

# STUDY ON THE FACTORS INFLUENCING THE OWNERSHIP OF FOREIGN SUBSIDIARIES IN MONGOLIA

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## Abstract

*The objective of this study is to empirically investigate the determinants of ownership level of foreign subsidiaries in the land – locked transition economy of Mongolia. The two important options of the subsidiaries are joint ventures (JVs) and wholly owned subsidiaries (WOSs). This study examines three factors which have been suggested in the literature as important determinants of the choice between these two entry modes. Key factors examined in this study include investment amounts, locations of investment and linguistic distance. The study employs a logistic regression analysis method to examine the entry mode decisions of 175 foreign subsidiaries which are operating in Mongolia. The result shows that the investment and location factors influence the entry modes of foreign subsidiaries in Mongolia as expected. The more amounts are invested, the more likely to choose JVs. Also it is likely to choose JVs when the subsidiaries are located out of Ulaanbaatar, the capital city of Mongolia. However, the relationship between entry mode choice and linguistic distance is not found statistically. It is conjectured that geographical distance may play more important role in deciding entry mode choice than linguistic distance.*

**Keywords:** entry mode, location, joint venture, wholly-owned subsidiary

## **1. INTRODUCTION**

A key decision faced by a multinational company engaged in cross-border Foreign Direct Investment (FDI) is what level ownership to assume (Tatoglu, Glaister and Erdal, 2003). The choice of affiliate ownership structure can be very complex, because it is influenced by a relatively large number of factors including characteristics of the firm, the industry, the host country, and the product (Dunning 1980, 1988a, 1988b).

Thus, the purpose of this study is to investigate the factors influencing on the choice of ownership structure of the foreign affiliate made by foreign investors in Mongolia. Despite the underlined growing importance of FDI in Mongolia, there has been few empirical works to date that provide an extensive analysis of ownership strategies of foreign investors in this largely neglected part of Central Asia.

FDI is a significant source of capital in Mongolia (UNCTAD, 2013). During 1991–2012, the country has attracted more than \$13 billion in FDI, the share of Gross Domestic Product (GDP) generated by foreign companies has reached 55 percent. According to the National Statistic Office of Mongolia ([www.nso.mn](http://www.nso.mn)), 2 862 foreign invested companies are operating in Mongolia as 2011. Among all these foreign invested companies, 767 companies registered as JVs and the remaining 2095 companies registered as WOSs.

## **2. THEORETICAL BACKGROUND**

Most existing researches in international business literatures explain the entry mode decisions of MNCs in developed countries, from the perspective of both the home countries of parent firms and host countries (Kogut and Singh, 1988; Brouthers, Brouthers and Werner, 1996, 1999; Padmanabhan and Cho, 1995, 1999; Hennart and Reddy, 1997; Cleeve, 1997; Shieh and Wu, 2012). However, these well studied factors influencing on entry mode choice in developed country are may not explain the entry mode choice in developing countries (Demirbag, Tatoglu and Glaister, 2009).

In the case of developing countries, the foreign firms investing to developing countries have different motives than the firms investing to developed countries (Luo and Tung, 2007). According to Demirbag, Tatoglu and Glaister (2009) foreign firms largely seek strategic assets when entering developed countries but pursue market opportunities when operating in developing countries. More recently, many researchers including Pan (1996), Zhao and Zhu (1998), Chen, Hu and Hu (2002), and Lee and Huang (2009) in China, Tatoglu and Glaister (1998), Tatoglu, Glaister and Erdal (2003), and Demirbag, Tatoglu and Glaister (2009) in Turkey, Tsang (2005), Shieh and Wu (2012), and Chien and Tu (2012) in Vietnam started to investigate the factors influencing entry mode choice in developing countries.

According to these studies, the investment amount and the location of operation and linguistic distance are most influential factors on entry mode choice of foreign investors in developing countries. Thus, we choose the investment amount, the location of operation and linguistic distance as main variables of this study.

## **3. RESEARCH MODEL AND HYPOTHESIS**

Previous studies provide mixed results concerning the effects of investment amount on the foreign equity share. However, the most previous studies including Gatignon and Anderson (1988), Shan (1991), and Pan (1996) find the opposite relationship that foreign investors are more likely to

choose lower equity ownership than a full ownership of their affiliates to reduce potential risk when the capital size of the operation is high. This leads to the following hypothesis:

**Hypothesis 1:** A foreign investor is more likely to choose a JV over a WOS when the total investment amount increases.

The location of investment is a significant determinant of foreign equity ownership level (Pan, 1996). Thus, the condition of infrastructure and the availability of related and support services of a geographical location have been seriously considered by foreign investors (Tatoglu and Glaister, 1998). The more conducive investment atmosphere in these areas would lower the risk of internalization and thus encourage the foreign partner to acquire a higher level of equity ownership. As suggested by previous studies, foreign investors are more likely to acquire higher equity ownership when the subsidiary is located in metropolitan cities (Chadee and Qiu 2001; Tsang 2005; and Pan 1996). It is expected that foreign investors may be more willing to choose high equity ownership entry mode in Ulaanbaatar. This leads to the following hypothesis:

**Hypothesis 2:** A foreign investor is more likely to choose a WOS over a JV when the subsidiary is located in capital city of Mongolia, Ulaanbaatar.

Linguistic distance, which is a new measurement of distance proposed by West and Graham (2004), provides a valuable measure of distance and it can be readily obtained for most nations and micro – cultures. Chen, Sokal and Ruhlen (1995) clustered genetic and linguistic relationship among 130 populations. Their analysis indicated that the Mongolian language appears to be closer to the family of the Japanese, Korean, Uighur, Ainu and Turkish languages which are belong to Altaic language. Suggested by most previous studies, the language similarity between home and host countries will reduce risk perception of foreign investors and they may feel more comfortable to do business in such host countries. Therefore, we hypothesize that:

**Hypothesis 3:** A foreign investor is more likely to choose a WOS over a JV when the linguistic distance between home and host country is short.

#### 4. METHODOLOGY

The data used in this study are collected from FIFTA (Foreign Investment and Foreign Trade Agency of Mongolia) – a government agency responsible for the promotion and facilitation of foreign investment and trade in Mongolia. The dataset includes 175 foreign invested firms which are established newly in 2014. This database includes foreign subsidiaries' name, country of origin, sector of operation, the dollar amount of total investment and the location of investment, and mode of entry (WOS & JV).

The dependent variable relates to the foreign investors' choice of entry mode (joint venture or wholly owned subsidiary) in Mongolia. Joining most of the previous studies on entry mode selection (Davidson and McFetridge, 1985; Gatignon and Anderson, 1988; Kogut and Singh, 1988b), this study defines entry mode choice as a dichotomous variable that assumes one if the equity of the affiliate is wholly owned and zero if it is jointly owned.

This study involves three independent variables: the amount of total investment, location of investment and linguistic distance between home country of foreign investor and Mongolia.

The amount of total investment is measured by the US dollar amount as agreed by the foreign investor at the time the venture is formed. Location of Subsidiary is a dichotomous variable that is coded one if the subsidiary is located in the capital city of Mongolia, Ulaanbaatar and zero if the subsidiary is located in the countryside. Linguistic distance is a dichotomous variable too. The foreign investors from linguistically similar countries take 1 and others who are from linguistically dissimilar countries take 0.

This study included industry of operation as a control variable. Entry mode choice may vary across industry factors (Brouthers and Brouthers, 2003; Zhao et al., 2004). Hence, this study control for the possible effects of industry and created dummy variables to represent which industry a firm is in. Industry categories include Trade and Public Catering (coded as 0); and others (coded as 1) including Agriculture and Farming, Engineering construction, Geology Mining and Oil, Information and Technology.

To test the hypotheses, a logistic regression analysis was used, that is common in studies related to entry mode choice (Gatignon and Anderson, 1988; Kogut and Singht, 1988; Agarwal and Ramaswami, 1992; Kim and Hwang, 1992; Erramilli and Rao, 1993). The regression is run by using the SPSS computer program, and the results are presented in the next section.

## 5. RESEARCH AND DISCUSSION

The first hypothesis concentrates on the positive relationship between investment amount and the JV choice. The result shows that the foreign investors are more likely to choose JV instead of WOS as the investment amount increased, which support hypothesis 1. Similar to other developing countries, the foreign investors who are investing in Mongolia are more likely to choose a JV as entry mode to share the potential risk with local partners rather than try to claim a larger share of profits choosing WOS.

There is a good deal of support for hypothesis 2. The coefficient on location of investment is positive and significant suggesting that the foreign investors are more likely to choose a WOS over a JV when the affiliate is located in the capital city of Ulaanbaatar, which is the most populated and developed region of Mongolia.

The last hypothesis concentrates on the positive relationship between linguistic distance and the entry mode choice of JV. Contrary to expectations, no support was found for this hypothesis (no significant coefficient). This means, linguistic distance between home and host countries did not have a significant impact on the entry mode choice of foreign investors in Mongolia.

	Dependent Variable			
	Joint Venture vs Wholly Owned Subsidiary			
	(JV=0; WOS=1)			
	Coefficient	Std.Err	Wald Statistic	Sig.
<b><i>Independent Variables</i></b>				
Investment Amount	-.207	.042	23.694	.000

Location of Investment	2.404	.496	23.527	.000
Linguistic Distance	-.683	.513	1.771	.183
<b>Control Variables</b>				
Industry of Operation	-.556	.861	.417	.518
Constant	2.84	.945	9.028	.003
N	161			
Model chi-square	63.696			
Significance	.000			
Correct classification (percent)	82%			

## 6. CONCLUSION

The purpose of this study has been to examine the influence of a number of key factors on the ownership choice of foreign subsidiaries in a land-locked transition economy, Mongolia. Drawing on previous studies this study identifies three key variables (investment amount, location of operation and linguistic distance) which were considered to influence the entry mode decision of foreign investors to invest in Mongolia. To investigate the impact of these three factors in a range of sample characteristics a binary logit regression was estimated in order to test the hypothesized relationships.

With respect to the choice between a JV and a WOS, in general, a relatively good level of support has been found for the study's hypotheses. Investment amount and location of operation have impact on the foreign investor's choice between a JV and a WOS. However, little or no support is found for the impact of the linguistic distance between the home country and the host country on the ownership level of foreign subsidiaries in Mongolia. Geographical distance may play more important role rather than linguistic distance in size and entry mode of FDI in Mongolia.

## 7. RESEARCH CONTRIBUTIONS AND RESEARCH LIMITATIONS

The main contribution of this study is provides an empirical study of foreign investors' ownership strategies in Mongolia, which is an important issue given the rapid growth of foreign investment in Mongolia. In the conceptualization of the influences on foreign investors' ownership strategies, efforts are made to incorporate key ownership determinants from the existing literature. The empirical results show that some of these factors contribute to the explanation of foreign investors' ownership strategies in Mongolia.

It is necessary to note the numerous limitations of this study. First, owing to the difficulties in obtaining data information in Mongolia, a major shortcoming of this research is lack of more important variables such as host country policy, market potential and competitive intensity. Second, this study uses a relatively small sample size due to the availability of data, and therefore the results should be considered as tentative rather than fully conclusive. Third, this study analyzes only two entry mode choices: WOS and JV. Maybe it is necessary to consider a wider choice of entry modes including non – equity entry modes such as export and contractual agreements.

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