

**STRATEGIC SHIFT FROM EXPORTS TO FDI IN THE INTERNATIONALIZATION
OF EMERGING ECONOMY FIRMS**

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ABSTRACT

In this paper we analyze an important step in the internationalization process of emerging economy (EE) firms: the shift from exports to foreign direct investment (FDI). We integrate the resource and institution-based views to suggest that EE firms, which can make use of the unique institutional advantages, are more likely to make a shift from exporting to FDI. We test our arguments on a longitudinal sample of 28,563 firm year observations during 1989 to 2007. Our findings suggest that firms which are affiliated to a business group, have a greater level of firm level and group level international experience, have more technological and marketing resources, and operate in industries with greater level of foreign participation, are more likely to make the shift from exporting to FDI.

INTRODUCTION

The number of emerging economy (EE) firms making foreign direct investments (FDI) has grown exponentially in recent years. This has led to increased scholarly attention to the interesting and, often, very complex international business (IB) phenomenon of the internationalization of EE firms (Luo & Tung, 2007; Ramamurti & Singh, 2009). While increased FDI by EE firms and, more generally, from EEs¹ has propelled this line of research, it has left several perplexing questions for IB scholars.

Are existing IB theories sufficient to fully explain EE firm internationalization? Do EE multinationals comprise a homogeneous set of firms? Is the internationalization process similar for EE multinationals belonging to service and manufacturing sectors? These are some of the important questions being fiercely debated by IB scholars (Dunning, 2006, Guillen & Garcia-Canal, 2009; Luo & Tung, 2007; Mathews, 2006a; 2006b; Narula, 2006, Ramamurti & Singh, 2009). Even though many EE firms have undergone accelerated internationalization, involving large scale mergers and acquisitions or high value FDI (Bonaglia, Goldstein, & Mathews, 2007; Luo & Tung, 2007; Mathews, 2002; Mathews, 2006a; Mathews & Zander, 2007), exports has been and continues to be the dominant form of serving international markets for a majority of EE firms (Aulakh, Kotabe, & Teegan, 2000, Child & Rodriguez, 2005; Yiu, Lau, & Bruton, 2007)². How do these firms make a shift from exports to FDI as a means to serve and operate in international markets? In this article, we examine the factors that lead to such a shift in EE firms' international strategy. We conceptualize a shift in international strategy when a firm engaged

¹ From a trivial amount in the early 1980s, outward FDI from EE firms has risen to USD 1.4 trillion in 2005, representing a 13% share in world FDI stock (UNCTAD, 2006).

² China the largest EE for outward FDI has now become the world's third largest exporter after Germany and United States (Williams, 2005). Exports from EEs already account for some 45% of the world total (Economist, 2006).

internationally via means of exports makes an FDI for the first time. As such, our treatment of a shift does not necessarily imply the end of exports as a means to serve international markets instead it marks the initiation of FDI by the firm to serve internationally.

Exports and FDI form two distinct strategies of internationalization with different motivations, resource requirements, cost structures, risks, and consequences. FDI typically involves greater commitment than traditional exports (McDougall & Oviatt, 2000; Zahra & Covin, 1995). Shifting from an international strategy based on only exports to that based on FDI (or a combination of FDI and exports) is a big step in the internationalization of a firm, akin to internationalizing in larger steps instead of in smaller steps (Barkema & Drogendijk, 2007). Extant research on EE firm internationalization provides deep insights on factors affecting EE firm exports (Aulakh et al., 2000; Daniels & Robles, 1982; Filatotchev, Dyomina, Wright, & Buck, 2001; Filatotchev, Liu, Buck, & Wright, 2009; Dominguez & Sequeira, 1993) as well as on factors affecting FDI (Buckley, Clegg, Cross, Liu, Voss, & Zheng, 2007; Deng, 2009; Wan, 2005; Yiu et al., 2007). However, to the best of our knowledge, there is no study that explicitly explores the factors determining the shift from exports to FDI for EE firms. We utilize a multi-theoretic approach, deriving insights from the resource-based view (RBV) and institution-based view (IBV) to provide answers to the above over-arching research question.

Our paper contributes to the extant literature in three ways. First, our integration of RBV and IBV provides a useful theoretical framework to analyze the internationalization process of EE firms. EE firms are often viewed as having weaker resource base in terms of traditional resources (Gaur & Kumar, 2009). While this limits the internationalization initiatives of EE firms, they compensate for their weakness in traditional resources using non-traditional, network-based resources arising as a result of unique institutional and industrial characteristics of

EEs (Contractor, Kumar, & Kundu, 2007, Cuervo-Cazurra & Genc, 2008; Elango & Pattnaik, 2007; Yiu et al., 2007). Outward FDI has become a source of motivation and an escape response from the weak home country institutional environment (Witt & Lewin, 2007) for many EE firms. The quick rise to global dominance of industries such as the business process outsourcing (BPO) in India can be attributed primarily to the institutional upheaval that underlies the Indian economy in general, and the information technology sector in particular (Peng, Wang, & Jiang, 2008). Given that such inter-linkages between resources, institutions and industries exist, it is necessary to have an inclusive and integrative theoretical framework when studying EE firm internationalization (Meyer & Peng, 2005; Yamakawa, Peng, & Deeds, 2008).

Second, even though a shift from exports to FDI is an important event in the internationalization process, we do not have sufficient understanding of the antecedents of such a shift for EE firms. A better understanding of when and why EE firms make this shift will help improve our conceptualization of the internationalization process of EE firms. Our discussions will also help resolve the differences and/or explore the similarities between the internationalization of EE firms vis-à-vis that of DE firms. In doing so, we hope to contribute to the debate on the applicability of IB theories to context specific IB phenomenon such as the internationalization of EE firms (Dunning, 2006; Luo & Tung, 2007; Mathews, 2006b; Narula, 2006; Ramamurti & Singh, 2009). Third, we provide empirical evidence utilizing a large panel data on firms from the second largest EE – India – that has not been widely used in scholarly studies.

BACKGROUND

Scholars have been interested in the issue of the internationalization of EE firms since the late 70s (e.g., Kumar & Mcleod, 1981; Lecraw, 1977; Lall, 1983; Wells, 1977; 1983), nevertheless,

research in this area still remains limited (Wright, Filatotchev, Hoskisson, & Peng, 2005; Yamakawa et al., 2008). Most research on EE has been focused on DE firms entering into EEs and on domestic competition within EEs (Hoskisson, Eden, Lau and Wright, 2000). It is only in the recent past, with the publication of focused issues in JIBS (2007, 2009), MIR (2009), JIM (2007), and JMS (2005), that research on EE firm internationalization has witnessed a phenomenal growth. Extant research has discussed the motivations, paths, processes and performance implications of EE firm internationalization, almost invariably, with a focus on differentiating it with DE firm internationalization.

Focusing on the motivations for internationalization, scholars have suggested that the main motivations for EE firm internationalization include risk diversification, exploiting experience with labor-intensive technology, social network through ethnic ties, small home markets and acquisition of management expertise in marketing, technology and general management. On the other hand DE firms internationalize to exploit experience with high technology production or when they face threats in their existing markets (Lecraw, 1977; 1993). With respect to internationalization path, EE firms direct their FDI mainly towards other EEs (Wells, 1977), which are geographically and institutionally proximate (Chen; 2003; Pang and Komaran, 1985; Tallman and Shenkar, 1994). Analyzing Chinese FDI, Morck, Yeung and Zhao (2008) found that Asia, Latin America, and Africa accounted for 63.9, 26.3, and 3.4% of the Chinese outward FDI respectively, whereas North America and Europe accounted for very small amounts of less than 3% each.

In terms of process, EE firms have historically used an export-based strategy for most of their international markets (Aulakh et al., 2000; Child & Rodriguez, 2005; Yiu et al., 2007). A number of studies have focused on factors affecting the export strategy of EE firms. Use of

capital-intensive technologies in the production process (Daniels and Robles, 1982), governance issues such as managerial and outside control (Filatotchev, Dyomina, Wright, & Buck, 2001), entrepreneurial characteristics such as founder's international background and global networks (Filatotchev et al., 2009) are some of the factors found to have significant impact on export intensity and performance of EE firms. Although, exporting remains the predominant internationalization strategy, some EE firms have the tendency to jump from no or minimal involvement such as exports to direct investments in foreign subsidiaries (Lecraw, 1993). This trend has gained momentum in recent years and has been described as 'accelerated internationalization', a feature distinctly associated with EE firms (Bonaglia, Goldstein & Mathews, 2007; Luo & Tung, 2007; Mathews, 2002; Mathews, 2006a; Mathews and Zander, 2007).

A few scholars have attempted to explain the process of rapid internationalization that some EE firms have achieved, in spite of their lack of traditional ownership-specific advantages. For example, Luo and Tung (2007) present the 'springboard perspective' of EE firm internationalization, suggesting that EE firms overcome their latecomer disadvantage in the international market place by aggressive acquisitions of assets from mature MNEs. This view has found some support in literature as EE firms pursue asset-seeking and asset-augmenting FDI strategies (Makino, Lau, & Yeh, 2002, Mathews, 2002), instead of the asset-exploiting FDI strategy pursued by DE MNEs. Mathews (2006a) presents the 'Linkage, Leverage, Learning' or the LLL framework to describe the unique ability of some EE firms to partner with foreign firms, leverage such partnerships for global competitiveness and continuously learn in this process to further internationalize their operations.

Research on performance implications of EE firm internationalization suggests that

performance of internationalizing EE firms, similar to that for DE firms, is to a large extent determined by the degree of internationalization the firm has achieved (Nachum, 2004). Given that on average EE MNEs have achieved a lower degree of internationalization than their DE counterparts, their internationalization-performance relationships is accordingly reflected by only a U or inverted-U shaped curve (Contractor et al., 2007; Gaur & Kumar, 2009; Thomas, 2006) as compared to the S-shaped curve reflecting this relationship for DE MNEs (Contractor, Kundu, & Hsu, 2003; Lu & Beamish, 2004). This relationship, however, both for EE MNEs and DE MNEs is influenced by a number of factors, including the resource base (marketing and R&D intensity) and the institutional environment of the home and host country markets (Chao & Kumar, 2009; Gaur & Kumar, 2009, Kotabe, Srinivasan, & Aulakh, 2002; Kumar & Singh, 2008; Venzin, Kumar, & Kleine, 2008).

The above review of motivations, paths, processes and performances of EE firm internationalization demonstrates that there are important differences between EE and DE firms' internationalization, with those relating to the process being most intriguing and researched upon. However, a key aspect in the process, the shift from exports to FDI has been largely ignored. Also, worthy to note is that even within this limited, albeit growing, body of literature focus has been almost entirely on Chinese firms' internationalization (e.g., Buckley et al., 2007; Child & Rodriguez, 2005; Cui & Jiang, 2008; Deng, 2009; Filatotchev et al., 2009; Morck et al., 2008; Rui & Yip, 2008; Yiu et al., 2007; Zhou, Wu and Luo, 2007). Indian firms have been active players in global business since a long time (see Lall, 1983; Singh, 1977; Wells, 1983), have gained global dominance in certain key industries (Peng et al. 2008; Khanna & Palepu, 2006) and more importantly are unique in certain characteristics even when compared to MNEs from other EEs. Indian firms' internationalization has been of-late (since 1995) characterized by

significant FDI to ‘up-market’ (DE) host locations, conducted by private entrepreneurial enterprises, primarily from the services sector (Ramamurti & Singh, 2009). On the other hand, China’s outward FDI is mainly into neighboring Asian countries and resource-rich part of Africa (thus, to other EEs), spearheaded by state-controlled monoliths, primarily from the manufacturing sector (Morck et al., 2008). Khanna (2009) argue that China and India are polar opposites on two key macro-level factors – the role of state and civil society in economic development of the country. These differences demonstrate the heterogeneity that exists even within EE firms (Dymsza, 1983; Ramamurti, 2009), and point to the potential for theoretical and empirical extensions of IB theories with studies focused on India.

THEORETICAL FRAMEWORK

Our theoretical model is based on the integration of RBV and IBV to explain the shift in international strategy from exports to FDI for EE firms. RBV and IBV are often used to analyze the strategic behavior of firms in EEs (Wan, 2005; Wright et al., 2005), and entry of MNEs into EEs (Meyer, Estrin, Bhaumik, & Peng, 2009). IBV has been recently advanced as an appropriate and effective lens to study IB strategy, especially those relating to EEs (Peng et al. 2008). However, it is widely recognized that no single theoretical lens is sufficiently powerful to comprehensively explain complex strategic choices such as those relating to internationalization of firms (Yamakawa et al., 2008). In addition, it is at times difficult to strictly compartmentalize the effects of resources and institutions, as they seem to interact and enhance each other’s effects (see Meyer et al., 2009). No other setting is better suited to exhibit such interactions between resources and institutions than the research context of EE firm internationalization.

The resources and capabilities that EE firms utilize in the internationalization process directly or indirectly emanate from unique institutional environment in their home countries. We

refer to these resources as institutional resources given that they have emerged as a consequence of the prevailing institutional environment. Institutional resources are non-traditional in nature in the sense that they have not received adequate attention in the analysis of internationalization strategy of the more established and traditional MNEs from DEs. While traditional, firm resources such as marketing, technology and international experience are important determinants of EE firm internationalization we argue that institutional resources play an equally critical role, by themselves as well as in conjunction with traditional resources. Similar to traditional firm resources, institutional resources affect every aspect of EE firm internationalization, from setting motivations to determining internationalization paths, processes and performances. Our contention is to explore how firm and institutional resources affect, and thereby determine the shift from exports to FDI for EE firms. In doing so we propose the boundary conditions for RBV and IBV based explanations of internationalization of EE firms.

According to RBV firm specific heterogeneity in terms of resources and capabilities determine strategic choices made by firms (Barney, 1991), including those pertaining to international business (Peng, 2001). Firms that are in possession of more valuable and inimitable resources are able to compete more effectively in the global marketplace than those that do not possess such resources. EE firms do rely on firm specific resources, although in a manner different from DE firms. Ghymn (1980) demonstrates that Korean construction companies (at the time very much in the category of EE firms) extensively used domestic manpower, abundant in supply and of relatively decent talent, for their FDI operations in the middle-eastern countries. Similarly, Indian software companies' internationalization has been characterized by extensive use of domestic manpower in their international operations. Such use of domestic labor for foreign operations is unheard of in the context of DE MNEs. EE firms production know-how

emerges from their capabilities in labor intensive, usually small scale, manufacturing and their marketing know-how emerges from being able to serve specialized niche market segments such as the small expatriate ethnic communities (Wells, 1983).

Consistent with the above, Miller, Thomas, Eden and Hitt (2008), found prevalence of ethnically similar customers and competitors to be a source of motivation and a basis to develop rare inimitable resources for EE firms internationalizing into DEs. Young, Huang and McDermott (1996) in their study of Chinese state-owned enterprises highlight the importance of distinctive technological proprietary assets held by such firms in their internationalization process. Hence, firm resources are critical in the internationalization of EE firms. Since FDI requires far greater capital and managerial resources, among others, compared to simple exporting, EE firms in possession of greater firm resources are better equipped to make the shift from exports to FDI. Greater resources devoted towards marketing will allow EE firms to more thoroughly scan various international markets and be able to make better choices in terms of location, entry mode and foreign partners. Greater resources devoted for technology enhancement will allow EE firms to come up with products that meet the often more stringent product-quality and safety- requirements for international markets, while keeping the costs low. Greater capital resources will allow EE firms to make expensive acquisitions of brands and technology, as well as enter into joint-ventures as a majority equity holder. Greater resources devoted towards management development will allow EE firms to be better able to integrate and assimilate acquired entities abroad. Furthermore, such commitments of resources towards management, marketing and technology will lead to superior capabilities that boost morale of firm managers and lend greater confidence to tread on a path that is more risky than simple exports. We make hypotheses for three specific types of firm resources - marketing, technology,

and international experience – in how they explain the shift from exports to FDI.

According to IBV, institutions affect firm strategy and performance (Peng et al. 2008). Well-developed institutions enable firms to conduct business more efficiently using the market, whereas under-developed or weak institutions create higher transaction costs, making market based exchanges less efficient. EEs are characterized by weak institutions (Hoskisson et al. 2000; Wright et al., 2005), which although not very conducive to business in general, may serve as a strong motivation for firms to engage in FDI. Some EE firms want to escape the stifling regulatory constraints at home (e.g., SabMiller's globalization motive cited in Luo & Tung, 2007) or overcome negative country-of-origin effects and acquire legitimacy in international markets (Deeds, Mang & Frandsen, 2004) by investing abroad.

In addition to impacting internationalization motives, institutions may also impact internationalization paths. Some EE firms view their home experience as a valuable resource to be exploited in other similar foreign markets. Cuervo-Cazurra and Genc (2008) showed that EE MNEs are at a competitive advantage compared to DE MNEs when entering and operating in other EEs. The source of this competitive advantage lies in the experience that firms gain by operating in environments characterized with underdeveloped institutions and difficult governance conditions. Likewise, Buckley et al. (2007) showed that Chinese FDI is attracted, rather than deterred, by political risk. This explains huge Chinese investments in many African nations marred by political instability. DelSol and Kogan (2007) demonstrated that affiliates of Chilean (an EE) firms successfully operated in Latin American countries (EE), in spite of institutions being relatively weak and the economy undergoing institutional transition. Their experiences of conducting business at home during a period of institutional transition acted as a source of unique competitive advantage that allowed them to outperform the local firms in Latin

America.

We treat the formation of business groups and unique attributes of firms affiliated to business groups a response and thus, a result of the institutional environment in EEs. Thus, by capturing traits associated with affiliation to business groups we in essence capture unique elements of the EE institutional environment. For example, access to common pool of resources – capital, labor, FDI experience - of the group through strong networking by individual firms is a trait unique to only those that have appropriately responded to the given institutional environment of the country. We focus on two types of institutional resources for EE firms, one arising from being affiliated to a business group and the second arising from being associated with certain industry sectors that are undergoing rapid institutional reforms. EE firms affiliated to business groups may access group resources such as capital, labor and international experience that can be invaluable in making decisions regarding FDI. Other advantages for affiliated EE firms emerge from their social and business networks and linkages (Elango & Pattnaik, 2007; Zhou et al., 2007; Yiu et al., 2007). Chen and Chen (1998) in their study of Taiwanese firms found that network linkages, both intra-firm as well as inter-firm, were important determinants of FDI location choice. In essence, such resource for firms affiliated to business groups can be traced back to their response to the unique institutional environment of EEs. We treat advantages that member firms of a business group have over unaffiliated firms as being institutional resources.

In addition to group affiliation, industry specific institutional conditions also act as a resource for EE firms. Industries in EEs are characterized by a low degree of competition, particularly from foreign players. However, owing to the institutional reforms that several EEs have undergone (Wan 1995), many industries in such EEs are now open to foreign players and

are thus exposed to a higher degree of competition. Higher industry competition through greater foreign participation is likely to drive some EE firms to venture into international markets, in search for new markets and in order to avoid clashing with other incumbents (Dawar & Frost, 1999; Mascarenhas, 1986). Furthermore, industries such as the service sector that has witnessed phenomenal easing of regulatory controls allowing entry and operation by private players, has unleashed an entrepreneurial spirit that has had tremendous impact on internationalization strategy of firms.

HYPOTHESES DEVELOPMENT

A shift from exports to FDI involves several challenges. Exporting is a low risk strategy to operate in international market as it requires fewer resources and can be easily reversed. FDI, on the other hand is a high risk strategy as it requires a higher commitment of resources and usually can not be easily reversed. The gains from exporting and FDI also correspond to the level of risk associated with the two. In the long run, FDI is potentially a more competitive way than exporting for operating in international markets (Lu & Beamish, 2001). Given the high gains associated with FDI, firms want to make a shift from exporting to FDI. However, not all firms are capable of doing so. In this section, we argue that firms that are rich in traditional as well as non-traditional resources arising due to unique institutional environment in EEs are more likely to make a shift from exports to FDI. We present our arguments and hypothesis under three broad categorizations - resource based explanations, institution based explanations and contingency effects.

Resource Based Explanations

Technological and market resources. Much of the theoretical discourse on internationalization process has relied on ownership specific advantages possessed by resource rich firms (Dunning,

1993). Ownership specific advantages provide greater motivation for internalization. Traditional firm resources also create a stronger domestic position for a firm, which it can exploit in the foreign markets (Delios & Beamish, 2001). Entry into new markets through FDI does not depreciate the home market value of a firm's resources (Morck & Yeung, 1998). Rather, in the case of EE firms, internationalization often strengthens their existing resource base.

Technological and marketing abilities comprise two important traditional resources for firms. There is evidence that such resources significantly impact the performance of internationalizing firms (Kotabe et al., 2002). According to endogenous growth theory (Grossman & Helpman, 1995), success of internationalization activities is dependent on the technological competitiveness, which in turn is dependent on the level of innovative activities. Buckley and Casson (1976) found technology as an important factor in determining the product mobility across national boundaries. Daniels and Robles (1982) in their study of Peruvian textile firms found that adoption of capital-intensive technologies in the production process had a positive impact on their exports as such technologies improved product quality perception, delivery reliability and lowered production costs for the more competitive foreign markets. Technological resources and capabilities can be a source of long-term competitive advantage for firms especially in foreign markets (Alvarez, 2004; Anand & Kogut, 1997). These capabilities translate tangible and intangible resources of the firm into new innovative products and technologies and thereby enhance firm's competitiveness (Buckley & Casson, 1976; Morck & Yeung, 1991). In fact, many firms invest in R&D with the specific purpose of innovating for foreign markets (Kuemmerle, 1999). Several scholars have found a positive link between technological capabilities and success of internationalization activities (Cooper & Kleinschmidt, 1985; Moini, 1995; Wagner, 1995).

Similar to technological resources, marketing ability of a firm is also an important determinant of its success in the foreign markets. Many EE firms, when going abroad, initially target the Diaspora and specific ethnic communities, who have knowledge about the reputation of the firm and its products in the domestic market. Firms, then build on this reputation over time, by investing more on marketing efforts in those foreign locations. Such marketing ability to benefit from diaspora communities is more pronounced in cases of EE firms entering DEs. Kapur and Ramamurti (2001) discuss the important role played by large Indian diaspora communities in DEs in the successful internationalization of the Indian software firms. Miller et al. (2008) demonstrate that many Latin American banks expanded their operations to the US with the motive to market to ethnically similar customers in the US, in the process creating unique marketing capability in targeting small communities. We posit that EE firms that have invested in international market research to gain unique marketing insights and build a strong market reputation to begin with are more likely to make a shift from exports to FDI. Accordingly, we hypothesize:

***Hypothesis 1a:** Firms with greater technological resources are more likely to make a shift from exports to FDI.*

***Hypothesis 1b:** Firms with greater market resources are more likely to make a shift from exports to FDI.*

International orientation. Importance of international orientation and experience for the success of internationalization initiatives is well documented in extant literature (Chang, 1995; Delios & Beamish, 2001). Filatotchev et al. (2009) show that entrepreneurial characteristics such as founder's international background and global networks as well as the presence of a "returnee" entrepreneur, factors determining international experience, have a positive influence on export orientation and performance of high tech EE firms. Scholars have suggested that firms that have

more experience of operating in a host country have a higher likelihood of sustaining their foreign investments. Such firms also make better utilization of their intangible assets, enhancing the success of foreign investments. While the host country specific experience is important for the success of foreign investments, just having more general knowledge of operating in foreign markets also helps in internationalization initiatives (Barkema et al., 1996).

EE firms may not have host country specific experience as the only internationalization activity for them may be exporting. However, EE firms pursue different types of export strategies (low involvement-low volume-low content, price-cost-volume, and product-service quality oriented) based on level of diversification in their exported products and export markets (Dominguez & Sequeira, 1992), thereby providing the general knowledge of operating in foreign markets. For successfully operating in export markets, firms have to change their processes to satisfy the design and operational specifications, and enhance the quality of their products. Serving multiple clients in remote locations is often more difficult than serving them from within the host countries. As such, exporting activities lead to learning about foreign markets that can be later used for designing more effective investment strategies for those markets. Prior exporting activities also act as a trigger for FDI as FDI helps in overcoming barriers for future exporting activities. Export-led growth for some EEs, like Argentina, Brazil, Hong Kong, India, South Korea and Taiwan, was soon being complemented and reinforced by FDI by firms from these countries (Wells, 1983). Analyzing FDI by Chinese multinationals, Buckley et al. (2007) suggested that one of the key motives of Chinese FDI is to promote domestic exports. FDI may help gain access to raw material, knowledge, and client contacts (Deng, 2004; Vermeulen & Barkema, 2001), all of which may help in future exporting activities. Thus, on the one hand prior export experience helps in making successful FDI, prior stock of exporting acts as a trigger to

make a shift from exports to FDI to gain more benefits from internationalization activities.

Accordingly, we hypothesize:

***Hypothesis 2a:** Firms with greater level of export intensity are more likely to make a shift from exports to FDI.*

***Hypothesis 2b:** Firms with greater level of export experience are more likely to make a shift from exports to FDI.*

Institution Based Explanations

Business Groups. Under-developed institutions create voids in markets, adversely affecting firms that depend on markets immensely for conducting their business, making them less competitive and profitable. In response to the prevailing institutional environment (well-developed or under-developed), firms adopt specific strategies to operate and profit. For example, firms operating in well-developed institutional environment tend to have more focused strategy in terms of products and industries, where as firms operating in under-developed institutional environment are generally diversified into multiple products and industries (Khanna & Palepu, 1997). Many EE firms attain such diversification through organizing themselves as business groups. While this organizational form is also present in DEs, it is more prevalent and dominant in EEs (Yiu, Bruton, & Lu, 2005).

Khanna and Rivkin (2001: 47-48) define business groups as “a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties, and are accustomed to taking coordinated action”. Business groups emerge as a response to imperfect or missing markets (Caves, 1989; Leff, 1976, 1978), as a result of strong interpersonal relationships such as those in a family or clan (Granovetter, 1994), or as a result of active or passive government support such as access to capital through loan guarantees and other favorable government policies (Evans, 1979; Ghemawat & Khanna, 1998; Guillen, 2000).

Affiliation to business groups provides various benefits to EE firms. EEs lack the formal and informal institutions needed for efficient market based exchange. Business groups fill the voids created due to lack of these institutions (Chang & Choi, 1988; Khanna & Palepu, 1997, 2000a, b; Leff, 1978) enabling firms to effectively conduct business activities. Affiliated firms tend to outperform unaffiliated firms in EEs with weak institutional environment (Khanna & Palepu, 2000a). A stronger domestic position lends affiliated firms with risk taking ability to venture into international markets through high commitment modes such as FDI. EEs are also more risky due to uncertain economic and political systems. Managing political risk and developing mechanisms to cope with as well as benefit from such political risks are important factors for the success of EE firms (Jankova & Katz, 2003). Firms that can control the sources and supplies of their raw materials as well as sales of their final products to the end consumers are in a better position to guard against these risks. Affiliation to business groups provides firms with these capabilities as they can rely on group-wide reputation and resources. Group affiliated firms also have broader and relatively easy access to capital, both internal and foreign, and are able to access labor and product markets more easily than firms that are not part of any business group (Khanna & Rivkin, 2001).

Internationalization through FDI involves substantive commitment of financial and other resources, which might be easier to manage for a group affiliated firm than for an unaffiliated firm. As we argued earlier, group affiliation provides affiliated firm with preferential access to financial resources and group-wide human and technical resources. Unaffiliated firms may find it difficult to have similar access to such resources and may have to develop the technical and human resources in-house, which is quite often an expensive and lengthy process (Dierickx & Kool, 1989). In addition, firms indulging in FDI should be willing to take a long position and

bear losses in the short run. Cross-subsidization across group companies would make it easier for a group affiliated firm to bear losses in the short run. Accordingly, we expect that firm affiliated to business groups will find it easier to make a shift from exports to FDI.

Hypothesis 3a: *Firms are more likely to make a shift from exports to FDI if they are affiliated to a business group.*

In addition to helping affiliated firms gain access to traditional resources through network relationships, group affiliation can also help in alleviating the lack of knowledge about the host country environment. The network structure of a business group allows affiliated firm to draw upon the knowledge that may be available anywhere in the network (Hoskisson, Kim, White, & Tihanyi, 2004). This is made possible through rotation of key employees across different group affiliated companies through inter-company transfers. Internationalization by way of FDI is often seen as bringing reputation to the group (Aguar et al., 2006). As a result, members firms of a business group are keen to be part of such reputation building exercise, and do not hesitate to part with their key employees and resources if that can help any other affiliated firm in making a successful FDI.

The above discussion suggests that group affiliated firms do not have to have the export experience in themselves. The export experience of other member firms is as beneficial as the experience gained through own exports. In addition, group affiliated firms can have access to invaluable knowledge about operating in foreign markets if any other member firm has made a direct investment. In the case of Japanese Kiretsu networks, scholars have suggested that Japanese firms replicate the patterns of relationships they have with other members of the Kiretsu in the domestic market, when they go to a foreign market (Gaur & Lu, 2007). A similar pattern is expected for business group firms from EEs when they go to a foreign market. Thus, FDI by one group affiliated firm may open the doors for similar FDIs by other members of the

group. Accordingly, we hypothesize:

Hypothesis 3b: *Firms are more likely to make a shift from exports to FDI if other affiliated firms of the same business group have made FDI.*

Institutional reforms. EEs like India are under a state of institutional transition (Douma, George, & Kabir, 2006). One of the major elements of the institutional changes has been to allow greater private participation including that by foreign players in a number of industries (Majumdar, 2009). As a consequence of easing regulations pertaining to inward FDI, many industries in EEs have dramatically transformed in terms of their competitiveness. The industry-based view suggests that the degree of competitiveness in a particular industry largely determines firm strategy and performance (Porter, 1980). With institutional reforms in EEs, some industries may become intensely competitive domestically and may drive some firms abroad in search for better opportunities and in order to avoid increasing competition at home (Yamakawa et al. 2008). Furthermore, greater foreign presence in certain industries give opportunities to domestic firms in those industries to form strategic alliances as outsourcing providers and in the process gain knowledge about foreign management styles more suited to foreign markets. Thomas et al. (2007) in their study on internationalization of Latin American (EE) firms into DEs found that alliance experience with DE firms, both successful and failures, along with an entrepreneurial mindset of going abroad were critical motivating factors for entry and survival of EE firms in DEs. Given that internationalization through FDI provides for a more competitive long run position compared to internationalization through exports (Lu & Beamish, 2001), we posit that EE firms in more competitive industries are likely to make the shift from exports to FDI.

A noteworthy aspect of the institutional transition in EEs has been the uneven manner in which it is progressed. For example, while the capital and product markets in India have

witnessed significant improvements, the labor market continues to remain inflexible and rigid with little signs of change even after the major liberalization drive in the early 1990s (Heritage Foundation, 2009). Looking at institutional changes brought about in different industries, it is clear that in the case of India, sectors like the BPO has evolved into an internationally competitive industry compared to others (Peng et al., 2008). On a more general level, firms in the service sector compared to that in manufacturing sector, in India, benefited immensely from the continued institutional reforms (Zattoni, Pedersen, Kumar, 2009). We posit that such a changed competitive landscape in terms of ability to benefit from institutional evolution will translate into greater likelihood of these firms to shift from exports to FDI. However, it is also important to note that there is evidence that many EE firms that invested abroad, early on in the 1970's and 1980's, were outside the manufacturing realm, from a diverse set of sectors such as trading, warehousing, transportation, mining, forestry and construction (Ghymn, 1980; Kumar & Kim, 1984). As such we make the following hypotheses:

***Hypothesis 4a:** Firms belonging to industries with greater level of foreign participation are more likely to make a shift from exports to FDI.*

***Hypothesis 4b:** Firms belonging to service sector are more likely to make a shift from exports to FDI than firms belonging to manufacturing sector.*

Contingency Effects

Firm and Institutional Resources. Meyer et al. (2009) argue that institutions moderate resource-based considerations for foreign MNE entry strategies into EEs. We posit that the arguments will largely hold true even when considering EE firm international entry strategies. The value of traditional firm resources gets enhanced when combined with non-traditional institutional resources emanating from unique institutional and industrial environments that prevail in EEs. For example, marketing capabilities of EE firms based on investment in marketing related

activities is likely to get further strengthened if the firm is affiliated to a business group. The affiliated firm may benefit by capitalizing on common brand names and overall market reputation that the group may possess. An individual firm may access capital and technology residing in the group in order to enhance its own technological capability and compete in technologically advanced foreign markets through means of FDI. However, one of the greatest advantages of affiliated firms derives from them being able to draw on the preferential access to governments that their group may possess (Chacar & Vissa, 2005). In spite of institutional reforms, there still remain hazards for EE firms to freely engage in FDI. There are limits imposed on the type and quantity of FDI that a firm can make. Business group affiliated firms with their greater political capital are able to negotiate through the bureaucracy more easily than unaffiliated firms in obtaining the necessary permissions to invest abroad. Hence, we expect that the impact of traditional firm resources such as marketing and technological resources on the shift in international strategy from exports to FDI will receive an impetus when combined with institutional resources such as being affiliated to a business group. Accordingly, we make the following hypotheses:

***Hypothesis 5a:** The positive effect of technological resources on a firm's likelihood to make a shift from exports to FDI will be stronger if the firm is affiliated to a business group.*

***Hypothesis 5b:** The positive effect of marketing resources on a firm's likelihood to make a shift from exports to FDI will be stronger if the firm is affiliated to a business group.*

METHODS

Setting

We use the international expansion of Indian firms as the setting for this study. There are at least two features of Indian firms' international expansion that make this a good setting in which to

test our hypotheses. First, Indian firms have arrived at the international stage relatively late as compared to their counter parts from other emerging economies such as China and South-East Asian countries. India was a closed economy until 1991, and majority of international expansion of Indian firms has happened in past 10 years. This feature limits concerns about left-censoring especially when compared to alternate empirical settings such as the outward investment of firms from other regions (e.g., the China, South East Asia) with high FDI outflows amongst emerging economies. Second, an Indian setting allows testing for several unique institutional features such as business group affiliation and group level internationalization, which make the core of our theoretical arguments.

Data Source and Sample

We derive our list of firms from the Prowess data base of the Center for Monitoring the Indian Economy (www.cmie.com). The 2007 edition of Prowess has data on 9,985 firms from 1989 till 2007. The Prowess data base includes all the companies traded on India's major stock exchanges and several others including the central public sector enterprises and foreign enterprises. These companies account for 75% of all corporate taxes and more than 95% of the excise duty collected by the federal government. We constructed a longitudinal profile of international expansion activity. The unit of analysis is a firm's international investment decision. To avoid left-censoring, we only included firms that had a positive exports for at least two consecutive years during the 19 year time period of our study. This restriction generated a sample of 28,563 firm year observations. We treated the end of 2007 for each firm as a right-censored case.

Dependent variables. We measured the event of shift from exports to FDI by a binary variable, which took a value of one if a firm made a foreign direct investment and zero otherwise. We did not reply on the absolute amount of FDI as our objective is to analyze the shift in the

internationalization process of a firm.

Explanatory variables. The explanatory variables include firm level technological and marketing resources, international orientation, business group affiliation, group level international exposure, foreign participation at the industry level and an indicator for service industry. We measured the technological and marketing capabilities by taking a natural logarithm of the total expenditure incurred by a firm in research and development, and marketing activities respectively. We measured firm level international orientation by two variables – export intensity, and export experience. Export intensity was a ratio of foreign sales to total sales. Export experience was number of years since the first export until the year in which a firm first made a FDI. We took a natural logarithm of this count variable in our analyses.

We measured business group affiliation by an indicator variable which takes a value of one if a firm is affiliated to a business group and a zero otherwise. We measured group level international exposure using a cumulative count of total number of FDI made by all the firms affiliated to the group. As with the previous case, we took a natural logarithm of the count variable. We measured foreign participation by a ratio of foreign firms to domestic firms at the 3-digit level national industrial classification, which is an equivalent of US SIC. Finally, we used a service industry indicator variable, which took a value of one if a firm belonged to services sector and a zero otherwise.

Control variables.

We control for firm size, firm age, debt to equity ratio, and prior profitability. We measured firm size as the natural logarithm of the total assets. We measured firm age by total number of years since its inception. Debt to equity ratio was based on the ratio of total debt to total equity at the end of the financial year. Prior profitability was measured as profit after tax, lagged by one year.

Modeling Procedure

We used an exponential event history estimation in which no age parametric dependence is specified in its functional form (Blossfeld & Rowher, 1995), to investigate the event of a shift from exports to FDI. We tested the robustness of our results using panel data logit and probit estimations. As the results of the three estimation procedures were qualitatively similar, we report the results based on exponential event history estimation.

RESULTS

Table 1 presents the correlation matrix and descriptive statistics for all variables in our models. While the FDI among Indian firms is still not very common, Indian firms have a high level of export intensity, with the mean being 19 percent. Group level FDI variable is highly correlated with the group affiliation variable, raising concerns about the deleterious effects of multicollinearity on our coefficient estimates. We address this problem by entering the group affiliation and group FDI variables in two different models.

Insert Table 1 about here

Table 2 presents the results of our exponential models. Model 1 has the controls of size, age, debt to equity ratio and prior profitability along with the four variables measuring a firm level resources and a firm's level of international orientation. H1a and H1b deal with the effect of traditional firm resources. H1a suggests that firms with more technological capabilities are more likely to make a shift from export to FDI. The coefficient on research and development expenditure variable is positive and significant, giving support to H1a. H1b suggests that firms with more marketing capabilities are more likely to make a shift from export to FDI. The coefficient on marketing expenditure variable is not significant. H1b is not supported.

Insert Table 2 about here

H2a and H2b deal with a firm's level of international orientation. H2a suggests that firms with higher export intensity are more likely to make a shift from exports to FDI. The coefficient on export intensity is positive and significant, giving support to H2a. H2b suggests that firms with higher export experience are more likely to make a shift from exports to FDI. The coefficient on export experience is positive and significant, giving support to H2b. The coefficients on both firm level international orientation variables remain positive and significant across all the models, providing a robust support to our arguments that firms with greater level of international orientation are more likely to make a shift from exports to FDI.

H3 and H4 deal with the institutional explanation of a firm's propensity to make a shift from exports to FDI. H3a suggests that business group affiliated firms are more likely to make a shift from exports to FDI. The group affiliation variable is positive and significant, giving support to H3a. H3b suggests that firms belonging to business groups, in which other affiliated firms have already made a FDI, are more likely to make a shift from exports to FDI. The coefficient on group FDI count variable is positive and significant, giving support to H3b. H4a suggests that firms belonging to industries with a greater level of foreign participation are more likely to make a shift from exports to FDI. The foreign participation variable, however, is not significant, H4a is not supported. H4b suggests that firms belonging to the services sector are more likely to make a shift from exports to FDI. The coefficient on service industry indicator variable is positive and significant, giving support to H4b.

H5 deals with the joint effect of institutional and firm level traditional resources. H5a and H5b suggest that group affiliated firms benefit more from the technological and marketing

capabilities than the unaffiliated firms. The interaction variable between group affiliation and technological capabilities is positive and significant, giving support to H5a. Likewise, the interaction variable between group affiliation and marketing capabilities is positive and significant, giving support to H5b.

DISCUSSION AND CONCLUSION

We investigated an important phenomenon in the internationalization process of emerging market firms – a shift from exporting to FDI. We argued that firms that are rich in both traditional and non-traditional resources, arising due to the unique institutional characteristics in EEs find it easier to make a shift from exports to FDI. Specifically, we suggested a positive link between firm level technological and marketing capabilities, export intensity, export experience and a firm's propensity to shift from exports to FDI. We also suggested that firms benefit from non-traditional institutional resources such as affiliation to a business group and group level experience with FDI. Further, we argued that firms belonging to service industries as well as industries with a greater level of foreign participation will find it easier to make a shift from export to FDI. Finally, arguing for the combined effect of traditional and non-traditional resources, we suggested that the positive effect of technological and marketing capabilities will be stronger for firms that are affiliated to a business group than unaffiliated firms.

Our findings largely support our hypotheses. We find a positive link between technological capabilities and a firm's propensity to make a shift from exports to FDI, even though marketing capabilities do not seem to have a direct effect. Firm level export experience as well as export intensity have a positive relationship with the propensity of a firm to make a shift from exports to FDI. Institutional resources also help in such a shift. Firms affiliated to business group find it easier to make this shift. In addition, group level experience with respect

to FDI also help in making a shift from exports to FDI for group affiliated firms. With respect to the effect of institutional changes, we found that firms belonging to service sector find it easier to make a shift from exports to FDI, but foreign participation has no effect. Finally, firms that have a greater level of technological and marketing capabilities find it easier to shift from exports to FDI if they are affiliated to a business group as compared to stand-alone firms.

Future research should address the limitations of our study. First, the empirical setting of our study is India, which limits the generalizability of our findings to other EEs. Even though, the theoretical arguments we proposed are context free and should apply to several other EEs where firms enjoy institutional advantages such as those arising from networks, it would be apt to empirically validate our arguments in other settings. Second, in this study, we only analyze the shift from exports to FDI. This does not cover the entire range of activities in the internationalization process. Future research can look at other milestones in the internationalization process as well as the different forms of FDI by EE firms. Third, as has been found by some other scholars (Buckley et al., 2007), internationalization for EE firms may not be sequential. Future research can investigate the factors that lead firms to jump some steps in their internationalization efforts. Finally, we tested for only one type of network related resources – those arising due to group affiliation. While group affiliation is a very important and unique phenomenon in EEs, there are several other network related resources that firms can tap into. For example, the network of CEOs and board members may provide invaluable resources to firms in their internationalization efforts. Future studies can explore this and other network related benefits that make it easier for firms to internationalize.

Our research contributes to extant literature in several ways. First, there is not much empirical research on the internationalization process of EE firms. Most existing studies

explaining internationalization of EE firms use foreign sales to total sales as a measure of international diversification (Contractor, Kumar, & Kundu, 2007; Gaur & Kumar, 2009). In the case of EEs firms, foreign sales often comes primarily through exports and several of these firms with a high level of international diversification may not have any foreign presence. As a result, we have a limited understanding of the actual internationalization process and its antecedents. To the best of our knowledge, this is the first study analyzing the internationalization process of EE firms.

Second, EE multinationals are often viewed as lacking the traditional resources and ownership specific advantages needed to compete effectively in foreign markets (Gaur & Kumar, 2009; Hitt et al., 2000). While this may be true, we argue that the unique institutional environment in EEs allows firms to develop other, network-based resources, which can compensate for their weakness in traditional resources. Specifically, business group affiliation in EEs provides firms with competitive advantage when they embark on major internationalization initiatives. Third, the integrative theoretical approach we propose to study internationalization of EE firms can help other scholars to make meaningful theoretical and empirical contribution to this field. Our use of institutional perspective helps us broaden the definition of what constitutes resources in EEs.

To conclude, internationalization by EE firms is a recent phenomenon about which we have limited understanding. Our empirical investigation found support for the conventional wisdom relating to the importance of resources, traditional as well as non-traditional, for successful implementation of a strategy – in our study, the strategy of shifting from exports to FDI. Furthermore, our findings support the argument that EE firms benefit tremendously from their experiences of operating in relatively harsh home institutional environments, during their

internationalization (Cuervo-Cazurra & Genc, 2008; Del Sol & Kogan, 2007). Finally, our findings call for greater attention to treating the ability to manage institutional idiosyncrasies as a firm-level capability akin to technology or advertising (Henisz, 2003). Given the rising importance of EE multinationals, and paucity of literature in this field, we hope that our study will ignite scholarly interest in this area.

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TABLE 1: Descriptive Statistics and Correlations ^{a, b}

Variables	Mean	S. D.	1.	2.	3.	4.	5.	6.	7.	8.	9.	10.	11.	12.	13.
1. FDI Event (=1)	0.01	0.10	--												
2. Size ^c	3.99	1.80	0.07	--											
3. Age	25.87	21.14	0.02	0.29	--										
4. Debt to Equity	2.76	41.38	0.00	0.00	-0.01	--									
5. Prior Profitability ^d	16.99	168.74	0.04	0.24	0.06	-0.01	--								
6. R&D Expense ^c	0.19	0.57	0.08	0.43	0.18	-0.01	0.30	--							
7. Marketing Expense ^c	0.75	0.98	0.07	0.63	0.24	0.00	0.18	0.47	--						
8. Export Intensity	0.19	0.59	0.03	-0.09	-0.10	-0.01	-0.01	-0.03	-0.05	--					
9. Export Exp.	1.63	0.73	0.09	0.32	0.32	0.01	0.07	0.22	0.29	-0.03	--				
10. Group Affiliation (=1)	0.47	0.50	0.03	0.30	0.17	0.00	0.00	0.14	0.24	-0.04	0.12	--			
11. Group FDI#	0.02	0.16	0.39	0.11	0.04	0.00	0.07	0.09	0.10	0.00	0.12	0.65	--		
12. Foreign Participation	0.06	0.06	0.01	0.06	0.07	0.01	0.04	0.23	0.15	-0.05	0.06	0.00	0.01	--	
13. Service Sector	0.20	0.40	0.06	-0.06	-0.05	0.00	0.04	-0.10	-0.10	0.06	-0.03	0.02	0.06	-0.08	--

^a Based on a sample of 28,563 firm year observations during 1989 – 2007 time period.

^b Natural logarithm.

^c Correlation greater than |.01| significant at $p = 0.05$.

^d In billion Indian Rupees.

TABLE 2: Exponential Event History Analysis (Event: Shift from Exports to FDI)

	Model 1		Model 2		Model 3		Model 4		Model 5	
	B	S.E.	B	S.E.	B	S.E.	B	S.E.	B	S.E.
Size	0.150***	(0.046)	0.099*	(0.043)	0.022	(0.043)	0.111**	(0.044)	0.125**	(0.043)
Age	-0.018***	(0.003)	-0.018***	(0.003)	-0.020***	(0.003)	-0.018***	(0.003)	-0.019***	(0.003)
Debt to Equity	-0.055	(0.240)	-0.036	(0.209)	-0.035	(0.228)	-0.034	(0.208)	-0.028	(0.201)
Prior Profitability	-0.007	(0.014)	-0.017	(0.016)	-0.034 [†]	(0.019)	-0.012	(0.017)	-0.009	(0.017)
R&D Expense (H1a)	0.207**	(0.065)	0.330***	(0.066)	0.256***	(0.069)	0.122	(0.136)	0.264***	(0.070)
Marketing Expense (H1b)	0.059	(0.060)	0.103 [†]	(0.057)	0.157**	(0.058)	0.093 [†]	(0.058)	-0.176 [†]	(0.099)
Export Intensity (H2a)	0.146***	(0.026)	0.116***	(0.027)	0.115***	(0.028)	0.118***	(0.027)	0.123***	(0.027)
Export Experience (H2b)	1.915***	(0.152)	1.941***	(0.151)	1.405***	(0.142)	1.943***	(0.151)	1.953***	(0.152)
Group Affiliation (=1) (H3a)			0.216*	(0.123)			0.103	(0.135)	-0.244	(0.165)
Group FDI# (H3b)					1.810***	(0.077)				
Foreign Participation (H4a)			0.089	(0.937)	-0.538	(0.951)	0.217	(0.937)	0.471	(0.928)
Service Sector (H4b)			1.313***	(0.123)	0.930***	(0.127)	1.298***	(0.123)	1.316***	(0.123)
Group * R&D Expense (H5a)							0.248 [†]	(0.134)		
Group * Marketing Expense (H5b)									0.400***	(0.102)
χ^2	406.67		515.06		886.71		519.04		533.49	
Log likelihood	-1486.22		1432.03		-1246.20		-1430.05		-1422.82	

n (firm-year) = 28,563

*** $p < 0.001$;

** $p < 0.01$;

* $p < 0.05$;

[†] $p < 0.10$; (all two-tailed tests)