Journal of International Management 21 (2015) 83–99

Contents lists available at ScienceDirect

Journal of International Management

Fox School of Business
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The relationship between product and geographic diversification: A fine-grained analysis of its different patterns

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ARTICLE INFO

Article history:
Received 7 July 2014
Received in revised form 23 February 2015
Accepted 23 February 2015
Available online 13 March 2015

Keywords:
Firm growth
Geographic diversification
Product diversification
Corporate strategy

ABSTRACT

This study seeks a richer and more complete understanding of the process of firm growth by making a more fine-grained distinction between (1) the different patterns of product and geographic diversification, particularly between entering new product and geographic markets compared to expansion in existing noncore product and foreign markets; and (2) between firms with different diversification experience, specifically between single-country single-industry firms, single-industry geographically-diversified firms, single-country product-diversified firms, and product- and geographically-diversified firms. It shows that short-run constraints compel firms to choose between entering new product markets and new geographic markets, within a given time period, and that prior experience in entering new markets lessens the impact of short-run constraints on firm capacity to simultaneously extend product and geographic scope. Furthermore, it reveals that there is a significant difference between firm capacity to enter simultaneously into new product and geographic markets, compared to firm capacity to expand simultaneously within existing noncore product and foreign markets. Thus, it demonstrates the main argument of this paper concerning the importance of distinguishing between the different patterns of product and geographic diversification.

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1. Introduction

Over the last 50 years, since the publication of Penrose's (1959) seminal book 'The Theory of the Growth of the Firm', the mechanisms that affect the process of firm growth have attracted the attention of both scholars and practitioners. Two important growth strategies that firms pursue to increase their profits are product and geographic (international) diversification (Hitt et al., 1994). Decisions about the extent of growth in a given time period along the product and geographic domains are central to corporate strategy. Accordingly, the diversification literature has devoted considerable attention to study the relationship between product and geographic diversification within a given time period (e.g., Caves, 1975; Denis et al., 2002; Kumar, 2009; Mayer et al., in press; Pearce, 1993; Rondi et al., 2003). That is, whether firms can simultaneously increase the product and the geographic domains within a given time period, or if they are forced to focus on a single domain (either product or geographic). Some scholars have argued that in a given time period the two activities make competing claims on the resources available to a firm for expansion, and, consequently, there is a negative relationship between the two domains (e.g., Caves, 1975; Kumar, 2009). Others have claimed that the two domains complement each other and found a positive association between them (e.g., Denis et al., 2002; Rondi et al., 2003). Recently, Mayer et al. (in press), have suggested that the relationship between growth along the two domains within a given time period is positive for firms with high prior diversification experience, and negative for those with low prior diversification experience.

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http://dx.doi.org/10.1016/j.intman.2015.02.002
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Product and geographic diversification may, in fact, consist of several different patterns including: expanded presence in existing noncore product markets, expanded presence in existing foreign markets, entering new noncore product markets (categories) in existing geographic markets (i.e., existing countries), entering new geographic markets with existing products, and entering new countries with new noncore product categories.[1] The distinction between these patterns is tremendously important, since each one involves a different level of departure from the firm's knowledge and resource base and implies different uncertainty and risk levels (Ansoff, 1965; Hutzschenreuter and Horstkotte, 2013; Penrose, 1959). For example, expanded presence in existing noncore product and/or foreign markets is mostly based on the replication of the firm's existing resources and routines, and thus, generally involves less risk and uncertainty compared to entering new markets which often requires building or acquiring entirely new resources and routines and is usually much more complicated and resource-consuming per dollar of expansion (Mishina et al., 2004; Nelson and Winter, 1982; Penrose, 1959; Pettus et al., 2010). Interestingly, the literature that has examined the process of firm growth within a given time period does not normally distinguish between the different diversification patterns mentioned above, particularly between entering new product and geographic markets compared to expansion in existing noncore product and foreign markets. In this paper, I argue that taking into consideration the various patterns of diversification can yield new insights and enrich our understanding of the process of firm growth. Moreover, I suggest that overlooking these patterns not only masks the exact relationships between the various components of product and geographic diversification, but also, as will be shown below, may lead to unjustified conclusions regarding the relationship between product and geographic diversification within a given time period.

This study takes the above distinctions into consideration and focuses on three research questions. First, it examines whether firms can simultaneously enter new product and new geographic markets in a given period (i.e., simultaneously enlarge their product and geographic scope), or if they are forced to focus on a single domain (either new product markets or new geographic markets). On the one hand, to the extent that a firm's (excess) resources allow it to enter simultaneously into several new markets and these resources are fungible across both new product and geographic markets, their presence may provide incentives for the firm to expand simultaneously along both domains. On the other hand, scholars have asserted that firms are subject to various short-run constraints, such as constraints on the replication and transfer of resources and restrictions on the development of new resources that are usually needed when entering a new market, which may limit the number and extent of new opportunities that they can undertake in a given time period (e.g., Cohen and Levinthal, 1990; Hashai, 2011; Penrose, 1959; Vermeulen and Barkema, 2002). These constraints may force a trade-off, within a given time frame, between entering new product markets and new geographic markets, leading to a negative relationship between the two. Thus this relationship provides important insights into whether short-run constraints play a more influential role in enlarging firm scope compared to incentives to expand such as exploiting (excess) resources. In addition, this study examines how firms cope with short-run constraints in entering new markets. Second, it examines whether prior experience in entering new markets lessens the impact of short-run constraints on firms' capacity to simultaneously extend their product and geographic scope. Third, this study examines whether there is a difference between firm capacity to simultaneously enter new product and new geographic markets, compared to firm capacity to simultaneously expand in existing noncore product and foreign markets. That is, it studies whether firm capacity to deal with short-run constraints is similar or different concerning entering new markets compared to expanding operations in existing noncore product and foreign markets.

To explore these issues, I use a database of U.S. public manufacturing firms. Because managerial decisions regarding the extent of growth along product and geographic domains within a given time frame are likely to be interrelated and are made simultaneously, I use the two-stage least squares (2SLS) approach that takes into account this simultaneity and potential endogeneity.

The results reveal a clear substitution between entering new product markets and new geographic markets, within a given time period (even after controlling for product market relatedness and country distance). That is, they show that while firms may have incentives to expand such as exploiting (excess) resources, the extent to which they can enlarge their scope in a given time period is limited by short-run constraints. The findings also show that firms tend to add a very low number of new markets within a two-year time window, often only one. This indicates that short-run constraints on entering new markets are usually sizable. Furthermore, the findings show that in those several cases where firms have simultaneously entered both new product and new geographic markets, only very few firms took the greater risk pattern of diversification and entered into new countries with new product categories. In most of these cases firms have added new product categories to existing geographic markets while entering new geographic markets with existing products. To some extent, this behavior helps firms cope with the short-run constraints.

The results also reveal that the probability to enter simultaneously into new product and new geographic markets is affected by prior experience in entering new markets. More specifically, prior experience in entering new markets lessens the impact of short-run constraints on firm capacity to simultaneously extend product and geographic scope. The results are consistent with Mayer et al. (in press) argument that prior diversification experience affects firm capacity to simultaneously enter new product and geographic markets. However, in contrast to their assertion that greater experience in product and geographic diversification will lead to a positive relationship between entering new product and new geographic markets, the results of the present study show that in the vast majority of cases, even firms with prior experience in entering both product and geographic markets do not simultaneously extend their product and geographic scope. The marked difference between the results of the two studies is, apparently, due to the fact

[1] Following, for example, Ansoff (1965), Kumar (2009), and Rumelt (1974) throughout this paper when discussing the product domain, I use the term 'core product market' to refer to a firm's 'main' product market (the market with the largest sales), while the term 'noncore product markets' refers to a firm's remaining product markets. This distinction is analogous to home and foreign markets in the geographic domain (when the core product market is analogous to the home market and noncore product markets correspond to foreign markets). Additionally, following the above scholars, I use the term diversification to refer to the process of entry and expansion in noncore product and foreign markets. That is, firm product and geographic diversification have two major elements: (1) entering new noncore product markets and/or new geographic markets (i.e., enlarging product and/or geographic scope); and (2) expanding operations in existing noncore product markets and/or in existing foreign markets (Hashai, 2011; Johanson and Vahlne, 1977).

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