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Firm-specific intangible assets and subsidiary profitability: The moderating role of distance, ownership strategy and subsidiary experience

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ABSTRACT

How does distance attenuate the value of MNC parent intangible assets on affiliate profitability? Beyond the basic assumption of internalization theory about the positive relationship between parent intangibles and foreign affiliate performance, we test how this relationship, is contingent on ownership strategy, subsidiary experience, and is moderated by the distance between home and host economies, in terms of differences in technological capacity, intellectual property regimes, economic development, language and geography. Based on newly-available accounting data on intangible assets, we test hypotheses on a sample of over 2000 multinationals and 5000 of their overseas affiliates in 45 home and host economies.

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1. Introduction

Internalization theory has long proposed that the profitability of a multinational company's (MNC) foreign affiliate should correlate positively with the intangible assets of its parent (Buckley & Casson, 1976; or Dunning's, 2001 OLI framework). But so far, MNC parent intangible value has mainly been tested by using proxies such as the all-company, or parent R&D/Sales ratio or marketing intensity. Recently however, more detailed accounting information has become available, where parent MNC intangible value is available as an actual financial number. This newly available financial data has not yet been used to test the hallowed assumption of internalization theory that parent intangible assets constitute the key competence of modern firms and that therefore we should expect a positive association between parent intangibles and subsidiary performance (Villalonga, 2004). We contribute to the literature on subsidiary performance by directly testing the link between parent intangibles and subsidiary profitability.

We build on this to focus on a more novel research question about the contingent value of parent firm's intangible assets: "how does the degree of difference between the home (MNC parent) and host (subsidiary) country, ownership strategy of the parent firm and subsidiary experience attenuate, or augment, the link between parent intangibles and foreign affiliate profits?" Recent academic literature operationalizes these differences as institutional, or cultural or geographical "distances" between the nation of the MNC parent and the country location of its subsidiary (e.g. Berry, Guillen, & Zhou, 2010; Malhotra & Gaur, 2014). The literature on country location distances, more often than not, takes a negative view of country differences, arguing that distance increases the liability of foreignness and creates greater obstacles in transferring ownership-specific (parent intangible asset) advantages to distant locations.

This view emanates from traditional thinking on MNCs, where it was assumed that the value of intangible assets of a MNC diminishes or attenuates as the psychic distance between the home and host country increases. However, this assumption is becoming increasingly invalid since (a) MNCs may invest in another similar or dissimilar country, and (b) MNCs from emerging and less developed economies are expanding internationally, and establishing subsidiaries in countries more institutionally and culturally advanced than their own, in search of resources and capabilities (Luo & Tung, 2007). Hence the measurement of distance has to take into account the directionality of the foreign direct investment (FDI), or how the destination (host) nation

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compares with the location of the parent. Setting up a subsidiary in a distant country may augment, or diminish, the parent firm's intangible assets (internalization advantage) depending on the directionality of the movement. Given that much of the extant literature treats distance bi-directionally neutral (Shenkar, 2012), we make an important contribution by examining the effect of directionality in the distance construct.

While distance is an exogenous factor, the value of parent intangibles may also be affected by the ownership strategy of the parent firms and the subsidiary experience. Accordingly, we argue that the parent intangibles – subsidiary performance relationship is likely to be also contingent on these parent and subsidiary specific factors. We test our theoretical arguments on data from a sample of 5010 foreign affiliates belonging to 2301 MNCs over a 12-year time period from 1996 to 2007. Past studies on subsidiary performance have often used subsidiary survival as a measure, due to limited availability of financial data at the subsidiary level. Other studies have used surveys to measure subsidiary CEO's perception of subsidiary performance. We contribute to this literature by using detailed, actual subsidiary and parent level financial data, which overcomes the limitations of relying on survival or perceptual measures.

2. Theory and hypotheses

2.1. Why do multinational firms exist? Three theory perspectives

Internalization theory and the knowledge based view (KBV) address a fundamental question underlying our study: why do MNCs exist? After all, capital, labor and other inputs are nowadays freely and ubiquitously available worldwide. If local inputs were the only sources of competitiveness and profitability, local firms would always prevail over their multinational rivals who have to overcome the liabilities of distance and foreignness to reach all the way into foreign markets in order to compete with local firms. The traditional answer is that MNCs possess proprietary intangible assets – tacit, embedded, or firm-specific, but internally transferrable – that are so superior to those of other firms, including local rivals, that even after bearing the higher costs of the liability of foreignness (Gaur, Kumar, & Sarathy, 2011; Ghemawat, 2001; Hymer, 1976), their foreign affiliates thrive and are profitable in distant foreign markets.

Knowledge-seeking investments, sometimes the motivation for MNCs based in emerging countries who wish to access knowledge from a subsidiary in an advanced nation location, can benefit the firm as a whole. Clearly, we need to empirically distinguish between subsidiary locations which are institutionally and economically inferior, or comparable versus superior to those of the parent nation.

Three streams of literature in the international management field suggest why companies invest abroad despite liabilities of foreignness: (i) Internalization Theory (e.g., Buckley & Casson, 1976; Dunning, 1981; Hennart, 1982), whereby the MNC accumulates firm-specific capabilities and experience which are more easily transferrable, shared and valuable within in its own network of foreign affiliates than exploitable through external market-based methods (Delios & Beamish, 2001); (ii) the Knowledge-Based Perspective of the firm in which the MNC through its network of subsidiaries seeks, or exploits, internally accumulated proprietary knowledge, intellectual property, trade secrets and organizational routines – knowledge which is, once again, "sticky" within the firm and best transferred within the firm's hierarchy (Kogut & Zander, 1992; Nelson & Winter, 2002), and (iii) the Resource Based View of the firm (Barney, 1991) wherein the firm develops internal assets – mainly intangible – that are valuable, inimitable, rare and best transferrable within the MNC's network of affiliates. The internal transfer of parent intangibles or headquarters capabilities creates value (economic rents) in the subsidiary location not merely because of their intrinsic worth (Buckley & Casson, 2009, 2010; Dunning & Lundan, 2008; Dunning, 2009; Hennart, 2010), but also because of the additional benefits of a multinational scope, *per se*, as articulated by Contractor (2012).

The question addressed in this paper is the extent to which the differences between the countries of the parent and subsidiary degrade, or augment, the value of the intangible assets transferred. MNCs pursue strategies to attenuate the liability of foreignness while enhancing the value their subsidiaries can derive in a foreign location, utilizing the parent's intangibles. The net effect on subsidiary profitability depends on the relative importance of institutional, economic and other environmental factors in the host market.

2.2. Intangible assets and subsidiary performance

Parent firm or company-wide intangible assets include technology or proprietary knowledge, intellectual property (IP) such as patents or brands, internal organizational routines (Nelson & Winter, 2002), production processes (Markusen, 1995), and the firm's relationships and reputation. These assets (i) are distinctive or unique to the firm, (ii) intangible, (iii) proprietary: can be confined or internalized within the firm's boundary, and (iv) transferable to foreign affiliates, so as to extend the MNC's competitiveness to the foreign nation.

We propose initially to test this venerable assumption – a positive relationship between a MNC's intangible assets and the performance of foreign subsidiaries – using more detailed accounting data on MNC subsidiaries that has recently become available. Our initial baseline test on a comprehensive international sample of 2301 multinational parents and their 5010 overseas affiliates, in 45 economies, between 1996 and 2007. The longitudinal nature of our data allows us to conduct a number of robustness tests, and a falsification exercise that seeks to control for the role of common shocks affecting the profitability of both the parent and its affiliate.

Having established the baseline effect, we examine why different affiliates of a MNC perform unequally, despite having the same parent knowledge or capability base. The variation of profitability across subsidiaries must be partially explainable by firm-specific factors and country differences between parent and subsidiary locations.

2.3. Distance between home and host country

Country differences could be a double-edged sword (Reus & Lamont, 2009). On the one hand, differences in formal and informal institutions such as culture, norms and regulations between the home and host country create informational disadvantages for the foreign subsidiary, making it more difficult for the parent to transfer its intangibles to its subsidiary. Even within a single firm (the transmission of capabilities from MNC parent to its wholly owned subsidiaries), problems arise due to differences in technological capacity, economic development, IP protection and language between the home and host countries. These country level differences create monitoring, oversight, and coordination costs even in the case of wholly owned subsidiaries; albeit at lower levels as compared to arms-length licensing contracts, or alliance-based relationships. On the other hand, distance also provide opportunities to derive benefits such as learning and arbitrage, which may not be available in proximate locations (Gaur & Lu, 2007). Thus, in some cases, MNCs may derive greater rent by transferring their intangible assets to distant locations if they provide learning and arbitrage opportunities.

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