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Firm internationalization, business group diversification and firm performance: The case of Latin American firms

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ABSTRACT

We examine the influence of multinationality and business group diversification on firm performance. Further, we examine how their interaction varies between service and manufacturing firms. We assess these relations in three Latin American countries using a sample of 103 firms over the period from 2000 to 2007. We found that there is a limit to the positive effects of business group diversification and that business group diversification effectively moderates the multinationality-performance (M-P) relationship. Our results also suggest that diversified business groups have a stronger positive influence on the M-P relationship for service firms compared to manufacturing firms.

1. Introduction

The predominance of diversified business groups and the rapid internationalization of emerging market firms have recently captured the interest of both international business and strategy scholars (Aulakh, 2007; Luo & Tung, 2007; Mathews, 2006; Tan & Meyer, 2010; Yiu, Bruton, & Lu, 2005). On the one side, the existence of business groups in emerging markets is explained as the most efficient response to the existence of large institutional voids (Khanna & Palepu, 1997, 1999; Khanna & Rivkin, 2001). On the other, the rapid internationalization of emerging market firms has been linked to the home country's adoption of pro-market structural reforms that reduce the transaction costs and agency problems that business groups are meant to help overcome (Cuervo-Cazurra, 2007; Cuervo-Cazurra & Dau, 2009a; Dunning, Kim, & Park, 2008). Specifically in Latin America, pro-market structural reforms have favored economic liberalization and improved governance mechanisms (Cuervo-Cazurra & Dau, 2009b; Kim, Kim, & Hoskisson, 2010) which, in turn, improved the competitiveness of emerging market firms (Dau, 2013). Considering that the existence of business groups is noted as the most efficient response to the existence of large institutional voids (Kedia, Mukherjee, & Lahiri, 2006; Khanna & Palepu, 1997, 1999; Khanna & Rivkin, 2001), we question whether business group diversification can still provide value and assist firms in leveraging their multinationality to provide better performance after a period of pro-market reforms.

Recognizing the need to better understand business group internationalization in the context of emerging markets, we analyze how business groups reap performance improvements as they increase their diversification and how business group diversification affects the multinationality-performance (M-P) relationship. Further, given the context dependent nature of the M-P relationship (Bausch & Krist, 2007; Contractor, Kundu, & Hsu, 2003), we explore how business group diversification influences the M-P relationship depending on the type of sector in which the firm participates. By doing so, we address the call for research on emerging market firms' business group diversification and its effects on the M-P relationship (Gaur & Kumar, 2009).

We investigate this phenomenon in the context of Latin America for several reasons. First, we expect that the presence of emerging multinationals from the region will increase rapidly in the following years. Consistent with this argument, FDI flows from the region increased almost 20% annually from 1992 to 2007, and Latin America's percentage of the world outward FDI total increased from 2.7% in 2007 to 7.4% in 2012 (UNCTAD, United Nations Conference on Trade and Development, 2013). Further, Latin America provides a special setting because most of the countries within the region have gone through

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extensive structural reforms (Brenes, 2000; Brenes & Dominguez, 1997; Cuervo-Cazurra, 2007; Dau, 2013). Cuervo-Cazurra (2008) suggests that this similarity helps not only the comparison of experiences, but also the generalizability of results within the region. Finally, Latin America has been characterized by the large presence of family business groups (Guillen, 2000), which are among the largest and most powerful companies in the continent. For those reasons, the Latin American institutional setting provides a good background for our analysis.

We contribute to the current literature stream on business groups by providing evidence from a resource-based/transaction cost perspective that business group diversification can provide benefits to firms located in emerging markets even when institutional voids have been alleviated. This finding is consistent with more recent investigations on the role of business groups as important conduits of information and resources, which are important means for the reduction of transaction costs and identification of new clients (Lamin, 2013). Yet, we also provide evidence that business group diversification is beneficial to firms' abilities to reap performance from their international investments, supporting a resource-based perspective, and that these benefits are enhanced for service firms.

The paper proceeds as follows: First, we review the relevant literatures and develop hypotheses associated with business group affiliation, the multinationality-performance relationship and the internationalization of manufacturing versus service firms. Then, we proceed to describe our methodology and results. The hypotheses were tested using a sample of 103 firms from three countries in Latin America over the period 2000 to 2007. A total of 771 firm-year observations were collected. Finally, we discuss our results and highlight the contributions and limitations of the paper.

2. Theoretical development

2.1. Business group diversification

Most of the literature on business conglomerates anchored in developed countries suggests that diversified business groups struggle to add value to their operations, are inefficient, and, as a consequence, will have a weaker performance compared to nondiversified firms (Khanna & Palepu, 1997, 1999, 2000a, 2000b; Singh & Gaur, 2009). Nevertheless, the business group is a dominant organizational form in most emerging markets (Chakrabarti, Singh, & Mahmood, 2007; Tan & Meyer, 2010; Yiu et al., 2005). A business group can be defined as 'a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action' (Khanna & Rivkin, 2001: 47–48). Hence, a major characteristic of a business group's affiliated firms is their propensity to act in coordination with other members of their own group.

Chatterjee and Wernerfelt (1991) argue in favor of a contingent effect associated with related or unrelated diversification. In particular, they suggest that the effect of a particular type of diversification on firm performance is contingent on the type of resources possessed by the firm and how appropriate they are to pursuing a specific diversification type. Later, Khanna and Palepu (1997: 45; 2000b) argue that the extent to which business groups add value depends on the characteristics of the 'institutional context' where they participate. In countries with high transaction costs, the institutional context favors a large scope of operations stimulating diversification into multiple businesses. Further, Khanna and Rivkin (2001) suggest that business group affiliation may play multiple roles whose effects cannot be fully explained by just one theory. In line with these arguments, we first acknowledge the existence of economic and sociological perspectives explaining the origin of diversified business groups and then utilize the resource-based and transaction cost theories as basis for our hypotheses development.

Under the economic perspective, which relies on transaction cost economics (TCE), business groups exist because of the presence of market imperfections (Leff, 1978). According to Khanna and Palepu (1999), there are two main drivers of these imperfections: the lack of reliable information and the potential conflict of interest among the parties involved. In developed countries, the presence of specialized and reliable institutions, high-quality regulations, and effective enforcement help reducing transaction costs (Khanna & Palepu, 2000a; Meyer, Estrin, Kumar-Bhaumik, & Peng, 2008). However, in emerging economies, such mechanisms are either nonexistent or inefficient (Diaz-Hermelo & Vassolo, 2010) and, therefore, the transaction costs are high. In institutional contexts where transaction costs are high, business groups are more efficient organizational forms than stand-alone entities. Business groups may overcome the lack of reliable information in product, capital, and labor markets that prevents transactions (Khanna & Palepu, 1997). For instance, business groups may leverage their reputation and image of high-quality products to gain access to new markets; they can use their internally generated capital to fund ongoing or new projects or use their track record in capital markets to obtain the required funding; and they may recruit, develop, and assign to different affiliated firms highly qualified managers that are scarce in this context (Khanna & Palepu, 1997, 1999, 2000a, 2000b; Khanna & Rivkin, 2001).

Further, business groups may leverage poor regulatory systems and erratic contract enforcement conditions by using their preferential access to government officials. Chang and Hong (2002) argue that one of the purposes of business groups is the appropriation of quasi rents associated with their access to privileged information. In this setting, business groups may use their political ties with bureaucrats to obtain favors that promote their presence in different industries (Khanna & Rivkin, 2001). Overall, under conditions of high transaction costs, previous research suggests a positive effect of business groups on firm performance (Hoskisson, Johnson, Tihanyi, & White, 2005).

But, according to the sociological/neo-institutional perspective, the predominance and benefits of business group affiliation are above and beyond purely economic considerations. Guillen (2002, 2003) argues that being part of a business group eases information sharing and organizational learning among affiliates. Further, using arguments of neo-institutional theory, the author posits that under conditions of uncertainty, firms tend to imitate other members of their immediate environments or 'organizational fields' (DiMaggio & Powell, 1983: 147) to justify the adoption of particular practices. Given the variety of ties shared among business group affiliates, the experience of one member may be considered relevant to the others and, hence, its behavior may affect future strategies of the other members. Granovetter (1994) suggests that within business groups, there is less risk of opportunistic behavior because of the existence of a similar moral ground that guides action. This emphasis on trust eases information flow and minimizes internal transaction costs (Khanna & Rivkin, 2001). Lamin (2013) demonstrates that business group ties are important conduits of information that help firms increase their ability to expand sales both locally and abroad. In this context of both economic and sociological conditions encompassing business groups, we argue that business group diversification can have contrasting effects on firm performance depending on the local degree of institutional development and diversification level, which is directly related to how these firms manage their resources in the context of increased (diminished) transaction costs.

2.2. Business group diversification and firm performance

According to the economic/transaction cost perspective of business group diversification described earlier, business groups exist due to the presence of market imperfections (Leff, 1978). In emerging markets these imperfections arise because of informational inefficiencies, misguided regulations, and poor judicial systems (Khanna & Palepu, 1997) that influence both the lack of reliable information and potential conflicts of interest among partners in a proposed transaction (Khanna & Palepu, 2000a, 2000b). Acknowledging the effects of increased transaction costs on business conduct in emerging markets, scholars have