CHAPTER 2:

LITERATURE REVIEW

2.0 Introduction

In this chapter, the literature review of internationalization and the relevant theories will be analyzed and discussed to support the conceptual model of this study. The discussion covers theoretical background, academics' arguments and the meaningful findings of previous studies. This chapter will be concluded with the conceptual framework applied for this research.

2.1 Firm International Diversification

Firms' international diversification is one of the key foundation scopes in International Business Study and Strategic Management. Its relationship with regards to the firms' financial performance has drawn many researches for attempting to establish the link empirically (e.g., Buhner, 1987; Grant, 1987; Daniels and Bracker, 1989; Geringer et al., 1989; Haar, 1989; Tallman and Li, 1996; Hitt et al., 1997; Delios and Beamish, 1999; Gomes and Ramaswamy, 1999; Geringer et al, 2000; Kotabe et al., 2002). Since the turn of 1980s, major shift in the international business and trade occurs, where many countries started to liberalize their trade and capital market to allow freer flow of products and capitals across the boundaries. This trend led to interdependence among nations for products' demand and supply, as such emergence of global market for goods, services, labor and financial capital (Deardorff & Stern, 2002; Hansen, 2002) as well as convergence of consumers' demand around the world (Fram and Ajami, 1994; Levitt, 1983). Further trade barriers were then

greatly minimized with the advancement of transportation and communication technology which giving rise to both the global opportunities and risks confounded the commercial enterprises around the world (Hitt, Keats, & DeMarie, 1988; Molle, 2002).

With the world getting more connected, it seems almost every firm, at one stage of time, will have to confront with the question of international diversification, unless they have enjoyed full monopoly in the local market. Increasingly, the need of international diversification is not just felt by the commercial enterprises, the governments of most countries also seek various opportunities and platforms to help the local firms ventured to foreign markets. Various regional economic integration efforts includes European Union (EU), North American Free Trade Agreement (NAFTA), MERSCOSUR of South American free trade agreement, Andean Pact, CAFTA, CARICOM, APEC and ASEAN. As such, internationalization becomes the very foundation of expansion strategy for most of the firms nowadays. International diversification in general, can take the forms of exporting and foreign direct investment. Exporting is normally the first strategy employed by firms during the course of firm internationalization, Proacter and Gamble developed most of its best-selling products such as Pampers disposable diapers and Ivory soap in the United States and exported them to overseas customers during early stage of their international diversification. Likewise for Asian corporate giant, Toyota also grew by

developing overseas market through exporting cars to around the world, before physically setting operation away from their home country.

Exporting is comparatively easy and fast way to penetrate foreign market because it involves low level of commitment and exposure risk. Unlike, foreign direct investment, a firm does not have to deal with complexities of establishing a full fledge foreign subsidiary, as such it is also easier to withdraw from the foreign market when there are business risks involving political instability and fluctuating market condition. On the other hand, foreign direct investment has other advantages over exporting mode of foreign market entry, for example when the volume to value ratio of the products and the transportation cost are high, as well as when the institution of various tariff and non-tariff barrier imposed by the host country contribute significantly to the bottom line of the sales. Moreover, a firm's competitive advantage is often in the form of intangible, proprietary assets, the use of exporting as an internationalization strategy can expose a firm to the risk of asset appropriation and the subsequent devaluation of its intangible assets, as such, foreign direct investment is a more attractive mode of strategy in this scenario (Jane W.Lu et al, 2006). Many times, most firms will adopt both strategies as the world markets is very dynamic and subjected to many influences by factors such as politic, culture, legal, economy and technology

The mode of entry, timing and rational of international diversification has been categorized by international business and strategic management study into 3 broad perspectives:

Resource-Based Perspective

This perspective has its roots based on industrial organization theory proposed by Hymer (1960) and further developed by Knickerbocker (1973), which relates a firm's performance is vastly decided by the quality and utilization of a sets of resources (both tangible and intangible) that is internal to the firm. Example of these resources includes firm specified knowledge like intellectual proprietary information, manufacturing processes, quality control system and etc, skilled labors, capital and the organization structure. Firm with strong competencies in these firm specified knowledge that is developed at home can utilize them in the international market (Bartlett and Ghoshal, 1989). Recent researches have drawn attention to the exploration benefits of internationalization using an organizational learning perspective. This perspective emphasizes that a firm's subsidiaries in disparate host countries can help to enhance its knowledge base, capabilities, and competitiveness through experiential learning (Barkema & Vermeulen, 1998; Delios & Henisz, 2000; Zahra, Ireland, & Hitt, 2000). In addition, each host country has its own unique resource endowments and location-specific advantages, which might not be available in the home country. Such host country specific advantages can motivate a firm to

establish subsidiaries there to explore these advantages and augment its competitiveness in both its home and host markets (Kogut & Chang, 1991).

Market-Power Perspective

The deduction of this perspective is a firm can gain market power by virtue of its size and expertise in specified operation, products or services developed in domestic markets, this economic of scale enable it to overcome entry barriers to similar industry in foreign market and possibly exploit any monopolistic profits available in such markets (Annavarjula and Beldona, 2000). Retail giant Walmart has successfully ventured out of United States to increase its size of operation to an equivalence of some countries domestic GDP, for example Philippines by value. This mammoth operation helps Walmart to establish strong bargaining power against suppliers, consumers, competitors, labor union and even host countries' government.

Portfolio / Geographical Diversification Perspective

This perspective views products and process diversification across international boundaries as having the opportunity to exploit market imperfections (such as less competitive environment) in the cross-border use of its intangible assets (Caves, 1971). A firm can gain above-normal returns by exploiting its firm-specific assets, especially intangible ones, in international markets (Buckley, 1988) to improve investors' risk / return performance. This perspective is not just perceived by the firms' management but shared by the individual investors as well. Investors always

hold that diversification of investment including geographical diversification reduce risk, as such, firms that have international diversification are always considered better vehicles for realizing extra normal financial returns with lower risk.

2.2 Stages of International Diversification and Financial Performance

International diversification is generally believed to bring substantial financial gain to firms else there will be no motivation for the firms to move out of the comfort zone in their origin countries. The firms achieve the gains through their ability to leverage scale of economies (Grant, 1987; Porter, 1985), taking advantage of arbitrage opportunities with differential cost factors across country boundaries (Kogut, 1985) as well as integrating operation across borders by standardizing products, rationalizing production and allocating resources more efficiently and effectively, thus bolstering the competitiveness of their products in the market (Kobrin, 1991). Past initial researches pointed to the linear relationship of international diversification and financial performance, however such findings were dismissed after more empirical data found that there is dynamic interplay of gains and cost associated with the internationalization of operation. The cost associated includes cost incurred for additional control and coordination of far-flung subsidiaries, the administrative obstacles encountered in managing culturally dissimilar and distinct markets with a variety of unique needs (Gomes and Ramaswamy, 1999). Moreover, each firm would expand geographically in progressive manner, as such, the relationship between

international diversification and financial performance is dynamic in nature and influenced by various stages of internationalization.

Early Stage of International Diversification

The expectation of superior financial performance during early stage of firms venturing overseas has been quite widely accepted by most of the research findings (Grant, 1987) before more researchers started to adopt the idea of 3 phases relationship between international diversification and financial performance in the early 2000. Pre-2000 findings concurred that at early stage of internationalization, the studies in locational choice have suggested that firms seeking international ventures tend to narrow their choices to locations or countries that are geographically and culturally in close proximity to their home countries (Davidson, 1980; 1983; Johanson and Vahlne, 1977; Papadopoulos and Denis, 1988). By choosing familiar settings such as the customer behaviors, taste, expectation and distribution system, similar government regulatory system, supplier behaviors and etc, the firms limit the costs that would otherwise be higher should they choose to expand first into unfamiliar business settings or environments. With this familiar setting, the competencies inherited from the home countries can be easily assimilated and enjoyed in the host country markets, and translate into superior profitability. Many researchers have examined the typical operational and organizational arrangement of a firm during this stage of internationalization. As the foreign sales is much lower than domestic sales, most firms handle foreign operations merely as an appendage to

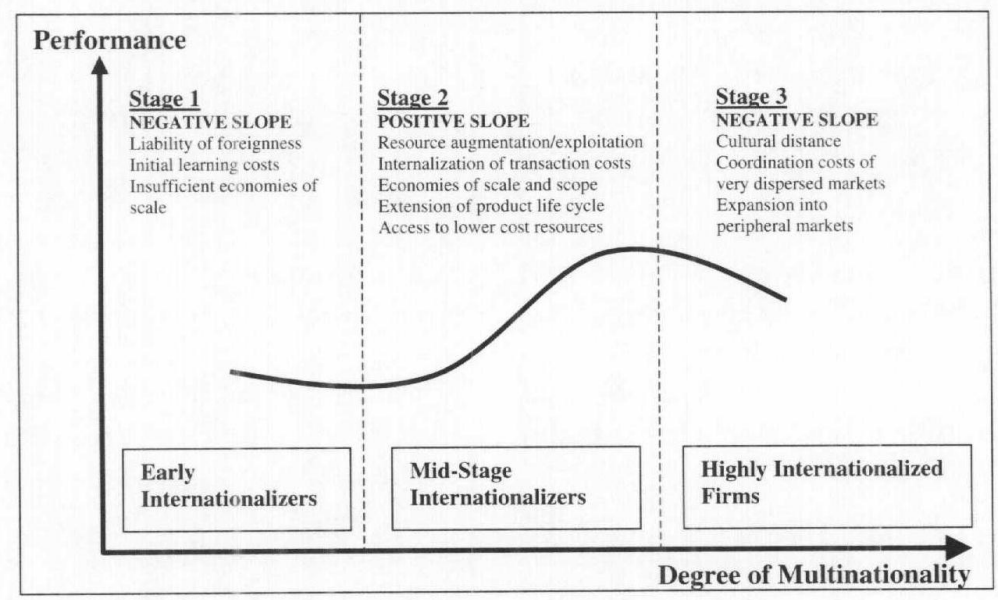
existing product or functional division (Daniels at el,1984), typically, some of the senior management from home countries will be tasked to shoulder additional responsibilities of overseeing overseas expansion program, as such, the firms merely reducing the slack resources available within the organization. This arrangement of overseas expansion strategy has been observed in most of the US MNEs early stage of overseas venture (Chandler, 1962).

Building on the above rational, during the early stage of international diversification, the benefits obtained due to increase in revenue will exceed the concomitant costs because of the advantage associated with market familiarity, leveraging home base skills and competencies and utilizing home base managerial and administrative resources more efficiently.

However, the post year-2000 researches suggested that indeed there is another phase prior to above mentioned positive relationship between international diversification and firm financial performance (Contractor at el, 2003; Lu and Beamish, 2004). The results found that for early internationalizers, as the initial scale of global operation is small, the upfront cost of creating an international operation due to liability of newness and foreignness are not yet to be recouped from the relatively new nations in which the firms operates. However, the cost and barrier of early internationalization are not assumed to be significant, hence, it is hypothesized to have a relatively shallow negative slop and to be of short extent than stage 2 described above. This

evolve of relationship is best explained with the following graph used by Contractor at el.

Figure 2.1 : A 3-stage sigmoid (S-Shape) hypothesis



Later Stage of International Diversification

During the later stage of firms' growth across international boundaries, when the overseas sales or revenues reach significant milestone as compared to the total sales, most of the firms will resort to more complex and costly organization structure, such as product /country matrix or transnational forms (Bartlett and Ghoshal, 1989; Egelhoff, 1988), moreover, firms also gradually venture into geographically and culturally more distinct setting territories (Vernon, 1966). This continued expansion

has led the firms to confront with the daunting tasks of managing a multicultural, multi-location workforce and competing in a more unfamiliar market places. The firms frequently, will response with strategy to set up differentiated roles among the foreign operation in accordance with their specific competencies and locations. Such differential roles involve complex inter-organization flows of information, resources, capital, product and service supports, and the management of this flow required significant investment of resources in turns, for coordinating, controlling and monitoring, as such, increase in cost associated that will reduce the overall benefits of venturing overseas markets (Geringer at el, 1989). It is empirically confirmed that increasing psychic/ cultural distance between the firms' home country and host country's subsidiaries influenced cross borders administration costs negatively (Johanson and Vahlne, 1977)

Quite often, firms expanding to foreign markets may choose to use joint venture or alliance with local partners to alleviate the problems of "foreignness", however this mode of foreign market entry could also expose to significant transaction costs and possibly wipe out the estimated financial gain (Gomes and Ramaswamy, 1999). In summary, many researchers found that the later stage with increasing degree of international diversification would see the decline of profitability due to the fact that highly dispersed foreign operation are bound to accompany with increasing managerial constraint that requires greater demand for control, communication and

co-ordination (Egelhoff, 1988; Geringer at el, 1989; Grant, 1987; Siddharthan and Lall, 1982).

2.3 Degree of International Diversification

To study the relationship between firms' international diversification and financial performance would require sound measurement of degree of internationalization (DOI). Portfolio theory suggests that diversification among investment can reduce the variability of corporate earnings, particularly, a firm diversifies its sales internationally, it can reduce the risks associated with its business by providing a larger portfolio of market upon which to rely for profit, as such, Foreign Sales as the Percentage of Total Sales (FSTS) is used as the measure for DOI (Daniels and Bracker, 1989; Geringer at el, 1989; Stopford and Dunning, 1983).

Another theory which is internalization hypothesis, explains that firms develop internal markets in place of those which were previously external to the firms, so that they can transfer knowledge inside of their boundaries (Rugman, 2005). Hergert (2004) noted the inefficiency of imperfect markets which frequently due to government's policy, as incentive for firms to create internal market as they internationalize. Many firms try to get around these imperfections by increasing their size and assets, using optimal location around the world to create a competitive advantage, thus improving firms' performance. Therefore, Foreign Assets as the

Percentage of Total Assets (FATA) is also being used as one of the construct for measuring DOI (Daniels and Bracker, 1989).

Other major theories that explain international diversification among firms include Vernon and Wells' (1986) product life cycle theory and Johnson and Vahlne's (1990) stages theory of internationalization. Both theories say that firms will often expand internationally after reaching saturation in home market or capitalize on specialized knowledge possessed in the new market. This requires the firms to hires foreign workforce for the benefits of cost or expertise to penetrate in the international markets. As a result, firms may obtain competitive advantage and market share through increase in the hiring of foreign workforce, hence another construct for measurement of DOI, Foreign Employees as Percentage of Total Employees (FETE).

Once firms internationalize, foreign affiliates often become important part of their growth strategy because affiliates can be established easily by mergers and acquisitions. Rugman and Verbeke (2001), suggested location-bound firm-specific advantages which allow affiliates to outperform native firms in the host country. Some of the examples include the research and development prowess achieved by locating in a research park, or utilizing logistic capabilities and home country experiences to obtain competitive advantage in foreign market. As such, Overseas Subsidiaries as Percentage of Total Subsidiaries (OSTS)

There are couple of constructs used for measuring DOI derived by other researchers over the years: Research and Development Intensity (RDI) is the means of gaining market share in global competition (Franko, 1989) as such, a possible DOI construct. Sullivan and Bauerschmidt, 1989, report that the degree of export activity – Export Sales as Percentage of Total Sales (ESTS), discriminates the relative internationalization of American and European firms. Eppink and Van Rhijin, 1988, suggest estimating DOI with Foreign Profits as a Percentage of Total Profit (FPTP), Sullivan 1994 suggested the attitudinal attribute of DOI, by measuring Top Managers' International Experience (TIMIE) with the cumulative duration of top managers' international assignment. He also derived second attitudinal measures by estimating the Psychic Dispersion of International Operations of a firm, this PDIO is measured by calibrating the dispersion of the subsidiaries of a firm among the ten psychic zones of the world as identified by Ronen and Shenkar, 1985.

2.4 Past Empirical Results

Early studies hypothesize a linear relationship between international diversification and firm performance, however, the results have been inconsistent and contradictory. The results ranging from "positive" (Grant, 1987; Kim at el, 1993; Tallman and Li, 1996), to "weak" (Kumar, 1984; Morck and Yeung, 1991), to "negative" (Siddhartan and Lall, 1982; Shaked, 1986). Subsequently, other researchers started to evaluate the costs factors and recognized that international diversification will expose the firms to

both advantages and risks, as such accompany with both benefits and costs associated with the overseas ventures. They revised the linear model relationship by assigning a square term to reflect the curvilinear model relationship. This model will see the existence of threshold point which denotes the change of performance once the DOI exceed the threshold. Again, there are contradictory results, with an "inverted-U" shape (Daniels and Bracker, 1989; Geringer at el, 1989) and "U" shape (Qian, 1997; Ruigork and Wagner, 2003).

This has prompted the researchers to further explored and improved the model to include a cubic term into the relationship model, this model is called "S" shape or 3-stage sigmoid (Contractor at el, 2003; Lu and Beamish, 2004; Yi at el, 2005). Contractor at el, first explored that previous studies might only capture part of the international diversification – performance relationship, those that have linear positive slope either have not specified a quadratic term, or may simply be capturing Stage 2 of Figure 1, studies that showed a negative sloped linear function may be only capturing Stage 1 in Figure 1. Similarly, studies have found a U-shaped curve may reflect Stage 1 and 2 combined, and finally, several studies had inverted U-shaped result, captured only the Stage 2 and 3 because they merely specified a quadratic function. Contractor at el 'result has supported this argument in knowledge based service industry. Lu and Beamish had further developed this S-shape by including firms' intangible assets as the moderating factor for international diversification – performance relationship and yielded positive result.

In summary, the study of firms' internationalization and performance has been evolving over the years, different models have been developed and tested, we can expect more models to be explored and introduced. As to now, few areas have not seen consensus among the scholars such as the measure of DOI, organization structure as the moderating factor and configuration of foreign investment as being influencing the relationship.

Nonetheless, the past empirical results can be summarized as bellow:

Table 2.1: Summary of Past Empirical Results

	Authurs (s) and year	**Performance Indicators**
Linear	Han et al (1998) (+)	ROE, Asset turnover, Profit margin
	Jung (1991) (+)	(After-tax net income)/(Total assets)
	Vernon (1971) (+)	ROI, ROS
	Kim and Lyn (1987) (+)	Excess market value; Tobin's Q
	Errunza and Senbet (1981) (+)	Excess return
	Grant (1987) (+)	ROA, ROE and ROS
	Grant et al (1988) (+)	ROA, ROE and ROS
	Brewer (1981) (-)	Stock return
	Siddharthan and Lall (1982) (-)	Sales growth
	Michel and Shaked (1986) (-)	Risk-adjusted return
	Collins (1990) (-)	Total risk, Debt to equity ratio, Beta
	Buckley et al (1977, 1984) (0)	ROA
	Kumar (1984) (0)	ROA, ROS
	Morck and Yeung (1991) (0)	Market value
U-shaped	Capar and Kotabe (2003)	ROS
	Qian (1997)	ROE
	Ruigrok and Wagner (2002)	ROA
Inverted U-shaped	Daniels and Bracker (1989)	ROA, ROS
	Geringer et al (1989)	ROA, ROS
	Sullivan (1994a, b)	ROA, ROS
	Ramaswamy (1995)	ROA, ROS, ROVA
	Al-Obaidan and Scully (1995)	Frontier production function, Variance in technical efficiency
	Gomes and Ramaswamy (1999)	Cost of sales/total sales, ROA
	Hitt et al (1994)	ROA, ROS
3 Stage "S" Shaped	Contractor et al (2003)	ROS
	Lu and Beamish (2004)	ROA and Tobin's Q
	Chiang et al (2005)	ROE
Findings: + : positive ; - : negative ; 0 : no relationship		

2.5 Conceptual Framework

The literature review discussed above suggests non-linear relationship between international diversification and firm performance. This study is one of the typical analyses on firms' internationalization and the performance. Another study is to investigate whether the more internationally diversified firms will outperform their domestic rivals, an issues treated by Vernon (1971), Horst (1972), Shaked (1986) and Collins (1990).

A number of researches have been conducted on firms mainly among the developed countries, which is understandable as internationalization was not a common trend for countries like Malaysia till the turn of mid 1995. There was only one research that conducted the study among some Malaysian companies, however neither its scope of research nor the result has been described in detail (Sally Sledge, 2007). As such, it is interesting to establish the relationship between international diversification and firms' financial performance among the top 100 Malaysian listed companies by market capitalization value for the year 2003-2007.

This study will adopt the model proposed by Contractor, Kundu and Hsu (2003) which integrates the prior inconclusive literatures into a unified 3-stage theory of international expansion, an S-shape relationship. With this model, the firms are expected to experience slight dip in performance in their early stage of internationalization, then improve in performance before declining again as the

degree of international diversification continue to increase. If the relationship does follow this model, there will be two thresholds. Besides, as among the top 100 listed companies, there are sizeable of them are mainly domestic operation based companies, this study intend to exclude them from the 3-stage model, but will be making a comparative study in terms of performance between these two groups, domestic based and firms with more than 10% degree of internationalization.

2.6 Variables

Dependent Variables

The dependent variable is firm performance. Based on previous studies listed in Table 1, the corporate performance measures can be summarized into 3 categories:

1) Accounting based financial performance:
    i. ROA, return on total assets, for which return refers to profit before interest and income tax. This measure has been widely used in many previous studies of the relationship between degree of international diversification and firm performance (Daniels and Bracker, 1989; Haar, 1989; Ramaswamy, 1995; Gomes and Ramaswamy, 1999)
    ii. ROS, return on total sales, for which return refers to profit before interest and income tax. This variable is selected to avoid the effect of different

assets valuations resulting from timing of investment or depreciation (Geriner at el, 1989)

iii. Firm Growth, which are normally measured in terms of annual growth rate of net sales and total assets (Siddharthan and Lall, 1982; Lu and Beamish, 2006)

iv. ROE, return of equity, for which return refers to profit before interest and income tax. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. This measure was used by Grant (1987), Grant et al (1988), Qian (1997) and Chiang et al (2005).

2) Market-based financial performance, Tobin's Q which is the ratio of market value of the firm assets and the replacement value of assets (Kim and Lyn, 1987; Lu and Beamish, 2004)

3) Operational performance, a ratio of operating cost to sales (OPSAL), which intends to capture the significant benefits of access to cheaper labor and material inputs overseas (Gomes and Ramaswamy, 1999)

Independent Variable

The independent variable in this study is DOI, Degree of International Diversification. There are many parameters for this measure used in previous studies

as mentioned in section 2.3. From single construct such as FSTS (foreign sales / total sales), FETE (number of foreign employees / total number of employees), FATA (foreign assets / total assets), OSTS (overseas subsidiaries / total number of subsidiaries) to multiple dimensions construct employed by Sullivan, 1994; Gomes and Ramaswamy, 1999; Contractor at el, 2003; Lu and Beamish, 2004. There is no consensus on which constructs would yield the most accurate result, and many times, the selection of DOI measure is also determined by the available of corporate data. This study intends to use FSTS as the single measure dimension.

Control Variables

Most of the studies in the past have used additional control variables that are deemed to be affecting corporate performance to ensure the results obtained for firm performance is accounted as much as possible by the level of international diversification. These studies include the works by Buckley et al (1977, 1984), Siddharthan and Lall (1982), Kumar (1984), Grant (1987), Daniels and Bracker (1989), Morck and Yeung (1991), Al-Obaidan and Scully (1995), Ramaswamy (1995), Tallman and Li (1996), Gomes and Ramaswamy (1999), Kotabe at el (2002), Contractor at el (2003), Lu and Beamish (2004) and Chiang at el, 2005. The common control variables used are firm size and sector effect, other control variables include home country effect, debt-to-equity ratio, export intensity and product diversification (Contractor at el, 2003; Lu and Beamish, 2004). For the firm size, two measures are employed by researchers – natural logarithm of net sales and natural logarithm of

total assets. Log transformation is found to be effective and easy to interpret as the change of firm size is closed to normal distribution.

2.7 Summary

Based on the literature review discussed in this chapter, the conceptual framework is generally formed by adopting the model used by Contractor et al. (2004). The methodology of study will be discussed in the following chapter.