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Environmental risks, localization and the overseas subsidiary performance of MNEs from an emerging economy

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ABSTRACT

Despite the fact that multinational enterprises (MNEs) from emerging economies invest actively in host countries with substantial risks, we have limited understanding of how they manage environmental risks to achieve desirable performance in their overseas subsidiaries. Drawing on resource dependence theory, we argue that different localization strategies serve as a mediating mechanism linking environmental risks and overseas subsidiary performance. Our findings based on a sample of Chinese MNEs show that industry risks significantly reduce the levels of input localization and marketing localization of Chinese MNEs' subsidiaries, and thus negatively affect subsidiary performance. Political risks have an insignificant impact on input localization and marketing localization, but a positive direct impact on Chinese MNEs' overseas subsidiary performance. We also find that state-owned MNEs' localization strategies are more sensitive to industry risks compared with privately owned MNEs.

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1. Introduction

Outward foreign direct investment (FDI) is being increasingly adopted as a key expansion strategy for firms from emerging economies (EEs) (Buckley et al., 2007; Cui and Jiang, 2012; Lu, Zhou, Bruton, & Li, 2010; Rui and Yip, 2008; Wang, Hong, Kafouros, & Wright, 2012). This strategy, however, is associated with several difficult challenges because of the heightened international exposure, competition and additional environmental risks present in foreign host countries (Elango, 2009; Lu, Liu, Wright, & Filatotchev, 2014; Jimenez and Delgado-Garcia, 2012). Environmental risks in host countries, such as political and industry risk, represent uncertainties and potential threats for multinational enterprises (MNEs) (Cuypers and Martin, 2010; Henisz, 2000, 2002). While much research in this area has found that environmental risks negatively affect firm performance (Chan, Isobe, & Makino, 2008; Cuervo-Cazurra, 2006, 2008; Deephouse and Wiseman, 2000; Habib and Zurawicki, 2002; Lambsdorff, 2003; Makino, Isobe, & Chan, 2004; Wei, 2000a,b; Veliyath and Ferris, 1997), several studies have also shown that environmental risks, especially political risks, can also present opportunities for MNEs with the political capability to proactively manage such risks for competitive advantage (García-Canal and Guillén, 2008; Jimenez and Delgado-Garcia, 2012). However, previous research has focused on the direct impact of environmental risks on subsidiary actions and performance through the lenses of institutional theory or transaction cost theory (e.g., Ahlstrom, Bruton, & Yeh, 2008; Chan et al., 2008; Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004). How MNEs respond to the external environment risks has been relatively under-explored (Makino, Lau, & Yeh, 2002). More specifically, we know relatively little about the mechanisms through which environmental risks impact subsidiary performance of MNEs.

In addition, extant research has tended to focus on how MNEs from more developed economies, such as the United States (U.S.), Europe and Japan cope with environmental risk when operating in host countries (Elango, 2009; Elango, 2009). However, fewer studies have examined how emerging economy MNEs (EMNEs) deal with such risks when venturing abroad. There is a need to delineate the path from environmental risks to the subsidiary performance of EMNEs, given that EMNEs originating from underdeveloped institutional environments may respond to environmental risks differently compared with established MNEs from developed countries (Luo and Tung, 2007; Makino et al., 2002).

To address these research gaps, we adopt the resource dependence perspective (Pfeffer and Salancik, 1978) to address the following research question: How and to what extent do

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localization strategies adopted by EMNEs in host countries mediate the impact of environmental risk on subsidiary performance? We propose that localization can act as an intermediate factor between environmental risks and subsidiary performance. Specifically, we focus on two aspects of localization, input localization and marketing localization, and their relationships with two environmental risks, namely political and industry risks, and subsidiary performance.

This study thus contributes to theory by extending the existing MNE literature on risk and subsidiary performance in general, and EMNEs in particular, in a number of ways. First, our research extends resource dependence theory (RDT) to understand the extent to which localization strategies mediate the impact of environmental risks on subsidiary performance. The findings from our study provide new insight into mediating mechanisms and thus contribute to theory in opening the black box of these mechanisms (Dunbar and Ahlstrom, 1995). In particular, environmental risks' effect on resource exchanges between subsidiaries and local environments in a host country is examined through input and marketing localization strategies. By making a trade-off between autonomy and environmental dependence when facing environmental risks in host countries, EMNEs tend to use intra-organizational resources to reduce environmental dependence (Feinberg and Gupta, 2009). This aspect adds to our understanding of how EMNEs in the early stage of internationalization manage environmental dependence when facing environmental risks.

Second, we further extend the concept of localization beyond staff localization by considering a wide range of input and marketing localization. This helps broaden our understanding of localization and its implications for the relationship between environmental risks and subsidiary performance. Our research demonstrates that EMNEs' localization strategies are more complex than staff localization and represent an important mechanism of resource exchanges between subsidiaries and local environments in a host country. Different levels of input and marketing localization are not only associated with subsidiary performance, but also reflect environmental risks. This aspect thus adds a new dimension to empirical research in this area. Third, we investigate whether state-owned enterprises (SOEs) and private firms have different strategic responses to environmental risks and behave differently given their different political status, and this study sheds new light on ownership-related performance implications in internationalization from the resource dependence perspective. Finally, this research moves beyond examining the motivation for outward FDI and entry mode sections by EMNEs by focusing on the post-entry outcomes of EMNEs, given that relatively few studies have examined these outcomes. The findings help to provide new insights into the relationship between environmental risks and the subsidiary performance of EMNEs and add much needed empirical evidence on factors such as environmental risks, input and marketing localization which affect the post-entry success of EMNEs in host countries. Subsidiary performance represents the outcome of resolving the tension between minimizing environmental risks and exploiting the advantages of localization. This study thus provides additional insight into both theory and practice with respect to multinational enterprises from emerging economies—a sector that is of increasing importance in today's competitive landscape (Ahlstrom, 2015; Doh, McGuire, & Ozaki, 2015).

2. Theoretical background

Environmental risks in host countries represent key factors affecting subsidiary performance (Elango, 2009; Jimenez and Delgado-Garcia, 2012). This study examines two such types of risks—political and industry risks. The former refers to the instability and incompletion of the set of laws, regulations, administrative procedures and policies formally sanctioned by the government that impact on MNE subsidiaries (Cuervo-Cazurra, 2006, 2008; Delios and Henisz, 2003a). The latter mainly consists of the degree of industry competition, industry growth rates, and accessibility of production inputs and human resources (Luo 2003; Luo and Zhao, 2009; Porter, 1990). These risks include input-market uncertainties, product-market uncertainties and competitive uncertainties, and represent the influence of customers, suppliers and competition in a host country.

Environmental risks in a host country affect the stability of the market and cost of inputs, thus reducing the profitability of MNEs that operate in the host country (Henisz, 2000; Jensen, 2006). While prior research has recognized the direct impact of environmental risks on subsidiary performance (Cuervo-Cazurra, 2006, 2008; Deephouse and Wiseman, 2000; Elango, 2009 Habib and Zurawicki, 2002; Jimenez and Delgado-Garcia, 2012; Lambsdorff, 2003; Mitchell et al., 1992; Wei, 2000a,b; Veliyath and Ferris, 1997), what remains unclear is whether the strategic responses of MNEs mediate the relationship between environmental risks and subsidiary performance. Firms are not passive takers of environmental risks, and managers often adjust their strategies, such as localization, to align their subsidiary operations to the external environment in host countries. This implies that there may be a mediating path between environmental risks, localization and subsidiary performance.

2.1. Resource dependence theory, localization and international performance

We adopt RDT to examine the extent to which localization strategies mediate the environment-subsidiary-performance relationship. RDT proposes that, as open systems, organizations are dependent upon external environments to access critical resources, such as financial capital, production inputs and legitimacy to operate, survive and thrive (Oliver, 1991; Pfeffer and Salancik, 1978). Organizations are both supported and constrained by their external environments (Bruton and Ahlstrom, 2003; Garud, Jain, & Kumaraswamy, 2002). In RDT, the external environment in host countries constitutes a source of scarce resources sought by MNEs (Moran, 1985), and a dependency situation arises when MNE subsidiaries rely on crucial resources controlled by local possessors (Pfeffer and Salancik, 1978). 'Resources' in a broad sense include production inputs, marketing resources (e.g., distribution networks and consumer base), and information resources (Luo 2003; Moran, 1985) as well as money. Recognizing the active agency of environmental actors (e.g., individuals, firms, groups, or governments) on organizations (Dunbar and Ahlstrom, 1995; Garud et al., 2002), RDT theorists highlight the interdependence of firms with environmental actors and addresses how organizations respond to external environments and counteract the power of key resource holders in order to stabilize and better manage resource exchanges (Garud et al., 2002; Pfeffer, 1987). Pfeffer and Salancik (1978: p. 40) defined interdependence as a phenomenon that exists whenever one actor does not entirely control all of the conditions necessary for the achievement of an action or for obtaining the outcome desired from the action.

RDT has been adopted to examine a variety of inter-organizational arrangements, such as mergers and acquisitions (M&As), strategic alliances and long-term contracts (Casciaro and Piskorski, 2005; Deng and Yang, 2015; Haleblian, Devers, McNamara, Carpenter, & Davison, 2009; Hillman, Withers, & Collins, 2009; Pfeffer, 2003; Pfeffer and Salancik, 1978; Xia, 2010) and joint innovation (Christensen, 1997; Wang, Ahlstrom, Nair, & Hang, 2008). These inter-organizational forms are used to mitigate external resource dependencies. Managing resource dependencies

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