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The Internationalization of Service Firms from Emerging Economies: An Internalization Perspective

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How can service firms internationalize in the absence of significant resources and capabilities prior to internationalization? This question is important, because internalization theory has dismissed the possibility of internationalization without firm-specific advantages (FSAs) or country-specific advantages (CSAs). This conceptual study argues that resource-scarce service firms undertake FDI to access intangible resources abroad, which are then used to develop FSAs in these firms' *domestic* market. We call this novel service internationalization strategy *domestic market-seeking internationalization* (DMSI). We embed DMSI within a comprehensive internalization theory-based framework that derives testable propositions. The framework extends internalization theory by explaining generic service internationalization strategies through leveraging different types of domestic and foreign-originated FSAs. In addition, this study provides recommendations for practicing managers who face the dilemma of increasing competitive pressures to take their firm international under severe resource constraints, a challenge typical to many emerging economy firms.

Introduction

How can service firms from emerging economies expand abroad without superior resources and capabilities prior to internationalization? In fact, the FSA/CSA framework (Rugman and Verbeke, 2008) explains why firms internationalize when either firm-specific advantages (FSAs); i.e., "knowledge bundles that can take the form of intangible assets, learning capabilities and even privileged relationships with outside actors" (Rugman and Verbeke, 2003, p. 127), or country-specific advantages (CSAs); i.e., production factors, such as competitive wages, costs of capital or land and natural resources (Rugman, 2005; Rugman and Verbeke, 1992) are strong. However, this does not explain internationalization when FSAs and CSAs are both weak or absent, a situation commonly ignored in the current literature (Rugman et al., 2011, pp. 766–8). The underlying problem is that weak FSAs are the rule rather than the exception in regard to the internationalization of service firms from emerging economies.

In disagreement with Rugman (2010), prior research has argued that emerging market firms seek access, frequently by mergers and acquisitions (M&A), to strategic assets (e.g., brands and operational and R&D resources), mainly in developed economies (Luo and Tung, 2007; Mathews, 2006; Yamakawa et al., 2013). However, this does not explain the internationalization of service firms without the means to implement expensive M&A strategies. While the internationalization of manufacturing MNCs from emerging economies has been explained by CSAs, such as low labor costs or an abundance of natural resources (Ramamurti, 2009; Rugman, 2010), we have yet to provide a theoretical explanation for the success of service firms from emerging markets that lack notable CSAs.

Seeking to address this gap in internalization theory, we draw on three streams of research: the theory of competence building in multinational enterprises (Rugman and Verbeke, 2001); research on internationalization strategies of emerging market multinationals (EMMs) (Cuervo-Cazurra, 2012) and research on the internationalization of service firms (e.g., Boddewyn et al., 1986; Rugman, 1981; Williams, 1997), due to the choice of service firms as the research subject. This combination is particular relevant in addressing simultaneously weak FSAs and CSAs.

To illustrate our propositions, we will focus on Multinational Banks (MNBs) from emerging economies for the following reasons: First, MNBs from emerging economies in particular suffer from weak or even absent FSAs, because proprietary knowledge and thus competitive advantages are difficult to protect (Guillén and Tschoegl, 2000). In contrast to manufacturing industries, customary emerging market CSAs, such as lower wages or abundance of natural resources, are irrelevant for retail or corporate banking when venturing abroad, given the specific characteristics of services, such as intangibility, inseparability, perishability or complexity (Villar et al., 2012). Furthermore, banks from emerging markets often suffer from country-specific disadvantages, such as higher cost of capital and institutional voids (Khanna et al., 2005). Therefore, MNBs from

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emerging economies generally cannot draw on either FSAs or CSAs to internationalize. This situation makes MNBs an ideal case for examining and illustrating internationalization when FSAs and CSAs are both weak or absent, which is the theoretical gap still remaining after Rugman and Verbeke (2008).

On this basis, we make the following contributions to scholarly and practitioner literature: First, by explaining how service firms from emerging economies can internationalize despite their lack of FSAs and CSAs, we propose a novel internationalization strategy that establishes an international presence to develop FSAs in the *domestic* market. Such FSAs are embedded in new client relationships, established as a consequence of international network development. We conceptualize this strategy as *domestic market-seeking internationalization* (DMSI), which contrasts with the widely known (*foreign*) market-seeking internationalization (Dunning, 2000). The internationalization discourse seems to have suffered from an optimistic bias towards accelerated expansion abroad (Mathews, 2006), and this bias could explain why DMSI has been overlooked up to this point.

Second, we extend internalization theory and fill the low FSA/low CSA gap in Rugman's framework (Rugman, 2010) by explaining how and under what conditions internationalization is possible in the absence of FSAs and CSAs. Accordingly, we argue that internationalization occurs when service firms access and internalize intangible FSAs located abroad, transfer them to their home market to win over domestic clients whose future international competitiveness can be strengthened by the services derived from the transferred FSAs. Thus, service firms prepare the ground for already known internationalization strategies, such as the follow-the-client strategy.

Third, by illustrating our propositions with anecdotal examples and prior research on financial services, this study indirectly addresses important gaps in understanding as highlighted by leading research on financial service internationalization. In particular, the internationalization of banks from emerging economies constitutes a growing, albeit incipient and rarely addressed phenomenon, possibly because "internationalization in financial services has lagged behind that of manufacturing" (Grant and Venzin, 2009, p. 562). Several studies have pointed to gaps in understanding, such as "little consensus" for "the appropriate strategy to be followed", "diverse performance outcomes" of financial service internationalization or the "absence of cost economics of cross-border integration" (Parada et al., 2009, p. 672). Petrou (2009, p. 628) calls for particular research on this subject as "to what extent, and in which markets, multinational banks (MNBs) would be best advised to internationalize." These above-mentioned gaps in understanding motivate our study and demonstrate why we need a comprehensive framework that seeks to explain major financial service internationalization strategies. Our framework complements an important recent study that addresses the importance of international knowledge creation and transfer in service internationalization (Dunford et al., 2010) by integrating several service internationalization strategies in a single overreaching framework. Finally, our conceptual framework can assist practitioners systematically develop service internationalization strategies based on an assessment of service firms' FSAs; therefore, our framework also constitutes an important contribution to managerial practice.

Internalization and strategic choices

Internalization theory has its roots in transaction cost economics (Coase, 1937; Williamson, 1971) and assumes markets are imperfect and may even fail in important intermediate products, such as information and knowledge (Rugman, 1981). The transfer of information and knowledge through markets often suffers from market failure, because once a piece of information is known to the buyer, there is no longer a need to pay for it (Arrow, 1973). This is also known as an information paradox, and implies that the incentive to organize information and knowledge transfers within an internal market is high (Buckley and Casson, 1976). Information is considered a critical intermediate product for many service industries. Accordingly, service firms internationalize to internalize information flows across borders (Boddewyn et al., 1986; Rugman, 1981). Hence, internalization in service industries is likely to reduce transaction costs, lower customer risks and assist in exploiting existing market-making and data analysis skills across borders (Boddewyn et al., 1986).

An additional reason for internalization in the service industries lies in the fact that knowledge embedded in services is difficult, if not impossible, to protect (Guillén and Tschoegl, 2000). Even if knowledge was protectable, weak institutional environments in some emerging and developing countries may further reduce the chances that an internationalizing firm can appropriate the gains from information and knowledge development (Acemoglu et al., 2005). For these reasons, the ownership and control of foreign assets are important for protecting firm-specific knowledge and for avoiding its dissipation to competitors.

Intangibles, such as information and knowledge-based resources and capabilities, constitute FSAs. CSAs, in turn, refer to production factors; e.g., competitive wages, costs of capital or land and natural resources (Rugman, 2005; Rugman and Verbeke, 1992). Within an emerging market perspective, these CSAs are likely to be irrelevant as even the cost of capital and transaction costs tend to be relatively high compared to those in more advanced economies (Khanna et al., 2005). Moreover, conceivable CSAs can be "endogenized" and thus transformed into new FSAs (Rugman and Verbeke, 2001). We therefore concentrate on FSAs.

FSAs can be location or non-location bound (Rugman and Verbeke, 1992, 2001). Non-location-bound firm-specific advantages (NLB FSAs) are intermediate products, such as product, process or client-specific information and knowledge, brands, marketing or credit analysis knowledge that can be transferred across borders easily and at low cost. Location-bound firm-specific advantages (LB FSAs) "benefit a company only in a particular location (or set of locations), and lead to benefits of national responsiveness" (Rugman and Verbeke, 2001, p. 241). Strong relationships with local key stakeholders, such as local