



The impact of domestic diversification and top management teams on the international diversification of Chinese firms



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ARTICLE INFO

Article history:

Received 19 December 2012

Received in revised form 24 July 2013

Accepted 24 July 2013

Keywords:

Domestic diversification
International diversification
Top management team
Emerging economies

ABSTRACT

Despite increasing research on outward foreign direct investment (OFDI) by firms from emerging economies, our understanding of the relationship between domestic operations and international diversification of these firms is still limited. Using a unique dataset of Chinese listed firms, we examine the impact of domestic diversification on their international diversification. We find that international diversification is positively affected by firms' domestic industrial and domestic regional diversification. We also find that top management team (TMT)'s previous international experience strengthens the impact of domestic diversification on firms' international diversification, whereas TMT's prior political connections weakens the impact of domestic diversification on international diversification.

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1. Introduction

Interest in the globalization of markets is increasingly focusing upon the drivers of outward foreign direct investment (OFDI) from emerging economies (EEs) (Child & Rodrigues, 2005; Hennart, 2012; Liu, Xiao, & Huang, 2008; Lu, Liu, & Wang, 2011; Luo & Tung, 2007; Wang, Hong, Kafouris, & Boateng, 2012) due to the substantial increase of OFDI from EEs. In addition to the liability of foreignness, these “new multinationals” must deal with the liability and competitive disadvantage of being latecomers who lack the resources and knowledge to internationalize from an environment characterized by institutional voids (Guillén & García-Canal, 2009; Meyer, Mudambi, & Narula, 2011). Observing that EE MNEs had become a major source of FDI in the world, scholars tried to explain the motivations of OFDI from EEs (e.g., springboard in Luo & Tung, 2007 and escapism in Witt & Lewin, 2007). However, it is still a puzzle why some EE MNEs are capable of diversifying widely across countries while others are not.

Using the knowledge-based view (KBV) of the firm as the theoretical lens, we study the relationship between firms' domestic diversification and international diversification which has been underexplored in existing literature. We also consider how important contingency factors, notably international experience and political connections of a top management team (TMT), affect this relationship. Specially, we identify two distinctive aspects of EE MNEs for the study of the drivers of international diversification. International diversification is defined as the ‘number of different (foreign) markets in which a firm operates and their importance to the firm’ (Hitt, Hoskisson, & Kim, 1997, p. 767). First, domestic industrial diversification may enhance international diversification through development of expertise and knowledge in managing complex activities (Nadkarni & Perez, 2007). Second, large EEs have substantial inter-regional disparity and exhibit different levels of economic and institutional development, and protection for segmented regional markets introduces a distinctive context for domestic regional diversification that may provide a learning resource that fosters international diversification of EE firms (Yang, Leone, & Alden, 1992). For example, China is well known for regional diversity in income disparity, institutional differences and cultural diversity. Firms undertaking domestic regional diversification in this context may have built certain advantages which help them to expand abroad. However, the transferability of benefits from domestic industrial and domestic regional diversification experience to internationalization may be limited. The impact of domestic diversification on

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international diversification therefore likely depends on whether the advantage associated with domestic diversification can be transferred across borders or is location-specific (Meyer, Wright, & Pruthi, 2009).

More specifically, EE firms are distinctive in terms of the importance of knowledge associated with political connections of top management team (TMT) members that may not be transferable to international contexts. This deficit in commercial and international knowledge may create a barrier to transferring knowledge developed through domestic diversification. At the same time, several EEs have recently experienced a substantial inflow of “returnee executives”, or TMT members who have studied and worked in foreign countries and returned to EEs (Filatotchev, Liu, Buck, & Wright, 2009). In China, these returnee executives are called “sea turtles”. Studying and/or working abroad, they exit local networks and have no deep roots in the domestic political system and its web of personal connections and patronage. However, they often possess unique international knowledge built up from experiences abroad and global networks (Xiang & Shen, 2009). We argue that there are opposite moderating impacts of the knowledge embodied in these two types of TMT’s human capital on international diversification. TMT international experience may reinforce the positive impact of domestic diversification on international diversification, while political baggage may impede effective domestic learning in internationalization.

We therefore address the neglect of domestic diversification experiences in international diversification studies by providing insights into the impact of domestic industrial and regional diversification, and TMT characteristics on internationalization through OFDI in the context of EEs. We focus on two principal research questions: To what extent does domestic industrial and regional diversification affect the international diversification of EE firms? To what extent do international experience and political connections of TMT’s members moderate the impact of domestic industrial and domestic regional diversification on international diversification?

We make several contributions. First, we build theoretical links between domestic diversification and international diversification by EE firms and provide empirical evidence that strongly supports this relationship. We emphasize the impact of domestic industrial and regional diversification in EE has largely been neglected in the literature. As research on international diversification is an important domain both within strategic management and IB, we therefore contribute to both these literatures. Second, we link TMT’s characteristics and domestic diversification and investigate how they jointly affect international diversification of EE firms. We show that organizational knowledge established through domestic diversification is a necessary but not sufficient condition for international diversification as there are limits to how such knowledge and capabilities can be transferred to other contexts. It is then important to recruit individuals with the appropriate international experiences. We highlight that competitive advantages derived from TMT’s political connections are location-specific and difficult to leverage in international diversification, while TMT’s international experiences help EE firms conduct OFDI through leveraging domestically developed competitive advantages. These novel perspectives provide better understanding of the strategic behavior of “new multinationals” in EEs.

2. Theoretical framework and hypotheses

Previous studies argue that MNEs need firm-specific competitive advantages that can be applied competitively in a foreign country (Markides & Williamson, 1996). Compared to MNEs in developed economies (Meyer et al., 2011; Benito, Lunnan &

Tomassen, 2011), the “new multinationals” from EEs seem disadvantaged in terms of their resource endowments, and thus should have limited capacity for OFDI (Guillén & García-Canal, 2009). As latecomers in global markets, EE firms may lack accumulated internationalization experience compared to developed economy MNEs. The KBV proposes that knowledge is the firm’s most valuable strategic resource and the principal basis for creating competitive advantages (Kogut & Zander, 1992). Knowledge is a multi-dimensional organizational feature consisting of information, know-how and organizational capabilities (Grant, 1996). Firms may undertake international diversification to maximize knowledge-based assets in multiple locations without incurring the full costs of recreating them (Kogut & Zander, 1992; Martin & Salomon, 2003). We extend these arguments concerning the importance of knowledge for internationalization by suggesting that, despite their disadvantages, EE firms can build unique heterogeneous knowledge bases at home as a foundation for international diversification as previous strategic decisions generate “internal momentum” impacting future strategic behavior (Child & Rodrigues, 2005; Liu & Buck, 2009; Yang et al., 1992).

From the KBV, pursuing domestic industrial and domestic regional diversification strategies helps EE firms develop organizational knowledge for international diversification (Wiedersheim-Paul, Olson & Welch, 1978). These firms can learn at home how to invest abroad. Specifically, domestic diversification in EEs with fragmented sub-regional markets enables firms to create unique knowledge and develop organizational capabilities, including how to gain legitimacy and overcome the liability of ‘foreignness’ in other regions within the same country. This diversification allows firms to develop coordination skills and knowledge about how to manage increased diversity of domestic activities. This generic capability can underpin international diversification as it is built on similar knowledge bases relating to how to manage complex product portfolios and institutional variations. Hence, domestic diversification may serve as a stepping-stone to international diversification (Nadkarni & Perez, 2007; Tseng, Tansuhaj, Hallagan & McCullough, 2007).

However, this strategic experience may not be sufficient for international diversification. A resource constituting an advantage in one country may not present an advantage in another (Cuervo-Cazurra, Maloney & Manrakhan, 2007). This is particularly relevant to EE firms as their competitive advantages are even more home-country specific, given that they rely heavily on social networks and political ties to compete (Wright, Hoskisson, Filatotchev & Peng, 2005). Unfamiliarity with global markets and environments induces uncertainties and risks further hindering EE firms’ international diversification (Li & Meyer, 2009).

Therefore, managing business portfolio diversity at home and exposure to heterogeneous domestic environments helps develop knowledge and organizational capabilities for international diversification, but represents only one element of “market expansion ability” (Yang et al., 1992). Application of organizational knowledge to a new context is also related to TMT characteristics, including knowledge embodied in their human capital (Argote & Todorova, 2007; Gupta & Govindarajan, 2002). Two opposite types of knowledge underpinning EE business strategies are identified: “whom you know” versus “what you know” (Peng & Heath, 1996). These two types of knowledge are expected to have different impacts on international diversification through either enhancing or impeding learning capabilities associated with domestic diversification. Prior research has found that TMT’s characteristics, such as international experience and networks, affect international diversification (Athanassiou & Nigh, 2002; Hambrick & Mason, 1984; Reuber & Fischer, 1997). We go beyond the direct impact of TMT’s human capital by arguing that international experiences of TMT may enhance the impact of organizational knowledge

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