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Performance of professional service firms from emerging markets: Role of innovative services and firm capabilities

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ABSTRACT

Professional service firms (PSF) from emerging markets face a financial dilemma: PSFs tend to utilize high-wage labor, yet their emerging market status makes foreign clients cautious regarding quality and less willing to pay high prices. To allay these concerns, PSFs may be able to develop attractive, highly innovative services, but as the resource-based view (RBV) notes, this requires emerging market firms to possess critical capabilities to support such a competitive advantage. Relying on services theory, we propose that entrepreneurial orientation (EO) of management and expert human capital (HC) are critical capabilities, enabling a PSF to develop and market innovative services profitably. In testing our model on 201 Indian PSFs, we find a mediating role for innovativeness whereby EO and HC drive service innovation which, in turn, accounts for financial performance. Further, we find EO positively moderates the innovative service–performance relationship as proactive, risk-tolerant managers improve foreign marketing. Insights for theory and practice are provided that enable PSFs to overcome the constraints and challenges of their emerging market origin.

1. Introduction

In the last few decades, the global business environment has changed dramatically through the rise of emerging economies, liberalization of markets, and advancements in information and communication technologies. As a result, global services, especially professional services, have become one of the faster growing sectors of the world economy (Dotzel, Shankar, & Berry, 2013; Brock & Alon, 2009; Javalgi, Gross, Joseph, & Granot, 2011). Particularly important is the rapid growth of services in emerging markets such as India, where service contributions to GDP as well as service exports far outpace the global average (UNCTAD, 2015).

Often perceived as low-cost providers of basic services, many emerging market service firms are attempting to increase financial performance by climbing the value chain and are increasingly offering high-value, professional services (Milberg & Winkler, 2013). Professional service firms (PSFs) are specialized providers of knowledge-intensive, high-skill services that utilize a well-educated, professional workforce (Reihlin & Apel, 2007), and are traditional in fields such as law, accounting, management consulting, and engineering (von Nordenflycht, 2010). Reflecting the economic development of emerging markets, many emerging market firms are offering traditional professional services as they shift to higher-value offerings, attracted by the promise of higher profits and greater revenue associated with professional services (Gupta, Seshasai, & Ganguly, 2008).

Yet many of these professional service firms struggle to be profitable, as they confront economic problems associated with their emerging market origins (Javalgi & White, 2002) Emerging market firms face a financial dilemma as they move up the services value chain: PSFs encounter a rising cost structure because they intensively utilize higher-wage labor, yet their emerging market status weakens their pricing power to foreign clients who often are

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unfamiliar with and resist procuring professional services from emerging markets (Oshri, Kotlarsky, & Willcocks, 2011). Rising wage levels at home and price resistance from foreign clients who continue to associate India and other emerging markets with low-cost outsourcing threaten PSF profitability (Fairell, Noshir, & Sascha, 2005; Milberg & Winkler, 2013). To meet these challenges, some successful PSFs have developed capabilities to offer highly innovative services that provide unique, high-quality offerings that are differentiated from the traditional professional services of competitors. Importantly, the services literature (Lee, Ginn, & Naylor, 2009) recognizes that innovativeness of a service is crucial, since innovation tends to enhance financial performance by differentiating offerings, better satisfying user requirements through novel, high-value service solutions (Lowendahl, 2000).

Relying on the resource-based view (RBV), we propose emerging-market PSFs are able to innovate profitably to the extent they possess key firm-level capabilities, specifically management and labor inputs that both develop and deliver competitive professional services in a way that overcomes foreign client resistance (Javalgi et al., 2011). A PSF's ability to innovate successfully depends on its operant capabilities, the key resources that act on other resources to create value (Vargo & Lusch, 2004). Operant capabilities involve management and front-line labor resources that enable PSFs to develop innovative services and aggressively seek out foreign clients. Traditionally, orientations of business managers in emerging markets such as India have been conservative, tradition-bound, and focused on conventional business practices and processes (Virmani, 2007). In contrast to traditional management, entrepreneurial management is thought to be a more productive operant resource since entrepreneurial managers are better able to exploit business opportunities in emerging and developed markets (Oviatt & Mcdougall, 2005; Naman & Slevin, 1993). As for labor capabilities, the traditional comparative advantage of emerging market service providers was competent, low-cost human capital (Milberg & Winkler, 2013). To implement an innovative professional service strategy, many emerging market PSFs have upgraded their human capital, increasingly hiring high-skilled, high-wage employees and investing in state-of-the-art training (Oshri et al., 2011).

We ask the question: "How do operant capabilities of managerial and labor resources enable emerging market PSFs to compete profitably in global markets for professional services?" Specifically, we examine the entrepreneurial orientation of management and the expertise of human capital as necessary for emerging market PSFs to derive financial benefits from developing and delivering innovative professional services. However, this investigation is not straightforward since prior empirical evidence yields mixed results for the relationship between these two firm-level capabilities and financial performance. While some researchers (Hult, Hurley, & Knight, 2004; Zahra & Garvis, 2000) find a positive relationship between entrepreneurial orientation and profitability, other studies report weak or no effect of entrepreneurial orientation on performance (*e.g.*, Atuahene-Gima & Ko, 2001; Slater & Narver, 2000; Jantunen, Puumalainen, Saarenketo, & Kyläheiko, 2005). As for human capital, some researchers (Sels et al., 2006; Ling & Jaw, 2006) find that human resource intensity enhances profitability. Others (Fung, Xu, & Zhang, 2007) find that proxies of human capital are either not linked to a firm's return on assets or negatively linked to financial performance. Overall prior findings are mixed, suggesting the relationship between operant capabilities and performance is complex, leaving unresolved the specific way entrepreneurial orientation and human capital create value for emerging market PSFs.

The current research makes three important contributions to the international business literature on services in the context of knowledge-based, professional service enterprises in emerging markets. First, we not only recognize the central role of service innovativeness, but also develop a conceptual model that draws from the resource-based view (RBV) of the firm and links PSF capabilities, innovativeness of service offerings, and financial performance. We explain how the unique context of emerging markets constrains a PSF's ability to engage successfully in an innovative service strategy, challenging the firm's capabilities to develop and execute the strategy profitably. Second, we explain how key PSF resources (*i.e.*, management and labor capabilities) are operant resources, meaning they influence financial performance indirectly by enabling a PSF to develop and market innovative service offerings. Our contribution lies in empirically demonstrating that the PSF capabilities–financial performance relationship is mediated by the innovativeness of a firm's service offerings. Third, we propose that financial payoffs from innovative service offerings are also contingent on PSF capabilities, demonstrating the need to efficiently implement an innovative service strategy to achieve profitability. We contribute by offering new theoretical insights into how and why operant capabilities may not directly drive financial outcomes for emerging market firms, but rather act as a moderator, enabling appropriately endowed PSFs to better develop and exploit their innovative service offerings.

2. Theoretical background

The resource-based view of the firm (RBV) builds on firm heterogeneity, attributing the development and maintenance of competitive advantage through innovation to firm-specific resources and capabilities (Ahuja & Katila, 2004; Leonard-Barton, 1992). The basic premise is that resources and capabilities increase the efficiency and effectiveness of firms in general (Barney, 1991), and the development of new products and services in particular (Rindova & Kotha, 2001; Smith, Collins, & Clark, 2005). A firm's ability to develop and capitalize on an innovative service strategy depends upon its operant capabilities which function as a firm's "core competence, the fundamental knowledge and skills of an economic entity that represent potential competitive advantage" (Vargo & Lusch, 2004: 5).

Theorists (Barney, 1991; Vargo & Lusch, 2008) suggest operant resources enable the innovative services offered by PSFs to be developed and implemented profitably, allowing firms from emerging markets to compete in global markets through effective service development and delivery. Two components of a firm's intangible capabilities that have been identified as most relevant to facilitating financial outcomes are human capital of front-line employees (Bollen, Vergauwen, & Schnieders, 2005; Subramaniam & Youndt, 2005) and the entrepreneurial orientation of management (Hult et al., 2004; Naman & Slevin, 1993). Based on prior research, we suggest entrepreneurial management and expert human capital are key firm-level capabilities, the operant resources crucial to a PSF's ability to engage in an innovative, professional service strategy.

According to the RBV, human capital, including tacit knowledge and specialized skill of employees, is usually acquired through personal experience and direct involvement (Prahalad & Hamel, 1990), and is specific to the context and profession (Ployhart & Moliterno, 2011; Szulanski, 1996; Szulanski & Jensen, 2006). Once acquired, human capital can build a sustainable competitive advantage because, as an operant resource, it can leverage a firm's ability to create value (Prahalad & Hamel, 1990; Teece, 1998), and the creation process is usually difficult to imitate or substitute (Barney, 1991). For PSFs, front-line employees endowed with the appropriate operational skills, tacit knowledge, and personal capabilities are fundamental to successfully executing a service strategy (von Nordenflycht, 2010).