

Greenfields and acquisitions: a comparative analysis

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Abstract: *This paper compares greenfields and acquisitions as foreign direct investment (FDI) alternatives used by transnational corporations (TNCs). First, the determinants leading to the choice of companies between the two modes of entry into a foreign market are laid out. Then, specific features of each alternative are highlighted, by contrasting the advantages and disadvantages of both types of FDI. Based on this analysis, some conclusions are drawn in the end concerning the most important factors that influence the decision of a company whether to choose a greenfield investment or an acquisition.*

Key-words: *FDI, greenfield, acquisition, TNCs*

1. Introduction

There is a whole strand of literature concerning foreign direct investment (FDI) as an alternative of entering markets, as opposed to exporting or licensing. Fewer studies focus particularly on the comparison between the two main types of FDI, namely greenfields and acquisitions. In this paper, mergers are incorporated in the ‘acquisition’ category, their number being insignificant out of the aggregate sum of mergers and acquisitions at international level. In-depth research of this comparison was undertaken by Kogut and Singh (1988), Svensson (1998) and Harzing (2000). A comprehensive guide dedicated to the similarities and differences between greenfields and acquisitions is the World Investment Report (UNCTAD, 2000), issued in the peak year of worldwide FDI until that time. Newer studies that have dealt with this matter at regional level are those of Meyer and Estrin (2001), Nisbet (2003), Grunfeld and Sanna-Randaccio (2005), Haar and Marinescu (2014).

Empirically, the ‘90s and 2000s brought a dominance of acquisitions in worldwide FDI as opposed to greenfields. During the 1990s, acquisitions became a widely used mode of transnational corporation (TNC) entry and expansion in virtually all industries. Indeed, they drove the FDI boom during the second half of the 1990s. But it was in services that most acquisitions took place, e.g. banking, telecommunications, electricity and water (UNCTAD, 2004). The explanations for the surge of acquisitions are to be found in the changes occurred in the global

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marketplace, including the fierce international competition triggered by excess capacity in several industries, and the strategic posture taken by oligopolies. Companies looked beyond frontiers to acquire targets due to the technological gap, poor sales of local firms, improvement of human capital in many countries, as well as a part of their desire to expand easier in the European single market or in other regional trading blocs.

2. Determinants for the Choice between Greenfields and Acquisitions

There are several determinants for the decision between a greenfield investment and a acquisition. Harzing (2000) has identified a number of firm-specific, industry-specific and host-country specific-factors that affect the choice of entry mode into foreign markets. Some of them will be discussed below.

Concerning firm-specific factors, one of the important drivers to initiate a greenfield or a acquisition are naturally the costs implied and the expected post-entry profits. A greenfield bears important bureaucracy costs, the process of acquiring real estate can be very slow, but if it is a pioneering investment, profits will be consistent. Even if traditionally perceived to be lower, Grunfeld and Sanna-Randaccio (2005) show that acquisition costs can be also surprisingly high, leading to low profits from acquisitions. Another essential factor is the speed of implementation. The setting up of a new production facility is not only costly in the short run but takes time to implement. A foreign firm wishing to take advantage of a rapidly expanding market may therefore prefer to choose to enter via acquisition as this allows a relatively quick method of gaining access to the same (Nisbet, 2003).

A greenfield project gives the investor the opportunity to create an entirely new organization specified to its own requirements, but usually implies a gradual market entry. Greenfield projects may be too slow to achieve investors' desired objectives, notably if they pursue first-mover advantages. An acquisition facilitates quick entry and immediate access to local resources, but the acquired company may require deep restructuring to overcome a lack of fit between the two organizations (Meyer and Estrin, 2001). Usually, the size of the TNC, the diversity of its product range, and its degree of multinational character positively and significantly influences the decision to acquire. It seems that larger TNCs, with a greater product diversification (but lower R&D intensity) favour acquisitions over greenfields. On the other hand, truly global TNCs, with a large experience in foreign activity, opt rather for greenfield investments.

The choice of mode of entry is also influenced by industry-specific factors. For example, a greenfield investment is more likely to be used in industries in which technological skills are significant and the TNC gains a competitive advantage by its differentiated products. The need for complete control and internalisation

advantages will direct TNCs rather towards a greenfield investment. Though, high market concentration and high barriers to entry limit the probability of a greenfield investment. Similarly, in industries characterized by slow growth or excess capacity, firms are not likely to add new productive capacity, if they can acquire existing assets (UNCTAD, 2000). Thus, if an investor fears that a market does not justify added capacity, an acquisition enables it to avoid the risk of depressed prices and lower unit sales per producer, which might result from new facilities (Daniels and Radebaugh, 1998). Additional reasons for choosing an acquisition over greenfield are the potential synergy and economies of scale envisaged by the investing TNC and the greater market power which it can enjoy in a reasonable period of time. Sometimes the acquisition is made for improving technology, a strategy employed by Chinese companies to gain access to high-end technology in developed countries (Boscor, Bratucu and Baltescu, 2013).

The decision between greenfields and acquisitions is also greatly influenced by several country-specific factors which enter into combination with the firm-specific and industry-specific factors. The choice is influenced by institutional, cultural and transaction cost factors, in particular, the attitude towards takeovers, conditions in capital markets, liberalisation policies, privatisation, regional integration, and currency risks (UNCTAD, 2005). If political and economic conditions are not that encouraging and the general country risk assessment is high, then acquisitions will be the preferred option.

The same goes for a more relaxed regulatory environment, weak or no requirements set by the local government for the acquired target, low power of trade unions and the desire (or pressure) to privatise. Cultural differences also play an important role. As Kogut and Singh (1988) document on this issue, the greater the cultural distance between the country of the investing firm and the country of entry, the more likely a firm will choose a greenfield over an acquisition. A greenfield project is also favoured if the availability of resources, such as real estate, or access to utilities and raw materials is not restricted and if incentives are offered for such a project. Then, resource-seekers and export-oriented TNCs will probably make a greenfield investment.

On the contrary, market-seeking TNCs that find an existing specific infrastructure, with skilled labour available and low access cost to distribution channels may enter by means of an acquisition. The necessity to adapt the products to local characteristics and the proximity to customers favour the acquisition as well. If there are strategic assets envisaged by TNCs under the form of resources held by local firms, such as physical assets, brands, vital information or know-how, then almost certainly the decision will be biased towards acquisition.

3. Greenfields versus Acquisitions: Advantages and Disadvantages

From the point of view of the investing company, each mode of FDI has its merits and shortcomings. Therefore, TNCs usually analyse the combination between firm-specific, industry-specific and country-specific factors to fundament their decision. Actually, the advantages of a greenfield investment reflect the disadvantages of an acquisition and vice-versa. Some of these pros and cons will be investigated further.

A greenfield has certain advantages due to its pioneering position. From the initial phase, the investing firm has the possibility to choose the location. The building of facilities is done according to the management's view. Human resources are hired and trained directly according to the organizational culture of the company and subsequent aspects related to work practices are easier to manage. The implementation of new products and technology works faster and the TNC has total control of decisions, whereas in acquisitions, ownership may include some local participation. A greenfield is easier to integrate in the network of the parent firm and usually carries a larger potential for profit compared to an acquisition. By setting up a new company, rather than acquiring an existing one, it avoids antitrust laws and by solely creating jobs, it avoids social problems (Harris, 1996). Thus, the relationship with the local government is a 'friendly' one and the bargaining power of the TNC is, at least theoretically, higher than with an acquisition. The potential for receiving incentives is therefore enhanced. Policy makers often view acquisitions of domestic firms by foreign predators as undesirable, fearing anti-competitive effects of increasingly concentrated ownership by TNCs and wanting to keep profits within their country. Even when acquisitions involve the transfer of improved technology into a country and have beneficial effects for consumers, subsidies are not offered (Albornoz, Corcos and Kendall, 2009).

Depending on the particular context, a greenfield is also subject to several disadvantages. The high start-up costs and the usually high capital investment in the initial phase, make it a riskier business as opposed to the acquisition. To this we can add the potential difficulties with the adaptation of products to customer needs, as the knowledge of the market has yet to be gained as well as uncertainties about demand trends. A greenfield investor has to conquer market share. Also, due to the more difficult process of building relationships to suppliers and distributors, the penetration of the market is likely to be slower than in the case of an acquisition.

In comparison, an acquisition displays specific advantages that cannot be reached by means of a greenfield investment. Due to the knowledge of local customs and institutions on part of the acquired firm, the investing TNC also gains access and relations to suppliers and distribution chains. It overtakes the brands, the reputation and the existing market share of the local firm. Thus, an acquisition builds market presence and cash-flow quicker than a greenfield. The acquiring firm can improve its competitive position and market power by eliminating a competitor. From the financial perspective, the acquisition requires a smaller initial investment.

Capital is injected step by step, leading to lower market risks as opposed to a greenfield. Specific for Central and Eastern Europe (CEE), most of the acquisitions were linked to the privatisation process and constituted the preferred option for TNCs, as many domestic firms were undervalued (Welge and Holtbrugge, 1998).

An acquisition is associated with some major disadvantages though. From the start, location is given, constraining freedom of choice. Time is needed and costs occur in the process of finding the right target for acquisition. Once found, the investing TNC will almost certainly face additional costs for changes regarding technology, working habits etc., especially if labour skills are not suitable or existing management poses resistance. The intervention of local government by means of performance requirements is always a potential source of conflicts. If heavy overstaffing exists, there are likely to appear problems with the trade unions. In frequent practical cases of acquisitions, difficulties with the integration of the implied organisational cultures occur. The investing TNC may also feel itself challenged in assessing the weak points of the acquired firm, such as possible costs of previous environmental pollution or the risk of a faulty management structure. Specific for certain CEE countries, including Romania, one pitfall of acquisitions in privatisation deals of formerly state-owned enterprises was that property rights have not been well clarified for a long time.

4. Conclusions

The aim of this paper was to investigate the characteristics of greenfields and acquisitions as the two main types of FDI used by TNCs to enter foreign markets.

The decision of any company to initiate one or the other type of FDI is a mix of factors that combines intra-company behaviour with the sector context and the national environment. The comparative analysis shows that an acquisition is preferred when the TNC has large bargaining power, when it knows the market conditions well and when the target is either a significant competitor or it finds itself in a vulnerable position. A greenfield investment is chosen when top technology and R&D are involved, when the company has pioneering experience and when it favours long-term planning over short-term growth in market share.

Given the results of this study, the next years will surely bring future research contributions that will further investigate the choice of greenfields versus acquisitions in individual countries and at international level.

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