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The Role of Cluster Presence and Quality Certification in Internationalization and Performance of Offshore Service Providers☆

Rajesh S. Upadhyayula [a], Karthik Dhandapani [b], Amit Karna [c,*]

[a] Strategic Management, Indian Institute of Management, IIMK Campus, P. O. Kozhikode, Kerala 673 570, India
[b] Strategy, Indian Institute of Management Tiruchirappalli, NIT Campus (Post), Thanjavore Main Road, Thuvakudi, Tiruchirappalli 620 015, Tamil Nadu, India
[c] Business Policy, Indian Institute of Management, IIMA Campus, Vastrapur, Ahmedabad 380015, India

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ABSTRACT

Offshore Service Providers (OSPs) have been a subject of research for several years now. However, there is little known about what drives the internationalization of OSPs. In this paper, we combine insights from economic geography and institutional view to investigate cluster presence and quality certification as the drivers of OSP internationalization and their performance. We hypothesize the facilitating role these two factors play in driving the performance of internationalized firms. We test our hypotheses using data from Indian software firms between 1992 and 2002. We find a positive effect of certification on OSP internationalization. Although certification contributes negatively to OSP performance, it positively moderates the performance effect of OSP internationalization. Cluster presence was found to drive OSP's overall performance, but has no effect on internationalization. Through our findings, we contribute towards the literature on OSP internationalization.

Firms have been reconfiguring their value chain by combining the benefits arising from specialization with location (Alcacer and Chung, 2007; Baden-Fuller et al., 2000; Lewin et al., 2007). As a result, many firms have centralized core activities (e.g. design and R&D, and sometimes manufacturing) in the home country and outsourced support activities to offshore locations (Jensen and Pedersen, 2011). Offshore activities are either performed by the firm's own subsidiary or are allocated to a local firm on a contractual basis (e.g. Contractor et al., 2010). Firms providing such offshoring services are referred to as offshore service providers (OSPs). As OSPs often have their operations in emerging markets (Contractor et al., 2010), they take advantage of the lower labor costs in their home country in order to produce backend services for clients in developed economies, typically as a low cost partner (Ramamurti, 2009). Recently, many of these OSPs have internationalized either by opening branch offices in markets where their clients are located or setting up operations in other low-cost nations (Athreye, 2003, 2004; Pant and Ramachandran, 2012). They do so in order to perform crucial marketing and customer liaison functions as well as help in local adaptation and customization needs (Contractor et al., 2007) or to further lower their costs (Farrell, 2005). We investigate the phenomenon of OSP internationalization and factors that drive the internationalization and subsequent performance of OSPs.

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* Corresponding author.
E-mail addresses: rajesh@iimk.ac.in (R.S. Upadhyayula), karthik@iimtrichy.ac.in (K. Dhandapani), karna@iima.ac.in (A. Karna).

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OSP internationalization provides a very interesting context for two reasons. First, OSPs typically originate in emerging markets and therefore often deviate from conventional internationalizers in the speed, path and mode of internationalization, but also in the way they handle institutional differences (Guillén and García-Canal, 2009; Kothari et al., 2013; Narula, 2012). Second, OSPs – by definition – have a cost advantage in their home country, and therefore it requires OSPs to undertake internationalization in a very strategic manner, i.e. without increasing their costs that could affect their performance adversely (Chadee and Raman, 2009; Graf and Mudambi, 2005; Oza and Hall, 2005; Wang, 2002) In this paper, we take an economic geography and institutional view to investigate how OSPs use resource acquisition and deployment strategies in order to internationalize effectively.

We conceptualize the location choice and signaling mechanisms employed by OSPs in form of cluster presence and quality certification respectively. OSPs require strategic resources to maintain competitiveness vis-à-vis their clients and other OSPs. Therefore, many of them choose to locate in clusters (Manning, 2012). Clusters have been seen as providers of resources, information or knowledge spillovers to firms, especially in emerging markets (Bresnahan et al., 2001; Manning et al., 2010; Porter, 2000; Zaheer et al., 2009). Therefore, cluster presence helps OSPs utilize externally and publicly available resources in order to build a competitive advantage in international markets (Mesquita and Lazzarini, 2010). Further, emerging markets are marked by institutional voids and information asymmetry (Gopal and Gao, 2009; Khanna and Palepu, 1997). To alleviate some of the information asymmetry, OSPs build high quality processes not only to be consistent in their service delivery, but also to signal this consistency to their clients. One of the ways for OSPs to signal their credibility in international markets is through certification by international agencies (Gao et al., 2010). Quality certification provides credibility to the OSPs, in turn enabling them to exploit internationalization opportunities.

In sum, we aim to advance the understanding of OSP internationalization by studying the effect of the firm's cluster presence, and quality certifications to signal acquisition, organization and deployment of resources on internationalization and performance. We test our hypotheses in the context of Indian IT firms during the period 1992 to 2002. Our sample provides a suitable research context as Indian firms have not only become key OSPs from emerging markets in recent years, but also have internationalized to advanced economies by setting up branch offices and development centers. Although their initial competitive advantage in international markets was derived from the low-cost factor markets in their home countries, in the last two decades Indian software firms have achieved a global presence either in the form of sales offices or global development centers. Internationalization has helped Indian software firms perform better by way of developing software services globally and selling it to clients in international markets (Athreye, 2003, 2004, 2005; Pant and Ramachandran, 2012). We attempt to investigate whether their cluster presence and quality certification of processes has facilitated their internationalization efforts. Furthermore, we look at the effects of these facilitators in enhancing the subsequent performance of the internationalized firms.

Our findings contribute to the understanding of OSP internationalization. First, we find that quality certification of OSPs has a positive impact on their internationalization. Second, we find support for internationalization affecting performance of OSPs positively. Third, we find that OSP's presence in clusters (in the home country) drives overall performance, although it has no bearing on internationalization. Finally, we find that although quality certification negatively impacts overall performance, it enhances the internationalization-performance relationship.

1. Theoretical background

1.1. Offshore service providers

Extant literature has explored the reasons for both outsourcing as well as offshoring by firms from developed economies. While outsourcing is the provision of services by vendors, offshoring has been seen "as a specific manifestation of firm internationalization that is primarily concerned with the internationalization of the firm's input-market side rather than with the internationalization of sales on the output-market side of the value chain" (Schmeisser, 2013 p. 390). Scholars in the area of offshoring have often focused on the reconfiguration of the client's value chain to a globally dispersed network of activities that enables it to achieve competitive advantage in various markets (e.g. Contractor et al., 2010; Ernst and Kim, 2002; Mudambi and Venzin, 2010) or on how client firms achieve efficiency by selecting the best outsourcing location (e.g. Bunyaratavej et al., 2008). Kedia and Mukherjee (2009) explained the outsourcing or offshoring phenomenon of developed economy firms through Disintegration–Location–Externalization (DLE) framework as an alternative to the conventional Ownership–Location–Internalization (OLI) framework. While the OLI framework explained the nature and extent of FDI investments by developed economy firms, the DLE framework suggests that firms in developed economies use location specific advantages (other country advantages) by disintegrating parts of their value chain and at times even externalizing the provision of the value chain to other service providers in developing economies. They also argued that this externalization (unlike internalization of the OLI) by firms in developed economies is aided by relationship capital based advantages (mutual trust and shared values between client firms and OSP) and co-specialization (of OSP) and organizational learning related advantages. One of the ways in which OSPs achieve the trust of the client firms is to internationalize their operations in such a manner that they co-locate part of their operations at the clients' locations.

Further, the literature on OSPs has outlined several advantages realized by firms that offshore their services to emerging market locations, including strategic flexibility (Contractor et al., 2010; Kedia and Lahiri, 2007; Quinn and Hilmer, 1994), access to superior resources (Dossani and Kenney, 2007; Lewin et al., 2009; Zaheer et al., 2009), and resource complementarities (Mudambi and Tallman, 2010). While a significant number of studies have explored the motives and performance of firms outsourcing and offshoring from developed economies, little is known on the behavior, competitive advantages and performance of OSPs (Chadee and Raman, 2009). Additionally, it is well known that OSPs have been internationalizing rapidly since the late 1990s, (Manning,

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