International Business Review 19 (2010) 607–618

Contents lists available at ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

Firm performance and international diversification: The internal and external competitive advantages

Alfredo M. Bobillo [a,*], Felix López-Iturriaga [b,1], Fernando Tejerina-Gaite [c,2]

[a] Departamento de Economía Financiera, ETS Ingeniería Informática, Universidad de Valladolid, Campus Miguel Delibes, 47011 Valladolid, Spain
[b] Facultad Económicas y Empresariales, Universidad de Valladolid, Spain
[c] ETS Ingeniería Informática, Universidad de Valladolid, Spain

ARTICLE INFO

Article history:
Received 1 October 2008
Received in revised form 22 March 2010
Accepted 22 March 2010

JEL classification:
F00
F14
F23
F40

Keywords:
Competitive advantages
External capabilities
Firm performance
Internal capabilities
International diversification
Ownership
Transaction costs

ABSTRACT

This paper examines (a) the relation between the institutional framework of a firm's home country and the firm's development of its internal and external competitive advantages, and (b) whether—and if so, how—a firm's preference for, or dependency on, either internal or external capabilities affects the relation between international diversification and firm performance. Based on a sample of more than 1,500 manufacturing firms in Germany, France, the United Kingdom, Spain, and Denmark, the results show that countries' institutional factors (i.e., capital markets, financial intermediaries, and skilled workforce) significantly impact both internal and external competitive advantages of the firms. The paper also sheds light on how the mix of internal and external competitive advantages affects the relation between international diversification and firm performance. Accordingly, the results support an S-shaped relation structured in three different phases, irrespective of the firms' orientation toward internal or external capabilities.

1. Introduction

Literature on international diversification has covered many topics (see Buckley & Casson, 2009; Buckley & Ghauri, 1999; Coviello & McAuley, 1999; Johanson & Vahlne, 2009; Rugman, 2009 for comprehensive reviews). One of the most promising fields among of them is the relation between firm performance and both international diversification/internationalization. Although the literature agrees that international diversification impacts firm performance (Ansoff, 1965; Auruškevičienė, Šalčiuvienė, & Vanagė, 2008; Brock & Yaffe, 2008; Vissak, 2009), exactly how it affects performance—and in which direction—remains an open and sometimes divisive question. Whereas some studies have shown a positive link (Delios & Beamish, 1999; Grant, Jammine, & Thomas, 1988), others have found a negative linear (Denis, Denis, & Yost, 2002; Michel & Shaked, 1986), a U-shaped (Lu & Beamish, 2001), an inverted U-shaped (Kotabe, Srinivasan, & Aulakh, 2002), or a horizontal S-curve relation (Li, 2005; Lu & Beamish, 2004). To reconcile these conflicting results, some authors (e.g., Capar & Kotabe, 2003;

* Corresponding author. Tel.: +34 983 423732; fax: +34 983 423671.
E-mail addresses: amartbob@eade.uva.es (A.M. Bobillo), flopez@eco.uva.es (F. López-Iturriaga), tejerina@sid.eup.uva.es (F. Tejerina-Gaite).
[1] Tel.: +34 983 424395.
[2] Tel.: +34 983 425465.

0969-5931/$ – see front matter
doi:10.1016/j.ibusrev.2010.03.006

Contractor, 2007; Contractor, Kundu, & Hsu, 2003) propose a model that incorporates three stages. Likewise, Lu and Beamish (2004), and Li (2005), in their studies of internationally operating Japanese firms, present a three-stage theoretical framework represented by a horizontal S-curve. In the same vein, Hennart (2007) bases on the transaction cost theory to state that there is no theoretical basis for expecting a systematic relationship between a firm internationalization and its performance. However, none of these models account for the institutional environment, such as the country's financial system or skilled labor market, which can greatly impact the internationalization process (Beck, Demirgüc-Kunt, Levine, & Maksimovic, 2001; Carlin & Mayer, 2003; Levine, 1998; Rajan & Zingales, 1995, 2003).

All multinational firms must exploit a set of specific assets, which are directly affected by the home country's institutional framework. Internal capabilities are defined as the firm's ability to generate added value and include, for example, developing a corporate culture[3] and work organization, generating innovative ideas, creating a culture of innovation, and raising funds for innovation. External capabilities allow the firm to reach the greatest added value in a more cost-effective way by, for example, good use of external information from partners, competitors, and banks; a stronger market orientation; a strong management team dynamic; and partnerships with scientific institutions that help develop capital and labor endowments. Of particular importance, given the importance of social relations to provide organizational legitimacy, is the creation of social capital (i.e., the ability to mobilize extramural resources and attract customers, conditioned by social external networks; Granovetter, 1985).

The success of internationalization is dependent on the exploitation of these firm-specific assets (e.g., organizational advantages, technological knowledge, and reputation; Caves, 1996; Dunning, 1993). Depending on the institutional framework, these capacities may be difficult to exploit through the market and, thus, may be more useful when internalized by the firm. On the other hand, institutional structures of individual countries may boost the combination of external and internal firms' capabilities and, thus, strengthen their competitiveness. Therefore, a country's institutional environment impacts how internationally functioning firms balance their internal and external capabilities to achieve their highest performance.

The paper has two goals. First, we examine the relation between institutional development of countries and the exploitation of internal and external competitive capabilities. Specifically, we explore the relation (a) between countries' relevant financial variables and their firms' external competitive advantages and (b) the relation between skilled labor and firms' internal competitive advantages. Second, we examine whether firms' preference for, or dependency on, either internal or external capabilities affects the relation between international diversification and firm performance.

This study employs social capital theory and the resource-based view (Agndal, Chetty, & Wilson, 2008; Fahy, 2002; Presutti, Boari, & Fratocchi, 2007; Yli-Renko, Autio, & Tontti, 2002). Specifically, included in social capital theory is an emphasis on the importance of a firm's capacity to use external capabilities to build business, information, research and social networks including customers, suppliers of funds, equipment, material, and other partners in the corporate group (Landry, Amara, & Lamari, 2002; Pennings, Lee, & Witteloostuijn, 1998; Rasiah, 2003; Wignaraja, 2007). Conversely, a resource-based view emphasizes the existence of unique resources within the firms, which allows them to set up internal capabilities that foster internal competitive advantages such as investment in intangible assets.

The remainder of the paper is organized as follows: Section 2 describes the theoretical background and hypotheses. Section 3 details the data, method, and variables. Section 4 reports the main empirical findings, and Section 5 summarizes the main findings.

2. Theoretical background and hypotheses

Prior research has shown that the institutional environment—especially financial factors—have important implications for firm growth (Cull & Xu, 2005; Hadjikhani, Lee, & Ghauri, 2008). In the same vein, some studies show that institutions are also important determinants of firm performance (Peng & Luo, 2000) and international diversification (Estrin, Meyer, Wright, & Foliano, 2008; Huang & Sternquist, 2007; Wan, 2005). Furthermore, individual dimensions of human capital (e.g., international orientation, management know-how, risk perception, international business skills) may favor international diversification (Hadjikhani & Ghauri, 2001; Tuppura, Saarenketo, Puumalainen, Jantunen, & Kyläheiko, 2008).

A supply of factors of production in each country (i.e., accumulation of capital goods and financial resources) eases firms' exploitation of business opportunities (North, 1990). For example, Grosse and Trevino (2005) find a link between institutional economics and organizational decision making of foreign direct investment. As a result, different strategies and corporate structures are pursued in different institutional contexts (Bansai & Sama, 2000; Bebchuk & Roe, 1999; Jackson & Deeg, 2008; Meyer, Estrin, Bhaumik, & Peng, 2009), and Meyer (2001) argues that multinational firms must adapt their strategies to the local institutions. In addition, human factors, such as labor quality, are also the keys to establishing the social labor scene of a given country and promote the development of innovative ideas (Barro, 1991).

From this perspective, a firm's degree of internationalization (DOI) is dependent on the adoption of business strategies based on internal or external capacities—strategies that are intended to achieve competitive advantages that depend on institutional factors, namely the home country's financial system and degree of human capital specialization (Carlin & Mayer, 2003). Therefore, a correspondence is likely between capital markets/bank dependence and external firm

[3] Litz (1996) suggests that the potential of ethical capabilities can improve multinationals' competitive advantage.