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Wholly owned foreign subsidiary relation-based strategies in volatile environments

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ABSTRACT

Drawing from dynamic capability, institutional, nonmarket strategy, and social-network literatures, we detail wholly owned subsidiary (WOFSs) relation-based strategies (RBSs). We explain how deploying RBSs with key nonmarket and market actors will create competitive advantages for WOFSs operating in volatile emerging market environments. We posit that dynamic capabilities will drive the deployment of RBSs by WOFSs, and argue that the positive relationship between dynamic capabilities and RBS deployment will strengthen as perceived institutional uncertainty increases. We further suggest that the greater the strength and frequency of RBS deployment, the more likely that a WOFS will establish a combination of nonmarket-based and market-based embedded assets. Also, our theory proposes that greater integration of nonmarket-based and market-based assets will enhance WOFS financial performance outcomes. Implications for future research are discussed.

1. Introduction

Volatile environments represent a key source of instability and risk for multinational enterprise (MNE) subsidiaries operating in emerging markets[4] because they can constrain, sometimes arbitrarily, critical transactions, access to local resources, and business opportunities (e.g., Luo & Peng, 1999; Peng & Heath, 1996). While "hardly uniform" in nature, volatile emerging market environments (hereinafter "volatile environments") "all fall short to varying degrees in providing institutions necessary to support basic business transactions" (Khanna & Palepu, 1997, p. 41). For example, the volatile environment in the Philippines has been characterized by different dimensions of its formal institutions fluctuating substantially (often in diverging directions) over time with regard to control of corruption, political stability, regulatory quality, rule of law, and government effectiveness (see generally Kaufmann, Kraay, & Mastruzzi, 2007).[5]

When operating in such environments, MNE subsidiaries are governed by host government institutions that fashion the formal rules of the game which determine the reward structures and character of commercial activity (Hillman & Hitt, 1999; North, 1990; Rosenzweig & Singh, 1991; Xie, Zhao, Xie, & Arnold, 2011). Laws and regulations established by host governments in volatile environments will, due to their coercive pressures, often dominate transactions (Hoskisson, Eden, Lau, & Wright, 2000; Rodriguez, Uhlenbruck, & Eden, 2005). This is particularly the case for wholly owned foreign subsidiaries (WOFSs)[6] established to protect

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[4] Emerging markets are defined as countries in periods of rapid growth with "structurally changing industries, promising but volatile markets, weak legal protection systems, and ... regulatory framework[s] [undergoing] drastic transformations" (Hoskisson et al., 2000; Luo, 2007, p. 42). Emerging markets, including transition economies such as China and Russia, consist of a broad range of countries including Brazil, Egypt, India, Indonesia, Mexico, the Philippines, and Turkey (MSCI Barra, 2009).

[5] The context of this study is volatile emerging market environments. Further, we focus specifically on the institutional (and nonmarket) aspects of volatility, rather than irregular financial crisis or natural disasters, in these environments. Such volatilities can exist in other more developed economies. However, developed economies are outside of the scope of this particular study. We thank an anonymous reviewer for making this observation.

[6] A WOFS is a subsidiary located in a foreign country that is entirely owned by a multinational enterprise (Li, Yang, & Yue, 2007; Peng, 2009).

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valuable proprietary resources through structural integration (via complete ownership and management control) (Feinberg & Gupta, 2009; Peng, 2009) for the purpose of extending the reach of the MNE into untapped markets (London & Hart, 2004) and/or accessing local resources that are either too costly or unavailable elsewhere (Nachum & Zaheer, 2005).

Because WOFSs are a form of market entry that are structurally integrated and have greater control over their activities and assets (e.g., the protection of intellectual property) than other modes of entry (Feinberg & Gupta, 2009), some will look for ways to create competitive advantages by developing subsidiary-specific skills and competencies that afford access to location specific resources available in volatile environments (Krueger, 1974). These capabilities are multifaceted in nature and involve deploying resources that allow the subsidiary to sustain competitive advantages (Andersson, Forsgren, & Holm, 2002). More specifically, strategic considerations concerning resource deployment by WOFSs are contingent on the building and exploitation of dynamic capabilities.

We suggest that WOFSs building dynamic capabilities will exploit location specific organizational resources and routines in order to adapt to the local environment through the use of relation-based strategies (RBSs). RBSs are a unique combination of market-based (Srivastava, Shervani, & Fahey, 1998) and nonmarket-based strategies (Baron, 1995a), and are formulated by establishing informal relational ties with local actors (e.g., government authorities and local business community) in the host country where they are operating (Hillman & Wan, 2005; Kostova & Roth, 2003; Li, Poppo, & Zhou, 2008; Srivastava, Shervani, & Fahey, 1999). It is our contention that the deployment of RBSs will lead to the creation of market-based and nonmarket-based assets (i.e., an organizational expertise in interacting with local actors) (Bonardi, 1999). We argue that the coordination of these assets are vital for WOFSs deciding to create embedded asset structures (in order to fill voids) for the purpose of enhancing viability and long-term financial performance outcomes (Peng & Heath, 1996). WOFSs that deploy RBSs will be able to achieve these ends by aligning their nonmarket-based and market-based strategic competencies through relatedness to and embeddedness in volatile environments (Peng, Lee, & Wang, 2005). However, not all WOFSs will possess the dynamic capabilities necessary to deploy RBSs in volatile environments. This leads us to ask the following questions: (1) what are WOFS dynamic capabilities and RBSs? (2) why do some, but not all, WOFSs build the dynamic capabilities necessary to deploy RBSs in volatile environments?, and (3) how will the deployment of RBSs impact WOFS performance?

In our conceptualization, we propose that some, but not all, WOFSs will build the dynamic capabilities necessary to deploy RBSs in a volatile operating environment. However, those that do build dynamic capabilities and deploy RBSs will have the potential to create preemptive advantages via relational ties with local actors, functioning as market-based (e.g., Srivastava et al., 1998) and nonmarket-based assets (e.g., Bonardi, 1999), to optimize long-term financial performance outcomes (Peng et al., 2005). We argue that the perception of highly uncertain institutions in volatile environments will strengthen the relationship between WOFS dynamic capabilities and RBS deployment, and that greater deployment of RBSs will strengthen the link between WOFS dynamic capabilities and embedded assets. We further advocate that the integration of market-based and nonmarket-based embedded assets will result in superior sustained competitive advantage, leading to improved financial performance for WOFSs.

We contend that the combination of RBSs will act as an embedded asset structure that, if properly deployed, will positively influence financial performance of WOFSs by filling perceived institutional voids in volatile environments. Some studies have indicated that relational networks have had a positive impact on organizational performance (e.g., Park & Luo, 2001); while others have argued that the importance of relationships has been overstated (e.g., Chung, 2006). Yet, the literature has failed to specifically address the theoretical underpinnings associated with antecedents and performance outcomes of WOFS RBSs acting as both market-based and nonmarket-based embedded asset structures in a volatile environment.

This paper extends our understanding of the factors influencing WOFS RBS deployment, as well as subsequent financial performance outcomes, by drawing from dynamic capability, institutional, nonmarket, and social-network literatures to create a theoretical framework for inquiry. We set-out to add to the literature and existing theory by exploring and addressing how RBSs play a role in WOFS strategic behavior in volatile environments. This includes bridging the gap that currently exists between the social network and nonmarket strategy literature, as well as offering a theoretical model that considers the strategic effects of coordinating market-based and nonmarket-based assets. We depart from prior literature in at least four ways. First, we theoretically explore how dynamic capabilities are strategic antecedents of RBSs. Second, we consider how perceptions of (and variance in) characteristics concerning uncertain institutions moderates the link between WOFS dynamic capabilities and RBS deployment. Third, we discuss the impact that RBS deployment will have on the establishment of market-based and nonmarket-based embedded asset structures. Fourth, in heeding the call by Bonardi, Hillman, and Keim (2005, p. 411) to better investigate "how economic and political resources and capabilities can be integrated, as well as the potential costs of integration", we explore how strategic integration of WOFS nonmarket-based and market-based assets will result in superior sustained competitive advantage, culminating in greater financial performance. We consider these strategic market-based and nonmarket-based assets to be interactive and evolutionary in nature, where resources necessary to deploy RBSs are evaluated on a constant basis. To date, these important issues have yet to be fully explored in the international business literature.

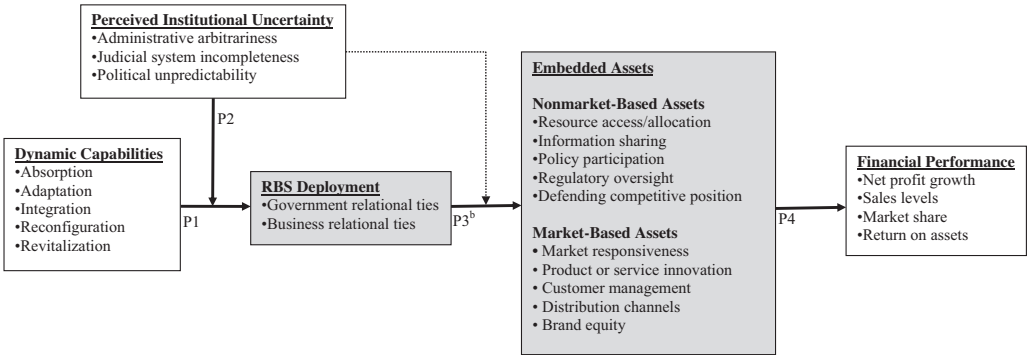

Fig. 1. A model of WOFS relation-based strategies in volatile environments.