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Local conditions, entry timing, and foreign subsidiary performance

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ABSTRACT

This study examines whether local conditions (i.e., location-bound advantages and local density) are significantly related to foreign subsidiary performance in an emerging market. We also explore the moderating effect of entry timing on the relationship between local conditions and foreign subsidiary performance. Analysis of a longitudinal dataset of 357 foreign subsidiaries in an emerging market (the People's Republic of China) from 2006 to 2012 provides evidence that location-bound advantage is positively related to foreign subsidiary performance and local density is negatively related to foreign subsidiary performance. Furthermore, these relationships are significantly contingent on timing of entry. Our findings highlight the importance of local conditions and entry timing mitigating liability of foreignness and enhancing foreign subsidiary performance.

1. Introduction

The success of MNEs' international expansion depends in part on their ability to mitigate the disadvantages they face when operating in host countries (Hymer, 1960; Zaheer, 1995). Zaheer (1995) termed these disadvantages liability of foreignness (LOF). Broadly defined, LOF is the total additional costs a firm incurs while operating in a foreign host market that a local firm does not need to pay out. The literature indicates that the greater the liability of foreignness in a country, the more disadvantages foreign subsidiaries face when operating there, which ultimately lowers their performance (Chang, Chung, & Moon, 2013; Miller & Eden, 2006). Clearly, understanding the effects of LOF and the potential strategies that foreign firms can implement to mitigate or overcome it remain critical issues for managers and international business scholars.

Scholarly studies have shown that there are generally two strategic approaches that can decrease LOF and enhance foreign subsidiary performance. One approach is for foreign subsidiaries to proactively adopt strategies that are anchored with their parent firm's resources and capabilities. For example, studies have shown that foreign subsidiaries can mitigate or overcome LOF by choosing an appropriate entry mode (Delios & Henisz, 2000; Martin & Salomon, 2003), timing market entry (Delios & Makino, 2003; Pan, Li, & Tse, 1999), diversifying product offerings (Delios, Xu, & Beamish, 2008), and incorporating multinationality (Fang, Wade, Delios, & Beamish, 2007). The other strategic approach is to adapt the subsidiary to resemble host country firms so that it can more easily gain local legitimacy. These modifications can be achieved by mimicking host country firms, a phenomenon known as local isomorphism (Salomon & Wu, 2012), and adapting to the local environment (Miller & Eden, 2006).

Although a great deal of research has been devoted to understanding LOF, some significant knowledge gaps remain. One gap concerns the intra-country heterogeneity of LOF. Previous studies have mainly examined LOF at the national level (Miller and Eden, 2006); however, international business and management scholars have also emphasized the importance of subnational locational differences (Beugelsdijk, McCann, & Mudambi, 2010; Kostova & Zaheer, 1999; Porter, 1990; Xu & Shenkar, 2002). For instance, McCann and Mudambi (2005) pointed out the importance of subnational locational analysis of MNEs, and they encouraged researchers to investigate the local conditions within individual countries in order to enhance understanding of location effects on MNE strategy. Other authors have argued that subnational regions within large emerging economies (such as China) are likely to have heterogeneous local production, institutions, and subnational agglomeration (Ma, Delios, & Lau, 2013; Ma, Tong, & Fitza, 2013). However, few studies have followed up with investigations of LOF at the subnational level (Qian, Li, & Rugman, 2013). We propose that subnational level heterogeneity

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influences foreign subsidiaries' performance because different regions have different opportunities and constraints, which shape the cost of doing business and lead to subnational differences in LOF (Qian et al., 2013).

A second knowledge gap exists about the precise nature of the relationships between entry timing, local conditions (i.e., location-bound advantages and local density), and foreign subsidiary performance. Several studies have found evidence for the importance of foreign subsidiary strategic orientations that are tailored to local conditions (Griffith, Kiessling, & Dabic, 2012; Luo & Park, 2001). Other studies have examined the relationship between location effects and foreign subsidiary performance (Chan, Makino, & Isobe, 2010; Makino, Isobe, & Chan, 2004; Ma et al., 2013). Similarly, entry timing has been shown to be a critical strategic decision that influences foreign subsidiary competitiveness and performance (Delios & Makino, 2003; Isobe, Makino, & Montgomery, 2000). However, relationships with entry timing are complex. On one hand, some scholars have argued that early entry provides entrant with opportunities to secure resources before competitors, which acts as a form of early-mover advantage and helps the firm increase competitiveness and overcome LOF (Delios & Makino, 2003; Lieberman & Montgomery, 1998). On the other hand, early entry often requires dealing with high levels of uncertainty, deficient market knowledge, and the lack of fundamental infrastructure (Lieberman & Montgomery, 1998). All of these factors can impair performance. Therefore, it is more likely that a firm's actual entry timing decision is the end result of a complex calculation of the various advantages and disadvantages of early versus late entry.

Adding further complexity to the discussion of the factors influencing entry timing is the argument that the entry timing decision might not be determined by firm characteristics alone (Lieberman & Montgomery, 1998). Entry timing is also influenced by the firm's home country environment (Stevens & Dykes, 2013) and host country conditions (Nakata & Sivakumar, 1997). Despite the numerous studies that have identified and measured the importance of local conditions, the effect of these conditions on entry timing advantage remains underdeveloped (Fosfuri, Lanzolla, & Suarez, 2013), and the relationships between local conditions, entry timing, and subsidiary performance have yet to be integrated.

A third gap exists in the contextual examination of LOF and subsidiary performance. International business researchers have explored the effects of LOF on foreign subsidiary performance in a number of contexts, such as LOF's impact on worldwide expansion (Miller and Eden, 2006; Zaheer & Mosakowski, 1997), its occurrence in advanced countries (Elango, 2009; Nachum, 2003), and its effects on developed country firms entering emerging economies (Chen, Griffith, & Hu, 2006; Ma et al., 2013). However, there is limited knowledge about LOF's effects on multinationals from developing countries (Jiang, Liu, & Stening, 2014), and few studies have examined firms from emerging economy (EMNEs) entering other emerging economies. This is an important topic because several studies have suggested that the FDI strategies of EMNEs are different from those of advanced economy firms (Filatotchev, Strange, Piesse, & Lien, 2007; Makino, Lau, & Yeh, 2002). Emerging economies pose significant and unique strategic challenges to multinationals. For example, Peng (2003) found relatively weaker institutional support for market transactions in emerging economies. Eden and Miller (2004) indicated that contextual differences enhance firms' unfamiliarity hazards. Chen, Li, and Shaprio (2011) maintained that a general management prescription is less effective in emerging economies. These studies show that a more in-depth understanding of the applicability of standard LOF logic and its effects on EMNE subsidiary performance needs to be provided in the context emerging economies.

The purpose of this study, therefore, is to address these three knowledge gaps. We examine the effects that two dimensions of local conditions (location-bound advantages and local density) have on subsidiary performance. Location-bound advantages are unique advantages found in a foreign location; exploiting these advantages can create competitive advantage for foreign firms and counteract the costs of LOF. Local density is the number of firms competing for the same resources in a foreign location. We also test whether the relationship between local conditions and foreign subsidiary performance varies with entry timing. We empirically test our proposed relationships with a sample of Taiwanese firms' subsidiaries operating in China.

This study makes the following contributions to the ongoing conversation about mitigating LOF and subsidiary performance enhancement. First, we extend the LOF literature by showing how local conditions can significantly affect foreign subsidiary performance at the subnational level. Second, we supplement and provide greater detail to existing research streams by identifying how local conditions interact with entry timing and further influence subsidiary performance. Third, our research explores these effects in the context of emerging economy firms' foreign subsidiaries in another emerging economy. This develops and extends LOF research in the increasingly important area of inter-emerging economy investment. Overall, this study enhances knowledge about the drivers of foreign subsidiary performance. The findings should be meaningful to international business researchers and managers interested in LOF and the internationalization of emerging economy firms.

The remainder of this study is organized as follows. In the next section, we review the current literature and relevant theoretical background, and formulate our hypotheses. Details about the research methodology and the data analysis used to test our proposed hypotheses follows. We conclude with a discussion of the empirical findings and their practical and theoretical implications, as well as the limitations of the research and potential future research opportunities.

2. Literature background

2.1. Liability of foreignness

Liability of foreignness is the term for the phenomenon of foreign firms facing additional costs in a host country that local companies do not face. In the international business literature, Hymer (1960) was first to discuss the concept of LOF. He argued that foreign firms face distinct disadvantages because domestic firms have much better information about local conditions than foreign competitors. Later, Kindleberger (1969) added that foreign firms' disadvantages arise from the spatial distance between parent firms and their subsidiaries. Caves (1971) recognized that firms doing business abroad must generate sufficient rents from their firm-specific assets to overcome whatever disadvantages they face relative to domestic firms. These arguments all accept and assume the presence of LOF, and they indicate that MNEs must leverage their firm-specific advantages to overcome the obstacles they face when investing abroad.

Business scholars have long accepted the existence of LOF, which has resulted in a substantial number of studies that have explored the topic. These studies fall within one of several streams. One well-established stream examines the antecedents of LOF. Zaheer (1995) pioneered this research topic and argued that LOF arises from at least four sources: (1) costs directly associated with spatial distance; (2) firm-specific costs based on a particular company's unfamiliarity with and lack of roots in a local environment; (3) costs resulting from the host country environment; and (4) costs from the home country environment. In

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