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GROWTH AND PROFITABILITY IN INTERNATIONALISED PIEDMONT SMES

1. Introduction

The debate on factors affecting the international development of SMEs is very lively and research in this field is attracting growing interest (Cerrato and Piva, 2007). In the Italian context, SMEs represent a relevant part of total enterprises and show a high international commitment, not rarely from their inception, thanks to the adoption of global niche strategies. In the last decade Italian firms have vigorously pursued internationalisation strategies: in 2001 Italy has been the country with the largest increase in the world of foreign direct investments outflows. This result is not isolated, but comes at the end of a ten years period of steady international growth of the Italian outward investments.

International expansion is an important decision especially for small and medium-sized enterprises (SMEs) who traditionally have a small financial base, a domestic focus and a limited geographic scope (Barringer and Greening, 1998). Recent studies have looked at the antecedents and the process of SMEs' internationalisation, but the performance implications of this strategy to SMEs remain under-explored (Lu and Beamish, 2006).

Following Lu and Beamish's suggestion to apply their model to samples of firms from other countries, the paper examines the relationship between internationalisation and growth and profitability (Singh and Nejadmalayeri, 2004) in a sample of Italian firms from an economically important Italian region, Piedmont, as it emerges from the accounting documents. We also considered Buttignon, Vedovato and Bortoluzzi's model (2005) about the performances after private equity investments and their impact on growth and profitability; Haynes, Onochie and Lee's model (2008) about the origin of loans of internationalised SMEs and their debt structure; Bopaiah's model (1998) about the availability of credit for internationalised SMEs; Gallo's analysis (2005) about the state of origin of board directors.

We directly test the differential effects that internationalisation strategies have on the growth and profitability of SMEs.

It is difficult to define what is called "internationalisation" and, especially, what is "the internationalisation of a firm". Internationalisation is a phenomenon researched intensively over the last few decades from a variety of viewpoints, including organization theory, marketing, strategic management, international management, and small business management.

Issues such as international decision-making and management, the development of international activities, and factors favoring or disfavoring internationalization have been studied for both large as well as small businesses (Ruzzier *et al*., 2006). Two of the most common goals attributed to international expansion are achieving firm growth and improving a firm's profitability (Oviatt and

McDougall, 1994; McDougall and Oviatt, 1996), whilst two of the most prominent avenues of internationalisation are exporting and FDI (Lu and Beamish, 2006).

Following Lu and Beamish's model, we connect the individual and joint influences of exporting and FDIs on Italian SMEs growth and profitability. We find that exporting and FDI both contribute to firm growth, but exporting may, under certain economic circumstances, negatively affect Italian SMEs' profitability. Our findings give a contribute to a wider comprehension of the relationship between internationalisation and performance of Italian SMEs.

2. Internationalisation of SMEs

The increasing importance of SMEs in international markets has led to substantial research on the internationalisation of SMEs (Lu and Beamish, 2006). Much of the literature on internationalisation of SMEs focuses on the export activities of these firms and the differences between successful and unsuccessful exporters (Leonidou and Katsikeas, 1996). This comes as no surprise, given the aforementioned obstacles to internationalisation. Bilkey and Tesar (1977) describe the export activities of small firms as incidental, whereby firms passively fulfill international orders instead of proactively seeking opportunities. As such, because of lack of resources, SMEs do not approach internationalisation in a systematic fashion and do not possess formal strategies (Bell et al, 2004). Given the heterogeneity of small firms and their operating environment, fundamental difficulties arise when seeking to identify and define the critical resources needed for internationalisation (Ruzzier *et al*., 2006). Drawing on different perspectives of analysis, international business literature stresses the role of factors both internal and external to the business as drivers of firm internationalisation.

Another stream of literature focuses on the internationalisation process. In this field, the *stage theory*, which is the dominant paradigm, suggests that the international activity of a firm increases gradually as it acquires knowledge and experience (Johanson and Wiedersheim-Paul, 1975; Johanson and Vahlne, 1977; Bilkey and Tesar 1977, Bilkey 1978). In these theories the internationalisation behaviour of a firm is linked with different stages of the firm's life cycle, starting from no foreign sales and expanding its international activities incrementally to a more resource-intensive commitment to foreign markets until a final stage of foreign direct investment is reached. Hence, the stage models not only try to explain the entry into a foreign market *per se*, but also the choice of the optimal market entry mode used at different stages of the firm's international involvement.

Most of the empirical studies, however, have been focused on large, well-internationalised firms, not on SMEs (McDougall and Oviatt, 1996; Dana *et al*., 1999). Very few papers focus on the first steps of small and medium-sized firms toward intermediate forms of internationalisation (Wagner and Schnabel, 1994). Only recently has the theoretical debate on internationalisation focused more deeply on the specific features of small firms in an attempt to establish a general theory (Julien, 1994). The "classical" literature on the subject had an abstract, general firm model as its reference point and implicitly considered the large firm as its object of analysis. However, a series of studies has underlined that size is no restraint in the international competitiveness of small firms, both because of their important contribution to the trade balance of their respective countries (Hardy, 1986; Beamish and Munro, 1986) and because sales abroad have been shown to be unaffected by firm size (Cavusgil and Tamer, 1980; Edmunds and Khoury, 1986; Ali and Swiercz, 1991; Julien *et al*., 1994). Not surprisingly however, the results of these studies have produced mixed results. It has also been shown that under certain circumstances, an entrepreneurial culture resistant to change, an increasingly centralised behavior and other *country-specific* factors can hinder the international development of small firms (Calof and Viviers, 1995; Caruana, Morris, and Vella, 1998; Minguzzi and Passaro 1997, 2001).

There is also divergence in the theoretical considerations of the advantages and limitations of SMEs in the literature. Basically, the empirical findings on the relationships between internationalisation and firm performance based on samples of large firms do not necessarily apply to SMEs because it has been well argued and documented that smaller business and larger business are different species (Shuman and Seeger, 1986). From a theoretical point of view, SMEs have certain advantages over large enterprises, in fact they are able to more easily overcome governance problems (McIntyre, 2002). Some researchers (e.g. Liesch and Knight, 1999) argue that SMEs have the advantage of flexibility and are able to internalise market information to the same degree or better than large firms. However, SMEs also face certain disadvantages to large enterprises, which may inhibit their success in the local market as well as discourage them from pursuing international opportunities. Obviously, a major impediment to SMEs' expansion, in comparison to large firms, is lack of resources (Berkema and Vermeulen, 1998; Calof, 1993, 1994).

However, lack of resources, firm size and market opportunity are not the only determinants of the internationalisation success of SMEs. Small firms depend much on the abilities, knowledge and attitudes of those individuals in the firm responsible for international decisions. Some researchers (Moini, 1995; Cooper et al, 1994), for example, have found that the success of exporting firms and new ventures depends on the demographics, while others (Knight and Cavusgil, 1997; Reuber and Fischer, 1997) point to the importance of the international orientation of decision-makers. Cavusgil and Naor (1987) have proposed that the former are less important than factors related to behaviour. Manolova *et al*. (2002) studied the impact of international business skills, international orientation, environmental perceptions and demographics of SME managers and found that skills and environmental perceptions are among the most important criteria for successful internationalisation. Thus, lack of resources in the form of physical capital, might not be such a hindrance if decision-makers of SMEs have a proactive view toward internationalisation. More important are the knowledge, skills, experience and networks of firms and the external environment, which form the strategic foundations of the firm (Welch and Welch, 1996). Jaklic (1998) suggested that networks can be especially useful for SMEs in catching-up economies since it is possible to overcome some of the problems of knowledge and technology as well as capital accumulation. Because large firms often have the resources to easily enter foreign networks, the establishment of network relationships will be even more important for SMEs, especially those which do not yet have clearly defined internationalisation goals. The development and coordination of knowledge inside the firm must be viewed as integral to its internationalisation processes (Knudsen and Madsen, 2001).

It has been proposed that SMEs follow a model of incremental internationalisation (Katsikeas and Lenidou, 1996; Pedersen and Petersen, 1998; Ellis and Pecotich, 2001). In this view, SMEs start with those internationalisation activities implying the lowest barriers (i.e. exporting goods) and accumulate experience used to develop other forms of international business such as alliances, sales branches, production, and R&D. This model has been challenged by the literature on so-called "born globals" (see Zucchella *et al.*, 2009; Zucchella *et al.*, 2008; Knight and Cavusgil, 2004; McDougall *et al.*, 1994; Madsen *et al.*, 2000; Fryges, 2004). In this view, to take advantage of unique selling propositions they were able to obtain through innovation, some SMEs seem to follow an international business strategy and adopt a global focus from their very beginning. Andersen (1993), however, has criticised the model and pointed to studies that have shown that SMEs do not select foreign markets as methodically as presumed by the model. Andersson et al (2004) argue that the stages model does not explain why some small firms internationalise while others do not. Some firms are international from their birth and have been called: international new ventures (McDougall, 1994; Oviatt and McDougall, 1994, 1995), born global (Madsen and Servais, 1997), and global start-ups (Oviatt and McDougall, 1995). Oviatt and McDougall (1994) and Knight and Cavusgil (1996) as well criticise the stages model as lacking explanations for the internationalisation of small born global firms, which lack both resources and experience. Differences in the scale and scope of SMEs' international operations are often attributed to their home market and industry conditions or the attractiveness of foreign markets (Dunning, 1988). Inter-firm and interpersonal relationships also appear to be influential in other internationalisation issues: foreign market selection (Andersen and Buvik, 2002); market servicing (Welch and Welch, 1996); dynamics of entry (Meyer and Skak, 2002); international market development and marketing-related activities (Coviello and Munro, 1995); time of internationalisation (Oviatt and McDougall, 1994); propensity to export (Westhead *et al.*, 2001); strategic choices and performance (Peng, 2001); and degree of internationalisation (Brush *et al*., 2002).

Lu and Beamish's model focuses on the influence of internationalisation on both the growth and profitability of SMES.

3. Setting of hypotheses

In the following paragraph, we considered the features of Lu and Beamish's model that can fit to the environment of Italian SMEs from Piedmont, in order to set the hypotheses to be tested.

Exporting

Exporting is the most common form of internationalisation. The internationalisation process model developed by Johanson and Vahlne (1977, 1990) describes the role of exporting. They regard internationalisation as a gradual process in which firms incrementally increase their commitment in foreign markets. A commitment is always associated with uncertainty. A firm evolves from a low level of international activities and commitment to higher levels, through stages which are assumedly one-way. The incremental nature of the process is considered not only as a shift from "soft" internationalisation (indirect exports) to more committed, riskier modes, also in terms of choice of foreign markets: the firm gradually expands from nearer markets to those further away. The firm extends its international business activities until its particular maximum tolerable risk is reached. This is a function of the degree of the firm's risk aversion and the firm's resource position. The commitment of resources to a foreign market increases knowledge of that market and thus reduces any existing uncertainty about the foreign environment. The internationalisation process is therefore combined with a dynamic learning process over time. An initial involvement in a foreign market reduces uncertainty, which in turn induces an additional commitment to this market. As a consequence, firms start their international activities with relatively few resources because the commitment of these resources is associated with a relatively high amount of risk. Improved knowledge acquired over time through additional commitment to the market leads to more resource-intensive international activities, since the latter become associated with less risk than the firm's initial foreign activities.

Lu and Beamish (2006) analyse the advantages of this internationalisation strategy, especially important for SMEs which typically face resource constraints and would not like to make excessive resource commitments and be exposed to unreasonably high investment risks. Exporting involves comparatively low levels of commitment and risk, so it is a relatively easy and fast way to enter foreign markets. Through exporting a firm does not have to deal with the complexities of establishing a foreign subsidiary and adopts a less risky strategy because it is easier to change geographic scope by adjusting export volumes or to withdraw from a foreign market when there is political instability and/or fluctuating market conditions. Moreover, exporting contributes to firm growth through sales increase. Consumer base and higher sales volume can be broadened through direct sales or export agents. Higher sales volumes can mean higher production volumes and expansion in production capacities to meet the market demands, and enable firms to achieve economies of scale and increase labor productivity and management efficiency. Cost savings and firm profitability derive directly from this kind of experience curve economies. Similarly, advantages related to increases in market power and gains from the diversification of revenues may be originated from the presence in multiple, different international markets. Exporting activities should have a positive impact on firm profitability, if we observe the economic benefits they could lead to.

Applying Lu and Beamish's model to Italian SMEs from Piedmont, we expect exporting to have a positive impact on their growth and profitability.

Hypothesis 1a: Italian SMEs' growth is positively related to their level of exporting activities.
Hypothesis 1b: Italian SMEs' profitability is positively related to their level of exporting activities.

Foreign direct investment

In the case of Italy, exporting is not necessarily the most important or most fundamental internationalisation way: Italian firms have recently begun to develop other, more advanced forms of foreign expansion, mainly of non-equity type (Basile *et al*., 2003).
FDI is an investment realised abroad ('active' or 'outward' investment) or from abroad ('passive' or 'inward' investment) in plants, and can take place either through the opening of branch plants ('green-field' investment), or through the acquisition of or financial participation in existing firms ('brown - field' investment). Lu and Beamish (2006) describe the features of FDI and compare them with the advantages and disadvantages of exporting. Exporting can be obstacled by various tariff and non-tariff barriers by host country governments, or being subject to distributor opportunism as the interests of foreign sales agents do not necessarily align with that of the firms. Internationalising firms are usually disadvantaged in competition with local firms in foreign markets (liability of foreignness), so they have to hold certain competitive advantages to be successful. Moreover, the use of exporting as an internationalisation strategy can expose a firm to the risks of asset appropriation and the subsequent devaluation of its intangible assets, since competitive advantage is often in the form of intangible, proprietary assets.
FDI shows some attractive means of internationalisation. It enables firms to minimise transaction-related risk, by establishing subsidiaries in foreign markets and internalising markets for proprietary asset exchange. When a SME's competitive advantage is in the form of proprietary assets, FDI can also be a potentially effective internationalisation strategy. FDI broadens a firm's customer bases through entry into new markets, enabling the firm to achieve a larger volume of production, and grow. FDI is associated with greater potential feedback learning as well. For example, FDI could provide firms access to a wider range of scientific and technological skills and knowledge than is available in the home market and thereby help to enhance a firm's technological capabilities. Applying Lu and Beamish's model to Italian SMEs from Piedmont, we expect FDI to give an important contribute to their growth.

Hypothesis 2: Italian SME's growth is positively related to their level of FDI.

4. Methodology

Sample and data sources

We use a panel of firms from the Piedmont area. Piedmont is one of the 20 Regions of Italy, in the north-west. Its territory presents a widespread industrialisation, featuring mostly SMEs. It has an area of 25,399 km² and a population of about 4,4 million. The capital is Turin.
We perform the analysis on a sample of 250 SMEs. Consistent with parallel studies on American small and medium sized firms in the entrepreneurship literature (Baird *et al.*, 1994; Hodgetts and Kuratko, 1998; Beamish 1999; Wolff and Pett, 2000), this study employs the definition of SMEs provided by the following European Community standard (Recommendation of the European Commission, May 6th 2003): a small enterprise has fewer than 50 employees, less than 7 million Euro in revenue and less than 5 million Euro in assets. The upper ceiling for a medium enterprise is fewer than 250 employees, less than 40 million Euro in revenue, and less than 27 million Euro in assets. The sample is stratified and randomly selected (it reflects sector's geographical and dimensional distribution of firms from Piedmont) for firms up to 250 employees. We use the database of AIDA (Analisi informatizzata delle aziende), in particular Piedmont SMEs' annual reports. Additional balance sheet information and FDI information has been derived from *Centrale dei Bilanci*, a well-known and reliable source of balance sheet data for Italy. The dataset provides information about who controls the firm. We consider reports of last three years (2006, 2007, 2008), so both qualitative and quantitative data are collected. Qualitative data provide, among other things, information on ownership structure and entitlement to state subsidies.
The empirical analysis draws on a sample which includes small and medium-sized firms in an economy where the market for corporate control has not developed yet. This reduces the impact of two types of selection bias. The first (Steer and Cable, 1978) occurs when only large firms are included in the sample, since only the most efficient ownership-controlled firms maintain this status when they grow in size. The second occurs in samples containing only small firms when, under an

effective market for corporate control, less efficient firms are taken over and excluded from the sample.
According to the Ateco 2007 code (used by Istat, the Italian Statistical Institute), the 250 firms have been classified within six industrial sectors.

Table 1: Division of the sample according to performed economic activity

Description	Nr. of firms	%
Chemical, rubber and plastic industries	29	11.6
Manufacture of electrical machinery and apparatus, optical instruments	66	26.4
Manufacture of fabricated metal products, except machinery and equipment	49	19.6
Manufacture of mechanical machinery and apparatus	54	21.6
Services	24	9.6
Transports	28	11.2
Total	**250**	**100**

Source: AIDA and Centrale dei Bilanci.

Table 1 highlights that the firms of the sample are distributed within all of the economic activities described in the table, with a good number coming from the electrical, electronic and optical industries, from metal products industries and from the mechanical industry.
Table 2 divides the firms analysed according to total sales and number of employees.

Table 2: Division of the sample by company size

Revenue (ml of €)	Number of employees	Number of firms	%
< 0.5	< 10	70	28.0
0.5-1	10-50	147	58.8
1-50	50-250	33	13.2
	Total	**250**	**100**

Source: AIDA and Centrale dei Bilanci..

Descriptive features of this sample illustrate some important characteristics of Piedmont's economy in the 2006-2008 period: the relative specialisation in traditional sectors and the underspecialisation in high-tech sectors, and the relevant weight of small firms (no more than 50 employees), which account for more than 86 percent of the sample.

Variables
Following Lu and Beamish's model, for analising the annual growth of SMEs over the 2006-2008 period, we created a record for each firm in each year of the 3-year period. Firm annual growth and profitability are the dependent variables for the model. The main independent variables are the level of exporting activity, the level of FDI activity and firm age at the time of internationalisation. For respecting the model, we included a number of control variables as well.

Dependent variables
Firm growth. We computed annual growth rate of net sales and total assets for each firm. As the computation of annual growth rate involved the comparison of sales/assets between two consecutive years, we constructed the measures for 3 years over the 2006-2008 period based on the information from Centrale dei Bilanci.
Firm profitability. In line with the model, we constructed two accounting-based measures, return on assets (ROA) and return on sales (ROS) to measure firm profitability. The information was available for each year of the 2006-2008 period from AIDA and Centrale dei Bilanci.

Independent variables
Exporting activities. We measured the level of exporting activities through export intensity, the percent of parent firm sales that were derived from export revenues. This variable was derived from annual export and revenue information given by Centrale dei Bilanci.
FDI activities. The measures to evaluate the magnitude of FDI activities are two. The first is the number of FDIs in which the parent firm had a ten percent or greater equity share. The second is the number of countries in which the firm had FDIs. These measures were derived from information given by Centrale dei Bilanci for the 2006-2008 period.
Age at the time of internationalisation. Following the model, we measured firm age at the time of first FDI as the difference between a firm's foundation year and the foundation year of its first FDI. The former information was derived from from AIDA and Centrale dei Bilanci.

Control variables
Following the model, we included two measures to account for the proprietary content of Italian SMEs' assets. The first considered the level of propriety content in technological assets (R&D expenditure as percent of sales), and the second in marketing assets (advertising expenditure as percent of sales). We next calculated two control variables for the characteristics of the SMEs. These were the size of the SME (log of net sales and total assets for corresponding dependent variables) and product diversification of the SME (a herfindahl measure). These variables were derived from AIDA and Centrale dei Bilanci on an annual basis for the 2006-2008 period.
After matching the parent information with FDI information and deleting cases with missing values, the sample size was reduced to 143 Italian SMEs from Piedmont.

5. Results
Table 3 presents a correlation matrix for the study's variables. All firms had export activities, and 143 had made FDIs. The SMEs of the sample represent the various phases of the early stage of the internationalisation process, so the analysis is consistent with Lu and Beamish's conditions.
As for the model we followed, the correlation matrix shows that there is high correlation between the two measures of FDI, by subsidiary and by host country.
Hypothesis 1 predicts that exporting is positively related to Italian SMEs' performance, in both growth dimension and profitability dimension. Observing Table 3, we see that the exporting measure has a positive relationship to sales growth and assets growth, and this leads to assess consistency with the prediction in Hypothesis 1a. As for the findings from prior model of Lu and Beamish's, exporting activities seem to negatively relate to firm profitability instead, and that is contrary to the prediction of Hypothesis 1b.
Hypothesis 2 predicts a positive relationship between the level of FDI activity and the growth of Italian SMEs. As shown in Table 3, the positive sign on some variables' term provide support for this Hypothesis. In fact, there is positive relationship between the number of subsidiaries and number of host countries terms and net sales, total assets and export intensity.

6. Discussion
For examining the differential effects of internationalisation strategies on different dimension of Italian SME performance we used Lu and Beamish's model for exploring the impacts of two internationalisation strategies, exporting and FDI, on firm growth and profitability, in a sample of

internationalising small and medium-sized Italian firms from th region of Piedmont. Further, the model examines how firms' age at the time of internationalising has an impact on SME performance.
The result we found is that exporting has positive impact on SME growth, as measured by sales growth and asset growth. When it comes to SME profitability, the impact from exporting is negative instead. Though, as for Lu and Beamish's analysis, the time period for this study (2006-2008) saw a general appreciation of Euro on other currencies. As a results, exports from Italy suffered a loss of competitiveness in the international context. Thus, our findings are substantially consistent with the conclusions of prior studies about exporting as a growth strategy for SMEs: if the national currency is in an appreciation phase, that can negatively influence the contribution of exporting to the SME's profitability.
FDI as well is found to have a positive relationship with firm growth. This positive net effect of FDI on firm performance is in line with the model and with the intrinsic value associated with FDI as argued by internalisation theorists. This is consistent with Lu and Beamish's conclusion that SMEs should not curtail internationalisation activities at the export stage, but explore opportunities to make FDIs, because FDI activities are associated with improved growth rates and profitability.

7. Conclusions

The internationalisation of Italian firms is a phenomenon of growing interest. In this paper we have focused on SMEs that have begun to tread on the internationalisation path. We sampled mainly firms that can be defined "late globalisers", following the definition from prior studies, and we examined the performance implications of their internationalisation strategies. It should be noted that our empirical results were derived from a sample of Italian SMEs and hence the findings might be country-specific.
Following Lu and Beamish's model, we tested the effectiveness of two internationalisation strategies, exporting and FDI, on the growth and profitability of a sample of Italian SMEs from the region of Piedmont. Consistent with their results, we find that, also for the firms of the sample, exporting and FDI both contribute to firm growth. Nevertheless, that is not the same for exporting and firm profitability. Our results seem to outline that there is negative relationship between these two variables; but, considering our observations and Lu and Beamish's research, it is rather possible to assert that if a SMEs has a high export intensity at a time of appreciation of its national currency, that will affect negatively profitability.
In conclusion, the findings suggest that Italian SMEs should use a flexible combination of high export levels and extensive FDI activities to pursue firm growth. It would be interesting if future studies could extend the testing of the findings of this research to other countries.

Table 3 Correlation matrix

Variables	Mean	S.D.	2	3	4	5	6	7	8	9	10	11	12	13
Growth in sales	0.049	0.301	0.125	0.085	0.172	0.063	-0.045	-0.051	-0.006	-0.021	0.212	0.098	0.034	-0.057
Growth in assets	0.053	0.239		0.147	0.243	0.036	-0.021	-0.032	-0.056	-0.035	0.238	0.075	0.061	-0.050
ROS	0.036	0.144			0.793	0.173	-0.013	-0.054	-0.021	0.052	-0.037	-0.032	-0.058	-0.015
ROA	0.045	0.083				0.112	0.032	-0.015	-0.087	-0.184	-0.065	-0.076	-0.162	-0.020
R&D intensity (percent sales)	0.011	0.015					-0.098	0.027	-0.198	-0.056	0.067	0.045	0.074	-0.222
Advertising intensity (percent sales)	0.019	0.014						0.013	-0.009	-0.011	-0.124	-0.021	-0.056	0.211
Product diversification (Herfindahl)	0.456	0.127							0.179	-0.097	-0.178	0.065	-0.002	0.312
Net sales	14,683643	15,637389								0.489	0.154	0.247	0.241	0.042
Total assets	16,874538	16,576968									0.023	0.384	0.398	-0.165
Export intensity (percent sales)	0.116	0.138										0.302	0.373	-0.123
Number of subsidiaries	1.109	2.167											0.901	-0.251
Number of host countries	0.853	1.458												-0.334
Firm age when making first FDI	31.562	19.659												

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