the M&A subsidiaries are familiar with local markets. Moreover, M&A subsidiaries established the closed relationship with local partners and government (Slangen, 2011; Kostova and Zaheer, 1999).

Second, entering a highly institutional distance country through greenfield, MNEs face difficulties in terms of using labour resource and other inputs or establishing distribution system because of local government's descrimination hazards (Eden and Miller, 2004). These difficulties increase business expenses in such the host country. In addition, entering a highly institutional distance country through greenfield, greenfield subsidiaries are not familiar local labor's culture and working skills. Thus, it is hard for MNEs to approach and obtain suitable labours and suppliers. By contrast, subsidiaries established through M&A access these resources easily (Spencer and Gomez, 2011). In addition, the other advantage of acquisitions over wholly owned greenfields is that they bring local market knowledge (Wilson, 1980), and hence enable MNEs to be locally responsive (Harzing, 2002). Such knowledge is typically location-bound, that is, applicable only in a particular country or a small set of institutionally similar countries (Rugman and Verbeke, 1992). Since market knowledge is to a large extent tacit and experiential, it is difficult to purchase in disembodied form (Hennart, 1982) and time-consuming to develop through greenfield investments (Johanson and Vahlne, 1977). It is therefore more efficiently obtained through acquisitions (Harzing, 2002). Local market knowledge is particularly important to MNEs expanding into institutionally distant countries (Tan and Mahoney, 2003), because such countries have radically different regulations, rules, values, customs, business practices, and customer preferences with which MNEs are likely to be unfamiliar or uncomfortable (Caves, 1996; Hofstede, 2001; Kogut and Singh, 1988). Hence, the larger the institutional distance to a country, the more MNEs will benefit from the market knowledge that comes with an acquisition in that country. Eventually, business costs in a high institutionally distance country are likely to reduce. In summary, the larger institutional distance between home and host countries, greenfield subsidiaries incur higher business cost than M&A subsidiaries. Therefore, we propose the following hypothesis:

Hypothesis: *The greater institutional distance between home and host countries, the greater an MNE prefers to enter host country through M&A rather than greenfield*

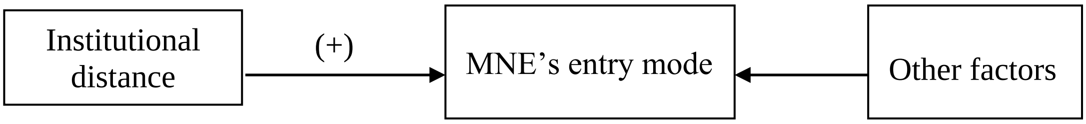

Figure 1. Theoretical model

3. Research methodology

3.1. Data

To test the hypothesis, the data used in the study are derived from several different sources. First, the data were extracted from the data set of the World Bank (for example, Ramadami and Van Witteloostuijn, 2012). The survey focuses on non–agricultural manufacturing industry and classify each group by ISIC Revision 3.1: manufacturing (Group D), construction field (Group F), service sector (Group G and H), and transportation field, and communication (Group I). This definition eliminated the following sectors: financial intermediaries (Group J), real estate and leasing (Group K, except from Group 72 - communication technology, is added to the survey), and public sectors.

This survey was conducted by interviewing face-to-face through the designed questionnaire in thirteen provinces located in five regions: Red River Delta (Ha Noi, Hai Duong and Hai Phong), North Central Coast (Thanh Hoa and Nghe An), Mekong River Delta (Can Tho, Long An and Tien Giang), South Central Coast (Khanh Hoa and Da Nang), and Southeast (Ho Chi Minh City, Binh Duong and Dong Nai). Enterprises are divided into three groups: small-scale enterprises consist of 5 to 19 employees; medium-scale enterprises consist of 20 to 99 employees; large-scale enterprises consist of more than 99 employees (full-time employees). The representative of firms who participated in the interview was the member of board of firm or the chair of section or the head of department.

The selected firms were then used as the frame for the selection of a sample with the aim of obtaining interviews at firms with five or more employees as the World Bank' plan. Enterprises are divided into three groups: small-scale enterprises consist of 5 to 19 employees; medium-scale enterprises consist of 20 to 99 employees; large-scale enterprises consist of more than 99 employees (full-time employees). After checking out the response questionnaires, there are 1050 response firms (both domestic and foreign firms) fulfilled the requirements of the survey (the questionnaire response rate is approximately 33.53 percent). Among these, 367 out of 1050 firms are foreign-owned firms (subsidiary), which are the subject of our study. Their headquarters stem from 44 different countries. After correction for missing values because of incomplete responses with respect to the aim of this study, the usable final observation of this study is 258. The parent firms of these subsidiaries are located in 22 various home countries. Using this information, we were able to produce 22 country pairs for calculating institutional distance between home and host countries

Second, we collected the data from the World Development Indicators, which Kaufmann, Kraay, and Mastruzzi (2006) identified the six dimensions of governance quality to reflect a country's institutional environment through scores. These scores are updated annually. Using this information, the scores of the six dimensions about institutional environment for Vietnam and 22 home countries were collected. Institutional distance measure is described in next section.

3.2 Variable and measure

Dependent variable (Y): The dependent variable of our study is entry mode defined as "a structural agreement that allows a firm to implement its product market strategy in a host country either by carrying out only the marketing operations (i.e., via export modes), or both production and marketing operations there by itself or in partnership with others (contractual modes, joint ventures, wholly owned operations)" (Sharma and Erramilli, 2004, page 2). Following Slangen and Hennart (2008), we measure our dependent variable by a dummy variable, which equals one when MNE established subsidiary as a full or partial acquisition or a joint venture, and zero otherwise (i.e. in cases of a greenfield investment – wholly owned subsidiary).

Key independent variable (X_1): Our key independent variable is institutional distance defined as "the extent of similarity or dissimilarity between the formal and or regulative and the informal or normative and cognitive aspects of institutions of any two countries" (Gaur & Lu, 2007, page 87). This variable is measured by six dimensions identified by Kaufmann, Kraay, and Mastruzzi (2006): voice and accountability; political stability and absence of violence; government effectiveness; regulatory quality; rule of law; and control of corruption. This study applied the formula of Kogut and Singh (1988) to calculate institutional distance between home and host countries with the equation as follows:

$$ID_j = \sum_{i=1}^{6} \left\{ \left(I_{ij} - I_{iv} \right)^2 / V_i \right\} / 6 \qquad (1)$$

where,

ID_j: *institutional distance index between Vietnam and home countries.*; I_{ij}: institutional dimension i^{th} of home country j^{th}; I_{iv}: institutional dimension i^{th} of Vietnam, Vietnam is reflected by "v"; V_i: is variance of institutional dimension i^{th}. Based on the formula (1) and the data source in the preceding section, institutional distance between home countries and Vietnam is measured. The value of the independent variable ranges from 0.28 to 9.68. The larger this value represents the greater institutional distance between home countries and Vietnam.

Control variables: We control parent firm's international experience, subsidiary's research and development (R&D) intensity, subsidiary size, subsidiary's export intensity and industry sector (e.g., Cho and Padmanabhan, 1995; Brouthers and Brouthers, 2003; Slangen and Hennart, 2008).

MNE's international experience (X_2)

Lacking of parent firm's international experience significantly impact on the MNE's entry mode decision because MNEs with high international experience reduce risk in their entry strategy (Slangen and Hennart, 2008). MNE's international experience is measured by the number of oversea operation years of MNE until 2009. This variable has values from 1.09

to 4.17 (after taking the natural logarithm). The greater value represents the greater of MNE's international experience.

Subsidiary's R&D intensity (X_3)

An MNE would run well in a market if its subsidiary's R&D intensity was properly concerned. Subsidiary's R&D intensity is very important in the exploitation of knowledge and available assets in local markets. Then, applying such knowledge and using such assets to create innovative products, processes and services, to satisfy better needs and preferences of customers in local markets (Slangen and Beugelsdijk, 2010). This variable is measured by the percentage of subsidiary's R&D expenses in its total sales. The value of this variable ranges from 0 to 19 percent, if this rate increases, multinational subsidiary's R&D intensity increases.

Subsidiary size (X_4)

Subsidiary size is likely to affect MNE's entry mode decision, because the larger subsidiary size, the greater the need of expanding the market. In this study, the size of the subsidiary is measured by the number of its employees (De Jong et al., 2015). The value of this variable varies from 1.10 to 8.29 (after taking the natural logarithm), the greater value represents the greater subsidiary size.

Subsidiary's export intensity (X_5) is measured by the percentage of export sales in subsidiary's total sales. The value of this variable ranges from 0 to 81 percent. The greater of this value illustrates the greater of subsidiary's export intensity. The higher ratio implies that an MNE prefers to entry through M&A rather than greenfield because the MNE wants to exploit local market.

Industry sector (X_6)

The industry in the production of goods are classified into 3 groups based on 6 groups of industries including: Group 1 (the industry uses less labor and uses high tech including product non-metallic mineral, metal and fabrication), group 2 (the labor intensive industry, including food, textiles and clothing) and group 3 is others. This variable is measured by a dummy variable, which equals one as subsidiary belongs to group 1 and zero otherwise. We argue that subsidiaries in group 1 are often required high technology and focus on exploiting the advantages of host countries, while group 2 and 3 usually focus on market operation. Thus, subsidiaries of the group 2 and 3 are likely to be established through M&A rather than greenfield. The opposite entry mode is applied for the group 1.

Table 1. The summary of the characteristics of the independent and control variables

Variables	Explanation	Measurement	Expected sign
X_1	Institutional distance	Using six dimensions of Kaufmann, Kraay, and Mastruzzi (2006) and applying the formula of Kogut and Singh (1988)	+
X_2	MNE's international experience	The number of oversea operation years of MNE until 2009	+
X_3	Subsidiary's R&D intensity	The percentage of subsidiary's R&D expense in total sales	-
X_4	Subsidiary size	The number of subsidiary's employees	+
X_5	Subsidiary's export intensity	The percentage of subsidiary's export sales in its total sales	+
X_6	Industry	Measured by a dummy variable (1: group 1; 0: group 2 and 3)	-

4. Empirical results

4.1 Descriptive statistics and correlation

Table 2 shows mean, standard deviation, variance inflation factor (VIF) and correlation coefficient between the variables. Table 2 indicates that the correlations between the independent variables are below 0.8. The correlation between subsidiary's R&D intensity and its export intensity is 0.36, which is the highest correlation coefficient compared to other pairs of variables in Table 2. In addition, Table 2 also shows that VIF of all the variables are below the threshold value of 10.0. These results imply that the multicollinearity phenomenon does not occur when including all these variables simultaneously (Hair, Black, Babin, Anderson, & Tatham, 2006). Moreover, Table 2 shows the correlation between institutional distance and MNE's entry mode are correlated moderately (the coefficient is 0.196 with a statistical significance at 1 percent). This result means that institutional distance has postively associated with MNE's entry mode. Similarly, subsidiary's export intensity and its size have also positively correlated with MNE's entry mode because the correlation of those two pairs of variables (0.167 and 0.144, respectively) are statistically significant at 5 percent. Furthermore, the result of White test reveals that p-value is 0.381, which means the null hypothesis: no heteroskedasticity in the data cannot be rejected.

Table 2. Mean, standard deviation and correlation (n=258)

	Variables	**Mean**	**Standard deviation**	**VIF**	1	2	3	4	5	6
1	MNE's entry mode	0.310	0.160	1.11	1.000					
2	MNE's international experience (log)	3.231	0.478	2.01	-0.068	1.000				
3	Institutional distance	4.203	2.056	1.93	0.196***	-0.076	1.000			
4	Subsidiary's R&D intensity (%)	6.288	3.635	2.04	-0.002	-0.064	-0.057	1.000		
5	Industry sector	0.704	0.625	1.15	0.011	-0.067	0.086	-0.019	1.000	
6	Subsidiary's export intensity (%)	60.83	37.30	1.89	0.167**	-0.100	-0.063	0.360***	0.088	1.000
7	Subsidiary size (log)	4.333	1.315	1.01	0.144**	-0.083	-0.022	0.s078	0.056	0.205***

, ** and * indicate statistically significant levels at 10, 5, and 1 percent, respectively.*

4.2 Result discussion

The estimated results of Logit regression are presented in Table 3. Model 1 shows the effect of the control factors on MNEs' entry mode in Vietnam. Pseudo R^2 in Model 1 is 0.337 and the ratio of lograrit is -122.64. In addition, p-value is 0.001, which means that Model 1 has statistical significant level at 1 percent. The results in Model 1 show that there is a positive relation between MNE's entry mode and its international experience at 10 percent statistically significant level (β_2=0.081; $p<0.10$). The results imply that the greater parent firm's international experience has, the greater MNEs tend to entry through M&A rather than greenfield. Similarly, the more subsidiary's export intensity is, the more MNEs prefer to enter local market M&A through rather than greenfield. Since the estimated coefficient of this factor is statistically significant at 5 percent (β_4=0.010; $p <0.05$).

In contrast, the results in the Model 1 also reveal that MNE's entry mode and R&D intensity have a negative relationship with statistically significant level at 5 percent (β_3=-0.140; $p <0.05$). This result means that the higher subsidiary's R&D intensity is, MNEs are more likely to choose entry mode by greenfield rather than M&A. In addition, multinational subsidiaries are authorized the roles in the industry of non-metallic minerals, metals and manufacturing, MNEs prefer to entry through greenfield rather than M&A, this effect has a statistically signficant level at 5 percent ($\beta 6$ =-1.888; $p <0.05$). In the meanwhile, subsidiary size does not affect the choice of MNE's entry mode (at least statistically) because the estimated coefficient of this factor is not statistically significant ($p> 0.1$).

Table 3. Effect of institutional distance on MNE's entry mode

Variables	Model 1	Model 2	Dy/dx
Key independent variable			
Institutional distance		0.238 (0,078)***	0.105***
Controlling variables			
MNE's international experience	0.081 (0.049)*	0.094 (0,053)*	0.031*
Subsidiary's R&D intensity	-0.140 (0.071)**	-0.151 (0,074)**	-0.081**
Subsidiary's export intensity	0.010 (0.005)**	0,023 (0,008)***	0.001***
Subsidiary size	0.247 (0.281)	0.274 (0,321)	0.130
Industry sector	-1.888 (0.929)**	-1.604 (0,787)**	-1.081**
Number of observations (N)	258	258	
Log likelihood	-122.64	-116.45	
Pseudo R^2	0.337	0.356	
P-value	0.001	0.000	

, ** and * indicate statistically significant levels at 10%, 5% and 1%, respectively.*
Standard errors are listed into parentheses.

The estimated results of Model 2 show that Pseudo R^2 significantly improves from 0.337 in Model 1 to 0.356 in Model 2. In addition, Log-likelihood also improves from -122.64 in Model 1 to -116.4 in Model 2. Statistically, these results imply that the statistical interpretation based on the estimated results of Model 2 is more relevant than Model 1 when institutional distance and control variables are included at the same time.

Model 2 indicates that the impact of control variables on the choice of MNE's entry mode is not different from the estimated results in Model 1 in terms of sign and statistical significance.

The results of Model 2 reveal that institutional distance between home and host countries has a significant and positive effect on MNE's entry mode (β_1=0.238, $p < 0.01$). This result means that MNEs investing in Vietnam with a large institutional difference between Vietnam and their home country prefer to entry Vietnam market by establishing subsidiaries through M&A rather than greenfield. The last column of Table 3 offers the marginal effect of institutional distance and control elements on MNE's entry mode in Vietnam. The marginal value of institutional distance (0.105) means that when institutional difference between Vietnam and MNE's home country increases one unit, the possibility of its parent firm establishing affiliates in Vietnam market through M&A rather than greenfield increases correspondently 10.5 percent. These results align with the hypothesis of the study, which proposed that the greater institutional distance between home and host countries, the greater an MNE prefers to enter the host country through M&A rather than greenfield. This implies that companies investing in an emerging economy like Vietnam – a high uncertainty institutional environment tend to prefer to collaborate with local companies through outsourcing, export or franchising contracts, which are easy to gain and adapt local legitimacy in the first business stage. This enables to reduce costs caused by liability of foreignness (Eden and Miller, 2004). Afterward they gradually acquire or merge local companies because of their dominant international technology, knowledge and experience. Through these strategies, MNEs increase penetration properties and explore local assets for the purpose of exploiting local market size through economy of scale and scope. Eventually, the MNEs gain competitive advantange and dominate the local market. The findings of the study is an empirical evidence to confirm again the relationship between institutional distance and MNE's entry mode. Therefore, the hypothesis of this study is strongly supported.

5. Conclusion, implication and limitation

MNEs need to gain their own competitive advantages in their country to go abroad doing business and to target foreign market, and hence obtain an efficiency. This is considered as one of the important strategies of multinational enterprises to be able to survive in host countries in particular and international market in general. This paper provides the new insights on the effect of institutional distance between home and host countries on the choice of MNE's entry mode – the sample of an emerging market. Adapting transaction cost theory (Hennart, 1982, 1991), we develop the theoretical arguments on relationship between institutional distance and MNE's entry mode. An empirical test in 258 subsidiaries operating in Vietnam reveals that MNEs with a large institutional difference between Vietnam and their home country prefer to establish subsidiaries in Vietnam market through M&A rather than through greenfield.

These results imply that foreign investors from countries, which have different institutional background with Vietnam intend to seek business opportunities in Vietnam market, they need to establish the relationship with local partners to conduct business contracts at the first stage. After that phrase, the foreign investor can establish affiliates at the local market through by M&A instead of greenfield. In addition, with regard to domestic enterprises, to enhance collaboration with foreign counterparts, domestic enterprises need to prepare capacity in terms of resources and skills, which enable to adapt and respond to the appropriate requirements from foreign subsidiaries. Thus, this facilitates the significant improvement of both competitive advantage and international integration with the global market. Furthermore, our results imply that policy makers in Vietnam need to improve rapidly institutional environment to fit with the change context of the global economy since Vietnam economy increasingly and deeply integrate with. These implications also demonstrate the limitations of the extent study. The institutional environment of each country can change that depends on the periods and different stages of its economic development. This has not been captured in our analysis. Therefore, future research can take this into account so that practical and theoretical implications are developed further.

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