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An empirical analysis and extension of internalization theory in emerging markets: The role of firm-specific assets and asset dispersion in the multinationality-performance relationship

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ABSTRACT

This study examines the relationship between firm multinationality and financial performance with a focus on firm-specific assets and dispersion of these assets for MNCs from emerging markets. Drawing upon internalization theory, the authors reveal that while the financial performance of manufacturing MNCs depends on technological assets, service MNCs are more dependent on marketing assets to succeed in international markets. Study findings further emphasize the critical role of the industry context in emerging markets as the authors demonstrate that international asset dispersion weakens the effects of internationalization on financial performance more for MNCs in manufacturing industries than for MNCs in services.

1. Introduction

According to internalization theory, the possession of firm-specific assets (FSAs) is a necessary condition for the successful internationalization of multinational companies (MNCs) (Buckley & Casson, 1976). Internalization theory predicts that firms choose the most cost-effective foreign locations for specific MNC activities and internalize markets up to the point at which the benefits of further internalization exceed or are equal to the total costs (Buckley, 1988). From this perspective, internationally diversified firms that possess productive FSAs gain a competitive advantage in the cross-border use of their FSAs *within* the MNC due to market imperfections (Buckley & Casson, 1976). Building on internalization theory, Kirca et al. (2011) demonstrate that firm internationalization (or multinationality)[1] positively affects financial performance as firms benefit from the cross-border use of their intangible assets within MNCs.

Several researchers suggest that the recent rise of MNCs from emerging markets (EMNCs) requires a careful assessment of the fundamental tenets of internalization theory. This is because the benefits of FSAs (e.g., technological know-how, management skills, patents, and brands) may not be readily available for EMNCs and/or these FSAs may have different effects on the successful internationalization of EMNCs (Cuervo-Cazurra & Genc, 2008; Hashai & Buckley, 2014; Kim, Hoskisson, & Lee, 2015; Ramamurti, 2009). Specifically, because EMNCs reside in less munificent resource environments, many of the benefits of FSAs enjoyed at home may be situation-specific given the relative institutional underdevelopment of their home countries (Guillen & Garcia-Canal, 2009; Kim et al., 2015; Wan & Hoskisson, 2003). As a result, EMNCs that come out of emerging markets characterized by institutional weaknesses such as poorly functioning capital, labor, and information markets, (Khanna & Palepu, 2000) may face two disadvantages in their efforts to expand internationally. First, they face higher transaction costs of exchange within their home economies, which make them less competitive globally. In addition, these MNCs have relatively little direct experience and knowledge of how to compete in foreign markets, and do not have time to acquire this knowledge incrementally through their own experience (Kumar, Mohapatra, & Chandrasekhar, 2009). As a result, EMNCs may generate low returns from their intangible

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[1] Degree of internationalization (Sullivan, 1994), international diversification (Hitt, Tihany, Miller, & Connelly, 2006), geographic scope of foreign operations (Goerzen & Beamish, 2003), and multinationality (Contractor, Kundu, & Hsu, 2003) refer to the extent to which a firm is extended beyond the borders of its domestic base into new country markets and geographic regions to undertake value-adding activities (cf. Hitt et al., 2006; Kirca et al., 2011). As such, we use these terms interchangeably in this study to stay consistent with the extant strategic management and international business literature, as well as Buckley and Casson (1976).

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assets (i.e., FSAs) because of the nature of emerging markets and characteristics of MNCs from these markets (Kirca et al., 2011).

On the other hand, both anecdotal and empirical evidence indicate that EMNCs have competed quite successfully in advanced and emerging markets over the past 20 years, challenging some of the world's most accomplished advanced-economy multinationals in a wide variety of industries (Cuervo-Cazurra & Ramamurti, 2014). Yet, we have little research that focuses on the internationalization of EMNCs and how they appropriate value from their proprietary assets in foreign markets (Cuervo-Cazurra & Genc, 2008; Hennart, 2012). In this study, our objective is to examine the relationship between firm multinationality and financial performance (M-P, hereafter) for EMNCs, with a focus on FSAs and dispersion of these assets. We focus explicitly on the traditional FSAs based on internalization theory because we intend to test the predictions of this critical and influential theory in the context of MNCs from emerging markets for the M-P relationship. In this way, we hope to shed light on the extensive debate on whether EMNCs possess traditional FSAs and how these FSAs impact successful internationalization. Moreover, we examine the role of industry context in this process, as the key dimensions along which manufacturing and service multinationals vary have diverse effects on the success of EMNCs, as detailed subsequently (cf. Capar & Kotabe, 2003; Kotabe, Srinivasan, & Aulakh, 2002; Kundu & Contractor, 1999).

In brief, our study makes two specific contributions to the literature. First, we demonstrate that the effects FSAs have on the M-P relationship depend on the industry context for EMNCs. Second, our work extends internalization theory by testing one of its critical assumptions regarding the limits of MNC governance structures. Specifically, for EMNCs from India we demonstrate that the dispersion of assets has divergent effects for service and manufacturing firms. In the following sections, we first briefly provide a theoretical background that focuses on internalization theory in the context of the M-P relationship. Next, we develop specific hypotheses that delineate the effects of FSAs and international asset dispersion on the M-P relationship in manufacturing and service industries. We then explain the data collection procedures and estimation method, and present the results. Finally, we conclude with the theoretical and managerial implications of our study.

2. Internalization theory and the M-P relationship

Transaction cost theory and its offshoot in the international business literature, internalization theory, have arguably the most influential theories to investigate the motivation and existence of the MNC, as well as why MNCs might be expected to perform well in international markets (Buckley & Casson, 1976; Doz & Prahalad, 1991). Internalization theory assumes firms are profit-maximizing entities and managers are boundedly rational. Based on the relative efficiency of hierarchy as compared to the market, managers select the governance mechanism that provides optimal returns. Internal transactions enable the firm to overcome problems associated with market transactions, thereby increasing the returns available for the firm's assets (Teece, 1986). Consistent with transaction cost theory, internalization theory predicts that firms that follow its prescriptions and align their organizational forms accordingly will economize on transaction costs, which translate into enhanced performance in international markets (Geyskens, Steenkamp, & Kumar, 2006). The rationale for firm internationalization and its positive effects on performance is attributed to the exploitation of market imperfections, as these imperfections provide opportunities for internationally diversified firms to gain a competitive advantage in the cross-border use of their FSAs within the MNC (Kogut, 1985; Rugman, 1979).

FSAs have some characteristics of public goods in that their value and benefits are enhanced in direct proportion to the scale of the firm's markets (Morck & Yeung, 1991). Based largely on proprietary information, these knowledge assets are not exchangeable at arm's length for a variety of reasons arising from the economics of information, as well as from their public good properties. Therefore, the value and benefits of these assets increase internally as the firm becomes larger and/or more multinational. In other words, because of their public good properties within the organization, FSAs depreciate little when applied to multiple markets within the same firm. Accordingly, FSAs provide additional benefits for firms that expand internationally because the efficiency of and returns to their exploitation are greater when their scope of use is greater within the MNC (Lu & Beamish, 2004). These firms can generate abnormal returns from multinationality through the exploitation of market imperfections due to their more efficient structure and better governance. Empirical evidence confirms that firms with high levels of FSAs achieve greater gains from multinationality than do those with low levels of technological and marketing assets (Kirca et al., 2011).

In addition, repeated transactions within the firm due to transfers of FSAs within the MNC, enable these firms to accumulate a capacity to affect these internal transfers in a way that helps them develop capabilities to more efficiently transfer and transform technologies (Kogut & Zander, 1993; Tallman, 2003). This architectural capacity allows the MNC to become both more proficient and efficient at exploiting its FSAs as it expands into foreign markets. With the growing reach of the MNC's international presence, as new FSAs generate, the firm essentially creates future strategic options (Kogut & Zander, 1995). Consequently, the MNC not only becomes more efficient as its geographic scope expands but it also appropriates a greater proportion of the possible rents of any given FSA.

Therefore, we expect that MNCs from emerging markets will enjoy increased FSA benefits with higher levels of internationalization because the efficiency of and returns to FSA exploitation are greater when their scope of use is greater *within* EMNCs. EMNCs with technological and marketing assets achieve greater financial gains from multinationality than EMNCs that lack these assets because they can generate abnormal returns from multinationality through the exploitation of market imperfections due to their more efficient structure and better governance (Geyskens et al., 2006). Thus, *prima facie* there is no reason to believe that the technological and marketing assets of MNCs from emerging markets are less valuable or special than those of MNCs from developed economies (cf. Cuervo-Cazurra, 2012; Hashai & Buckley, 2014; Ramamurti, 2012). Given that we attempt to replicate the main predictions of prior research in the context of EMNCs, we do not provide separate hypotheses for the moderating effects of FSAs on the M-P relationship (cf. Buckley & Casson, 1976; Kirca et al., 2011).

To further extend internalization theory, it is critical to specify the boundary conditions under which markets will not be efficient because of contracting problems and transaction costs, and how these special conditions enhance the returns available from firms' assets (Morck & Yeung, 1991; Teece, 1986). In doing this, we follow Buckley and Casson (1976) to identify industry context as a theoretically relevant variable that potentially creates market imperfections in intermediate markets for FSAs with significant benefits to internalization. We focus on service and manufacturing industries because the market imperfections for various types of knowledge created in these industries provide a rich study context with unique challenges for theory and practice (cf. Capar & Kotabe, 2003; Kotabe et al., 2002), as detailed in the following section.