Real options and the theory of foreign direct investment

Jing Li\textsuperscript{a,\*}, Alan M. Rugman\textsuperscript{b,1}

\textsuperscript{a}Faculty of Business Administration, Simon Fraser University, 8888 University Drive, Burnaby, British Columbia, Canada V5A 1S6

\textsuperscript{b}Kelley School of Business, Indiana University, 1309 E. 10th Street, Bloomington, IN 47405-1701, USA

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Abstract

We extend applications of real options theory to foreign direct investment (FDI) research regarding choice of location and choice of market entry mode under uncertainty. Our study is motivated by the regional configuration of multinational enterprises (MNEs), as well as observed deviations from the stages model in internationalization theory. We shed light on these issues using real option modeling and computer simulations. The results suggest that from the standpoint of pursuing business opportunities and generating real options, building a subsidiary in a nonhome region could be more beneficial than in a home region. However, high option exercise cost may reduce the option value of a nonhome-region location. Our models also imply that choice of entry mode depends on the magnitude (high vs. low) and the type (exogenous vs. endogenous) of uncertainty. When uncertainty is high and endogenous, MNEs may prefer high-commitment entry modes because they contribute to the reduction of uncertainty and provide valuable growth options.

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1. Introduction

It has been recognized in international business (IB) that uncertainty, which often exposes multinational enterprises (MNEs) to unfavorable conditions or favorable

\textsuperscript{*}Corresponding author. Tel.: +1 778 782 4568; fax: +1 778 782 4920.
\textit{E-mail addresses: }jingli@sfu.ca (J. Li), rugman@indiana.edu (A.M. Rugman).

\textsuperscript{1}Tel.: +1 812 855 5415; fax: +1 812 855 9006.

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