

# “Factors influencing the entry mode of South African retailers expanding into Africa”

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## SECTION 1. Macroeconomic processes and regional economies management

Rasoava Rijamampianina (South Africa)

### Factors influencing the entry mode of South African retailers expanding into Africa

#### Abstract

Over the last decade, South African companies' presence in the Sub-Saharan retail market has steadily solidified. In this regard, the purpose of this study is to determine the importance attached to key factors influencing the choice of entry mode of South African retailers entering new African markets. The author also ascertains the preferred mode of entry. This research follows a positivism paradigm, and the methodology used a mixed method technique. A structured interview together with some open-ended questions were used to gather data. All Johannesburg Securities Exchange (JSE) retail sub classifications were represented in the study with 76% of the listed retail sector by market capitalization and 70% of the total retail sector by sales. The results showed that country specific factors were the factors influencing the choice on entry mode more than others. The most preferred mode of entry by South African retailers was a high control greenfield.

**Keywords:** South African retailers, entry mode, factors, internationalization, Africa.

**JEL Classification:** F21, F23.

#### Introduction

With a consumer spending projected to reach \$1 trillion by 2020 (Hatch, Becker & Van Zyl, 2011, p. 3), and the fastest rate of urbanization worldwide (Moriarty, Warschun, & Rucker, 2014, p. 3), Africa's economic prospects look favorable. The African retail market, particularly, is finally luring some of the biggest international retailers ("The grocer's great trek", The Economist, 2013).

From a South African perspective, Shoprite took the edge in 1990 by opening its first store in Namibia. Since then, other local firms have seized the African opportunities to largely dominate the current retail landscape ("The grocer's great trek", The Economist, 2013), with South African retailers collectively holding 90% of Africa's retail market share in 2011 (Wharton school, 2011).

This current research aims to assist in understanding the suitability of the choice of entry mode by unpacking the thought process followed by retailers who have ventured into new African markets. To this purpose, the key factors determining the entry mode choice by South African retailers and their order of importance are identified, as well as their preferred entry mode. The particularity of this paper resides in its specificity to the retail sector for South African companies internationalizing into a pre-emerging market like Africa, thus, could lead to the key factors differing significantly from theoretical

literature. It also furthers and consolidates the work of several studies, such as Dakora, Bytheway & Slabbert (2010), Antrobus (2009) and Borchardt (2009a, 2010b), which identify suitable market criteria and critical success factors when expanding into Africa. Though there have been studies relating to factors influencing the internationalization of South African companies (Mwangi, 1995; Luiz & Charalambous, 2009; Luiz & Stephan, 2011), as well as foreign direct investments in Africa (Luiz, 2006; Aregbeshola, 2014, pp. 557-568), they normally only identify the factors (Ruplal, 2010) and their level of importance (Luiz & Stephan, 2011) without trying to relate these factors to understand how they influence the choice made by the would-be entrants on the mode of entry. Therefore, the contribution of this research is to go beyond this topic by focusing on the rationale employed by retailers entering the African markets.

The article is presented in the following format: In the next section, the literature on entry modes, international business perspectives, and factors influencing entry mode in the African context are reviewed. This is followed by the methodology carried out in the research and, finally, the findings of the research are presented and discussed.

#### 1. Literature review

**1.1. Modes of entry, level of control and risk.** The type of entry mode adopted by an entrant into a foreign market seems to be key to its success (Anderson & Gatignon, 1986; Meyer, Estrin, Sumon, Kumar & Peng, 2009; Ahsan & Musteen, 2011). Root (1987) describes entry mode as "an institutional arrangement that makes possible the

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entry of a company's products, technology, human skills, management, or other resources into a foreign country". Normative decision theory posits that the choice of mode of entry should be based on a trade-off between risk and returns (Anderson & Gatignon, 2005). In this regard, studies suggest that where the entrant has superior resources, it will use high control entry modes to protect its interests and maximize returns (Pan & Tse, 2000; Luo, 2001; Dunning, 2003; Lu, Karpova & Fiore, 2011). This study takes a broad viewpoint of entry mode as a governance form. In this regard, the mode of entry leads to varying the degrees of ownership from non-equity to high-equity involvement depending on the transaction specific characteristics, firm specific resources and capabilities, strategic goals and environmental settings, and contingencies. The different forms of establishment range from acquisition, greenfield (start-up), to brownfield, in which a firm is acquired but plant, equipment, labor and product line are almost completely replaced. The forms of ownership, i.e., control, faced by the would-be entrant are either: a wholly owned subsidiary, a joint venture (in which the entrant would be majority, equal or minority partner), or a non-equity arrangement (exporting, franchising or management contract). A greenfield project presents less risk than acquisitions which may entail managerial problems (Anil, Tatoglu & Ozkasap, 2014). Meyer and Estrin (2001) maintain that in emerging countries, due to the extensive restructuring required, many initial acquisitions transform into greenfields. Also, greenfield remains the most prominent method of entering African markets (UNCTAD, 2013).

**1.2. Four leading international business (IB) perspectives on foreign markets entry.** It would seem special theoretical approaches for the internationalization of emerging economies companies have yet to emerge. In absence thereof, the leading contemporary research in international business (IB) provides the framework for this study. The transaction cost theory (TCT) asserts that a decision over governance mechanisms, such as entry mode choice, requires a rational trade-off between the transaction costs (TCs) associated with market and with hierarchy modes (Anderson and Gatignon, 1986). Typically, to avoid high entry costs, firms will elect joint ventures or non-equity modes. Cuervo-Cazurra (2012) distinguishes emerging economies multinationals practices according to the high transaction costs that they are confronted to in their home country. The resulting capabilities affect their choices of ownership and modes of entry abroad (Anil, 2014). The eclectic paradigm (OLI model), developed by Dunning (1988), explains foreign direct

investment (FDI) by three factors: ownership advantages, locational advantages and internalization advantages. Net ownership advantages of the company are a precondition for internationalization. Depending on the firm's motive for FDI (e.g., natural resource-seeking; market-seeking; efficiency-seeking; and strategic asset-seeking) and its OLI advantages, the eclectic paradigm can inform an organization on the viability of a market entry strategy. Particularly, in the case of market-seeking South African retailers (Dakora, Bytheway & Slabbert, 2010), economic growth and market size of the host country are determinant factors. Resources-based theories (RBTs) are concerned with the influence of a firm's resources and capabilities in understanding the difference between firms and how they achieve and sustain competitive advantage (Barney, 2001). An investor that possesses more advantageous resources than a local firm will probably opt for a greenfield investment in order to preserve its resources and knowledge. Finally, the Institutional Theory (IT) focuses on the role of political, social, and economic systems surrounding firms in shaping their behavior (North, 1990). Emerging economies multinationals, who are often better at coping with risky and uncertain environments, are more likely to choose high commitment modes such as wholly owned subsidiaries or equity joint ventures when investing (Cuervo-Cazurra, 2012; Anil et al., 2014).

**1.3. South African retailers in Africa.** South African retailers have been seizing the opportunities Africa offers through improved stability, political and economic reforms, and the opportunities created by "African agenda" initiatives such as the new economic partnership for Africa's development (NEPAD) (Dakora et al., 2010). The South African government has also been encouraging greater investment and trade in Africa by adopting tax and financial sector reforms (Media release, South African Ministry of Finance, 2014). However, it would seem most of South African retailers have limited their African foray to Sub-Saharan Africa before progressing into the rest of the continent.

All the retail sub-classifications of the Johannesburg Securities Exchange (JSE), including food and drug retailers, broadline retailers, home improvement retailers and apparel retailers are represented in Africa. Of the top ten retailers by sales in Africa in 2013, nine were South African (Euromonitor International, 2014). Most recent examples of the trend to enter the African market included retail chains Foschini and Edgars entrance into the Kenyan market with their franchise partner Nakumatt ("SA retailers Edgars, Foschini to open Store in Nairobi", Ventures-Africa, 2013). In the

same year (2014), Steinhoff International, South Africa’s biggest furniture company, agreed to buy Pepkor, Africa’s largest retailer, in a \$5.7 billion cash-and-share deal with a clear agenda of driving its African footprint (England, 2014).

**1.4. The African business environment.** The continental GDP growth is close to 6% and several Sub-Saharan African countries rank among the 10 fastest growing economies globally (UNCTAD, 2014). By 2020, poverty levels are expected to drop to 20 percent from nearly 45 percent in the 1980s (Hatch et al., 2014). Urbanization has also significantly contributed to increased consumer spending as consumers move away from subsistence farming (Roxburgh, Dorr & Leke, 2010). With consumer spending projected to reach \$1 trillion by 2020 (Euromonitor, 2011), the African market looks appealing. However, most countries on the African continent carry a low ease of doing business. The market is diverse, fragmented and fails to gain economies of scale as each country thrives to be self-sufficient (World Bank, 2014). Additionally, the large market suggests an entrant would have to try to maximize profits by having full control of the foreign operation (Anderson & Gatignon, 1986a, 2005b; Luo, 2001; Lu et al., 2011). With only a few African capital markets being active and well-developed, raising capital remains a costly and risky exercise (Al Kudsi, 2012). Hence, the entrant may be confined in terms of making a choice on the mode of entry (Borchardt, 2009). Though, some emerging economies multinationals have been able to internationalize with a financial and institutional backup from their home country (Williamson & Zeng, 2009). Burnete (2013) notes the important role of business groups in the internationalization process of these multinationals. The structure of the

labor market and the underdeveloped infrastructure are further causes influencing the attractiveness of the Sub-Saharan economies (De Mauro, 2013). Furthermore, finding suitable retail space in Africa seems to be difficult, particularly outside of the main centers (Borchardt, 2009). The inefficient borders throughout Africa imply logistical bottlenecks (Dakora et al., 2010). With Africa’s political instability, legal weakness and corruption are perceived to be high compared to the rest of the world providing further challenges. This implies that an entrant would probably try to limit the risk by opting for a lower control (Meyer, 2001). However, in certain cases, such as substantial operations, cultural proximity, linguistic and historical factors, companies may consider wholly-owned subsidiaries (Demirbag, Tatoglu & Glaister, 2009; Teixeira & Grande, 2012).

**1.5. Factors influencing entry mode of South African retailers in Africa.** The factors investigated in this study consist of a subset of factors as identified in the Galan study (Galan & Gonzalez-Benito, 2001). Prior studies done on the order of importance of factors which influence the internationalization of South African companies tend to agree on a hierarchy of importance in influencing internationalization despite the industry (Arnold, 1998; Luiz & Charalambous, 2009; Ruplal, 2010). However, in order to bring specificity to the current work, only factors inclined towards the retail sector (Lu et al., 2011), and those prevalent in Africa (Borchardt, 2009) were selected for this study. A firm needs to consider the most important firm, environmental and any other factors when it chooses entry mode (Wu and Zhao, 2007). Figure 1 below summarizes the impact of elected factors on entry mode selection.

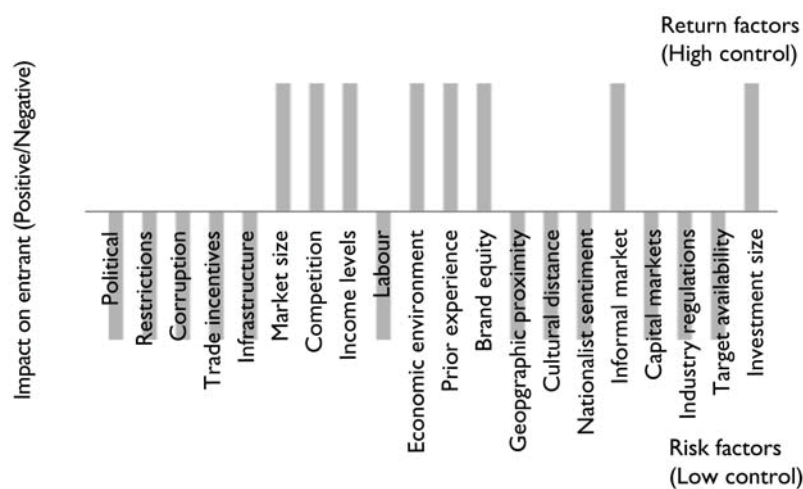


Fig. 1. Impact of elected factors influencing entry mode selection

Return factors, such as a large market with strong demand, are expected to lead to the preference of high control venture, while a risk factor, such as political uncertainty, is expected to lead to the preference of low control venture (Hoskisson, Eden, Lau, & Wright, 2000; Luo, 2001; Lu et al., 2011). There are many influencing factors and the theoretical approaches suggest a different entry mode per factor, and, hence, the question that arises is how South African retailers blend all these factors and come up with a single choice of entry mode.

## 2. Research methodology

**2.1. Research methodology.** A structured interview survey process was used to gather data with an open-ended section at the end that gave the respondent opportunity to give their own input, and to include other factors faced by companies that were omitted by our approach. The strategies of enquiry employed involved collecting data simultaneously in both numeric and text information (Creswell, 2003). Thus, the final database had both qualitative and quantitative information. With regards to the specific respondents, responses were obtained from the company secretaries, heads of companies, investor relations departments, corporate strategy departments, or a department responsible for African expansion. The interviews were mostly conducted telephonically.

**2.2. Sample population.** The target sample was made up by 26 major South African retailers that have expanded into Africa and was made up of both JSE listed and unlisted companies. The response rate at group company level was 81% (21 of 26) and this generated 72 responses at subsidiary company level. The sample accounted for at least 65% of total South African retail sales in 2010. Each sub-sector of retailing was represented. The listed companies amongst the respondents represent 74% of total retail sector market capitalization.

**2.3. Data analysis and interpretation.** The data collected on the method and mode of entry preferred, importance of key factors which influence entry mode decisions of the company is quantitative in nature, while the information regarding other entry mode decision is qualitative.

The questionnaire used to gather the quantitative data is based on a 5 point Likert scale of measurement. This type of data is classified as ordinal data as the scale “measures” in terms of “Not important” or “Extremely important” without specifying the size of the intervals (Leedy & Ormrod, 2005). In order to analyze the ordinal level data, without measurement bias, the Distribution Fitting Algorithm (Stacey, 2005) was used:

$$Y_{k,j} = \frac{\int_{\tau_{k-1}}^{\tau_k} x \cdot e^{-\frac{(x-\mu_j)^2}{2\sigma_j^2}} dx}{\int_{\tau_{k-1}}^{\tau_k} e^{-\frac{(x-\mu_j)^2}{2\sigma_j^2}} dx} \quad (1)$$

Where  $Y_{k,j}$  is equal to the rescaled value for the  $k$ -th ordinal response to the  $j$ -th survey item and are the estimated mean and standard deviation of the normal distribution fitted to the responses to the  $j$ -th survey item. The approach calculates item means and standard deviations of the sample, rather than respondent level data (Stacey, 2005, p. 21). This method is more reliable and valid if the result of the chi-squared test is not significant. The distribution fitting approach allows the factors to be ranked as extremely, very important and less important. The model generated a chi-squared  $p$ -value of 0.3345 at a 5% significance level, hence, it was a sufficient/satisfactory fit to the research data. In the analysis the  $t$ -value statistic was compared to the mean ( $\mu$ ) in order to determine if the  $t$ -value was significantly above or below the mean. In the instances where it was found to be less than the mean, it was interpreted that the factor was generally of low importance.

**2.4. Limitations, validity and reliability.** The top retailer in Africa, Shoprite Holdings, refused to participate in the research. The study, however, used almost all of the largest retailers in South Africa, which accounts for about 65% of the total South African retail industry and 98% of the retail sector market capitalization of the JSE. In this regard, this should be a fair representation of the major retail groups in South Africa. Nonetheless, the sampling technique comprised only larger companies which are mostly listed, and may have failed to capture some other aspects experienced by smaller unlisted companies who have increased flexibility. Another limitation lies in the fact that, smaller companies would sometimes refer the research to the finance department or company secretary, who possibly has a different risk perception as that of the company. This could have a bearing on the reliability of the responses.

## 3. Presentation of results and discussion

**3.1. The most influencing factors: country specific factors.** Four of the twenty factors emerged as being of “high to very important” in directly influencing the entry mode decision. In order of importance they are: (1) country governance and political risk, (2) government restrictions, (3) market size and demand conditions, and (4) the local economic environment. South African retailers would only enter into an

African country with an “acceptable” country risk where they could use strategies, such as entry mode, to mitigate some of the perceived risks. Nonetheless, they also highlighted that some of the political risk was almost impossible to address through using entry mode. The use of a local company Director, especially a board Chairman with political influence, was seen as a popular mitigating factor against politically related adversities. A key critical restriction was the enforcement of local partnership by government policy, as it directly affected growth strategies. Furthermore, restricting regulations on the movement of capital or repatriation of profits would deter some investors. Economic indicators, such as

GDP growth, inflation and exchange rate stability, emerged as key indicators influencing the choice of entry mode. The objective was the maximizing of returns through owning as much as the venture as possible while accessing debt capital within the host country. Organizations report that astute operations management is used to manage the economic factors rather than to resort to a shareholding structure. Retail remains a business driven by low margins and high volumes, and achieving critical mass seems more likely in a country with a larger population and a growing consumer base. The choice of entry mode in this regard would be inclined more towards profit maximization via wholly-owned subsidiaries compared to other options.

Table 1. Interpretation of statistics and level of importance

Factor	$\mu$	t-value	p-value	Significance	Reject HO ( $\alpha = 5\%$ )	Interpretation	Ranking
Political	0.9190	13.7860	0.0000	+	YES	Extremely important	2
Restrictions	1.3383	12.5576	0.0000	+	YES	Extremely important	1
Corruption	0.3639	4.1163	0.0001	+	YES	Moderately important	5
Trade	0.2570	2.5636	0.0125	+	YES	Moderately important	7
Infrastructure	-0.5814	-2.6230	0.0107	-	YES	Less important	16
Demand	0.7951	13.3481	0.0000	+	YES	Very important	3
Competition	0.1140	2.5111	0.0143	+	YES	Moderately important	9
Incomes	0.2673	4.6042	0.0000	+	YES	Moderately important	6
Labor	-0.9861	-14.6749	0.0000	-	YES	Not important	19
Economy	0.7333	23.6712	0.0000	+	YES	Very important	4
Experience	-0.4124	-5.0248	0.0000	-	YES	Less important	15
Brand	-0.0513	-0.7300	0.4678		NO	Moderately important	11
Proximity	0.1918	2.5958	0.0115	+	YES	Moderately important	8
Culture	-0.1326	-1.4829	0.1426		NO	Moderately important	14
Sentiment	-0.1322	-1.2606	0.2116		NO	Moderately important	13
Informal market	-0.0387	-0.4938	0.6230		NO	Moderately important	10
Capital markets	-1.2650	-14.6129	0.0000	-	YES	Not important	20
Regulations	-0.0719	-1.1357	0.2600		NO	Moderately important	12
Target	-0.6580	-7.2617	0.0000	-	YES	Less important	18
Investment	-0.6501	-8.4106	0.0000	-	YES	Less important	17

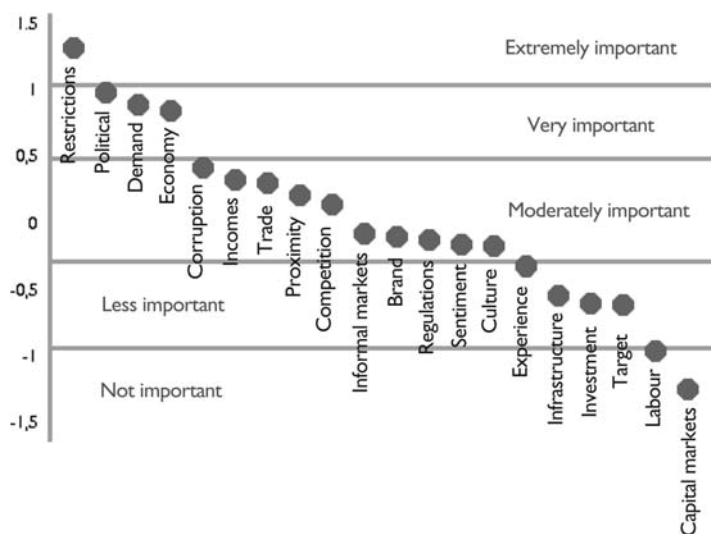


Fig. 2. Ranking of level of importance

**3.2. Factors of medium importance: country specific and market specific factors.** The factors of medium importance ranked in their order of importance emerged to be: (1) the level of perceived corruption and bureaucracy, (2) income levels and income distribution, (3) trade incentives, barriers and agreements, (4) geographical proximity to South Africa, (5) the level of competition, (6) the informal market, (7) brand equity, (8) industry regulations, (9) nationalist sentiment and (10) cultural distance. The only entry mode related strategy to dealing with the lack of integrated trade blocs in Africa was the choice between actual FDI or using franchises/licensing. Being as tax efficient as possible was a necessity. When the taxation rates were different for local and foreign companies, the entrants were persuaded to use entry mode to seek efficiency. In addition, the closeness of the host country to South Africa was found to be important when it came to matters of procurement, centralized distribution and brand equity. Competition in most African countries was regarded as still being low, and, hence, entrants did not feel the need to partner with locals. The influx of cheap imports with fake brands posed a threat on the profitability of apparel retailers. Harnessing the informal market was found to be only successful in the long run as it is considered an issue of culture and consumer behavior underpinned by infrastructure deficiencies. However, the weak industry regulation was globally viewed as an opportunity rather than a threat. In light of nationalist sentiment factor, retailers would mitigate the risk by partnering with a local and branding the store with a local name, or would stock local products. The strategy employed to address the cultural distance with the customers was through employing some senior local staff to handle business portfolios that were prone to the threats posed by cultural differences. The approaches to entry mode based on these factors were found to be either through entry mode or other operational level tactics. However, the notion of profit maximization and risk aversion was quite apparent in the responses.

**3.3. The factors of low importance.** The outcome of the research revealed the factors of low importance to be: (1) prior experience in other African countries, excluding South Africa, (2) infrastructure, (3) size of investment, (4) target availability, (5) labor considerations and (6) depth of capital markets. African countries are so different that prior experience in one country was found completely irrelevant in the other. A number of South African retailers had to rely on companies,

such as Old Mutual, to build shopping malls where they could operate from (Mahajan & Gunther, 2009), or built their own premises. In this regard, the level of infrastructure was assigned low importance in influencing the entry mode as the resources were not available in the local market. South African firms generally considered themselves to be more endowed with financial resources compared to their African peers and, hence, did give this factor limited consideration as an entry mode determinant. Existing companies posed weak competition and, hence, acquiring that very company would not accomplish much. South African retailers had to use expatriates for their foreign operations for senior management, rendering entry mode failing to address this risk factor. The only form of capital that companies raised from the local markets was working capital in the form of short-term overdrafts from banks. Thus, the capital market factor was justifiably considered not important. They preferred to differentiate themselves from the local through offering an augmented shopping experience in shops with an appealing environment.

**3.4. Other factors influencing choice of entry.**

A number of respondents mentioned that the further the geographical location of the host country was from South Africa, the more relevant supply chain management challenges and factor became in influencing entry mode. Access to short-term funds for working capital purposes from banks and reasonable creditor repayment periods were also flagged as potential influencing elements. Finally, some respondents highlighted the need to protect technology and intellectual property as an important factor influencing entry mode choice.

**3.5. Safeguarding the investment: greenfield investment and high-control venture.**

The preference of entry mode was based on level of control and type of entry. The results of the research show overwhelmingly (83% of responses) that greenfield investment is the most preferred entry mode type into new African markets. Only 10% of the respondents favored acquisitions, while 7% preferred brownfield. The companies practising franchise or licensing within South Africa were found to replicate the model into African markets. Furthermore, a total of 75% of the respondents preferred at least 51% control which could include: wholly owned subsidiaries, significant majority and simple majority. The wholly owned subsidiary (WOS) emerged as the most preferred level of control in mode of entry into new African markets.

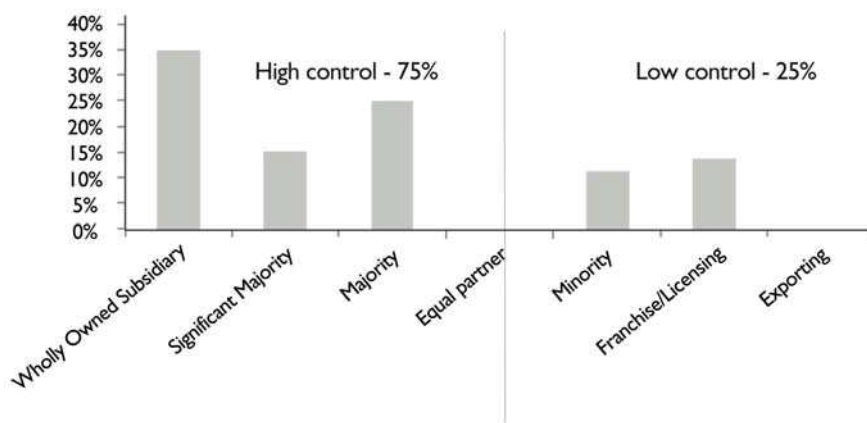


Fig. 3. Preference of level of control on entry mode

While literature would advocate for low control in a high-risk environment (Anderson & Gatignon, 1986; Dunning, 1988; Agarwal & Ramaswami, 1992; Luo, 2001; Lu et al., 2011), the results imply that there may be other aspects to the selection of entry mode driving the decision. The differences in culture and ways of doing business also emerged as a reason that high control entry mode was preferred. Polosello, Amal and Hoeltgebaum (2013) describe the absence of an organizational culture of joint venture in an emerging economy multinational as a factor affecting its decision of entry mode.

The need to “safeguard the investment” emerged prominent as one reason why South African retailers preferred high control. Moreover, respondents highlighted that the markets were simply underdeveloped to offer feasible acquisition options. This argument is in line with notion by Dunning (2001) who argued that market failure gives an incentive to internalize. The key resources that came to the fore were: financial resources, brands and distribution channels, as well as systems or processes that gave the entrant a competitive advantage, entailing South African retailers to prefer high control entry modes. A number of institutions felt that by being in a low control joint venture while having put in the bulk of the resources would equate to giving out proprietary information or trade secrets. Weak competition also presents an opportunity for established South African companies to enter these markets and maximize returns through exploiting the opportunity using their superior resources. By preferring high control entry mode, South African retailers may be implying that the expected returns may surpass the risks.

### Conclusion

After standardizing the results obtained from the semi-structured interviews using the Stacey (2005) distribution fitting algorithm, four factors emerged as having high importance in determining the entry

mode choice of South African retailers entering African markets. They were: governmental restrictions, the political situation, the market size and demand conditions, and the economic environment. Factors deemed to be of medium importance were the level of perceived corruption, levels of income, trade relations between the host country and South Africa, the geographical proximity of the host country to South Africa, level of competition, the size of informal markets, the brand equity, industry regulations, nationalist sentiment and cultural distance. The factors found to be of least importance in influencing the entry mode decision were: prior experience in other African countries, the infrastructure, the size of the investment, the availability of an acquisition target, the labor market and the depth of capital markets.

The research also revealed that South African retailers predominantly preferred to use greenfield ventures with high control when entering African markets. These findings initially appear to contradict classical entry mode literature (Anderson & Gatignon, 1986a, 2005b; Root, 1987; Dunning, 1988; Agarwal & Ramaswami, 1992; Brouthers & Brouthers, 2000), but are consistent with illustrations on the internationalization of emerging economies multinationals, who mostly adopt high equity modes (Cuervo-Cazurra, 2012; Anil et al., 2014). Despite the high perceived risk, the explanations were found to lie in market failure, ownership advantages and the profit maximization objective driving most African growth strategies. The study also raised the question on whether the level of perceived risk in Africa may be overstated, or whether South African companies have a high-risk appetite?

Irrespective of case, most of the respondents pointed out that the most appropriate entry mode cannot be based on the experience of another country. Only, it is, therefore, recommended that internationalizing firms perform a top-down analysis on the entry

mode structure. The factors identified can be listed and ranked against the tolerance scale of the company. With the combination of this rating scale and the analysis of the relevant firm specific advantages, a company can then adopt the most appropriate entry mode strategy.

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