International Business Review xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

SME foreign market entry mode choice and foreign venture performance: The moderating effect of international experience and product adaptation

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ARTICLE INFO

Article history:
Received 4 February 2015
Received in revised form 11 May 2016
Accepted 18 July 2016
Available online xxx

Keywords:
SMEs
Entry mode choice
International experience
Product adaptation
Performance

ABSTRACT

Firms' foreign market entry mode choice attracts considerable research attention. However, the performance implications of this choice remain inconclusive, particularly in the context of small and medium-sized enterprises (SMEs). The present paper draws on the resource-based view (RBV) and develops a theoretical model specifically tailored to the context of SMEs in order to study the relationship between entry mode choice and foreign venture performance. Testing hypotheses on 133 German SMEs, we show that international experience as a resource and product adaptation as a capability improve the performance of non-equity entry modes by mitigating liabilities of smallness inherent to SMEs. We furthermore find empirical support for the joint moderating effect of international experience and product adaptation on the focal relation. Our findings contribute to the SME foreign market entry mode literature and have implications for practitioners and future research.

1. Introduction

Foreign market entry mode choice is an important strategic decision determining a firm's organizational structure when initially entering a host country market (Nakos & Brouthers, 2002). This choice can be classified into two categories: equity entry modes encompass direct investments into the host country (e.g., joint ventures or wholly-owned subsidiaries). Non-equity entry modes include direct and indirect exporting as well as contractual agreements such as licensing (Pan & Tse, 2000). Extant literature demonstrates that entry mode choices can have major performance implications (Brouthers, 2002; Chen & Hu, 2002). To this end, the advantages and disadvantages of the respective modes have to be taken into consideration (Shrader, 2001). That is, equity entry modes demand a higher level of initial resource commitment (Sharma & Erramilli, 2004), but facilitate greater closeness to host country markets and customers (Zahra, Ireland, & Hitt, 2000). Non-equity entry modes are less resource intense and provide greater flexibility to the firm (Brouthers & Nakos, 2004), while firms simultaneously lack market closeness impeding the monitoring of foreign market developments (Yeoh, 2004).

Two research deficits motivate the present paper. First, given the advantages and disadvantages of different entry modes, studies examining the foreign market entry mode choice and performance association obtain largely inconclusive findings. For example, a study finds joint ventures to be the best performing mode (Beamish & Banks, 1987), while other studies reveal greenfield operations to perform best (Nitsch, Beamish, & Makino, 1996; Woodcock, Beamish, & Makino, 1994), or do not find a significant direct influence on performance at all (Brouthers & Nakos, 2004; Rasheed, 2005). To contribute resolving inconsistent findings, prior literature began to examine the influence of moderating factors on the relationship between foreign market entry mode choice and performance incorporating the industry context (Anand & Delios, 1997), R&D and advertising intensity (Shrader, 2001), or environmental factors (Rasheed, 2005). While these studies provide valuable insights into the boundary conditions of the entry mode choice—performance relationship, there is a need to contextualize this association even further to advance existing theorizing regarding firms' resource deployment in internationalization (Crook et al., 2008).

Second, extant literature has largely focused on the performance implications of the foreign market entry mode choice of large MNEs (Anand & Delios, 1997; Pan & Chi, 1999) with comparably fewer studies focusing on SMEs (e.g., Lu & Beamish, 2001; Rasheed, 2005). However, SMEs differ from large MNEs in at

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http://dx.doi.org/10.1016/j.ibusrev.2016.07.003
0969-5931/

least three specific liabilities of smallness (Aldrich & Auster, 1986; Maekelburger, Schwens, & Kabst, 2012) that are likely to stress the entry mode choice—performance relationship. First, SMEs suffer from limited financial and personnel resources and the respective capabilities to employ these resources (Nakos & Brouthers, 2002), making them highly vulnerable to costly failures in foreign markets (Buckley, 1989). Second, SMEs often lack foreign market knowledge as they are less internationally diversified and possess fewer international engagements compared to their larger counterparts (Lu & Beamish, 2001). Third, SMEs are particularly sensitive to external challenges arising in the host country market (Brouthers & Nakos, 2004; Buckley, 1989).

The aim of the present paper is to investigate the relationship between SMEs' foreign market entry mode choice and foreign venture performance by drawing on the resource-based view (RBV; Barney, 1991; Wernerfelt, 1984). According to the RBV, resources and capabilities contribute to a firm's competitive advantage if they are valuable, rare, and hard to imitate or substitute (Barney, 1991; Barney, Wright, & Ketchen, 2001). The paper's main premise is that such resources and capabilities enable the firm to pursue strategies with greater efficiency (Ainuddin et al., 2007) by reinforcing the benefits of a firm's strategy while mitigating potential drawbacks (Ortega, 2010). Therefore, we study the efficiency (in terms of foreign venture performance) of foreign market entry mode choice (as a strategy) under particular consideration of the moderating impact of 1) *prior international experience* as a resource and 2) *product adaptation* as a capability enabling SMEs to mitigate their liabilities of smallness (i.e., drawbacks). International experience reflects the extent to which a firm and its management team have been previously engaged in international business (Burgel & Murray, 2000; Maekelburger et al., 2012) and constitutes tacit, firm-specific knowledge (Barney et al., 2001; Hennart & Park, 1993). Product adaptation is a firm's ability to adapt its products to foreign markets' idiosyncrasies (Cavusgil & Zou, 1994). We establish that international experience and product adaptation allow mitigating SMEs' lack of foreign market knowledge as well as their high sensitivity to external challenges in host country markets without overstretching their limited (personnel and financial) resources. To study the boundary conditions of the entry mode choice and performance relationship comprehensively, we examine the moderating influences of international experience and product adaptation (i.e., by employing separate two-way interactions) as well as their joint effect in a configurational model (i.e., by employing a three-way interaction).

Our paper offers three contributions to extant research. First, we contribute to theory advancement in the SME foreign market entry mode choice literature by drawing on the RBV and developing arguments for the moderating effect of international experience and product adaptation on the relationship between entry mode choice and performance. Prior SME entry mode choice studies drawing on resource-based argumentations are scant as recently identified as a research deficit (Laufs & Schwens, 2014). Given SMEs' liabilities of smallness (Aldrich & Auster, 1986; Maekelburger et al., 2012), the yet limited consideration of a resource-based perspective is surprising. We contribute to reducing this deficit by grounding our work in the RBV and developing theoretical mechanisms that are directly tailored to SMEs overcoming their liabilities of smallness.

Second, we advance extant literature by including a three-way interaction showing how a resource and a capability *jointly* affect the relation between entry mode choice and performance. By this means, we adhere to more recent advances of the RBV identifying a missing link between the possession of resources and their exploitation so as to impact a firm's competitive advantage (Eisenhardt & Martin, 2000; Newbert, 2007, 2008; O'Cass & Sok, 2012; Sok & O'Cass, 2011). This literature suggests that resources may only fully unfold their potential to increase firms' competitive advantage when coupled with appropriate capabilities to effectively exploit resources—an argument that we incorporate in our work by theorizing and empirically validating a configurational effect.

Third, contextualizing the relationship between entry mode choice and foreign venture performance contributes to reducing the inconclusive findings prevailing in the field. That is, we offer a more detailed understanding of the boundary conditions under which SMEs' entry mode choices enhance performance. In this regard, our study is consistent with and enhances prior literature contextualizing the relationship between foreign market entry mode choice and performance (Anand & Delios, 1997; Rasheed, 2005).

2. Theory

2.1. The resource-based view, entry mode choice, and the particularities of SMEs

The RBV considers a firm's valuable, rare, hard to imitate or substitute resources and capabilities as foundation of sustainable competitive advantages and, in turn, superior firm performance (Barney, 1991; Wernerfelt, 1984). According to Wernerfelt (1984), resources encompass the tangible or intangible strengths or weaknesses tied semipermanently to the firm. In contrast, capabilities are firm-specific abilities that combine firm resources to achieve a desired outcome (Amit & Schoemaker, 1993). Hence, capabilities constitute complex combinations of skills and knowledge that are embedded in firms' processes and routines with the purpose of directly or indirectly creating value for the firm (Grant, 1996; O'Cass & Sok, 2012). Capabilities are idiosyncratic due to their inertness (Kogut & Zander, 1992) and cannot be readily provided by markets (Teece & Pisano, 1994; Teece, 1982). Consequently, a major tenet of the RBV is that firms are heterogeneous regarding the resources and capabilities they possess while both are imperfectly mobile across firms (Barney, 1991). In turn, resources and capabilities enable firms to pursue strategies with greater efficiency (Ainuddin et al., 2007).

The foreign market entry mode choice determines a firm's organizational structure when initially entering a host country market (Nakos & Brouthers, 2002). One important distinction is between equity and non-equity entry modes (Pan & Tse, 2000), as both types differ regarding their inherent advantages and disadvantages (Shrader, 2001). That is, equity entry modes allow firms a greater closeness to foreign markets and customers (Zahra et al., 2000), but require significant managerial and financial resources in order to set up such foreign operations (Sharma & Erramilli, 2004). In contrast, non-equity entry modes require lower amounts of resources and provide greater flexibility (Brouthers & Nakos, 2004), but lack foreign market closeness (Yeoh, 2004). Entry mode decisions are critically important strategic decisions (Brouthers, 1995), as such choices are hardly reversible (Root, 1987) and have considerable performance implications (Brouthers, 2002; Chen & Hu, 2002).

Despite the importance of resources in SME entry mode choice, a recent literature review reveals a dearth of studies applying a resource-based perspective (Laufs & Schwens, 2014). This lack of RBV studies is particularly surprising given that SMEs typically suffer from liabilities of smallness (Aldrich & Auster, 1986; Maekelburger et al., 2012). First, they generally face scant financial and managerial resources and also lack the adequate capabilities to exploit these resources effectively (Nakos & Brouthers, 2002). Second, smaller firms typically have limited foreign market knowledge, as they often have a domestic focus with fewer international activities (Brouthers & Nakos, 2004). Hence, SMEs