Master thesis – International Marketing



**Application of chosen internationalization theories on Slovak SME**

***AG Náradie – Agrodeal, Ltd. case***

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# I Abstract

This paper’s purpose is to confirm or deny applicability of chosen internationalization theories on particular company.

First of all globalization and internationalization factors were introduced providing reader with current situation and understanding of business environment. All the theories explaining internationalization process of the firm were presented afterwards. Uppsala theory and Transaction cost theory seemed to be the most relevant as a choice for further analysis. Both theories are able to explain how small and medium sized company enters foreign market and what aspects managers have to be aware of before decision is made.

In methodological part comprehensive attention was related to choice of framework. Burrell and Morgen FISI and RRIF typologies were compared to Arbnor and Bjerske’s six paradigms. FISI typology was chosen for its economical and managerial purpose. Subjective understanding of Interpretivism offers individualistic qualitative study on case company.

As the paper continues theoretical framework based around Uppsala and transaction cost theory was developed. Main aspects were emphasized and used for applicability section. In this section chosen theories were explained from SME’s perspective.

The empirics are based on interviews of individuals with past and present experience within the internationalizing small and medium sized firm. The interviews were intended to develop a deeper understanding of what influences a SME’s internationalization decisions.

Furthermore empirics were collected by performing semi-structured interviews with top managers at internationalizing firm. In the following comparison of the theoretical framework on the empirical findings was created in order to evaluate the applicability of the selected theory on the studied companies by answering research questions.

In principal our empirical findings confirm the applicability of the Uppsala and TCE on particular SME. Since they are focus on explaining the fundamental elements of internationalizing of firms it is possible to apply the theories to a wide range of situations.

**Key words:** Uppsala model, transaction cost theory, Internationalization process of the firm, Small and medium enterprise, Applicability of the theory

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# Introduction

This chapter will give an overview of internationalization and globalization. Furthermore internationalization of firm will be described throughout theories which are explaining this process. In the built up to problem formulation Small and medium sized enterprises will be presented. The chapter will be finalized with the problem formulation, research questions and objectives.

## Internationalization and globalization

*Globalization* and *internationalization* have been discussed in almost every economical related paper for decades. All the authors of different time periods who uses these terms have to agree that world became more global than ever before. Discovery of the Internet has unquestionably the biggest impact on globalization. It shaped the world to one giant network, consisting of billions ideas. Progresses in communication technology, transportation and production processes are the driving forces behind this (Axinn, & Matthyssens, 2002). World seems to be smaller as distances are reached easier and people are connected faster. According to Bisson, Stephenson & Vigueri the exchange of information between markets increased exponentially. Globalization and digital technology have formed networks that enable firms to find relevant information about potential business areas. People, products, money and data have never crossed countries in such ease.

Rapid globalization has forced companies to expand beyond the national borders (Dung Le, 2008). Every firm is “fighting” for its position in a global market exposed to threats and opportunities. Companies usually decide to internationalize because they want to increase sales and profit, outrun competitors or domestic market is stagnant and small. Economical, organizational, managerial and marketing models have been designed in order to underline behavioral and structural perspectives of internationalization (Dalli, 1994). Neo-classical economic literature (Smith, 1776 and Ricardo, 1817) explains the topic of internationalization, although rather on national level than the firm level. Hymer (1960) and Johansson and Vahlne (1977) in their papers describe the internationalization process as a guideline on which markets to enter. In contrast, Transaction Cost Theory (Williamson, 1981) stresses bounded rationality and opportunistic behavior. “Internationalization of a firm not only concerns what foreign markets to serve, but also how to enter” (Dung Le, 2008, p.1). Anderson (2004) claimed that internationalization theories have usually concentrated their attention first on decision whether to internationalize and then the market selection process. “Once an incorrect decision had been made, it cannot be revised without serious consequences for the firm’s future performance” (Petersen et al., 2003) is explaining how managers decision is important towards internationalization process. When it comes to market selection process it is also important to take into consideration choice on control and commitment required in foreign market. Wind and Perlmutter (1977) have identified the “modes of entry” as the key issue. There are different forms of market commitment – from export, via licensing to wholly owned subsidiaries.

## Internationalization of firm

Existing theories are insufficient to explain behaviors of firms in the international business marketplace (Axinn, 2002). Since theory creation is time consuming and time is part of a change it is not possible to explain actual characteristics of firm’s decision making process. Researchers have developed tools and theories to describe internationalization of firms and have made suggestion of how to deal with changing situations.

Origin of internationalization theories is dated to industrial organization and economics. Foundation of Neo-classical theory consists of assumptions that markets are balanced, people act rationally and have full knowledge of markets, firms focus on profit maximizing. Smith (1776) believed that country should only specialize on commodities in which it has absolute advantage. Much more attention was focused on states and their trade. At the beginning of 20th century this approach was criticized by scholars and new factors were added in order to explain internationalization of the firm rather than internationalization of country itself.

Theories which explain internationalization of firms are:

* Internationalization theory (INT) – Coase (1937)
* Eclectic paradigm (OLI) – Dunning (1958-1988)
* Industrial organization theory (IO) - Kindleberger (1969), Caves (1971), Hymer (1960)
* Transaction cost theory (TCE) – Williamson (1971-1981)
* Product life cycle theory (PLC) - Vernon (1966 - 1979)
* Uppsala model – Johanson & Vahlne (1977)
* Network theory – Johanson & Mattsson (1988)

These theories start to target their attention on multinational enterprises (MNEs).

Coase (1937) explains in INT that firms’ interactions with the market are not strictly under its control. He claims that establishment of firm in foreign market helps to decrease transaction costs by using price mechanisms. He introduces different types of transaction costs and uncertainty of the world with its actors. He criticized neo-classical theories with extended factors such as relationships, planning and creation of trust. These elements occur when long-term contract is required.

The *eclectic theory* (Dunning, 1958)considering trade as an additional option to invest in order to enter foreign markets. He combines the different existing models and creates three factors, *the ownership advantage, the location advantage and the internationalization advantage*. Each variable has its characteristics for particular market. Analyzing them firm decides whether shifts production to this country, choose different country or stay in current one. Dunning comes to the conclusion that firms can also profit from production in distant countries (Axinn, & Matthyssens, 2002).

Imperfect competition due to bounded information and transaction costs was mentioned in Industrial organization theory. In this theory it is assumed that it is more costly to operate abroad than in domestic market. MNEs have to decide up to transaction costs and particular country regulations if it is profitable to operate in such market.*TC* and *INT* theory argue with the *IO* theory since it assumes that MNEs can avoid consolidating with market imperfections.

Williamson (1971) introduces transaction cost theory as overlaps of Coases’ theory of firm. He claims that existence of firm rests on asset specificity of its production. He introduces ex post and ex ante costs in order to explain that firm might be re-negotiating contract as situations on market are constantly changing. Williamson sees the limit on the size of the firm because of the cost of delegation.

The *PLC-theory* is process-based view of internationalization of firm introduced by Vernon (1966) in order to explain international trade. Firms have to seek if their products are demanded and so theory is characterized by the intensive communication between producers and users. Thus they need to be localized in same market or very close distance at the beginning. If there is high demand on firms’ goods, production will be moved to the market with comparative advantage. This process will end with importing the product to country of origin.

Vernon (1966) divided this process into 4 stages:

* Introduction
* Growth
* Maturity
* Decline

New products are introduced to meet local needs and then exported to countries with similar preferences and income level. In this stage firm might struggle with uncertainty and limited export. Model expects that new product will be more likely introduced in developed countries with a high income level and a highly skilled labor force (growth phase). In maturity phase the lowest cost producer wins. When the domestic market is saturated and mass production is reached in the mature phase, the company will be exporting competitively to less developed countries. As soon as competition increases in home market and demand rises in the developing countries then production will be moved to one of these countries. Products will be exported to the original domestic market when these markets become sufficient for large-scale production, (Vernon, 1966, 1979).

The *Uppsala Model* isbased on research on the internationalization process of large Swedish manufacturing firms in the 1970’s by Johanson & Vahlne, (1977, 1990). Theory explains that firms has tendency to enter markets depending on their knowledge and experiences. Uppsala Model is focusing on factors of process such are knowledge, learning, commitment and uncertainty.

Relationships are the main assets in the *Network theory* thus they seek for more attention in international process of firms. Firms compete on network level which involves all domestic and foreign suppliers and customers as well as their further relationship network (Johanson & Mattsson, 1988). The network approach has lately been included into the new version of the Uppsala Model (Johanson & Vahlne, 2009) therefore it seems that it is further developed than any other internationalization theory, due to its regular updates.

## Small and medium sized companies

There has been done extensive research on small and medium enterprises in last few years. However, different authors use different definitions and characteristics of SMEs. No unified definition exists, since different authors use different definitions of SMEs.

Nevertheless, most common factors or variables determining whether a company is an SME are (European Commission, 2013):

* Number of employees
* Turnover or balance sheet total

|  |  |  |  |
| --- | --- | --- | --- |
| **Company category** | **Employees** | **Turnover** | **Balance sheet total** |
| Medium-sized | < 250 | ≤ € 50 m | ≤ € 43 m |
| Small | < 50 | ≤ € 10 m | ≤ € 10 m |
| Micro | < 10 | ≤ € 2 m | ≤ € 2 m |

Source: self made

Small and medium sized enterprises are also characterized by managers’ high independency level, they usually operate in domestic local market and capital is provided by the owners (Scott, 1987). However, they are often confronted with market imperfections. Small and medium enterprises have much more difficulties to enter foreign market than multinational companies because of their nature and characteristics. There are few reasons mentioned below:

* Entering a new distance market for a small company brings the high risk of market failure, since resource investments are desirable to search for customers and the brand is not recognized yet in the target market (Ajami, 2006).
* Target market knowledge needs to be acquired in order to be successful. Small companies don’t have large-scale knowledge as multinationals have and it is necessary to obtain it as soon as possible earlier than decision is made (Ajami, 2006).
* The lack of capital and the low financial flexibility of SMEs is a barrier for the internationalization process. Foreign market entry modes can cover risks and might result in failure (Eicher et al, 2009; Ferrell & Friedrich, 2011).
* SMEs have often no or a small market share and therefore not benefit from economies of scale as multinational corporations do. A large manufacturing facility would be expected to have a lower cost per unit of output than a smaller facility while a company with many facilities should have a cost advantage over a competitor with fewer. This leads to a low bargaining power towards stakeholders, such as suppliers and distributors (Ajami R. A., 2006).

SMEs regularly have difficulties in obtaining funds or credit, particularly in the early start-up phase. Their limited resources may also reduce access to new technologies or innovation (European Commission, 2013). SMEs are more affected by a number of risks compared to large companies, such as a financial instability, fluctuations of sales, market failure, competition and the relationship between employers (Analoui & Karami, 2003).

## Research and problem formulation

From the international theories explained above Uppsala model and Transaction cost theory was chosen in order to explain internationalization process of particular company. These theories were firstly designed for different reasons and different business context than today.

European SMEs started to invest in neighbor countries in 1970s and 1980s and scholars search for characteristics of these actions (Weisfelder, 2001). At that time almost no research was done on small and medium companies and all the economical theories could explain only partly how these firms behave and reasons behind their internationalization process.

Development of new international approaches (Aximm, 2002) and essential reconsideration towards past research (Hamill, 1997) became unavoidably in changing business environment and increasing number of SMEs expanding to foreign market.

Small companies sometimes do not really know what market to choose in order to internationalize their activities. In this case picking up relevant market is centre of interest. There are several theories which describe process of market selection and thus help managers to do right decisions.

Since 1970s and 1980s many things had changed, lots of time and money were invested on explanation of internationalization process of SMEs. However, it is still extremely hard to find theory which can explain all the actions of particular small company. Managers have different experiences and use various approaches how to enter new foreign. Due to ifc.org there is almost 1 million MNE compare to 125 millions of SME. Therefore it is very difficult to find theory which covers all the aspects of managers’ decision making process for chosen company.

The intensity of application of the theories and their comparison will be investigated in the subjective methodological perspective. Analysis of the chosen theories, namely Uppsala internationalization theory and Transaction cost theory, will be helpful when creating qualitative research questions. In addition, the application of the theories to the determined business setting will generate results, which might explain how particular company internationalizes.

**Based on manager’s perspective of internationalization process the aim of this paper is to analyze the applicability of the Uppsala Internationalization Model and the Transaction Cost Theory for Slovak SME when selecting foreign market.**

The reasons for choosing the Uppsala theory and the Transaction cost are:

* Both theories describe entry modes in foreign market.
* Both theories were created at a time that influence of small and medium companies was not considered as relevant.
* Theories are undiscovered in the changing business environment.
* Both theories take into consideration the risk minimization and profit maximization when internationalize to foreign market
* Gradually experiencing new market and thus generating knowledge might be relevant for SMEs internationalization process because of their limited resources.
* TCE sees the limit of the size because of costs for delegation and thus might be appropriate for SME

To sum up, two chosen theories have common elements and would be most relevant between all internationalization theories for the research, as they emphasize on market entry and considers managers’ perspective. It is also challenging to compare analysis-based TCE and process-based Uppsala theory and find out which characteristics suits chosen company the most.

### Objectives

Objectives have to characterize steps that will are taken in order to achieve goals. Overall aims of the research needs to describe chosen theories from manager perspective, describe actions that are taken in my case company when entering foreign market and compare theoretical and practical assumptions. These objectives have been formulated:

**Objective 1:** *describe market selection process of chosen theories*

**Objective 2:** *Identify international activities of particular Slovak SME*

**Objective 3:** *Formulate comparison between theory and practise*

### Research questions

Research questions were formulated in order to achieve objectives of this thesis.

**Research question 1:** *What is the way the company handles international activities (entry mode)?*

**Research question 2:** *What are the experiences company gained throughout their existence on foreign market?*

**Research question 3:** *Is Uppsala theory explaining all aspects of market selection process of particular company?*

**Research question 4:** *Is TCE explaining all aspects of market selection process of particular company?*

# Methodology

Right at the outset, while processing thesis, a significant attention was hold to theoretical study, factual documentation of foreign literature mostly. The result of this activity is an overview of the current state of the literature.

## Paradigm

Explanations of paradigms will be presented in this section. The detailed description of paradigms and typologies will guide and help me to evaluate and compare the chosen theories based on their root assumptions.

Process will be done within steps mentioned below:

* Presentation of several views of paradigm
* Discussion on various characteristics of paradigm
* Selection of typology choice

## Four Dimensions of Paradigms

Thomas Kuhn (1970) presented theory of research structure for the first time. He argues that general understanding of study is characterized by research questions and author’s approach which is used to answer them. Paradigms represent crucial view of its followers. It is not possible to proof them right or wrong, but to give arguments for their usefulness (Guba and Lincoln, 1994). Most researchers categorize paradigms in four dimensions of assumptions – *ontology, epistemology, human nature* and *methodology*.

### Ontology

*Ontology* describes researchers’ understanding of what is real (Campbell, 1988). Ontology together with human nature describes the element - the “reality” - based on what research is being done (Kuada, 2012). Ontology also relates to “how the researcher sees the relationship between human beings and their environment” (Kuada, 2012). Some researchers see the environment outside of individuals (objectivism), others believe in codetermination of individuals and environment (subjectivism). Ontology is divided into two groups:

* Realism – research is done externally to individual and truth is tangible
* Nominalism – truth is constructed subjectively and viewed by own reality of individuals

### Epistemology

Kuada (2012) defines *epistomology* as “how we know what we know”, how scholars approach the knowledge. Cambell (1988) also divided this dimension into 2 views where one is objective and the other is subjective:

* Positivism – specific social construct can be acquire by regularities and causal relationships which makes it completely objective (Kuada, 2012)
* Anti-Positivism – researcher is individual, social construct is relative and cannot be objective

### Human Nature

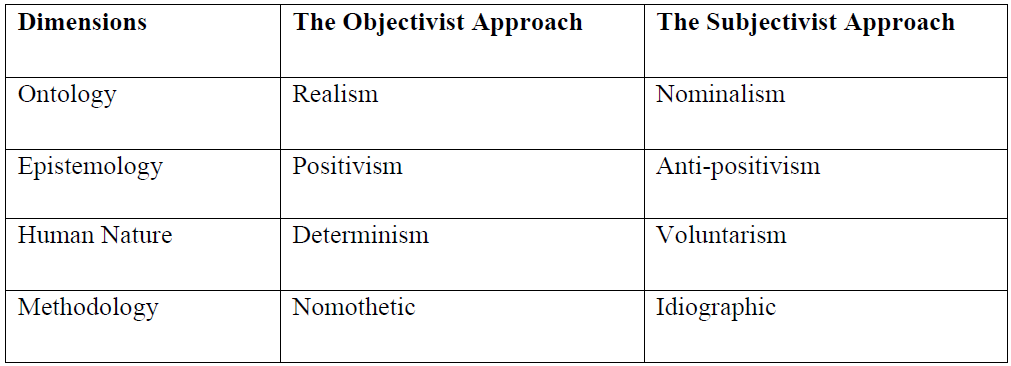
The term *human nature* determines social sciences as the relationship between humans and their social environment in the researcher’s point of view. Again, two main groups can be described:

* Determinism – individuals cannot reach their social environment, sees it from objective (similar for everyone) distance (Kuada 2012)
* Voluntarism – individuals can construct their own reality (field of study)

### Methodology

*Methodology* is system of methods used in particular area of research (oxforddictionaries.com). It is strategy or plan of actions guiding the entire research in order to find requested knowledge. Guba and Lincoln (1994) claim that the scientific research methodology works as a tool. It needs to help answer research questions. Methods are also divided into two groups:

* Nomothetic – this approach seeks for regularities which are summed up into general view (quantitative methods), truth is observing from outside
* Ideographic – deep analyze of individuals can be use in order to understand the social world (qualitative methods), truth is observing from inside



Source: Kuada (2012)

## Methodological Framework

There are numerous types of typologies characterizing paradigms. Parts of those are explaining economical and organizational studies. Kuada (2012) presents in his work 3 typologies which has strong roots in sociological studies. All of them explain approach towards organization and their managers with their sociological paradigms (Biedenbach & Muller, 2011).

* *FISI typology* of Burrell and Morgen (Functionalism, Interpretivism, Structuralism and Interactionism)
* *RRIF typology* of Burrel and Morgen (Radical humanism, Radical structuralism, Interpretivism and Functionalism)
* Classification of Arbnor and Bjerke’s six paradigms

Burrell and Morgan (1979) have presented their typology of paradigms for investigation of social and organizational theories. They identify four paradigms - functionalism, interpretivism, radical humanism and radical structuralism. It shows four common ways of researching an organization through different perspectives comparing objectivity versus subjectivity and regulation versus radical change (Biedenbach & Muller, 2011). Burel and Morgen (1979) compare objective and subjective approach in terms of its 4 dimensions paradigm. Drawing on Guba and Lincoln (1994) both qualitative and quantitative research methods can be applied appropriately within any research paradigm.

RRIF typology has better use for political sociology then for economical market-driven societies (Kuada, 2012). In contrast, the FISI typology is used for analyzing external and internal background and deeper understanding of organizations. Radical approach is less suitable for changing economical environment such is internationalization process (Goles & Hirschheim, 2000). Globalization has resulted in the overcoming regional and national boundaries. Growing number of scholars argue, that the dominance of a single perspective results in a narrow view that does not fully reflect the complex nature of social, organizational and phenomenological reality (Willmott, 1993; Blau, 1996; Frost, 1996).

Arbnor and Bjerke’s (1997) classification indicates three general approaches (analytical, system and actor) that inquirers understanding of human organizations. They combine theory of science with methodology. Research is more focused on individual’s view of reality and type of methods which are used to answer research questions. “The research paradigm has an influence on the whole research process, including the choice of the research problem and the research methods, the implementation of the research and, finally, the kind of contribution that can be achieved through the research”(Jokinen, 2004).

Arbnor and Bjerke’s classification will not be used as a framework in the report, as it is seen more suitable as a framework for methodological research rather than to describe the applicability of theories. Furthermore, the approach from Arbnor and Bjerke’s categorization has been criticized that “it reduces knowledge to only those things that can be codified and measured” (Lowder, 2012).

Having in mind the criticism of Burrell and Morgan and the choice of the theories which are complex in their substance, the framework of FISI is chosen to analyze the theories in methodological perspective. Objective and subjective perspectives will very useful when trying to evaluate the theories of internationalization processes, especially with their complexity.

## FISI Typology

### Functionalism

*Functionalism*belongs to positivist (objective) epistemology. Borg and Gall (1989) describe positivism as “a system of philosophy that excludes everything from its consideration except natural phenomenon and their interrelationships.” Positivist believes that the researcher and the topic are independent and that the research question is value free. Borg and Gall (1989) believe that objective observation can be made when methods will be used correctly. Functionalists explain structural changes within company as effective because they are derived from actual situation. Functional approach might be contrasting with type of research in the thesis. SMEs are actors on global market where quick and smart change may result in great success. Positivism defines knowledge mostly on visible facts and does not give any credibility to non-observable objects such as feelings and values (Borg & Gall, 1989). Company itself is an individual element which codetermine with other elements on the market from network and competition to business related issues such as macro and micro economic aspects.

### Interpretivism

*Interpretivism*stresses the need to understand peoples’ definition of their experiences and situations in which they are involved. This means that researchers have to be alert that people have different ideas about what and how they are thinking, different meanings and understandings of their current state and different cultures. In other words, interpretive paradigm requires researchers to observe their actors as involved in continuous process (Kuada, 2012). Researchers therefore focus their work on understanding rather than explaining. Interpretivism in epistemology gives the understanding that all knowledge is a matter of interpretation. The researchers’ point of view is that human beings actively respond to the world and to what is going on around them. This approach actually explains the right way how can one approach individual company in their environment. It is critical to understand manager’s decision rather than describe them. Only that way this research might explain how particular company internationalizes their activities and reasons behind this process. This typology will be used as methodological tool.

### Structuralism

*Structuralism*sees human societies and natural environment as complex systems of consistent parts. Every single individual which is part of the social system is determined by the structure of that system thus one of the most important characteristic of the structuralism is importance on the collective rather than the individual. For the statements above structuralism is unusable since the study of this thesis is focused on individual small and medium enterprise in Slovak market. Collective description of internationalization process might be totally different than the one of particular company. The expressions of the structuralism approach are documented in the analysis of organizational structures and their actions (Kuada, 2012). Variables such as size, type of industry, number of competitors, number of buyers and seller are some of the main target topics in such analyses; however these macroeconomic aspects won’t have such a usage in this paper.

### Interactionism

*Interactionist*approach to social knowledge highlights the role of human relations in the active social life. Individuals with different experiences do and understand the world and actively react on each other. The understanding of the researchers is that individuals do not simply respond to the environment in prearranged ways, but instead of that, they construct their acts through “minded behavior”. This “minded behavior” involves the presentation of oneself with expected future actions (Kuada, 2009). This approach might be similar as one needed in order to explain internationalization process of one company but this typology focused more on interactions than subjective understanding of the world and human beings. If network theory would be presented than interactionistic typology would be considered as guideline throughout the project.

There were 4 typologies presented in this section. Interpretivism is the one which will be used father in the project because of its individualistic approach to environment.

## Interpretivism as a choice for research

Interpretivism is an alternative to positivism and many ideas can be found tin work of Guba and Lincoln. Human beings are in centre of importance. “Like Dilthey before them, they sought to establish an objective science of the subjective with the aim of producing verifiable knowledge of the meanings that constitute the social world” (Blaikie, 2004). Subjective understanding and experiences of international process in empirical study will be compared to objective assumptions of theory characteristics. Great research was done on understanding patterns in social life and its actions. There are 3 kinds of subjective meaning introduced by Blaikie (2004):

* Actual meaning of social actor
* Average meaning of few social actors
* Typical meaning attributed to a social actor

According to Weber, the statistical patterns produced by quantitative data are not understandable on their own. “Not only must the relevant actions that link the two components of the relationship be specified, but the meaning that is attached to these actions must also be identified” (Blaikie, 2004). Thus qualitative research clarifies detailed relationships between actions and actors on specific market. This methodological tool is focused on deeper understanding of managers’ actions as it observes reasons not only results.

#### Ontology

Interpretivism underlines the meanings and beliefs in socially constructed reality, filled with multiple interpretations and involved emotions (Hurworth, 2005). Thus interpretivism uses subjective approach. Subjectivist assumes that beliefs and principles determine how one sees the world. Interpretivism assumes the subjective reality leads to the multiple realities (Collis & Hussey, 2009).

In regards to the internationalization theories and market selection process, interpretivism seeks for the uniqueness of the organization and emphasizes that organizations perceive the business reality differently based on their conditions. Understanding of company experiences and beliefs might result in various conclusions.

#### Epistemology

Interpretivists observe the knowledge as a matter of explanation. Interpretivism stresses the necessity of understanding the difference between humans in their role of social actors (Saunders *et al,* 2007). It is necessary to understand the meanings and perceptions that individuals add to the studied element. Therefore it addresses the particular rather than general. Internationalization theories has its level of generalization therefore approach will be positivistic when describing their characteristics but on the other hand comparison with the case study uses anti-positivistic approach because author’s subjective understanding will be emphasized.

#### Human Nature

Interpretivist sees the person in relation to others. Historically and socially some situations tend to be similar and thus create objective results. Humans construct their own environments rather than are influenced by one reality. Voluntarism explains how individual company acts on particular market and what tools are used in order to be successful on foreign market. When managers of company decide to operate in new market they construct new environment.

#### Methodology

There is no separation in interpretivism between the researcher and those to be researched. The underlying principles are based on dialogue. Interpretivist is therefore considered as subjective. This usually leads to diverse findings within the evaluation (Hurworth, 2005). The goal of interpretivist is to provide an understanding of direct experienced impressions instead of abstract generalizations. Interpretivism is often associated with qualitative research techniques, where the researcher constructs the impression of the world.

## Integration of Theory and Practice

In this section integration of theory and practice will be presented. Main focus of this paper rests on comparison between chosen theories and manager’s practical actions. “Scholars normally present their understanding of aspects of social phenomena in general statements, terminologies, concepts and theories” (Kuada 2012, p.8). These statements may not fully characterize specific realities of investigating company. Therefore it is challenging to observe level of similarity between them. One could suggest that chosen theories might be modified with observed differences but it is not the intention of the author. This analysis is strictly subjective and involves only one company. Discovered dissimilarities do not have to be applicable on any other company. If all the companies act on the market similar there would be no progression. Complementary approach is used in order to combine the truth from objective and subjective point of view.

## Methodological view

An empirical investigation of a contemporary phenomenon within its real-life context is one situation in which case study methodology is applicable ([Yin](http://www.nova.edu/ssss/QR/QR3-3/tellis2.html#yin94), 1994). The unit of analysis in a case study could be "an individual, a community, an organization, a nation-state, an empire, or a civilization" (Sjoberg, Williams & Vaughan, 1991). In this case investigation of small and medium company is made in order to compare its internationalization process decision with Uppsala model and Transaction cost theory. For this reason single company from Slovak market will be analyzed. Single cases may be used to confirm or challenge a theory, or to represent a unique or extreme case ([Yin](http://www.nova.edu/ssss/QR/QR3-3/tellis2.html#yin94), 1994).

The specification of company also provides the internal validity as the theories are developed and data collection and analysis test those theories. In case studies, data collection should be treated as a design issue that will enhance the construct and internal validity of the study, as well as the external validity and reliability ([Yin](http://www.nova.edu/ssss/QR/QR3-3/tellis2.html#yin94), 1994). In the intention of getting better results interview questions were extracted from theories specifications and carefully ordered.

There were two types of sources gathered during writing process:

• Internal sources (primary data) - drawn from the managers’ own perceptions

• External sources (secondary data) - all other sources outside the company and their managers (books, articles, websites...)

The practical part of the thesis is focused on finding reasons for market selection and amount of international activities. For this purpose the following methods were used:

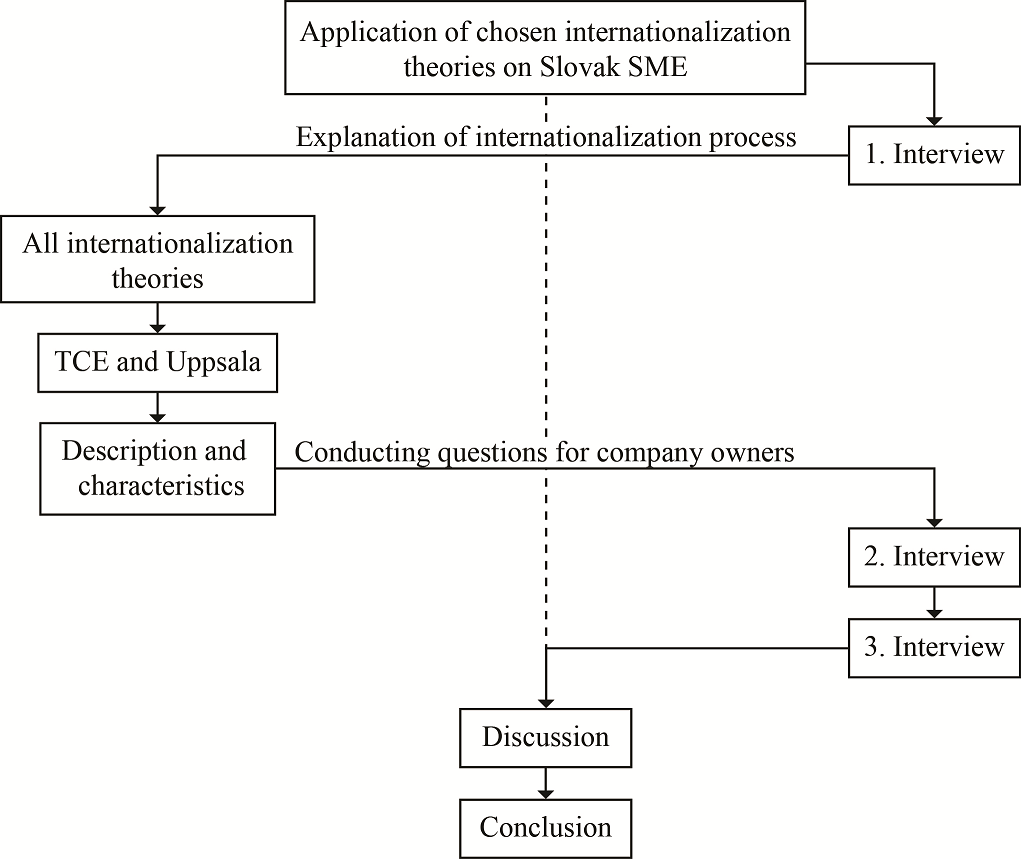
* Method of managing the interview - conducted with individual executives and business owners. Questions related to individual decisions and processes that lead to internationalize.
* Analysis - lay in the thought of breaking down the whole into parts, allocating individual pages of articles, events and facts
* Synthesis - was based on unification of thoughts, linking together ideas or relations of objects, phenomena and facts
* Comparison – arguing thoughts which investigated the similarities and differences between multiple objects and phenomena

Observation - has focused attention on all aspects of the subject or phenomenon

Interviews are one of the most important sources for the case study information. The interview could take one of several forms: open-ended (conversation), semi-structured or structured. In an open-ended interview, the researcher could ask for the informant's opinion on events or facts. This could also serve to support previously gathered data. In a semi-structured interview, the interviewer prepares few main questions (topics) before interview. The advantage is that he is able to add few extra questions during interview. The structured interview is particularly useful in studies where a formal survey is required.

Below, there is a road map which shows guideline of this thesis. It is divided on 2 parts where left side explaining sourcing secondary data and right side primary data. It starts with the name “Application of chosen internationalization theories on Slovak market”. I was interested in this topic because I gained many experiences with internationalization theories during my master studies and internship in China.

Process of thesis creating starts with searching for company. First interview was conducted as a conversation in order to find out if company has any experiences with international activities. For this reason explanation of internationalization process was needed. Two theories were chosen from all of theories which explaining this process. Uppsala theory and transaction cost theory are characterized with different approaches for entering foreign market. There characteristics helped to define if managers of chosen company follow the same steps or differ in important parts. Second interview was semi-structured and the questions were related to Uppsala and TCE. Third interview was created as follow up to second one in order to get few more details about decision making process of the company. Discussion was created in order to compare theoretical and practical part. This process finished with conclusion.



Source: self made

# Theories and definitions

Uppsala Internationalization Model and Transaction cost economics have been selected to answer the research questions. Both theories will be described from the theoretical point of view in this chapter.

## Uppsala theory

Authors of Uppsala model, Johanson and Vahlne (1997), presented their analysis of Swedish multinationals and identified tendency of slow internationalization process. Many scholars have been inspired by this work. They distinguished four steps of the internationalization process that company takes when entering foreign market:

1. Irregular export activities
2. Export activities via independent representatives or agents
3. The establishment of an overseas subsidiary
4. Overseas production/ manufacturing units

Their attention was focused on the development of an individual firm, particularly on use of knowledge about the foreign markets and operations, its acquisition and integration by its gradual commitment to foreign markets. Johanson and Vahlne (1977) have later advanced their work and further explained the concept of incremental change. The model has been endorsed by the finnish research by Larimo (1985) and Luostarinen (1980), Swedish research by Swedenborg (1982), Hornell and Vahlne (1982) and Gandemo and Mattsson (1984), norwegian research by Juul and Walters (1987), as well as work in other, non-Scandinavian, settings (Yoshihara, 1978). The model “reinforces a previous conclusion made by Wilkins (1974) who identified a gradual process of firms’ international involvement from his longitudinal study of American firms’ internationalization patterns” (Morgan and Kastikeas, 1997).

Johanson and Vahlne (1977) do not consider internationalization as a result of a strategy for optimum allocation of resources in foreign markets. The roots of Uppsala internationalization theory are rests on - lack of market knowledge and the difficulty in acquiring it. Important knowledge can be acquired mainly through operations abroad (Johanson and Vahlne, 1977). Thus companies have to enter foreign market first in order to gain some experiential knowledge of the desired market. Mentioned lack of knowledge might be caused by language, cultural or historical differences. Furthermore, those differences represent the main characteristics of international operations in comparison to domestic ones.

The internationalization of a firm consists of:

* increasing involvement in the foreign country
* establishment of the operations in new countries

Johanson and Vahlne (1977) state that the internationalization is a process of incremental steps and argue that it is not only a case of Swedish MNEs. They refer that export is first step of continual market development. Even though investment is unavoidable in the future, exporting helps to detect size and nature of the market as well as potential demand. In the next step subsidiary and production facilities are established. The incremental character of internationalization helps to reduce risks of early high investments in manufacture establishing abroad. Knickerbocker (1973) also identifies that process clearly distinguishes the agents from sales subsidiaries as continuous steps in the process. This process is characterized with risk minimalization.

### The psychic distance

Johanson and Vahlne (1977) have identified that the time constrain seems to be related to the psychic distance. The psychic distance between the home and host country seems to be of high importance and is defined as “the sum of factors preventing the flow of information from and to the market where there are differences in language, education, business practices, culture, and industrial development.”(Johanson and Vahlne, 1977 p. 24)

“The state aspects of internationalization are market commitment and market knowledge; the change aspects are current business activities and commitment decisions”(Johanson and Valhne, 1990). Market knowledge determines the decision of commitment of resources in foreign markets. On the other hand, market commitment and market knowledge are results of current activities and commitment decision.

Goal of incremental commitment is long- term profit. This is comparable to goal of growth in Williamson (1966) transaction cost theory. Firm is taking risks at the low levels first: “These strivings are assumed that characterize decision- making on all levels of the firm” (Johanson and Vahlne, 1977).

### State aspects

Commitment to the market determines how company perceives the risks and opportunities. Market commitment is constructed from two factors:

* the amount of resources committed
* the degree of commitment

Resources gained in a particular market can be considered as the market commitment, whereas, those resources can be sold and transferred into financial capital used for other purpose. The amount of market commitment is measurable by investments in the market, which includes funds in the marketing, organization, personnel and other. “Knowledge relates to present and future demand and supply, to competition and to channels for distribution, to payment conditions and the transferability of money, and those things vary from country to country and from time to time"(Carlson, 1974). Johanson and Vahlne (1977) argue that the commitment is dependent on the amount of different kinds of market knowledge and evaluation of alternatives.

### Change aspects

Differentiated or innovative products call for higher commitment to the market. When entering a new market experience needs to be acquired and the long learning process is required in connection to current activities. That is the reason for internationalization process to proceed slowly.

Decision to commitresources to foreign market is the second change aspect. Johanson and Vahlne (1977) have concluded that the commitment decisions are made in small steps unless the firm has very large resources and/or the market conditions are stable, or the firm has a lot of experience in the markets with similar conditions.

### Limitations of the Uppsala Model

Johanson and Vahlne (1977) admit that the application of Uppsala internationalization model is only limited due to disregarding the “decision style of the decision-maker himself, and, to a certain extent, the specific properties of the various decision situations”. As the model bases the decisions of the firm on the previous experience, it has been criticized for being too deterministic and too limited by focusing only on one variable (Andersen, 1997). Andersen (1997) refers to most internationalization theories as being static in nature. The aspect of psychic distance seems to lose importance with the expansion of markets without regards to geographic and cultural distance (Axinn, 2002). Axinn (2002) states that the model is unable to explain or predict the formation of strategic alliances early in the internationalization process.

## Transaction cost theory

This theory was founded by Coase (1937). He argued that “a firm will tend to expand until the cost of organizing an extra transaction within the firm will become equal to the cost of carrying out the same transaction by means of an exchange on the open market or the costs of organizing in another firm” (Coase, p.395). Coase is the inventor of the expression “transaction cost”. His work was unnoticed almost half of the century before Oliver E. Williamson (1985) used his piece to describe economic changes in the 1970s. This theory became incremental to contemporary understanding of economy.

At the beginning it is important to understand what transactions are. “Transaction occurs when a good or service is transferred across a technologically separable interface {…} One stage of activity terminates and another begins” Williamson (1985, p. 1). Transaction costs are economic equivalent of friction in physical systems. Every actor of the market (consumers, firms or government) carries out self profitable activities entering to relationship with other agents (Williamson, 1985). Actors make use of the transaction because of advantages they gained else they would not be interested.

Transaction costs are the costs incurred in the transaction. TCE has been developed to simplify an analysis of the “comparative costs of planning, adapting, and monitoring task completion under alternative governance structures” (Williamson, 1985, p. 2). It is important to distinguish ex post and ex ante types of transaction.

* ex ante are the costs of drafting, negotiating, contracting and
* ex post are known as maladaptation, haggling, establishment, running and bonding costs

### Ex ante costs

*Drafting costs* - getting information in order to find and evaluate potential export partners

*Negotiating costs -* associated with negotiation of the contract between actors when it is necessary to agree on prize, quality, time of delivery, etc.

*Contracting costs -* associated with an agreement finilizing between seller and buyer

Knowledge about potential market is necessary. There is a difference between unfamiliar market where information are absenting and nearby market where costs for searching data are tolerable (Hollensen, 2010 p. 79).

### Ex post costs

*Enforcement or maladaption costs -* obligations were not met within agreement and one of the actors is sanctioned

*Monitoring or bonding costs -* agreement control if set conditions where fulfilled, costs of effective secure commitments

*Set up and running costs -* associated with the governance structures

*Haggling costs -* incurred if two-sided efforts are made to revise agreement

Due to Williamson (1985, p. 29) it is impossible to concentrate all of the relevant bargaining action at the ex ante contracting stage. The behavioral characteristics of human agent such are bounded rationality and opportunism are joined at this stage.

Managers must consider the production and transaction costs associated with implementing a transaction within their companies (in-sourcing) versus the production and transaction costs associated with executing the transaction in foreign the market (outsourcing). If they decide to use the foreign market, they must then determine the satisfactory type of entry mode to apply.

Hollensen (2010) explained that a firm establish internal management to control and implement their own system or rely on the partner when deciding how to perform their activities abroad. It depends on lower costs. Firms internalize to reduce transaction costs between markets.

Williamson (1985) argues that two human and three environmental factors lead to transaction costs arising. The two human factors are:

1. Bounded rationality: Humans do not have the abilities to outcome all transaction that might arise
2. Opportunism: Humans will act as they follow self-interest

The three environmental factors are:

1. Uncertainty: it is caused mainly by bounded rationality and opportunism and its level is likely to affect whether a manager chooses to out-source or in-source
2. Frequency: it might be hard to find alternative players once company has internationalize and has bad experiences if one of those
3. Asset specificity: The value of an asset may be attached to a particular transaction that it supports. The party who has invested in the asset will incur a loss if the party who has not invested withdraws from the transaction

As asset specificity and uncertainty increase, the risk of opportunism increases too. Thus, managers are more likely to choose a hierarchical entry mode. As frequency increases, the comparative advantage of using FDI decreases. Due to Williamson (1985) asset specificity evokes to opportunism.

## Theory comparison

|  |  |  |
| --- | --- | --- |
| **Perspectives** | **Uppsala Theory** | **Transaction cost theory** |
| Key features | A process based model, experimental knowledge | Data analysis, Calculation, competitor analysis |
| Function of the theory | A guidance of internationalization | Decision-making tool |
| Service objective | Firms | Management |
| Determinant on market entry | Experiences in foreign market | Internal/external Transaction Costs |
| Focus areas | Knowledge acquisition | Cost calculation |
| Time Period | Long-Term | Accumulated period |
| Reason | Risk minimization, profit maximization | Cost optimization |

Source: Self made

To conclude, the two theories have different functions and features. TCE is for managers’ decision-making tool when Uppsala theory is using firms’ guidance of internationalization process. Uppsala theory emphasizes on market commitments and experiences gained in the process, and TCE concentrates on cost calculation in order decide if to internationalize or externalize. However, these two theories have common characteristics. For example, they have the same purpose of risk minimization, but TCE is more concentrate on cost optimization. In order to understand the theory in practical level application of theories will be introduced in next section.

# Application of Theories

In this section application of the Uppsala Internationalization Model and the Transaction Cost Theory in the context of SMEs internationalizing in foreign markets is described. This section will be concluded with a comparison of both.

## Application of the Uppsala Model

Based on the description of Uppsala and the context setting for this paper, this chapter will explain Uppsala internationalization model towards to SMEs, it will be evaluated how managers of SMEs acts and to what extent can use Uppsala theory in their choice of entry modes when entering a foreign market.

Globalization, technological, political and economic changes as well as gathering more knowledge are some of the main drivers for increasing internationalization of SMEs in today’s world. Uppsala model has been applied to large extent in both, MNEs and SMEs context (Olejnik & Swoboda, 2012). During the last years, firms have been focusing on different business activities as ways of internationalization and considering them to be important to achieve competitive advantage

### SMEs’ motives for internationalization

Some of the main motives for managers of SMEs to go international are gaining access to new and large markets in order to achieve growth. Different entry modes have been used in order to expand in the new market such as exporting and joint ventures. That will give them an access to know-how and technology in order to stay competitive.

In 1977, Johansson and Vahlne observed that when firms internationalize, they move along in a series of incremental steps which they termed as “establishment chain” or “step by step”. The theory focuses on four aspects that firms should face while going abroad: market knowledge and commitment, commitment decisions and current activities which are divided into stage and change aspects that interact with each other in what seems to be a cycle. This raises the question, if the Uppsala Model can be applied to small and medium sized enterprises SMEs. Fundamental concepts of the Uppsala Model are knowledge, learning process, uncertainty, risk and commitment.

Market knowledge helps the managers to make right decisions. State aspects are the resources committed to the foreign market: market knowledge and commitment decisions that would affect the firm’s opportunities and risks. Market commitment stands for those resources that will be committed as well as the degree of involvement. There are two main types of knowledge: objective, which can be transferred from one market to another and experiential, which is gained by experience, learning by doing or acting. After the firm has right information about the market decision-makers can decide the way the firm will commit to that market, and will therefore be able to plan and execute the current activities needed to complete the cycle by committing to the market.

SMEs have to employ in long-term relationships to get access to external resources. The One of the characteristics of SMEs mentioned before is their low financial flexibility. International activities of a firm are consequently highly dependent on the firm’s relationships to other actors fixed in the business network and on the activities that these companies perform.

Uppsala is very deterministic in the process of internationalization and assumes the incremental commitment of resources, on one hand it reflects on the lack of resources for SMEs with the necessity of low investment, on the other hand, causes loss of control. Final step of Uppsala is opening a subsidiary in a foreign market, especially when entering emerging markets. That might cause high instability and higher probabilities of failure for SMEs comparing to the case of MNEs.

### Ways of internationalization

There are three basic entry decisions that management has to consider before going international (Hill, 2007):

1. Which market: the one being more attractive to the firm, seeking a balance between benefits, costs and risk?

This aspect is important for managers of SMEs as this type of companies do not have much or not enough resources to take big risks or to pay big costs in order to get international. When managers are making the decision of which market they want to enter, they need to make deep analysis of the situation on that market and which external and internal factors would affect the decision. The Uppsala theory will help to decision-making when showing to managers where is less risky to go first, which entry mode will be the most effective when entering a new market. In general, countries that are geographically, culturally and economically closer to home country are better options than those that are with great geographical distance and have big differences comparing to the home country. SMEs are generally companies with limited international knowledge and experience when compared to MNEs. Knowledge and learning are some of the critical issues in Uppsala which ensure the success in the foreign market.

1. When to go abroad: or timing of entry can be described either as first-mover or later entrants. First movers are those firms that enter the new market before other firms. Later entrants are those firms that enter after other firms have done it.

Managers should be prepared when they are going to be international. They need to have information about new market – how is the situation with competitors and is it a good choice of entering one particular market, won’t be too “late” for the company if they are too many existing “players” on that market. On the other hand, it is just the time to enter than market and gain huge benefits of being first on it.

1. What scale: a firm can enter on a large or small scale depending on the involvement of commitment they are willing to have. It depends on resources firms have and could possibly involve into entering new market process.

In order to answer this question managers should have enough information about how developed the SME is and if they have enough power to internationalize. This power is facing two main aspects: internal and external. The internal is aspect concerns whether the company has enough finances, networks, and resources to go abroad. The external factor concerns whether managers have enough information about the situation in the chosen market. In other words, are there no political or legal restrictions, how many competitors they will face, etc.

To conclude, it can be highlighted that managers of SMEs can use Uppsala theory in the primary stages of internationalization, as guide in making the decision of which market to enter, while balancing between benefits, costs and risk. However, the later stages of Uppsala are difficult to follow by SMEs, due to obstacles such as lack of resources and lack of market knowledge and experience.

## Application of Transaction Cost Theory

Within this chapter, the transaction cost theory will be applied on the context of objective in order to see if the theory can provide a guiding solution to the problem statement.

In the purpose of a suitable entry mode, three different factors are applicable. These factors are control, risk and return (Anderson and Gatignon, 1986). The factors that influence the choice of entry mode are highly related to one another.

### Control

Control is main factor within Internationalization process when SMEs are internationalizing into a new market, the firm takes a big step. Also, entering a new market with high geographical, cultural and language distance increases the risk factor of the foreign entry. In general, SMEs have more limited experience, resources and capabilities when entering into a new market compared to large multinational firms. Therefore, the control element is highly important in the choice of a particular entry mode since it enables the firm to keep setting strategies and maintain decision making in how to penetrate the new market. Therefore, SMEs can aim for direct involvement when it comes to exporting and importing although this can be a problem in particular for SMEs since this type of companies have limited resources. Direct involvement means that the firm works with foreign customers or markets with the opportunity to develop a relationship (Czinkota, Ronkainen, Moffett, 2011). In addition to this, the SME is eliminating a certain amount of risk by maintaining high control.

Another element that comes with keeping control over the foreign entry is the commitment to resources (Anderson and Gatignon, 1986). The high commitment to resources in the foreign market also includes high overhead. For SMEs it is expectable to get high commitment to resources since they have fewer opportunities to use resources from their domestic market. In addition, switching costs for an SME can be an obligation to switch between different resources which make resource commitment high. Another possible risk in a high commitment to local resources in the foreign market lies in the losses of the resources’ value caused by currency changes (Davidson, 1982). These factors cause that the firm’s switching costs will rise as well. Thus, high control entry modes will cause into higher return but also higher risk. In contrary, low-control modes, such as contractual agreements, lower the resource commitment and risk but the disadvantage is the lower returns.

Anderson and Gatignon (1986) state that “international entry mode choices are most usefully and tractably viewed as- a tradeoff between control and the cost of resource commitments, often under conditions of considerable risk and uncertainty. Preserving flexibility should be a major consideration of most firms in making the tradeoff.” Especially for SMEs in Emerging Countries where more uncertainty exists, a thoughtful tradeoff between control and flexibility is highly important since it can make or break the success of internationalization.

Nevertheless, maintaining high control will result in a high price (Vernon, 1983). For a SME, the high price for maintaining high control will in general be an obligation. The next paragraph will elaborate on the costs/return of the foreign entry.

### Costs

When it comes to the Transaction Cost Theory, the cost aspect is highly important. As stated in the explanation of the theory, transaction costs are the costs incurred in the transaction. In other words, to implement beneficial transactions actors successfully in the real world, one must spend costs on them.

Transaction costs occur when a firm enters a foreign market. In case the foreign market has great similarities to the home market of the firm, transaction costs still occur. When a SME is planning to internationalize into distance market, it can count on relatively higher transaction costs compared to a similar market. This makes the process of drafting, negotiating, contracting even more complex. Two types of costs occur in greater terms when a firm is internationalizing into a foreign market:

### Ex ante costs

Ex ante costs are the costs of drafting, negotiating and safeguarding an agreement. Within today’s business environment, great technological changes have their effect on the internationalization process. The internet aspect has influenced when it comes to the ex ante costs of the firm. The internet factor enables the firm to conduct all the research for possible partners and market information more easily. In addition, negotiation will be more in favor to the SME which is entering the foreign market, since the internet provides comparative information about the general contracting conditions within the market as well as the market’s competitors, customers and other characteristics.

### Ex post costs

Ex post reasons are the maladaptation, haggling, establishment, running and bonding costs. These costs occur after the entry of the SME within the foreign market. The technology influenced the business world and enables the SME to monitor the set agreements more secure by more advanced systems and online monitoring tools. This has its effect on the set up and running costs since it simplifies the set up and running processes involved in internationalization.

Most of the transaction cost research and internationalization research will have taken place before the actual entry into the foreign market, which means that they occur in the home market. This research is focusing on micro aspects of firms that show particular behavior such as opportunism (Williamson, 1986). Nevertheless, also the macro elements that have influence on the firm, such as country level laws and regulations, should not be neglected.

### Opportunism

Hollensen (2011:78) states, “the friction between buyer and seller can often be explained by opportunistic behavior. Williamson (1986) defines it as a ‘self-interest seeking with guile’. It includes methods of misleading, distortion, disguise and confusion.” Therefore, one could state that opportunism is an important factor in driving transaction costs.

The costs for contracting have declined, since price comparison negotiated relationships and progresses can be compared, managed and monitored. It also cuts the coordination costs: business processes can be managed online and relevant information easily shared. One could state that the technologies has enabled SMEs to get access to low cost data information systems, which eventually has leaded into improvement of their competitiveness.

### Designated Entry Mode

Based upon the findings of the previous chapters, the Transaction Cost Theory will guide in the choice of entry mode for SME´s, which internationalize into foreign markets in today´s global environment.

As has been discovered in the previous paragraphs, in the transaction cost theory control is leading in the choice of entry mode. Hence, choosing an entry mode can be done from three different clusters (Anderson 1986). The first cluster is formed by the *High Control Modes* where the firm has dominant equity interests (wholly owned subsidiary). The second cluster includes *Medium Control Modes* (contractual joint ventures, contract management, franchises) where the firm has medium interest and is balanced with other parties. The third and last cluster contains *Low Control Modes* where the firm has diffused interest (nonrestrictive contracts, small shareholder).

Anderson (1986) states that “The theory, transaction cost analysis, combines elements of industrial organization, organization theory, and contract law to weigh the tradeoffs to be made in vertical integration (and by extension, degree of control) decisions.” Therefore, to begin the determination of which entry mode to choose, the SME assumes that the foreign market has promising potential to breakeven in entering costs. As described by Anderson (1986), the optimal outcome of the entry mode in terms of efficiency and control are dependent on the positivity of four factors:

Transaction-specific assets: investments (physical and human) that are specialized to one or a few users or uses;

Environmental uncertainty: the unpredictability of the entrant's external factors that influence the new market entry;

Internal uncertainty: the entrant's inability to determine its agents' performance by observing output measures;

Free-riding potential: agents' ability to receive benefits without bearing the associated costs.

### Transaction-specific assets

Focusing on transaction specific assets, several propositions can be made in order to distinguish which entry mode is most suitable for a SME. First, an entry mode that secures high control is most preferable in case the firm deals with highly proprietary products or processes. These kinds of processes, knowledge and products show in general more complexity. Therefore, the firm prefers to keep these under own responsibility in order to properly enter the new market. Second, products and processes that contain highly complex understanding generally demand high control entry modes. Third, products that are highly customized to the final customer and entail a customized relationship between buyer and seller, generally need a higher degree of control. Fourth, it is less likely that the firm requires high control over the foreign entry, in case they operate within a mature product class. Thus, the more innovative the product class is, the more control is needed.

One other factor that is also leading in the determination of a suitable entry mode is the level of competition within the foreign market. High level of competition will lead into a highly cooperative relationship with suppliers. When a relationship with an external party is unsatisfactory, the firm can easily switch to one of the competitors of the current party. In this case, vertical integration of the foreign partner is unnecessary and therefore the firm can realize high return and low risk. Transaction costs occur when bargaining power of the SME is low (Anderson et al. 1986). When a particular party possesses valuable transaction-specific assets, vertical integration is more likely since the firm obtains the resources itself.

### Internal uncertainty

The internal uncertainty has to do with possible difficulties in objectively monitoring the performance of agents. This results in the misunderstanding of monitoring inputs and outputs of the agent. These kinds of situations can occur internationally when the market is unknown. Therefore, a high control entry mode is desirable in order to terminate this kind of uncertainty.

Another factor that has been mentioned earlier in this chapter is the social cultural distance from the firm’s domestic market. This can affect the firm’s staff that has to operate within the foreign market and thus possible causes some inefficiency. Richman and Copen (1972) state that a great social cultural difference can diminish over time when the pool of personnel that is active within the new market is getting trained and growths into local methods and uses. When this personnel group is big, the less control is needed for the firm to overcome the barrier to efficiently enter the market.

### Environmental uncertainty

External factor can influence the entry of the SME especially within in the emerging market. Therefore, the firm should strive to minimalize its commitment to the market, remain its flexibility, and try to shift risk to other parties. Doing so, the firm enables itself to react upon major changes within the market and the firm’s environment.

Environmental uncertainty can be caused by factors such as political instability, economic and currency changes. Markets where changes occur one after another are known as volatile markets. In these kinds of markets, the SME should focus on low-control entry modes in order to remain flexible. However, when the transaction specific of assets is high (as discussed in Transaction-specific asset paragraph), high control is needed because the costs of switching partners in this situation are relatively higher.

# Case study – Agrodeal

## Description of AG Náradie

AG Náradie, Ltd. is trading company which was established in 1991 in Trnava. Creation proceeded by mutual agreement of four members with the same amount of financial contribution, which counted to SKK 150 000. Capital of the company totals the equivalent of € 20,000.

Name: AG Náradie, Limited

Location: Bulharská 37/2, 917 00 Trnava

Legal form: Limited Liability Company

ID number: 18049401

VAT number: SK2020390438

Graphic logo:

Picture: Logo AG Náradie [self made]

In addition to headquarter situated in Trnava, firm has offices also in Piestany and capital city Bratislava.

Main business activities – distribution of technical goods such as:

* Workshop hand tools
* Workshop electric tools
* Welding materials and supplies
* Tools for gardening
* Construction tools and supplies
* Workshop tools for protection
* Grinding and cutting materials
* Compressors

AG Náradie managed to become a major distributor of tools. Long-term cooperation with major industrial companies in Slovakia and many distribution companies throughout the country has help to develop quite successful business.

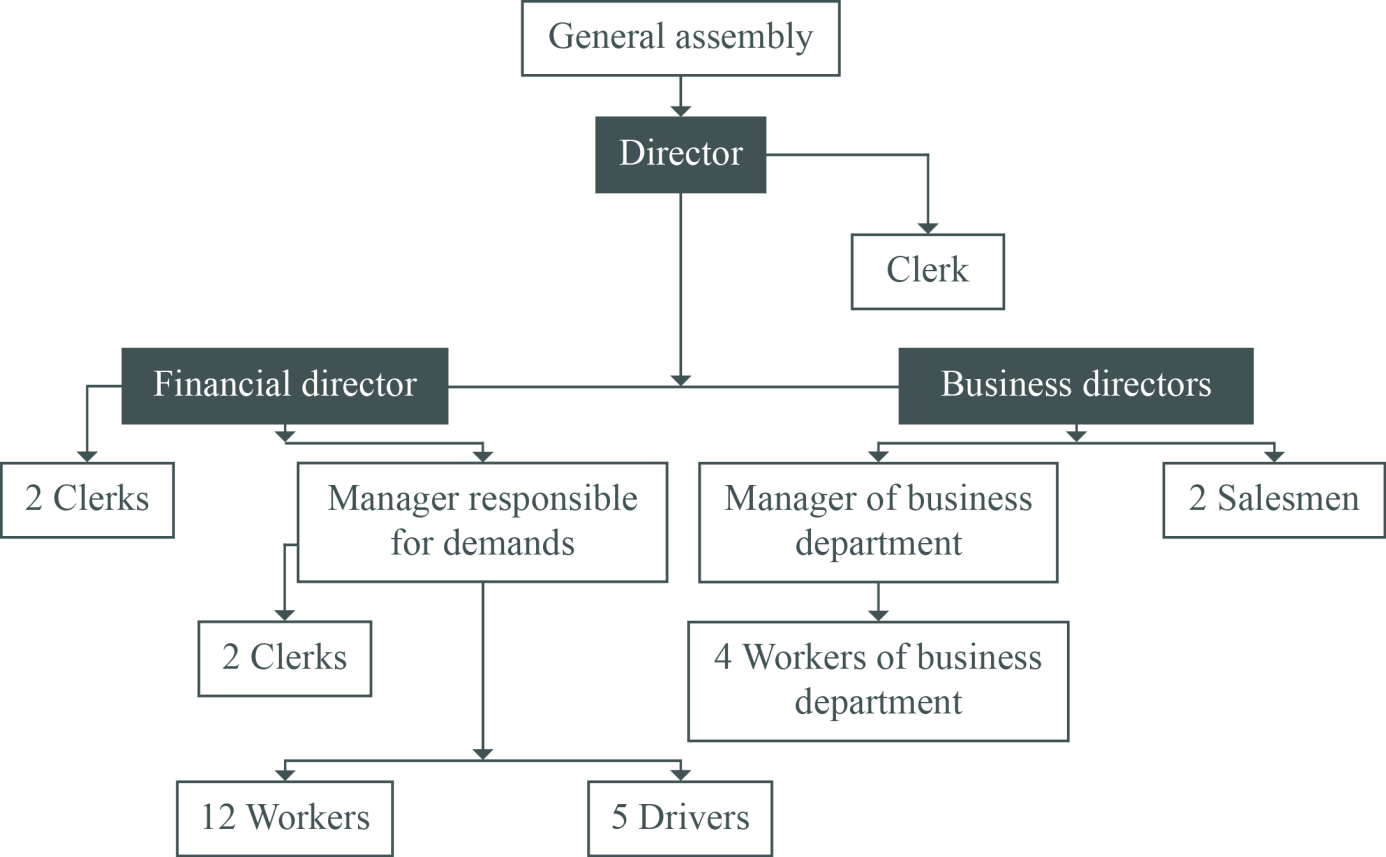
Company employs exactly 50 trained employees at this time. It offers more than 20,000 items for immediate delivery (stocks and goods at the store) and tens of thousands more in the form of ordering. Present offer is specified in several catalogs, which are offered free of charge to business partners. Goods are mostly ordered by internet and then transported to customers within distribution routes.

The company is a distributor of major brands of tools Profi Class - Tona, Zbirovia, Narex, Ajax, Esab, Knipex, Gedore, Pferd, Tyrol, Bahco. Emphasis on appropriate quality is delivered by careful selected range of goods in DIY types of stores.

The company possesses a long-term certification - Quality Management System - ISO 9001.

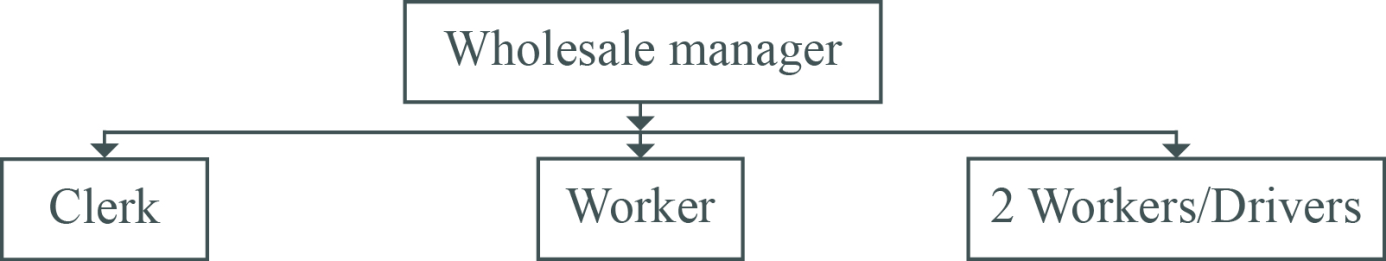
Organizational structure of AG Náradie Ltd. is presented below. There are 3 operation buildings in Slovakia. All of them are concentrated in western Slovakia, 50 km from each other.

Central operation building in Trnava



Source: self made

Subsidiary in Bratislava



Source: self made

Subsidiary in Piestany



Source: self made

# Discussion

In this section comparison between theoretical and practical part will be presented. Research questions will be answered in order to fulfil objective of this thesis.

For this purpose theoretical analysis has been conducted and characteristics of chosen theories have been pointed out. On these characteristics interview has been created. Managers of the particular SME answer questions and thus introduce their understanding and experiences of internationalization process. This process enables us to find out if theories of last century are able to explain all the aspects of internationalization process, or at least some of them.

**Research question 1:** *What is the way the company handles international activities (entry mode)?*

Chosen company has been running their business for over 25 year. During these years it has gained many experiences. Internationalization process is presented in their activities in foreign countries such are Czech Republic, Serbia, Hungary or Slovenia. After great success on domestic market (Slovakia) managers started to look forward to the future and searched for ways to enter foreign market. At this time Slovakia was still part of Czechoslovakia and thus business has been done also in Czech market, no customs were required since it was part of one union. Managers were able to gain more and more partners. Their network was increasing gradually and their experiences positively. As the time has gone by Slovakia became independent and borders have been created. This caused difficulties as transaction costs increased rapidly. Managers searched for different options in different countries

Throughout the years company consider to enter foreign market only with person who knows the environment. Thus uncertainty was rapidly decreased. Company entered only Czech market until 2007. In this year chance to enter was offer by one their partners contact. Company created competition and demand analysis. Serbia seems to be market with strong demand, low competition and thus possible high margins. Managers decided to use direct investments and entered market through subsidiary. Subsidiary survived for one year. The main reasons were dissimilar mentality and law enforcement. Byers were not able to pay for their goods on time. After these experiences company never use direct investment in foreign country.

At this time contractual agreements and indirect export are only two entry modes that company is willing to use.

**Research question 2:** *What are the experiences company gained throughout their existence on foreign market?*

Company experienced export in Slovenian and Czech market, and FDI in Serbian market.

**Research question 3:** *Is Uppsala theory explaining all aspects of market selection process of particular company?*

Fundamental concepts of the Uppsala Model are knowledge, learning, uncertainty, risk and commitment. Market knowledge is firstly delivered by representative of foreign country. Company has no intention to commit to the market.

International activities of a firm are highly dependent on the firm’s relationships to other actors fixed in the business network and on the activities that these firms perform. These specifications matched with Uppsala characteristics.

Final step of Uppsala is opening a subsidiary in a foreign market, especially when entering emerging markets. As mentioned before, tested company has open subsidiary as first step thus skip all the stages of commitment process.

Countries that are geographically, culturally and economically closer to home country are better options than those that are with great geographical distance and have big differences comparing to the home country. Managers decided to enter Serbia, market with culturally and economically distanced because of desirable high profit.

Timing of entry can be described either as first-mover or later entrants. Company entered Serbian market where almost feared no competition. However, its absence might be caused by explained by stern environment.

**Research question 4:** *Is TCE explaining all aspects of market selection process of particular company?*

In the purpose of a suitable entry mode, control, risk and return are applicable. Control is related to high investment. This approach does not explain how decision making process is done in particular company. High investments are not considerable because of the limited resources and previous bad experiences. In contrary, low-control modes, such as contractual agreements, lower the resource commitment and risk but the disadvantage is the lower returns. This is exactly the one way company wants to act on foreign market. There are few actual agreements company holds at this time with Czech partners.

Both theories focus their attention on risk minimization and profit maximization. After failed on Serbian market, company is not willing to invest in foreign market directly anymore. Profit was claimed as reason why company enters foreign market in first place.

# Conclusions

The main purpose of this paper is to increase the understanding of the Uppsala Model and Transaction cost theory through testing its applicability on SME. In principal, empirical findings confirm the applicability of the Uppsala and TCE theory on chosen company.

Both theories can explain company international processes in some level, however none of them can explain all the aspects.

Nevertheless we continue to believe that psychic distance is still an important factor of uncertainty. However we argue that this barrier can be overcome by being part of a strong network and trustworthy partners. The background of a firm’s management can also get rid of psychic distance and influences the choice of foreign markets.

This results in conclusion that many trading SME firms such as presented one will not increase their commitment in a foreign market infinitely. Instead they will stop increasing their commitment at an early stage, in which they feel more comfortable with its level of commitment.

To sum up, it is decided that the Uppsala and Transaction cost theory are very general. This is the reason why it fails to explain some actions of the company. At the same time the model’s general approach is also its biggest strength. Since they are focus on explaining the fundamental elements of internationalizing of firms it is possible to apply the theories to a wide range of situations.

This thesis explain one company and its decision making process towards internationalization process. Subjective approach of methodology was chosen in order to analyze individual experiences when entering foreign market.

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# Appendice

## Apendix 2 Semi-structured interview

1. What are your experiences with foreign markets?
2. What markets is your firm operating on?
3. In your opinion, what motivates SMEs to enter foreign market and what steps they need to take?
4. What were your reasons for entering foreign market?
5. What steps did you when entering foreign market? (indirect export, direct export, agent..)
6. Do you think an incremental order is advisable when going abroad? Starting with low commitment and then steadily increasing commitment as uncertainty decreases?
7. How experiential and objective knowledge did influence your internationalization decisions? Are they equally important?
8. What were your main driving goals when entering foreign market? What aspects influenced the markets choice?
9. What is necessary to be done right before entering new market?
10. How, do you think that the background of top management (language, culture, history…) influences the choice of country?
11. Do you consider physical distance between domestic and foreign market to be important?
12. Did you experience any changes in importance of entry mode choice?
13. Would you agree with the statement, that market knowledge decreases uncertainty and therefore allows an increase in commitment?
14. **)** What influence did the network of your firm have on the market choice?

## Appendix 3a: Interview with Mr.Kocian (answers only)

1. Imports in 2013 consist of 33% of total purchase. From this imported countries and their percentage are:

* Czech Republic 90, 5%
* Germany 7%
* China 1%
* Italy 1%
* Hungary 0, 5%

Export in 2013 consists of 6% of total sales. From this exported countries and their percentage are:

* Czech Republic 98%
* Slovenia 2%

Experiences with **Czech Republic** rest on contractual agreements. Partners are similar business-related and very solid. Close culture, language and same historic past. Close partners network.

Experiences with **Serbia** rest on direct investment, creation of subsidiary. Company sees the opportunity of high margins. There were almost no compention 60% of control was hold by the company and the rest by foreign partner. Big differences in culture, mentality and law enforcement has forced company to withdrawal. Physical distance was an obstacle in order to control subsidiary activities.

Experiences with Slovenia rest on indirect export. Partner from Slovakia introduced client from Slovenia, creation of network. Close language, distance market, network of business partners.

1. Slovakia, Slovenia and Czech Republic
2. To make a profit
3. Lack of competition, profit
4. Company seeks for risk minimization.
5. Yes they do.
6. Analysis of the market is inevitable, network and recommendation of trustworthy person is very important. Company does not want enter market with high commitment and high investments because of bad experience on Serbian market.
7. High profit, market expansion are main goals when entering foreign market. Choice of the market strictly depends on networks.
8. To make deep analysis of the market. Find out how the law, taxes and peculiarities of business are processed. Mentality of people, similarity of the country has to be studied.
9. Background is very important. Company does not want to enter countries with economical problems because of the level of uncertainty.
10. No. there is no problem in physical distance.
11. Yes. No more high direct investments. Only contractual agreement and export.
12. Definitely
13. Maximal

**Manager Quote:**

“A [bird](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/bird) [in](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/in) [the](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/the) [hand](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/hand) [is](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/is) [worth](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/worth) [two](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/two) [in](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/in) [the](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/the) [bush.](http://www.translate-slovak.com/sk/slovnik-angli%C4%8Dtina-sloven%C4%8Dina/bush.)”