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# Regional and product diversification and the performance of retail multinationals

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ABSTRACT

Despite the importance of geographic expansion in the services sector, few studies have analyzed the relationships between regional diversification, product diversification and performance for services firms. Here, we focus on experiential learning benefits and managerial complexity to investigate whether and how firms in the retail sector may benefit by expanding their activities within and across regional boundaries. Using panel data of 65 large European retailers from 19 countries for the period between 1997 and 2010, we find that intra-regional diversification has an inverted S-curve relationship and inter-regional diversification has an S-curve relationship with firm performance. Moreover, the results show that product diversification has a negative moderating effect on the relationship between inter-regional diversification and firm performance. Overall, these results add support in the services sector for the three-stage paradigm of international expansion and firm performance.



## 1. Introduction

Of the *Fortune Global 500* firms, 242 firms are manufacturing firms, 111 firms are financial firms, 100 firms are services firms and 47 firms are utility firms, based on their listed main industry sectors in 2012. The combined revenue of the 100 services firms was $5431 billion U.S. It is evident the services sector makes up a substantial part of the global economy, and its rapid growth deserves more scholarly attention (Kundu and Merchant, 2008).

Among these 100 services firms, 45 are from the retail sector and have a combined revenue of $2627 billion U.S. This is an increase from 2003 when there were 40 firms with a combined revenue of $1399 billion U.S. Most of these retail firms are multinational enterprises (MNEs), but their international footprint is relatively weak compared to MNEs in manufacturing industries (Rugman and Oh, 2010; Corstjens and Lal, 2012). According to Rugman and Girod (2003), retail MNEs mainly focus on their domestic markets or home-region markets.

The high capital intensity and location specificity in the retail sector lead to this focus on home-region markets (Campbell and Verbeke, 1994; Rugman and Verbeke, 2008). While manufacturing firms are able to internationalize sales by exporting products to foreign markets, retail firms need to significantly invest in the development of a store network to sell products in foreign markets. Building a network of retail stores involves selecting and managing local real estate, suppliers, human resources and logistics channels (Corstjens and Lal, 2012). Moreover, retail firms need to develop a deep understanding of shopping behaviors in foreign markets,

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beyond purely product-related consumer preferences (Levy and Weitz, 2008). Effectively managing an international store network and understanding foreign customers are important determinants of the success of retail MNEs.

A key question both academic scholars and managers may ask in regard to retail firms' relatively weak international activities is whether and how they may benefit by spreading their retail operations within and across regional boundaries. In other words, what are the performance implications of intra- and inter-regional geographic diversification of retail MNEs? Previous research on the relationship between geographic diversification (or multinationality) and firm performance provides important guidance to answer this critical question. In particular, the three-stage paradigm of internationalization (Contractor et al., 2003) generalizes different arguments and findings, and implies that the performance of MNEs may depend upon their international trajectory. The three-stage paradigm is particularly relevant in the retailing context because retail firms typically follow an internationalization process: domestic expansion is followed first by expansion into primary international markets and then may follow into secondary and tertiary markets that are less culturally, economically, and geographically proximate (Alexander and Myers, 2000; Dawson, 2001).

Since retail MNEs follow a pattern of regional focus and internationalization process, this study integrates the three-stage theory of international expansion (Contractor et al., 2003) with the regional MNE framework (Rugman and Verbeke, 2004) to build on and extend earlier research on the relationship between regional diversification and firm performance. We argue that in the context of retail MNEs, the nature of the relationship is an inverted S-curve and S-curve respectively. In the case of intra-regional diversification, we argue that while a retail firm may leverage the experiential learning acquired from its home country across neighboring countries, it may experience increased coordination and adaptation cost when it first enters into non-neighboring countries in the home region. Conversely, in the case of inter-regional diversification, the retail firm may immediately suffer from environmental complexity, experiencing substantial coordination and adaptation costs when it crosses regional boundaries. Notably these can be decreased with improved experiential learning in the foreign region. These differences generate different theoretical relationships for intra- and inter-regional diversification.

In summary, our study contributes to the literature in three ways. First, by integrating the three-stage paradigm and regionalization theory, we argue that performance implications of intra- and inter-regional diversification are different and can be mainly explained by the mechanisms identified in research on experiential learning and managerial complexity. Second, we analyze the interactions of these two types of geographic diversification with product diversification. Third, we extend the existing literature that focuses on U.S. manufacturing firms to European service (retail) firms, providing additional insight into both the three-stage paradigm and regional diversification.

Empirically, we estimated a dynamic panel data model using information on 65 leading European retailers for the period between 1997 and 2010, which totalled 351 observations. Our findings showed that intra-regional diversification of large European retail MNEs has an inverted S-curve relationship with performance, while inter-regional diversification has an S-curve relationship. Moreover, the results indicated that product diversification had a negative moderating effect on the relationship between inter-regional diversification and performance in the case of European retail MNEs.

## 2. Theory and hypotheses

The relationship between geographic diversification and firm performance has been a fundamental topic of research in international business. The topic has been advanced with different theoretical views and methodological applications. Studies in this area have attempted to improve theoretical explanations and boundary conditions about the geographic diversification–performance relationship (Hitt et al., 2006). Recently, a few studies have cast doubt upon the theoretical relationship between geographic diversification and firm performance (Hennart, 2007, 2011; Verbeke et al., 2009; Verbeke and Forootan, 2012). We agree with these studies in that the level of multinationality or geographic diversification may be determined by fundamental firm- and location-specific factors (Kirca et al., 2011; Asmussen and Goerzen, 2013; Rugman and Oh, 2013) and that such fundamental factors may eventually determine firm performance (Kirca et al., 2011; Verbeke and Forootan, 2012). Multinationality or geographic diversification is often used as a proxy of international competitiveness (Rugman et al., 2012). However, multinationality does provide additional intrinsic benefits and costs (Contractor, 2012; Kirca et al., 2011).[2] These intrinsic benefits include scale and scope economies, foreign knowledge and experience, market power, and risk reduction. The costs include coordination and monitoring costs. Scholars are still debating this topic and the results have yet to prove or disprove whether geographic diversification determines firm performance and whether geographic diversification has a mediating or direct effect on firm performance.

One major criticism about studies that examine a specific functional form of the internationalization–performance relationship is that firms may invest where they expect to make profits, and to disinvest if operations do not meet the firm's target rate of profitability. Consequently studies assert that unless managers of some firms suffer from a systematic bias, there should be no systematic and general relationship between international diversification and firm performance (Hennart, 2007, 2011). However, the literature on behavioral economics indicates that there are systematic biases that explain why managers may over- or under-diversify internationally over longer time periods. One such bias is that described by the sunk cost fallacy

[2] Indeed, taking a multinationality measure for a proxy of international competitiveness or considering the mediating role of multinationality in the relationship between firm-specific and country-specific factors and performance is a methodological issue. We used the GMM approach in order to reduce the potential of the endogeneity issue in operationalizing multinationality. It is also important to note that Rugman and Oh (2013) found that various multinationality measures are explained by home region, home country and industry factors, and firm factors explain only small portion (less than 5%) of multinationality. Thus, this finding explains that an optimal level of multinationality may exist, but may vary based on these factors.