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Strategic complexity and global expansion: An empirical study of newcomer Multinational Corporations from small economies

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ABSTRACT

The purpose of this paper is to analyse the determinants of global expansion strategies of newcomer Multinational Corporations (MNCs) by focusing on Iceland, Israel and Ireland. We argue that newcomer MNCs from small open economies pursue complex global expansion strategies (CGES). We distinguish four different types of global expansion strategies, namely, horizontal, vertical, lateral integration, and risk diversification. Building upon the traditions of Caves and Dunning and applying a multinomial logistic approach, we model CGES as a function of firm and country specific factors. The empirical evidence suggests that newcomer MNCs move away from simplistic dualities in the formulation of their strategic choices towards more complex options as a means of maintaining and enhancing their global competitiveness.

1. Introduction

Data indicate that small open economies, such as Estonia, Ireland, Iceland, Israel, have emerged as dynamic newcomer generators of outward foreign direct investment (OFDI) alongside other mature small economies such as Singapore, Norway, Austria and Denmark (UNCTAD, 2008). There is considerable evidence that there are certain common characteristics of small open economies (Bellak & Cantwell, 1998; Dunning & Narula, 1996; Freeman & Lundvall, 1988; Van Den Bulcke & Verbeke, 2001; Van Hoesel & Narula, 1999) that cause their firms to be more globalized than firms from larger countries (Buckley & Ghauri, 2004; Narula & Dunning, 2000). Firms from these countries tend to be competitive in a few niche sectors. Small countries tend to face market size constraints and limited resources (most notably human capital) and prefer to engage in activities in a few targeted sectors rather than spread resources thinly across several industries (Benito, Larimo, Narula & Pedersen, 2002). The limited domestic market size means that, if such firms are to achieve economies of scale in production, they must seek additional markets to those of their home location in order to increase their target market (Bellak & Cantwell, 1998; Narula, 1996; Walsh, 1988). Firms from small countries also have access to fewer kinds of created location advantages at home. Their infrastructure and national business systems tend to be focused on fewer industrial sectors. As firms need to maintain competencies in several areas with products becoming increasingly multi-technological in nature (Granstrand, Patel, & Pavitt, 1997; Krugman, 1998), Multinational Corporations (MNCs) from small economies tend to be more aggressive in order to capitalise on investing opportunities outside their home market. Among more mature developed small economies, Switzerland and the Netherlands have for many decades had firms with overseas sales representing a vast proportion of their total operations, such as Nestlé, Roche Group and Philips Electronics.

At the same time, the investment choices of many MNCs today are by far more complex. Grossman and Hart (1986) conclude that MNCs can pursue more complicated international integration strategies determined by factors such as transport costs, productivity and the relative size of the host market. Delios, Xu, and Beamish (2008) emphasize the importance of the network of subsidiaries in product diversification and highlight the importance of the characteristics of host-country markets as well as the corporate strategy in understanding the extent and direction of

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product diversification. Thus, the determination of strategic choices of MNCs depends both on internal – firm level – and external environment, i.e., location factors (Dunning, 1993, 1998; Markusen & Maskus, 2001; Narula & Dunning, 2000).

Table 1
Definition of complex global expansion strategies.

	Parent	CGES
Foreign unit	Same primary industry	Horizontal integration
	Natural resource industries	Vertical integration
	Operate in the same industry/different stages	Lateral integration
	Unrelated industries	Risk diversification

Source: Lexis Nexis Corporate Affiliations Directory, 2008 (authors' specification).

The main purpose of this paper is to investigate the location and firm-level determinants of the global expansion strategies (defined as the decision choices made in entering an increasing range of markets) of newcomer MNCs from small open economies that have recently emerged as outward foreign direct investors. In doing so, we attempt to fill several significant gaps in the literature. First, we provide evidence on the complexities and determinants of expansion strategies of newcomer multinationals from emerging small open economies. Whilst some evidence exists of the behaviour of multinationals from more mature small economies, the emerging small open economies have not received yet significant attention in the literature. In this paper, we focus on Iceland, Ireland and Israel. All three countries, are small open developed economies, ranked among the top 20 outward investors in 2006 and 2007 (UNCTAD, 2008). Further, their MNCs are emerging as dynamic competitors in the international investment scene with a diversified geographical and product portfolio. Second, we differentiate between several global expansion strategies that derive from international business and industrial organization theories. To our knowledge no prior systematic investigation has been conducted that addresses this issue in an integrated framework. Finally, we explicitly model the effect of a number of firm and location specific determinants of MNCs' global expansion strategies, thus providing evidence of the importance and differential effect of these determinants on such strategies.

The rest of the paper is organized as follows: in the next section we review the relevant theoretical and empirical literature, and develop our hypotheses; we then proceed with the discussion of the data and methodology followed by the reporting and discussing of the econometric results. Finally, we conclude with implications and managerial relevance of our results.

2. Theories and determinants of global expansion strategies

In the relevant international and strategic management literature it has been widely acknowledged that the network of overseas units is the main vehicle for MNCs to pursue their global strategies (Bouquet & Birkinshaw, 2008; Rugman & Verbeke, 2001). Thus MNCs, in order to meet the challenges of global competition, "follow complex integration strategies" (Yeaple, 2003, p. 312) and opt for heterogeneous forms of organization among their overseas units.[5] Furthermore Faeth (2009), in critically developing a thorough review of FDI determinants and theories, concludes:

> "*Therefore, FDI should not be explained by single theories but more broadly by a combination of ownership advantages or agglomeration economics, market size and characteristics, cost factors, transport costs and protection and risk factors and policy variables. Many empirical studies have already taken that approach, even when focusing on specific theories or aspects of FDI*." (Faeth, 2009, p. 188).

In this spirit, and following an integrated approach towards the understanding of FDI determinants, we build upon the traditions of Caves (1971, 1974) and Dunning (1980, 2000) and argue that FDI activities by MNCs are explained by a synthesis of different firm- and location-level determinants (as developed and empirically tested in the existing literature). We postulate a varying explanatory power of the diverse ownership and location determinants on different global expansion strategies.

Departing from the aggregate perspective of FDI, we distinguish among four different global expansion strategies of MNCs: horizontal or market-seeking strategies, i.e., the duplication of the home-market activities of the firm in foreign locations (Caves, 1996); vertical or resource-seeking and lateral or efficiency-seeking strategies, i.e., investment in resource-seeking operations, ranging from natural resources to lower-cost inputs, and the location of different stages of the production process, respectively (Grossman & Hart, 1986; Helpman, 1985); as well as risk diversification strategies, i.e., the location of business activities in a number of markets in the pursuit of new competences in the form of new knowledge and risk aversion (Caves, 1996; Rugman, 1977).

In order to identify the four types of global expansion strategies at an overseas unit level we adopted Palepu's (1985) approach. We related the industrial specialization of the overseas unit to that of its ultimate parent (see Table 1) by using the four-digit SIC classification for each overseas unit and that of its ultimate parent. This permitted us to differentiate more accurately between the production profiles of overseas units and, at the same time, to be able to consolidate observations with common characteristics, i.e., group overseas units with common production profiles (Haskel, Pereira, & Slaughter, 2007; Liu, 2008).[6] Based on this, the strategy is deemed to be *horizontal integration* if the overseas unit operates in the same 4-digit SIC industry as its parent. *Vertical integration* captures overseas foreign units specializing in natural resource industries, independently of the core 2-digit SIC industry of the parent, whilst *lateral integration* captures foreign units whose 4-digit SIC industry corresponds to different stages of the value chain, forward or backward, compared to the 4-digit SIC the main industry the parent is operating in (Hanson, Mataloni, & Slaughter, 2005).[7] Finally, we identify a fourth strategy, namely *risk diversification*, if the overseas unit and its parent operate in unrelated industries, i.e., overseas units and the parent are specialized in different 2-digit SIC industries (Hobdari, Sinani, Papanastassiou, & Pearce, 2010).

In the following sections we analyse the firm and location determinants of global expansion of MNCs around the differentiating forces of horizontal, vertical, lateral and risk-oriented diversification strategies.

2.1. Horizontal and vertical integration expansion strategies

Markusen and Maskus (2001) note that the choice between vertical and horizontal production structures basically depends

[5] See Feinberg and Keane (2001, 2006) for detailed empirical evidence on observed variation of US–Canadian affiliates.

[6] Doukas and Kan (2008) point out that 2, 3 and 4-digit SIC levels have all been used, and argue in favor of the application of 2-digit SIC levels in order to show industry relatedness within diversified firms and thus to distinguish between core and non-core business segments.

[7] See Kahle and Walkling (1996) for arguments for and against the use of different SIC digit levels as well as the potential problems arising to empirical research.