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Foreign direct investment location choice of small- and medium-sized enterprises: The risk of value erosion of firm-specific resources

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ABSTRACT

Drawing on the resource-based view and FDI theory, the present study introduces the risk of value erosion as a core concept to explain the moderating effect of SMEs' resources (knowledge intensity and international experience) on the relationship between motives (market seeking, resource seeking, strategic asset seeking) and FDI location choice (developed countries vs. developing countries). Testing our theoretical predictions on survey data obtained from 100 German SMEs, our results indicate that knowledge intensity and international experience significantly influence the relationship between motives and SMEs' FDI location choice. Adding this perspective, we provide an enhanced understanding of SMEs' FDI location choice and beyond.

1. Introduction

Foreign direct investment (FDI) location choice is a key strategic decision in firm internationalization (Galan, González-Benito, & Zuñga-Vincente, 2007; Jean, Tan, & Sinkovics, 2011). To understand why firms direct their FDI toward a specific location, extant literature examined the motives behind firms' location choice (e.g., Dunning, 1993; Galan et al., 2007). As a result of this research, the motives market seeking, resource seeking, and strategic asset seeking revealed a significant explanation for the FDI location choice of large multinational enterprises (MNEs) (e.g., Chidlow, Salciuviene, & Young, 2009).

Studies on small- and medium-sized enterprises (SMEs) regarded the same motives (i.e., market seeking, resource seeking, and strategic asset seeking) as important drivers of the FDI location choice (e.g., Lei & Chen, 2011). However, the findings on the motives-FDI location choice relationship remain more inconclusive in the SME context (Chen & Chen, 1998; Lei & Chen, 2011) than for large MNEs. For example, Lin (2010) found that market seeking SMEs prefer to invest in developing countries providing attractive, rapidly growing markets and a large market potential for firms. In contrast, Urata and Kawai (2000) report that SMEs prefer to invest in developed countries when seeking for new markets as developing countries typically provide a lower GDP per capita and are less reliable with respect to forecasts and prognoses (Svetličič, Jaklič, & Burger, 2007).

The present study argues that inconclusive results from previous studies can be attributed to the non-observance of a core underlying characteristic of SMEs – their firm-specific resources or the lack thereof (Brouthers & Nakos, 2004; Nakos & Brouthers, 2002). More specific, we draw on the resource-based view of the firm (RBV; Barney, 1991) and FDI theory (Dunning, 1980) in order to develop a rationale for the moderating impact of resources (i.e., knowledge intensity and international experience) on the relationship between motives (i.e., market seeking, resource seeking, and strategic asset seeking) and FDI location choice (developed countries vs. developing countries) of SMEs. Resources differ with regard to their ability to be transferred and to create value in foreign contexts (Cuervo-Cazurra, Maloney, & Manrakhan, 2007). Some resources are more location bound and

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are only transferable and deployable in specific locations providing necessary host country characteristics such as sufficient property right protection systems or complementary production assets (Fang, Wang, Delios, & Beamish, 2007; Rugman & Verbeke, 2001). Other resources are less or non-location bound, and thus can easily be transferred and deployed internationally (Rugman & Verbeke, 2001). We therefore argue that based on their value creation and value transfer potential (Cuervo-Cazurra et al., 2007), resources may unfold different effects in different contexts (e.g., a resource may generate value in one location but not in another location) (Chen & Chen, 1998; Erramilli, Agarwal, & Kim, 1997) and, hence, resources are likely to vary motives' impact on FDI location choice. This is particularly pertinent to SMEs as they have to employ specific resources effectively in order not to overburden their organization with their host country location choice in light of their limited resources.

We seek to offer three major contributions to extant research. First, we aim to contribute to reducing inconclusive results regarding the impact of motives on SME FDI location choice by considering the interactive effect of motives *and* resources. This way, we expand the results of previous studies from the SME context (e.g., Chen & Chen, 1998; Lei & Chen, 2011; Lin, 2010) examining the direct impact of motives and firm-specific resources on SMEs' FDI location choice separately without establishing a link between both perspectives. Given that SMEs possess limited resources (Brouthers & Nakos, 2004; Nakos & Brouthers, 2002) and resources' impact depends on the environment where they are employed (Erramilli et al., 1997), we regard the establishment of the link between motives and resources as an important contingency to resolve previously inconclusive findings.

Second and related with the former, we introduce the concept of resource-based value erosion as underlying rationale to explain the moderating effects of SMEs' resources on the relation between motives and FDI location choice. Value erosion occurs (a) when the underlying value of firm-specific resources cannot be transferred to a foreign location or (b) when resources do not unfold their rent-generating value in a foreign context (Cuervo-Cazurra et al., 2007). Since firm-specific resources differ regarding their inherent risk of value erosion (Foss & Foss, 2005; Hashai & Almor, 2008; Jensen & Szulanski, 2004), we theoretically argue that resources do not reveal uniform moderating effects (Makino, Lau, & Yeh, 2002), but that the resources' underlying risk of value erosion may cause them to exert varying effects on the relationship between motives and FDI location choice. Our theoretical reasoning helps to reconcile the previously diverging argumentations regarding the impact of different motives on FDI location choice of SMEs. It is furthermore consistent with and expands prior studies which have shown that the transfer of firms' resource advantages to a foreign location is bounded to the risk of value erosion (Brouthers, Brouthers, & Werner, 2008; Madhok, 1997). Beyond the SME FDI location choice literature, our argumentation aims to contribute to the important discussion in the international business domain that firm-specific resources may also cause liabilities dependent on the context where they are employed and their very nature in terms of the risk of value erosion (Cuervo-Cazurra et al., 2007; Foss & Foss, 2005).

Third, we tailor our arguments specifically to SMEs as they are typically characterized by resource constraints (Mutinelli & Piscitello, 1998; Nakos & Brouthers, 2002) making the risk of resource-based value erosion particularly pertinent to this specific firm type. Larger MNEs possess slack resources (George, 2005) allowing them to – at least partially – offset the risks of value erosion. Despite our specific SME focus, we envisage our study and its underlying rationale to inform future research and theory building beyond the SME context.

2. Conceptual framework and hypotheses

2.1. Motives, resources, and FDI location choice

Arguing from FDI theory (e.g., Caves, 1971; Dunning, 1980; Hymer, 1976), firms engage in FDI to exploit and develop the value of firm-specific advantages abroad (Madhok, 1997; Trevino & Grosse, 2002). Dunning (1993) suggests that firms' reasoning to engage in FDI can be classified into three motives: (1) *Market seeking* FDI aims at extending firms' customer base by supplying products to foreign markets; (2) *Resource seeking* FDI refers to the transfer of firms' production to a foreign location providing lower resource costs or resources that are either not available or are only limitedly available in the present organizational structure of the firm; (3) *Strategic asset seeking* FDI captures the exploration of complementary knowledge abroad to develop and strengthen a firm's resource advantage. These motives[4] are firms' primary drivers to engage in FDI and, hence, play a pivotal role in FDI location choice research (Dunning, 1993; Galan et al., 2007; Narula & Dunning, 2000).

Although FDI theory is mainly applied in the context of large MNEs, the same motives are also relevant for SMEs' FDI engagements (Dunning, 1993; Lei & Chen, 2011). Svetličič et al. (2007) demonstrate that both large MNEs and SMEs are driven by the same motives and encounter similar barriers when engaging in FDI, even though SMEs face managerial and financial constraints more intensively than their larger counterparts. Therefore FDI theory and the underlying motives are considered as a suitable framework to examine FDI location choice in the SME context (Lei & Chen, 2011; Svetličič et al., 2007).

However, prior studies (e.g., Makino, Lau, & Yeh, 2002; Trevino & Grosse, 2002) suggest that FDI theory refers to only one side of the coin and that resource-based considerations are also critical in explaining FDI location decisions. The RBV describes the development of firm's competitive advantage from a set of firm-specific resources (Barney, 1991). Such resource advantages give ground to the capacities to successfully pursue FDI (Chen & Chen, 1998) making each FDI location choice significantly influenced by the type and amount of resources a firm possesses (Makino et al., 2002). Accordingly, researchers argued that RBV and FDI theory are complementary (Trevino & Grosse, 2002), because firms' resources and motives "are the most critical [...] to describe and explain the international expansion patterns of any MNE" (Rugman & Verbeke, 2001, p. 239). This perspective is consistent with more recent studies (e.g., Bu, Liu, Wagner, & Yu, 2013; Makino et al., 2002) proposing that motives and resources not only independently influence FDI location choice but that they also interact with each other. The effect of motives to invest in a particular location may vary depending upon firms' resource advantage as firms' "unique resources [...] may be matched to the local environment because of location-specific advantages" (Trevino & Grosse, 2002, p. 340).

Next, we therefore suggest that firm-specific resources provide an important boundary condition for the influence of firm motives on FDI location choice. More specific, we establish that the way firm-specific resources moderate the motive-FDI location choice relation is systematically determined by the underlying risk of resource-based value erosion.

[4] Dunning (1993) also refers to the motive efficiency seeking as important driver for FDI. Efficiency seeking aims at outbound FDI that is meant to relocate firm's manufacturing activities to a foreign country to realize employment advantages (Dunning, 1993). However, informed by Makino et al.'s (2002) study, we do not explicitly distinguish between cost advantages resulting from realizing manufacturing material advantages and labor advantages.