The Choice of Governance Modes in LSPs Foreign Operations

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Introduction

Different theoretical approaches have been used to understand why firms select or prefer one organizational arrangement to others in order to carry out their businesses. Transaction cost (TC), resource based (RB), and the “Nordic” paradigms offer different but somewhat complementary explanations to the problem (For a discussion of the rivalry and complementarities between theories see, for example, Conner and Prahalad, 1996; Foss, 1996; Williamson, 1998, 1999). These theories have been used in a wide range of empirical studies. Most of them have centred their attention on manufacturing firms (see for example Osland et al., 2001), and quite a few have focused on the service sector (Contractor and Kundu, 1998a). Almost no interest has been shown in the analysis of the factors affecting the LSPs selection of governance models to perform foreign operations.

With the interest in filling this gap, this paper focuses on the identification of the main variables or factors able to explain LSPs modal choice in foreign operations. The analysis was done using an eclectic-syncretic paradigm (Contractor, 1990), which combines the main trends within TC and RB theories.

The paper is organized as follows: This introduction is followed by a literature review on international expansion of LSPs; the organizational models used by the firms to expand internationally are highlighted. In the next section an overview of the main theoretical frameworks related to organizational modal choice are presented. Based on the theories and a review of the empirical studies carried out by different authors, the factors influencing the choice of a governance structure to carry out foreign operations are presented. A set of general hypotheses, and a set of specific propositions devoted to the LSPs industry is developed.

The European expansion of LSPs

The seminal study of O’Laughlin et al. (1993) mentioned mergers and acquisitions, joint ventures and strategic alliances as the most popular expansion forms used by LSPs in the European market. Through M&A LSPs have gained control over their assets, eliminated duplicated activities, rationalized their operations, and reduced competition levels. Joint ventures have been a powerful instrument to overcome regulatory entry barriers. Strategic alliances have facilitated LSPs’ market access and operational integration without the capital investment and legal framework required by M&A.

Stone (2001; 2002) examined the expansion of UK-based logistics distribution service providers in the European market. According to Stone’s results, during the 1990s the most favoured organizational structures used by UK-LSPs to reach the European expansion were (1) organic growth; (2) acquisitions, and (3) piggybacking, or following customers into new markets. Joint ventures and strategic or logistics alliances have been less prevalent to European expansion among UK-based LSPs.

Other studies (Peters et al., 1998) have showed that larger customers expanding their activities into foreign markets have encouraged international expansion among 3PL services in Europe. The firm Arthur Andersen (2002) confirmed this trend in a study carried out among 4PLs.

Hertz (1993) analysed the European expansion process of three Nordic freight transport companies, who began their international expansion in different historical moments. Between 1940 and 1954 the establishment of informal but long-term cooperative agreements with agents localized in different European countries was the favoured route to internationalise. During the second period (1955-69) the firms made Greenfield investments, and started to cooperate with competitors resulting in the creation of some joint ventures and acquisitions. In the 1970s acquisitions of competitors began to popularise as a mechanism to seize new international markets. From 1980 onwards, M&A, not of single firms but of transport firms' nets, became the main organizational vehicle used to develop and consolidate companies' activities in the European market.

Ludvigsen (2001) conducted a study among seven European Logistics Service Providers covering a period between 1980 and 1997. The internationalisation tool of the LSPs was based on the creation of a voluntary and non-equity logistic alliance, known as the E1 Alliance. Each of the LSP enrolling the E1-Alliance had their own network of firms in which subsidiaries, cooperative agreements with agents, joint ventures, franchise, and loose partnerships with other allies co-existed.

Lemoine and Dagnæs (2003) offered a case study, based on a net created between Stinnes, Schencker, BTL and other European and non-European LSPs. The research covers the second half of the last decade of the twentieth century up to the first years of the new millennium. During the 90s the market expansion of the networked firms was based mainly on mergers and acquisitions of groups of companies, on the use of agents, and on Greenfield investments. In the new millennium an increasing importance has been assigned to alliances and they, as organizational form, will probably surpass the traditional arrangements based on equity-shares. With the new millennium Stinnes network has accelerated the development of inter-industry co-operative agreements; some of them entered with manufacturing firms, others with high-tech firms. Although partnerships are gaining terrain, the "old" models based on entirely or partially owned assets continue to be of great importance when expanding internationally.

The revision of the literature showed that LSPs have combined a broad variety of business models to reach their expansion in international markets. However, it was noticed that a theoretical an empirical explanation of the reasons why LSPs favour one governance mode over the other is missing. The next section is devoted to reviewing the main theoretical frameworks used to understand the problem.

Theoretical approaches

The Transaction Cost (TC) theory is concerned with the minimization of costs in order to decide the most efficient organizational form to expand activities in foreign markets. The firms will choose the organizational mode, which minimizes transaction costs (Contractor, 1990; Contractor and Kundu, 1998a, 1998b; Eriksson et al., 1997; Madhok, 1997; Williamson, 1998). The theory rests on two principles: bounded rationality and opportunism, and it has three key attributes: frequency of the transactions, uncertainties and asset specificity (Williamson, 1998, 1999). The choice between contract arrangements or internalised business methods depends on the relative costs and benefits of each modality. In general the TC theory predicts that firms with high proprietary specific assets try to exploit their advantages internally by fully owned operations (WOS). Firms with low specific assets are expected to use shared-control modes (Erramilli and Rao, 1993; Williamson, 1999).

The Resource based theoretic approach is also based on bounded rationality, but in contrast with the TC, opportunism is substituted by a truthful behaviour of individuals (Conner and Prahalad, 1996). In addition, the RB points out that the selection of organizational modes is not based on transaction costs, but on the resource availability and organizational capabilities and competencies of the firm (Davis et al., 2000; Madhok, 1997; Reve, 1990). According to this perspective, the organizational mode is determined by the firm's existing stock of knowledge, and by the compatibility between the firm's existing routines and the ones required to be successful in international markets (Madhok, 1997). The theory emphasizes strategic learning and competence (Koch, 2001a), and inter-firm collaboration as an organizational tool to facilitate the transfer of knowledge and the expansion of activities at the international level (Kulkarni, 2001). Thus, the theory predicts that when the transfer of knowledge is difficult, and when the proprietary content of products and processes is high, the firms may prefer WOS as organizational arrangement.

The Resource based theory has created new avenues of analysis creating a fertile terrain to the development of the "Nordic" paradigm. The "Nordic" approach comprises an evolutionary perspective, according to which the development of capabilities to act in international markets is a time-dependent and dynamic process, that must be seen in connection with the firm's long-term strategy and learning capabilities. The emphasis is on grasping capabilities throughout the relationship of one firm with another; in this way the "Nordic" approach relates the international expansion of firms to networks (Johanson and Matsson, 1988), all of this seen within a process of increasing experiential knowledge (Johansson and Vahlme, 1990).

Different authors (Conner and Prahalad, 1996; Contractor, 1990; Brouthers et al., 2003; Foss, 1996; Madhok, 1996; Williamson, 1998, 1999) have recognized that TC and RB theories are rivals, but, at the same time, complementary approaches. TC and RB alone cannot explain entirely a firm's modal choice, reason why a amalgamation of both paradigms is needed: "By combining capability/resource-based theory with TC theory future research efforts may be able to determine the types of entry mode that provide: (1) the least-cost method of exploiting firm capabilities and (2) the least-cost method for the enhancement or acquisition of new capabilities" (Brouthers et al., 2003: 1246).

The consideration of the multiple paradigms not as enemies but as opposites able to complement each other has opened new avenues in the analysis, giving place to the birth of the eclectic-syncretic approach. Following the eclectic approach, the preference for one organizational form over another to internationalise is the result of many factors such as firm-specific advantages, country-specific advantages, and internalisation advantages (Andersen, 1997; Contractor and Kundu, 1998a; Dunning, 2000; Eriksson et al., 1997). The fact of whether a firm will decide to "go it alone" or cooperate with partners, and if so, under what mode of association, depends on multiple factors related not only to the intended transaction costs, the transfer of knowledge and competencies, and the divergent motivations of the actors or agents involved in the process, but on the broader structure of the firm and its industry. Within this context it is important to distinguish between internal forces corresponding to the firm, and external forces anchored in the cultural, economic and political context of the company (Davis et al., 2000).

Variables influencing modal choice among LSPS

Environmental uncertainties

Empirical contributions based on the TC, RB and eclectic paradigms (Erramilli and Rao, 1993; Contractor and Kundu, 1998a; 1998b; Kulkarni, 2001; Koch, 2001a; 2001b) have postulated that environmental uncertainties influence the selection of an organizational model to expand internationally. The theoretical approaches have claimed that high levels of uncertainty at social, economical or political levels tend to favour business models involving contractual and cooperative approaches – e.g. agents, licensing, franchising, and joint owned ventures. On the contrary, companies perceiving low levels of environmental uncertainty will prefer fully owned organizational business models. Thus when confronted with environments characterized by high economical and political risks, companies would reduce uncertainties by making more cooperative ventures rather than using the same capital over one or a few fully owned investments (Contractor, 1990; Chen, 2003; Erramilli and Rao, 1993; Kulkani, 2001). In general the literature reveals that loosened or transitory alliances are suitable organizational forms to cope with unpredictable changing environments (Duysters and de Man, n/d; Erens et al., 1996). Based on the mentioned statements a first general proposition can be derived from the literature: *Hypothesis 1: In turbulent environments, firms are more likely to implement a co-operative approach than a full-ownership approach when carrying out foreign operations*. Nevertheless, the empirical results related to the relationship between environmental uncertainty and entry modes indicate that environmental uncertainties do not seem to be a direct driver of firm's modal choice (Brouthers and Brouthers, 2003). The direction and strength of the variable seems to be mediated by other factors like assets related to firms asset specificity (Erramilli and Rao, 1993). Hence, for example, firms in possession of high assets would prefer full control modes regardless of environmental risks.

Host country specific conditions

Country specific conditions refer to the overseas business environment such as national/regional policies, the legal, political, institutional and cultural frameworks (Brouthers and Brouthers 2000). Some studies (Contractor, 1990) have found that national protectionist policies and regulations can force companies to avoid full internalisation and work together with local partners. Thus our second *hypothesis* stresses the following: *In countries characterized by restrictive economical, political and legal frameworks, firms are more likely to establish co-operative models to carry out their foreign operations*.

Cultural distance with the host country

A considerable body of the literature suggest that the greater the cultural distance between home and host country, the less willing the firm to make larger investments in wholly owned enterprises (Arora and Fosfuri, 2000; Brouthers and Brouthers, 2000; Chen and Chu, 2002; Contractor and Kundu, 1998; Fina and Rugman, 1996). Based on this assumption a third proposition can be drawn: *Hypothesis 3: In culturally unfamiliar international settings, firms are more likely to choose more co-operative entry modes when carrying out foreign operations*. It is important to point out that this variable does not seem to have a direct influence on modal choice. For example, Erramilli and Rao's (1993) postulate that when large cultural distance with the host country exists, companies prefer more contractual relationships. However in another study Erramilli et al. (2002) could not find a direct relationship between cultural distance and modal choice.

Competitive Environment

In general, theoretical and empirical studies indicate that with the increased international competition, companies can improve their specific advantages across national borders using partnerships (Dunning, 2000; Contractor, 1990). The literature on networks shows how this organizational arrangement is particularly useful to survive in very competitive environments (Castells, 2000, Gomes Casseres, 1996). Following this idea we can hypothesize that: *Hypothesis 4: In highly competitive business environments firms are more likely to use a co-operative approach when carrying out international business operations*. In spite of that, the incidence of competitive environment onto modal choice seems to be mediated by factors such as the type of industry – e.g. services vs. manufacturing (Brouthers and Brouthers, 2003), by the size of the company (Chen and Hu, 2002), by the cultural differences between prospective partners, and by the perception of partner opportunism (Contractor, 1990).

Technology/ICT environment

Firms working in industrial sectors characterized by many alternative technologies and services, and by rapid technological changes, would prefer entering cooperative agreements and joint ownership modes to WOS. Rapid changes in technologies induce inter-firm cooperation and the formation of networked firms (Beverland and Bretherton, 2001; Gomes Casseres, 1996). In addition, and as an outcome of the development of the Information and Communication Technologies (ICTs), the inter-firm relationships and management philosophy have changed. One of the consequences is that firms no longer need to maintain long-terms relationships, which means the emerging of very short-term and contractual relationships; this seems to be particularly true with the e-marketplaces (Williams et al., 2002; Mukherji, 2002). A proposition can thus be derived: *Hypothesis 5*: *Rapid technological changes and the ICTs developments increase the firms' propensity to carry out their foreign business operations using contractual and short-term co-operative approaches.*

Firm size

The influence of the size of the company onto the choice of an organizational model to carry out activities at an international level has been recognized, for example, by Brouthers and Brouthers (2000), Contractor and Kundu (1998), Chen and Hu (2002), Koch (2001b), Erramilli and Rao (1993), Erramili et al. (2003). The literature on modal choice shows large firms' preferences for an international expansion pattern based on full equity modes; in contrast, small and medium-sized companies seem to prefer share-control modes when carrying out their international business. Having such claims in mind it is possible to hypothesize the following: *Hypothesis 6: Large firms, in contrast with small and medium-sized companies, are more likely to carry out their business operations using full-ownership models.* Nevertheless, when the literature on networks and alliances is examined, it is possible to notice that large firms such as IBM or Texas Instruments do not always follow a WOS model. De Man (2002) has shown how high-tech and powerful firms prefer to establish cooperative arrangements and operate in networks. One of the reasons is the necessity to create and follow the new technological developments at a short pace. Thus, technological environment and firms' competences and capabilities could moderate the influence of the variable firm size.

Tangible assets - Financial resources

Different researchers (Osland, et al., 2001; Chen and Hu, 2002; Erramilli and Rao, 1993; Brouthers and Brouthers, 2000, 2003) have emphasized the role of capital investment - considered as a component of firm's assets – in the organizational arrangements chosen by the firms to internationalise. A direct or indirect relationship between size of investments and organizational mode preferences has been assumed in the literature. In general, quasi-arm's length and contractual relationships – as opposed to equity enterprises and company run operations – are associated with low capital investments, and with the companies' desires to share development risks and costs in for example infrastructure and technological developments. Therefore, in accordance with the literature, it is possible to claim: *Hypothesis 7: Firms lacking capital, firms making small investments, and firms wishing to share costs are more likely to implement co-operative models than to internalise their operations in foreign markets*. Again, not all the empirical data have been able to validate the above-mentioned statement related to the direct effects of financial resources and governance structures. For instance, Erramilli and Rao (1993) and Contractor and Kundu (1998a) could not find evidence of a direct impact of capital intensity and investments onto modal choice.

Intangible assets - Capabilities, competencies and skills

The role of human specific assets and firm's capabilities in modal choice has been emphasized not only by the RB and eclectic theoretical approaches, but also by the new developments in the TC theory. The terms competency and capabilities embraces many indicators; it can be mentioned as an illustration, professional skills of the employees and firms' specialized know-how, routines and procedures.

Firms with high specialized intangible assets (or capabilities) would try to exploit them internally by extending their own organization and control across national boundaries by means of wholly owned operations. Firms with low specific intangible assets are expected to use shared-control modes (Erramilli and Rao, 1993; see also Koch, 2001b; Kulkarni, 2001) in order to enhance their competitiveness (See for instance, Varadarajan and Cunningham, 1995). Within this framework Lemoine and Dagnæs (2003) noticed that when preserving core-competencies, firms appear to prefer to internalise their business operations, but when developing new competencies, co-operative modes would be selected. On this basis a firm can use, simultaneously, different business models going from transitory alliances to M&A and WOS in order to protect and/or develop its specific assets or core business (Rindfleish and Heide, 1997). Looking at such statements we can draw the following proposition: *Hypothesis 8: In the case of protecting core competencies, firms would prefer to internalise their business operations in foreign markets; but when developing new competencies, firms would favour partnership models in international business operations*.

Experiential knowledge

Although the "Nordic" approach has been one of the main paradigms emphasizing the role of experiential knowledge in modal choice (Eriksson et al., 1997; Johansson and Vahlme, 1990), recent empirical developments within other theoretical approaches, like the TC theory and the eclectic paradigm, have also underlined the importance of this variable on the organizational models to expand internationally. Some authors (Brouthers and Brouthers, 2000) have considered the experiential knowledge as part of the resource capabilities of a company and, therefore, as an intangible asset. The experiential knowledge includes many indicators such as previous international experience of the firm, the knowledge of the target country or the region in which the company is going to initiate or expand its activities, and the institutional knowledge - represented by the knowledge of language, laws, norms and standards prevalent in foreign markets.

A great deal of the literature points out that firms having gathered a considerable experiential knowledge prefer company run operations rather than more contractual modes (Arora and Fosfuri, 2000; Contractor, 1990; Harzing, 2002; Koch, 2001b). Following the above-mentioned statements we can draw the subsequent proposition: *Hypothesis 9: Companies that have gathered a considerable experiential knowledge would prefer to carry out international business operations using ownership models rather than non-equity co-operative business models*. However, some authors did not find firms' international experience having a direct influence on modal choice (Brouthers and Brouthers, 2003; Erramili and Rao, 2002). The impact of the previous international experience can be conditioned by the size of the firm (Contractor and Kundu, 1998a), the nationality (Osland et al., 2001), and the type of experience (Chi and MacGuire, 1996) gathered by the companies.

Culture, trust and opportunism

The establishment of cooperative models like strategic alliances entails to share a collaborative-based culture and trust with partners (Harbison and Pekár, 1998). Dissimilarities in corporative cultures and managerial philosophies and practices between firms – i.e. considerable cultural distance between the firm and its prospective partners - can impede companies to form partnerships (McIvor and McHugh, 2000). In addition, and looking at the TC theory, the fear for partners' opportunism can close the door for cooperative arrangements (Contractor, 1990). The following proposition results from the literature review: *Hypothesis 10: When a substantial cultural distance between the firm and its prospective partners exists, and when the perceived partners opportunism is high, companies will be more likely to internalise their business rather than to use co-operative modes to perform international expansion*.

However it is important to point out that this variable can be mediated, among others, by the familiarity with the host-country culture. In non-well known cultures a partner can help to understand local conditions, and force firms to choose cooperative arrangements. But it also depends on the availability of prospective partners and networks in the international arena. Likewise, as Parkhe (1993) has found, the opportunistic behaviour among alliance partners can be attenuated by previous co-operative histories or previous experiences of the firms.

Specific propositions. LSPs industry

Looking at the studies on the LSPs industry it is possible to infer that the general business environment, the political and economical characteristics of the country, and the cultural distance between home and host country can influence LSPs modal choice (See O'Laughlin et al., 1993; Stone, 2001, 2003). A proposition follows: *In environments characterized by low levels of uncertainties and by liberal policies, and when a little cultural distance exists between the home and host country, LSPs would prefer to carry out their international business operations using WOS and M&A.*

In relation to the competitive environment, and as stated before, the general literature suggests that WOS and Greenfield investments seem to be a preferred organizational tool in low competitive environments, whilst non-equity co-operative agreements are preferred in highly competitive settings. On the other hand, the empirical information on LSPs (O'Laughlin et al., 1993; A. Andersen, 2002; Hertz, 1993; Lemoine and Dagnæs, 2003) suggest that M&A of large groups of firms has been used as a tool to control and reduce the competition level in international markets. Due to this information the following specific hypothesis can be derived: *In highly competitive environments, LSPs are more likely to form co-operative agreements and/or to merge or acquire other operators. In contrast, low competitive environments would foster Greenfield/WOS*.

As the current ICT environment favour the formation of e-markets, and the coordination and monitoring process between companies, it can be hypothesized that within the LSP industry ICTs developments can increase the probability of foreign business via contractual and co-operative agreements. However, it is possible to hypothesize that ICTs can impact the LSPs choice of a business model in two different and perhaps contradictory directions: *Direction 1: The developments of e-market places would probably encourage arm's length/short term contractual agreements between shippers and LSPs. Direction 2: As ICTs developments favour the governance and coordination between independent firms, it would encourage the establishment of long-term intra-industry co-operative agreements - like strategic alliances - among LSPs; and inter-industry cooperation both, non-equity, and* – as suggested by A. Anderson's (2002) data – *equity cooperation* - as JVs.

Within the LSPs industry, the size of the firm seems to influence the selection of organizational modes to establish in foreign countries. Large firms have a dominant role when establishing partnerships with small and medium-sized companies. Large firms are, in general, the centre point of a network, and all of this could encourage equity approaches like M&A among the big companies. Thus, *large LSPs would prefer to carry out their foreign operations using equity models. Small and medium-sized firms would probably form non-equity arrangements with other LSPs to expand in international markets*. In addition, large firms generally have previous international experience, or have been born global, reason why they would prefer to establish their own subsidiaries, or merge/acquire competitors.

By definition LSPs are organizations executing and managing logistics activities using its own physical assets and resources on behalf of another company. Consequently, physical properties like trucks, vessels and buildings dedicated to warehouses can be considered as core LSPs' physical assets. The studies here analysed on LSPs could support the general proposition concerning financial resources and physical assets, internationalisation and organizational modal choice. Therefore it is possible to hypothesize the following: *LSPs having strong managerial and economical resources, and having large investments in physical assets would prefer equity modes to carry out activities in the international markets*. However it is important to point out that the above mentioned relationship between resources and organizational modal choice could be mediated by factors such as environmental uncertainties, host-country specific conditions, the size of the firm and firm's core competencies.

Looking at intangible assets, the literature shows some evidence of the relationship between core competencies and the selection of a particular organizational business model in the LSPs industry (Lemoine and Dagnæs, 2003; see also the data provided by A. Anderson, 2002). Consequently, *LSPs would prefer working with fully ownerships modes when protecting core competencies. But when developing new core business or when complementing competencies, the firms would prefer to enter in equity and non-equity co-operative agreements*.

The co-operation between LSPs – and a good deal of a successful co-operation – will rest on the proximity between the corporate culture and the culture of the prospective partners; and on trust vs. opportunistic behaviour. Thus, *when the cultural distance between a LSP and its potential partner is large, and when fear for opportunism is high, quasi arm's length relationships and/or WOS-Greenfield models would be preferred to internationalise*.

An interesting point emerges from the literature review on LSPs. It concerns the customer's role in organizational modal selection. As stated by Peters et al. (1998) and A. Andersen (2002), and as exemplified by Stone (2001; 2002), customers' internationalisation can compel LSPs to go abroad following a 3PL or 4PL scheme. Thus firms with this type of relationship in the home country can be obliged to follow their customers and to implement the same organizational model in the new foreign market. Furthermore, and looking at the freight transport as a service industry, the size of the customers could influence LSPs' internationalisation and modal choice. For example, large customers, and customers requiring single sourcing and one stop-shopping might press their LSPs associates to expand internationally by using a 3PL arrangement. Consequently, a hypothesis can be derived: *The requirements and characteristics of the customers influence the selection of the type of business model used to carry out international operations*.

Concluding remarks

One of the most important strategic issues confronted by a company is the decision between alternative business arrangements to internationalise. LSPs have used multiple organizational modes in order to perform activities in the international markets. Although studies on the dynamic of LSPs internationalisation were found in the literature, the interest in explaining why LSPs favour one organizational model over the other is almost neglected.

As a first step in understanding the problem, and using an eclectic-syncretic theoretical approach, this paper identified the main variables able to explain the choice of governance structures in LSPs foreign operations. For each variable a set of general propositions and a set of specific hypothesis devoted to LSPs were posited. New avenues of analysis are open. The direction and strength of the relationships between the factors must be analysed and tested in future research using both qualitative and quantitative methodologies.

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