Internationalization of Emerging Economy Firms – Need for New Theorizing

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The paper argues that the extant theories are too broad to explain certain attributes of the internationalization process adopted by emerging economy firms. It seeks to strengthen the existing theories by suggesting directions for new theorization in the context of internationalization of firms from emerging economies such as India. The author reviews the relevant theoretical literature on the international expansion of firms in general and by TMNCs in particular. The paper examines evidence from the unique context of the internationalization of emerging economy firms and offers an argument for the need for fresh theorizing.

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Emergence of Third World MNCs

The emergence of firms from developing countries as important players in global markets has been a distinctive phenomenon of globalization in the twenty first century. Not only have the emerging market economies[1] been among the top destinations for foreign direct investment (FDI), but the outward FDI flows from these economies have also been growing steadily. FDI from emerging economies accounted for 17% of world outward flows at US $133 billion in 2005 (UNCTAD 2006). The value of the stock of FDI from emerging economies was about $1.4 trillion in 2005 constituting around 13% of the world total. All these have resulted in a resurgence of interest in internationalizing firms from emerging economies, a number of which have been transforming themselves into 'third-

1 Hoskisson et al. (2000) have defined emerging market economies as low-income, rapid-growth countries marked by government policies towards economic liberalization and identified 51 developing countries in Asia, Latin America, Africa and the Middle East and 13 transition economies in the former Soviet Union and China as emerging economies.

world multinationals or TMNCs' (Wells 1983).

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The international expansionary activities of TMNCs from emerging economies are fraught with many challenges. To begin with, they have to overcome the 'late mover' disadvantage. In addition, they hail from less munificent resource environments and have to acquire resources and capabilities to successfully compete with established players from the developed economies (Guillen 2000). Most of the theories offered as explanations for international expansion behaviour of TMNCs were modifications of the prevailing theories of internationalization developed primarily in the developed economy context (Dunning 1981, Dunning et al. 1998, Mathews 2006). In this paper, we attempt to review the predominant theories of internationalization and examine whether they adequately explain the internationalization behaviours of emerging economy firms, particularly taking into account the empirical evidence on internationalization of firms from India. We argue that the extant theories of internationalization are too broad to explain certain attributes of the internationalization process adopted by emerging economy firms and seek to strengthen the existing theories by suggesting directions for new theorization in the context of internationalization of firms from emerging economies such as India. The remainder of the paper is organized as follows. The next section reviews the relevant theoretical literature - first of international expansion of firms in general, followed by TMNCs in particular. Then we examine evidence from the unique context of the internationalization of emerging economy firms and offer an argument for the need for fresh theorizing.

Theories of Internationalization

A rich body of work exists that attempts to explain international expansion activities of firms, though almost all of it was developed in the context of MNCs from the developed economies. This literature can be broadly grouped under two theoretical streams namely the internationalization process models (Vernon 1966, Johanson & Wiedersheim-Paul 1975) and internalization theories (Buckley & Casson 1976, Dunning 1980). Some aspects of the international expansion phenomenon primarily addressed by these theories include selection of foreign markets, choice of the entry mode and pace of internationalization and choice of partners.

One of the important early attempts to explain foreign expansion activities was that of Vernon (1966), which focused on the effect of product cycle on investment in foreign markets by US firms. Vernon argued that initially firms focused on exploiting the advantages of the country of origin, but subsequently, as the products became more mature and

competition became more intense, firms tended to shift production abroad. A four-phase trade cycle was posited for most international products consisting of export dominance in the first phase, production in the foreign country in the second phase, foreign firm competition in foreign markets in the third phase, and foreign firm competition in the home market in the fourth phase.

Johanson and Wiedersheim-Paul (1975) and Johanson and Vahlne (1977) put forward a sequential or incremental approach to deepening of foreign commitments of firms that came to be known as the 'Uppsala School' or the 'stages' model. It was proposed that a firm would internationalize its operations in the following stages: (i) no regular export, (ii) export through independent representatives or agents, (iii) establishment of sales subsidiaries and finally, (iv) production /manufacturing plants. Knowledge of markets was considered the main rationale behind this approach and it was proposed that firms would first enter those markets with which they were most familiar and then based on knowledge acquired from exporting to or investing in those markets, they would enter progressively less familiar markets. The incremental approaches were labelled internationalization models and addressed primarily the pace of internationalization and evolution of commitment in choice of foreign markets and investment.

Why do firms from one country prefer to own value-adding activities in another country instead of just engaging in contractual transactions with foreign firms? A group of economists viewed foreign production as a market-replacing activity. They proposed that firms would prefer foreign production if the net benefits of using cross-border markets to organize the transactions of goods and services were perceived to be lower than those of hierarchical control. Rooted on the concept of 'transaction cost economics' (TCE), this approach became widely known as 'internalization' approach and prominent among its proponents were Buckley and Casson (1976) and Hennart (1982). Internalization theories focused on the conditions prompting the foreign investment decision and the choice of the foreign entry mode.

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Internalization approach was extended by Dunning (1980, 1988), through his eclectic paradigm which posited that there were three major sets of interdependent factors that influenced the extent, geography and industrial composition of foreign production undertaken by a firm – Ownership advantages (O), Location advantages (L) and Internalization advantages (I). According to the 'O' sub-paradigm, the greater the relative competitive advantages of the investing firms, particularly

compared to those in the host country, the more they are likely to engage in foreign production. The Location advantage 'L' sub-paradigm posits that the more the immobile, natural or created endowments (that are needed by the firms) are associated with the foreign location in comparison to the domestic location, the more likely that a firm will engage in FDI. The third sub-paradigm, 'I', offers a framework for evaluating alternative ways in which firms may organize their activities between domestic and foreign locations.

The eclectic framework was further developed by others such as Hill et al. (1990) and Kim and Hwang (1992) who emphasized the influence of strategic variables on entry choice. Hill et al. (1990) proposed that entry choice of firms is influenced by strategic variables, environmental variables and transaction-specific variables; for example, pursuing a global strategy as against a multi-domestic strategy will lead to higher control entry mode choices, but the issue of how a firm chooses one strategy against the other remains. Increasingly in the nineties, the proportion of 'knowledge' in the total value-added by a firm has grown tremendously, whereas many of the internationalization theories including eclectic paradigm have presumed that firms create their assets including knowledge in their home countries, prior to engaging in FDI. Strategic-asset seeking investment has now become an integral part of globalizing, knowledge-based economy. Many studies (Kuemmerle 1996, Shan & Song 1997) have shown that the motive for foreign investment was gaining new knowledge than exploitation of existing knowledge, particularly in knowledge-based industries. In addition, Madhok (1997) shifted attention on the influence of organizational capabilities on internationalization and entry mode choices and proposed value maximization instead of cost minimization as the driver of internalization.

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As mentioned earlier, all the above theories/frameworks were developed in the context of firms from developed economies; whereas, changes in economic and political context would need a complete review of the theories of international expansion appropriate for the new context (Dunning et al. 1998, Mathews 2006). New economic contexts such as developing and emerging economies have motivated a few attempts at re-examination of the existing theories of internationalization.

International Expansion of Firms from Emerging Economies

The phenomenon of the emerging MNCs from developing countries attracted the attention of researchers way back in the seventies (Heenan & Keegan 1979). A series of books (Kumar & McLeod 1981, Lall 1983, Wells 1983) were written on the TMNCs in what was termed as the 'first wave' by Dunning et al. (1998). Then there was a lull for

many years till almost the end of the century.

Lall (1983) and Wells (1983) were one of the first to propose a theoretical explanation for the emergence of TMNCs. They argued that there are certain conditions under which it is theoretically possible that firms operating in developing countries can establish a proprietary advantage which is exploitable by direct foreign investment. Some of the identified factors that possibly contributed to the proprietary advantage are low input costs, inexpensive labour, management and marketing skills adapted to third world conditions and advantages associated with conglomerate ownership. These advantages helped TMNCs expand predominantly into other, similar, less developed countries.

Two other theoretical explanations for the phenomenon of TMNCs, though at a much more macro level, were put forward by Porter (1990) and Dunning (1981). Porter's work, though not directly related to TMNCs, focused on the key factors that gave rise to competitive advantage of firms in specific countries or regions. Porter (1990) attributed the competitive advantage of firms from specific countries to four interlinked advanced factors (mostly specific to country of origin) namely, 1) firm strategy, structure and rivalry; 2) demand conditions (demanding customers improve the competitive advantage of firms); 3) related supporting industries; and 4) factor conditions of specialized factors such as skilled labour, capital and infrastructure.

Dunning (1981) proposed the concept of investment development path (IDP) which postulated that the level and

Table 1: Characteristics of Outward FDI at various stages of the IDP

Characteristics	'First wave' (Stage 2)	'Second wave' (Stage 3)	Conventional MNCs (Stages 4 and 5)
Destination	Neighbouring and other countries developing	Mostly regional, but expanding to global	Global
Motivation	Resource seeking and market seeking in developing countries	Resource and market seeking (developing countries); Asset and knowledge seeking and market seeking (developed countries)	Efficiency seeking
Ownership advantages	Primarily country of origin specific	Both firm and country specific	Mainly firm specific
Representative countries	India, Philippines, Argentina, Columbia	Hong Kong, Korea, Taiwan, Singapore	Japan, USA, Western Europe

Source: Adapted from Dunning et al. (1998)

the nature of outward FDI of different countries would be related to, and changes with, their economic development. As an explanation of the increasing trend of TMNCs' investment in developed countries, Dunning et al. (1998) extended the IDP concept by proposing that the outward FDI of TMNCs could be categorized into 'first wave' and 'second wave'. Similarly the economic development of nations can be categorized into five stages ranging from 1 to 5. The first wave outward FDI can be associated with the countries in the second stage of economic development. As the firms from these countries acquire experience in their international operations, they improve their 'O' and 'L' advantages and enter into the second wave of outward FDI. At the same time the countries enter and progress through stage 3 of the IDP. The characteristics of outward FDI at different stages of the IDP proposed by Dunning et al. (1998) are summarized in Table 1. Firms from emerging economies such as India and Argentina constitute the first wave and are posited to internationalize in neighbouring and other developing countries (and *not* into developed countries) primarily through country-specific ownership advantages.

Firms from emerging economies such as India and Argentina constitute the first wave and are posited to internationalize in neighbouring and other developing countries.

The above theories only provide partial understanding and explanation of the internationalization of MNCs, in particular TMNCs (Sim & Pandian 2003). Internationalization theories developed in the Western context overlooked the active role played by the state and neglected the institutional or contextual perspective in the internationalization of Asian firms (Yeung 1994, Zutshi & Gibbons 1998). Highlighting the predominant institutional influence in emerging economies, Sarkar et al. (1999) argued that the extant internationalization theories needed to be augmented with contextual idiosyncrasies of specific industries and geographies.

On the other hand, taking into account the unique environmental contingency of recent economic liberalization in many developing economies, there have been attempts in literature to develop specific conceptual models (Craig & Douglas 1997, Dawar & Frost 1999, Khanna & Palepu 2006) that proposed a set of generic strategies available to firms from developing economies as they responded to severe institutional changes. However, except for the recent study of Khanna and Palepu (2006), their primary focus has been on survival strategies in the light of opening up of their economies and not on the possible competitive strategies to succeed in international markets and emerge as TMNCs. Craig and Douglas (1997) proposed that the strategic responses of developing economy firms could range from cost-oriented commodity approaches based on low-cost labour and other resources on one extreme – component manufacturing,

private-label manufacturing - to higher value-creating approaches that capture a greater share of the value chain. Dawar and Frost (1999) observed that the typical response of most developing economy firms to liberalization seemed to be one of the three – call on the government for support, become a subordinate partner to a foreign multinational or sell out. They offered a mix of defensive and assertive options leveraging on some of the unique assets or resources possessed by developing economy firms. Arguing that each firm should assess whether it has any unique assets and whether these assets are exploitable abroad, they suggested four strategic options for firms in developing economies based on whether a company's unique assets are exploitable overseas and based on the intensity of globalization pressures – defend, dodge, extend and contend. In a recent paper, Khanna and Palepu (2006) suggested a few generic approaches that focused on capitalizing the institutional voids that characterize developing economies. Developing economy firms possess the unique advantage of managing institutional voids which they could exploit to counter foreign multinationals both in their local economies as well as in foreign markets with similar institutional environment.

The common thesis across all these frameworks (with the exception of Khanna and Palepu 2006) seems to be that developing economy firms would find it difficult to develop resources and capabilities to compete head-on with foreign MNCs and hence their predominant strategic options would be defensive strategies that include fitting in at the lower end of the value chain or partnering a foreign multinational. Khanna and Palepu (2006) posit that indigenous companies are more likely to succeed in terrains typically characterized by institutional voids. Successful internationalization is therefore possible by means of exploitation of locally available or developed proprietary advantages (such as low costs or experience in dealing with institutional voids) in foreign markets, predominantly in other, similar, less developed countries. A few empirical studies that exist in this context find support for this thesis. For example, based on twelve case studies of emerging multinationals from Taiwan and Singapore, Sim and Pandian (2003) found that their strategic advantages stemmed from low cost, responsiveness and knowledge of local markets.

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Indian Firms' Distinctive Internationalization Paths

When we take a closer look at firms from emerging economies, particularly from India, some distinctive differences in their internationalization paths can be observed when compared to those of developed economy firms as well as predictions from the above theoretical adaptations. We focus and elaborate on three such distinctive internationalization behaviours below and argue for the

need for fresh theorizing to explain these unique internationalization patterns.

Exploration and Learning Motives: As predicted by extant theories, anecdotal evidence of Indian international firms indicates firms' international expansion driven by *exploitation* of local advantages, but interestingly, there is also equally compelling evidence of firms rapidly *exploring* and acquiring resources and capabilities to move up the value chain (to cite a few examples, Wipro, Infosys in information technology industry; Sundaram Fasteners, Bharat Forge in auto ancillaries; Dr. Reddy's Labs, Ranbaxy in pharmaceuticals). The target markets for most of these firms were not other developing economies with similar institutional environments, but predominantly developed economies such as U.S. and Europe.

Thus a fundamental difference seems to underlie the internationalization process of firms from emerging economies, as compared to their developed economy counterparts. The dominant paradigm within which past research on internationalization has progressed rests on one fundamental assumption typical of Western models of international expansion - that the firm in question already possesses the technology and product-related knowledge it needs in order to meet the demand of the foreign markets, and the act of internationalization is undertaken in order to exploit this stock of existing know-how (Hitt et al. 2006). Another key postulate has been that internationalization progresses incrementally through a systematic process of learning-by-doing. This path-dependent model argues that firms accrue internationalization capabilities to deal with cultural diversities and operational uncertainties of operating in foreign markets through an endogenous process of experiential learning. However, in the case of firms from developing economy firms it is likely that even prior to moving into international markets, they would need to upgrade their technological, financial and managerial resources so as to be able to offer products that are able to meet the more advanced needs of the international markets. Due to underdeveloped strategic factor markets for finance, technology and management, emerging market firms often face difficulties in acquiring resources (Hitt et al 2005). Overcoming this initial resource hurdle to be globally competitive is critical. Thus, it appears that emerging market firms need to first internationalize their resource-base before it can exploit them in foreign product-markets and thus internationalization of these firms is driven by the motives of learning and seeking strategic resources. In a recent empirical study of Indian pharmaceutical firms, Chittoor et al. (2009) find that internationalization of technology and resource bases drives their participation in international markets.

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Overseas Acquisitions: Jumping the Stages: Another distinctive aspect of the internationalization of the emerging economy firms is their pursuit of aggressive, accelerated internationalization characterized by overseas acquisitions as against the incremental, stages approach. Despite severe constraints, many emerging economy firms seem to adopt strategies which are neither path dependent nor evolutionary (Luo & Tung 2007, Aulakh 2007). In 2005, twenty-five emerging economies had made outward or overseas investments compared to just six in 1990. Between 1987 and 2005, the share of global mergers and acquisitions (M&A) by multinational firms from emerging economies rose from 4 per cent to 13 per cent in value terms (UNCTAD 2006), driven mostly by Indian and Chinese companies. Coming to the Indian scenario, Indian companies acquired 244 foreign companies between 2000 and March 2006, out of which the IT & ITES industry accounted for 82 (MAPE 2006). What could possibly be driving this acquisition route to internationalization despite it being arguably the riskier path?

Multinationals with low international diversity and capabilities preferred acquisitions over green field ventures.

One important motive of overseas acquisitions is their potential for accelerated learning and capability building (Vermeulen & Barkema 2001). It is argued that in the case of tacit resources, the market for firms is more efficient than market for resources and hence one of the main goals of acquisitions is to obtain tacit resources (Capron, Dussauge & Mitchell 1998). Barkema and Vermeulen (1998) proposed learning as a major motive of overseas acquisitions and found that multinationals with low international diversity and capabilities preferred acquisitions over green field ventures. On the other hand, a firm that operates in diverse national settings can develop rich market knowledge and capabilities and hence chooses to operate through start ups than acquisitions. In a study comparing Asian firms with those in Europe and North America, Mitchell and Shaver (2002) propose that Asian firms use acquisitions to obtain resources that they need to compete outside their home markets. From an analysis of 425 international acquisitions by Indian firms between the years 2000 and 2007, Gubbi et al. (forthcoming) find evidence of positive abnormal returns for acquiring firm shareholders which they attribute to the potential acquisition possibilities of resources from developed markets. It can be posited therefore that internationalization through overseas acquisitions could serve as a mechanism for emerging economy firms to obtain resource inputs from international markets.

Unique Role of Business Groups: We now turn to an important firm-level characteristic in the context of emerging economies which has a significant influence on the resources and capabilities that are at a firm's disposal and hence is likely to be a key determinant of internationalization – the membership

of a firm in a business group. A rich body of work has established the significance of business groups in the socio-economic landscape of emerging economies (Strachen 1976, Khanna & Palepu 1997). Ranging from Korean *Chaebols*, Turkish *families*, Latin American and Spanish *grupos* to Indian business *groups,* they have been defined as "a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action" (Khanna & Rivkin 2001: 47).

Member firms of a group are able to leverage their group's scale, scope, track record and reputation in moving up to higher modes of internationalization. Higher modes such as foreign direct investment require high resource commitments, financial as well as managerial. As affiliated firms can leverage on group's resources, they are better endowed compared to unaffiliated firms to pursue committed internationalization. Group affiliation could confer a number of benefits onto affiliated firms including pooling of resources, sharing information among members, sharing managerial resources, brand names and so on (Lamin 2006), which could be valuable as they embark on internationalization. Favourable group reputations help firms secure resources and customers by signalling superior quality and increasing confidence in a firm's products and services (Fombrun 2005). Business groups may also have affiliates in foreign countries and they serve the role of strategic networks providing member firms with access to information, knowledge, resources, markets and technologies (Elango & Pattnaik 2007). Thus affiliation to business groups seems to affect in important ways internationalization processes of firms in emerging economies, where business groups are widely prevalent, but our current understanding of their effects is quite limited.

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Conclusion

The above three distinctive features which we chose to elaborate in this paper are only a few of the many unique aspects that characterize the internationalization of emerging economy firms. Our brief review in turn leads to several research questions that could throw further light on this interesting phenomenon of emerging economies and emerging multinationals. Why do some firms resort to *exploration* and build a distinctive set of capabilities in addition to exploitation, while some others focus only on *exploitation* of their idiosyncratic capabilities? Could the primary driver for the exploratory behaviour as opposed to exploitative behaviour be attributed to differences in the leadership or managerial intentionality of the firms? What is the role of institutional changes that characterize emerging economies in driving the internationalization choices of firms located in these economies? Child and Rodrigues (2005:405) argue that 'the interaction between the institutional

legacies of developing economies and the dynamic capabilities of their corporate entrepreneurs will be crucial for understanding the internationalization strategies that the latter pursue'.

Organizations are forever caught in a dilemma between exploitation of existing products, markets and capabilities and exploration of new products, markets and capabilities. This dilemma between exploration and exploitation is particularly severe for emerging market firms and no empirical studies have examined this issue thus far. Do internationalizing emerging market firms face different concerns and challenges in striking a balance between exploration and exploitation of 1) products 2) geographic markets 3) consumer markets 4) resources and capabilities? How do these firms resolve this dilemma of striking a balance? What factors determine the relative balance or imbalance? What is the linkage between this balance and performance?

While the extant research clearly establishes the important influence of business groups, the actual direction of their effect on internationalization as well as performance is inconclusive (Gaur & Delios 2006). Could this be due to too broad a classification in our conceptualization and empirical testing of business group effects? It is conceivable that different types of business groups (more diversified versus less diversified, family managed versus professionally managed, those with and without their own internal markets for labour and finance etc.) with differential resource endowments and organizational structures may exhibit unique outcomes. Is it high time then to dissect business groups and classify them into homogenous sub-clusters such that their differential effects can be untangled and measured?

Lastly, we see an important need to analyze the role of overseas acquisitions in pursuing internationalization and performance of emerging economy firms. A large number of studies have dealt with the relationship between overseas acquisitions and firm performance, but only a few studies (Gubbi et al., forthcoming) have examined the relationship in the emerging economy context, given the relatively recent emergence of the phenomenon. Could there be a significant difference in their motives when compared to developing economy firms and does their value creation potential differ in the context of emerging economies? These are but some of the innumerable directions that new theorization can take in the context of internationalization of emerging economy firms.

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