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Establishment modes and network relationships of foreign subsidiaries

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ABSTRACT

This research examines the effects of the establishment mode of foreign subsidiaries (greenfield vs acquisition) on the type of network relationships (social vs business) they develop in local markets. The authors use the network approach to better understand the role played by local subsidiaries for the development of networks in multinational enterprises. The empirical study is based on a dataset covering 120 foreign-owned subsidiaries in Italy. The findings show that acquired subsidiaries are more directly involved in business relationships, whereas greenfield subsidiaries pay more attention to social relationships before building business networks. The establishment mode thus affects the type of network relationships developed by local subsidiaries, which can help them to overcome the liabilities of foreignness and outsidership.

1. Introduction

Multinational enterprises (MNEs) play a predominant role in the process of globalization and contribute significantly to the creation of wealth in national economies. According to data provided by UNCTAD (2016, 2017), the flows of foreign direct investment (FDI) grew by 38% between 2014 and 2015, to $1.76 trillion, the highest level since the beginning of the global economic and financial crisis. In 2016, FDI flows decreased by 2% to $1.75 trillion and are forecast to increase by 5% to almost $1.8 trillion in 2017. The statistics provided show that an increasing number of FDI take the form of cross-border mergers and acquisitions (M&As) (who achieved a total value of $721 billion in 2015 and $869 billion in 2016), even if the announced greenfield investments also remain at high levels ($766 billion in 2015 and $828 billion in 2016). Inward FDI flows to developed economies almost doubled to $962 billion between 2014 and 2015, and rose by 5% to $1 trillion in 2016, and this growth mainly concerns European countries.

"*MNEs are companies who engage in foreign direct investments (FDI) and who own or, to a certain extent, control value-added activities in several countries*" (Dunning & Lundan, 2008: p. 3). These activities generally take place within subsidiaries. Multinational enterprises play an increasing role in host country environments, since foreign subsidiaries are embedded in local networks and interact with a variety of actors (suppliers, distributors, customers, public authorities, etc.) (Ciabuschi, Holm, & Martín Martín, 2014; Forsgren, 2008; Hennart, 2009). Foreign subsidiaries differ considering the extent to which they are able to build strong and interdependent relationships with such local stakeholders (Halaszovich & Lundan, 2016; Hsu, Chen, & Caskey, 2017).

Extant literature has shown how such local embeddedness positively impacts the stock of knowledge (Almeida & Phene, 2004; Hakanson & Nobel, 2001; Mu, Gnyawali, & Hartfield, 2007) and performance (Andersson, Forsgren, & Holm, 2002; Oehmichen & Puck, 2016) of foreign subsidiaries, helping them to contribute and improve the competitive advantage of the multinational enterprise (Nell, Andersson, & Schlegelmilch, 2010). Being embedded with local actors and learning from them is strategically important for foreign subsidiaries because they can access valuable resources and knowledge to build a competitive advantage for themselves and for the multinational enterprise (Doz, Santos, & Williamson, 2011; Mayrhofer, 2013). For instance, Frost (2001, p. 101) indicates that *"a potentially important source of competitive advantage for multinational firms is the capacity of their foreign subsidiaries to generate innovations based on stimuli and resources resident in the heterogeneous host country environments in which they operate"*.

Previous research has explained how internal (e.g. Andersson, Bjorkman, & Forsgren, 2005; Hakanson & Nobel, 2001) and environmental factors (Giroud & Scott-Kennel, 2009; Nell et al., 2010; Scott-Kennel, 2007) are associated with such embeddedness. Despite the growing importance of local embeddedness for building competitive advantage, little is still known about this topic. The concepts of "liability of foreignness" (Zaheer, 1995) and "liability of outsidership" (Vahlne & Johanson, 2013) contribute to a better understanding of the situation faced by foreign subsidiaries. Holding an outsider position complicates the process of being embedded in host country networks.

The local embeddedness of foreign subsidiaries raises important

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questions for both academic research and corporate practices. This research attempts to contribute to this debate. Using a network approach (Forsgren, 2008; Johanson & Vahlne, 2009; Vahlne & Johanson, 2013), the aim of this paper is to determine the way the establishment mode of a subsidiary (greenfield vs acquisition) influences the type of network relationships (social and/or business) developed in local markets to overcome the liabilities of foreignness and outsidership. For the empirical investigation, we use a dataset covering 120 foreign-owned subsidiaries in Italy. Following Andersson et al. (2005) and Dellestrand and Kappen (2012), data were collected through structured interviews with top and senior managers of these subsidiaries.

Our findings indicate that the type of relationships developed by foreign subsidiaries is linked to the establishment mode. Acquired subsidiaries are more directly involved in business relationships than greenfield subsidiaries. They already benefit from a relevant position in local business networks and thus increase their commitment in those well-known networks to strengthen their position within the company who bought them and to maintain a high level of autonomy. Conversely, greenfield subsidiaries pay more attention to social relationships with local stakeholders before then building business relationships. They generally suffer from liabilities of foreignness and outsidership in their host country. To overcome this situation and to become accepted insiders, they need to develop social relationships with local key players before they can establish business relationships.

In the next section of the paper, we will explain the theoretical framework which focuses on network relationships and the establishment mode of foreign subsidiaries. The following sections are dedicated to the presentation of the methodology, and the analysis and the discussion of the findings of the empirical study conducted for this research.

2. Foreign subsidiaries and network relationships

In this section, we will first highlight the importance of network relationships for the internationalization process of MNEs. We will then explain different types of networks and how they may be related to the establishment mode of foreign subsidiaries.

2.1. Can network relationships of foreign subsidiaries help to overcome liabilities of foreignness and outsidership in host countries?

Research in international business has demonstrated that MNEs developing business abroad have to deal with additional costs that are often linked to their unfamiliarity of the local environment, cultural, economic and institutional differences between their home and host countries and the need for coordinating geographically dispersed activities. This liability of foreignness can represent a major barrier to the development of foreign subsidiaries since they need to compete with local firms in their host country environment.

As mentioned by Zaheer (1995: p. 343), *"whatever its source, the liability of foreignness implies that foreign firms will have lower profitability than local firms, all else being equal, and perhaps even a lower probability of survival"*. In the same way, Wu and Salomon (2016, 2017) point out that foreign firms often need more time to set up their subsidiaries, face higher operating costs, achieve lower levels of profitability and have higher failure rates than their domestic counterparts.

To overcome this liability of foreignness, MNEs can provide their subsidiaries with firm-specific advantages, for example in the form of branding, technologies and factor-cost advantages or organizational and managerial capabilities (Zaheer, 1995). It is then necessary that foreign subsidiaries get access to local business networks (suppliers, distributors, customers, etc.) to set up operations and to develop in their local markets. The establishment of networks can thus be considered as a *sine qua non* condition to deal with the liability of foreignness in host country environments. The process of building new business relationships in local markets takes time and appears to be more difficult when psychic distance is important (Johanson & Vahlne, 2009).

The Uppsala process model of internationalization revisited by Johanson and Vahlne (2009, 2011) and Vahlne and Johanson (2013) highlights the growing importance of business networks for the international expansion of companies. Johanson and Vahlne (2009, 2011) consider markets as networks of relationships in which firms are linked to each other in various patterns. The authors argue that the "insidership" in business networks is necessary for successful internationalization. The possibility of acquiring stable positions in such networks depends on psychic distance, learning capacities and experience. Johanson and Vahlne (2009) show that network relationships allow identifying and exploiting new market opportunities. Moreover, relationships offer potential for trust-building and commitment, two important aspects for expanding into foreign markets.

In line with the original version of the Uppsala model (Johanson & Vahlne, 1977; Johanson & Wiedersheim-Paul, 1975), the revised model integrates two types of variables: state variables (knowledge, opportunities, network position) and change variables (relationship commitment decisions, learning, creating, trust-building). It suggests that knowledge and opportunities influence relationship commitment decisions. In the same way, learning, creating and trust-building have an impact on business network positions.

For firms expanding abroad, networks are an essential way of gaining knowledge about foreign markets and accessing new resources. Johanson and Mattsson (1987, 2002); Johanson and Mattsson, 1987 emphasize that internationalization performance depends on a firm's ability to build relationships and position itself vis-à-vis various actors abroad (suppliers, customers, public authorities, etc.). Networks are a major source of information, enabling firms to identify and seize new opportunities and to develop lasting trust-based relationships with foreign partners (Johanson & Vahlne, 2009). Consequently, belonging to a network means interacting and sharing resources in a long-term perspective. It is necessary to develop trust-based relationships between network members who must display a clear will to become involved in joint activities. The revised Uppsala model highlights that the success of firms on international markets largely depends on their ability to embed themselves in key networks, to identify their most influential members and to interact with the other members (Johanson & Vahlne, 2009).

According to business network theory, a multinational enterprise consists of several business units, the subsidiaries, even if the firm is one legal and administrative entity. Each subsidiary is embedded in a specific network of business relationships, which can be different from the networks of other subsidiaries. An MNE can be considered as a geographical configuration of assets owned by the firm and a configuration of business networks. The business network theory focuses on the environment of each subsidiary by analysing the business relationships surrounding the subsidiary. Through their subsidiaries, MNEs are thus embedded in multiple business networks (Forsgren, 2008).

MNEs are shaped as a "multiple network": one network is formed by the headquarters and the subsidiaries operating in different countries; hence, it can be defined as the "internal network" (see Fig. 1). Each of these subsidiaries develops its own relationships with suppliers, distributors, other companies, institutions, different stakeholders in the territory(ies) where it operates; therefore, it develops an "external network". The outcomes generated by the relationships the subsidiary develops in its "external network" can affect the ones it has in the "internal networks"; hence its role and relevance within it.

Local business embeddedness is seen as a key factor for the success of international operations, since it is often via relationships that companies learn, and build trust and commitment. Insidership in local networks is thus a necessary condition for the development of foreign subsidiaries. It seems important to note that foreignness often complicates the process of becoming an insider, which can be facilitated in the case of acquisitions (Johanson & Vahlne, 2009). The established relationships with local actors can provide access to resources, knowledge

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