# Internationalization from a SME Perspective

***Work-in Progress Paper***

Maria Forsman
Susanna Hinttu
Sören Kock*

**Abstract**

*In this article we examine the internationalization process of Finnish SMEs. Earlier studies have shown that Finnish firms follow the Uppsala Internationalization model by first doing business with Sweden and then advancing to other countries (Holmlund & Kock 1998, Kock & Laine 2000). According to the Uppsala model of internationalization, increased commitment will lead to an increase in investments and vice versa. Another issue that we are dealing with is if experience from early inward international activities can influence on later outward international activities in small and mid-sized firms. Thus relationships established when importing from a specific market are useful when initializing exports to the same market. On the other hand inward and outward activities could be regarded as separate flows that are not connected or only weakly connected. This implies that outward activities would not be connected to or dependent on the firm's previous inward activities. The theoretical frame for the study has been derived from the network approach where also social relationships are regarded as important in the internationalization process.*

*The presented empirical findings are based on a mail survey conducted among 3000 small and mid-sized Finnish firms with a response rate of 15 %. The results show that initial export markets are closely situated both culturally and geographically. The initial operational mode tend to be direct export to buyers. The findings of this study show an increased commitment in the most important export markets, in this case Sweden and Germany. Furthermore, the presented theory about SMEs stopping at one stage of the process seems to hold true also for the majority of the companies studied. The study shows no clear evidence of connections between inward and outward flows. Important factors when internationalizing seem to be the management's interest in international activities, as well as enquiries from abroad about the products.*

## BACKGROUND

The internationalization process of firms has been studied extensively. However, an area, which has obtained fairly limited attention, is the internationalization process of small and medium sized enterprises (SMEs) in the 21st century. These firms are also affected by the globalization of the markets, forcing the firms to act and think more globally. The internal market of the EU, e-commerce, and other institutional changes are gradually shifting the behavioral pattern within the Finnish SME sector. We know that the creation of business networks is becoming increasingly important in the internationalization process (Holmlund & Kock 1998). SMEs have not been studied as extensively as large sized firms have been when it comes to international activities. According to Miesenbock (1988) there is a particular lack of empirical studies, and the available

* *) Corresponding author, Department of Management and Organization, Swedish School of Economics and Business Administration, P.O.Box 287, FIN-65101 Vasa, Finland. E-mail: soren.kock@wasa.shh.fi. Fax: +358 6 3533702, Telephone: +358 6 3533722

ones tend to suffer from inconsistencies implying that a conclusive framework for understanding small business internationalization is still lacking.

The objectives of this study is to identify a possible connection between inward and outward international activities in the internationalization of the studied SMEs, and to analyze whether the internationalization process has been influenced by the managers' earlier international activities.

The most traditional way of describing the process of internationalization is by the U-model or the Uppsala internationalization model (Johanson & Wiedersheim-Paul 1975; Johanson & Vahlne 1977). The U-model contains different steps that describe the firm's level of internationalization. In the beginning the firm has no regular export. According to the model a firm often initiates its internationalization process by direct exporting to a foreign country. After some time the firm starts exporting with the help of independent representatives (agents) abroad. This is also called indirect exporting. The following stage is to develop sales subsidiaries in a foreign country. In the fourth and last stage the firm establishes a production/manufacturing facility abroad. (Johanson & Wiedersheim-Paul 1975; Johanson & Vahlne 1977) A basic assumption of the model is that one cycle of events constitutes the input of the next. This indicates that the present state of internationalization is an important factor in explaining the direction of further internationalization.

The theory of the internationalization process is broadly accepted. Later though, a need for development of the original model as it was created in the 70's was acknowledged. Firstly, when for example large firms have surplus resources, they can be expected to make larger internationalization steps. Secondly, in a situation when market conditions are stable and homogeneous, it might be possible to acquire important market knowledge in other ways than through experience. Thirdly, a firm may have considerable experience from markets that have similar characteristics and may thus generalize this experience to the specific market (Johanson & Vahlne 1993). Rasmussen et al (2000) state that the factors leading to a more accelerated internationalization are: (1) new market conditions, increased specialization demanding larger markets and quick spread of innovations, (2) i.e. technological developments in the areas of production, transportation and communication, and (3) more elaborate capabilities of people, i.e. more mobile personnel and increased knowledge about foreign cultures and markets.

The original model was developed as a result of a study of four Swedish firms. This could be seen as a fairly limited number of study objects. It is also difficult to get a clear picture of the different stages of the model. The stage model has been criticized in different respects, e.g. for being too deterministic (Johanson and Vahlne 1993), for lacking leapfrogging (Hedlund and Kvarneland 1993), for not including acquisition (Forsgren 1990), and for putting too much emphasis on psychic distance (Melin 1992), for not emphasizing the impact of social networks (Holmlund & Kock 1998). Social relationships have been pointed out as extremely important for entrepreneurs (e.g. Aldrich and Zimmer 1986; Greve 1995; Johannisson 1996) and in international business (Björkman and Kock 1995). Turnbull and Valla (1986) have come up with some aspects that contradict the concepts of the Uppsala-model. Their studies show that firms do not follow any particular and consistent pattern in their internationalization process. Companies may also stop at one stage, or even reverse the process (Luostarinen & Welch 1990).

Especially in the 1990's several studies have identified an increasing number of firms that do not in all respects follow the traditional internationalization patterns. Such companies have been called global start-ups, high technology start-ups, international new ventures and born globals (see e.g. Oviatt & McDougall 1994; Knight & Cavusgil 1996; Madsen & Servais 1997 and Rasmussen et al. 2000). These firms have received increasing attention in the 1990's and an analysis of these kinds of firms - their key features, strategies used, especially the successful internationalization strategies of those firms - will be one of the key issues also in this project.

A slightly different approach to internationalization from a network perspective has been argumented for by Welch and Luostarinen (1988) when they define internationalization as ”... *the process of increasing involvement in international operations...*”. Hereby they indicate that both inward and outward international operations ought to be taken into account when analyzing internationalization. According to the inward-outward internationalization model (Welch & Luostarinen 1988) inward flows like importing raw materials and machinery proceed exporting. The experience and knowledge acquired during importing can later on be used when starting exporting. The network approach of internationalization is most often applied on vertical relationships, between sellers and buyers. However, relationships between competitors have not been studied to the same extent. (Bengtsson & Kock 1999 & 2000, Johansen & Johansen 1998) Bengtsson and Kock (1999) claim that relationships between competitors are both complex and important. They call for more research in the field of horizontal business networks, in order to get a deeper understanding of how to manage multidimensional relationships and the advantages that can arise out of relationships between horizontal firms.

## INTERNATIONALIZATION ACTIVITIES AS FLOWS

Firms engaging in international activities have been considered to follow certain steps depending on the amount of knowledge gained and the commitments made. From a network perspective, earlier studies focusing on internationalization are mainly based on the so-called stage model (e.g. Johanson and Vahlne, 1977, 1990; Johanson and Wiedersheim-Paul, 1975; Luostarinen and Welch, 1990; Johanson and Mattsson, 1990). International activities generally start from markets that are culturally and/or geographically close (Johanson and Vahlne, 1977). Furthermore, a firm tends to start with entry modes that do not need substantial commitment. Thus the use of agents or direct selling is most common in the first phase of internationalization.

Internationalization has traditionally been regarded as an outward flow and the stage model has not explicitly dealt with how earlier inward activities, and thereby gained knowledge, can influence on later outward activities. A natural way of internationalizating would be to first get involved in inward activities, i.e. imports, and thereafter in outward activities, exports. Relationships and knowledge gathered from import activities could thus be used when the firm engages in export activities (Luostarinen and Welch, 1990; Welch and Luostarinen, 1993; Korhonen, Luostarinen and Welch, 1996). Welch and Luostarinen (1993) claim that few empirical studies have analyzed these questions although they from a network perspective are of importance. From a governmental point of view they are also of importance as most Western countries clearly prioritize outward activities when they grant economic support. Inward activities have, on the other hand, traditionally been discouraged. Nevertheless, Korhonen et al. (1996) have found a connection between import and export activities, i.e. that experience from importing helps the firm to initiate exporting. In their study of Finnish SMEs in 1990, they found that more than half of both small and medium-sized companies had started with inward international business operations, and that almost all of them later were engaged in outward business operations. Only 44% of the studied companies had started with outward flows. The authors state that these findings “raise serious questions about the true nature of internationalization, especially in the formative stage” (Korhonen et al. 1996). Holmlund and Kock (1996) did not find any connections between outward and inward international business operations in their study among Finnish SMEs. The survey in the study consisted of 182 companies; 156 small-sized firms and 26 mid-sized firms.

Inward international operations usually cover a variety of different forms used to strengthen a firm's resources. Usually inward flows imply importing products needed for the production process, such as raw materials and machinery. But inward operations can also include finances and technology through different operational forms, franchising, licensing, direct investments and alliance agreements, for instance (Luostarinen and Welch, 1990). According to Welch and Luostarinen (1993), inward and outward connections can develop in different ways. These connections are most tangible in counter trade arrangements, but they can also be found in the complex webs of relationships between sub-units within multinational enterprises and in strategic alliances. Through inward activities, the focal firms' uncertainty may decrease as they gain knowledge of and experience in international business. Visits to foreign markets, investigation of potential suppliers, negotiations, learning about foreign cultures and deciding on what operational mode to use when importing may give the management experience and courage to later initiate outward activities. Knowledge about foreign markets and networks gained as a by-product of importing can result in an outward flow, or in the creation of a relationship through which a "fortuitous" order can eventuate (Bilkey, 1978; Czinkota and Tesar, 1982; Rosson and Reid, 1987; Welch and Luostarinen, 1993).

Relationships to foreign suppliers and other actors, such as import agents, freight forwarders and distributors may be used to gain information about potential buyers or be used directly as business partners for outward activities. If the focal firm initiate exports to the same market from which importing takes place, the connection between inward-outward activities is more obvious. The connections may, however, also be present when the firm imports from one market and exports to another. For instance, this is the case when a supplier, from whom the focal firm imports, is able to help establish and facilitate contacts to buyers in another market. The inward-outward connection may be easier to identify in small firms because the number of decision-makers is usually limited and sometimes the same person is responsible for both import and export activities. In larger firms, the person responsible for importing may be separate from the person responsible for exporting (Reichel, 1988).

A major obstacle for SMEs engaging in international operations is generally limited resources (e.g. O'Farrell and Hitchens, 1988; Rönning, 1991; Christensen and Lindmark, 1993; Kaufmann, 1994). This means limited personal and financial resources, but also limited software and hardware resources may be substantial obstacles for SMEs (Holmlund and Kock, 1995). Malecki and Veldhoen (1993) state that small firms are *"most plagued by a general problem of inadequate expertise and skills at several levels - managerial, supervisory, and production employees*".

For SMEs, management is crucial for when and how the firm engages in international activities (Bilkey and Tesar, 1977). The individuals of the firm will have a substantial impact on the internationalization since close social relationships with other individuals influence their interest of doing business abroad. Social relationships have been pointed out as extremely important especially for entrepreneurs (e.g. Aldrich and Zimmer, 1986; Greve, 1995; Johannisson, 1996) and in international business (Björkman and Kock, 1995). In a small firm, the entrepreneur is often the key actor that positions the firm on the foreign market. The commitment of the management to rhe internationalization process is in these cases higher. (Lindmark, 1996; Imai and Baba, 1989). Management will get access through strong and weak ties (Granovetter, 1973) to different kinds of information needed in the internationalization process. Especially in the beginning of the internationalization process, management's former international experience plays an essential role. It has been argued that the lack of this kind of experience is one of the reasons behind Finnish firms' weak performance on the international market. (Luostarinen & Welch 1990)

SMEs have to engage in long-term relationships to get access to external resources. The international activities of a firm are consequently highly dependent on the firm's relationships to other actors embedded in the business network and on the activities that these firms perform. The network approach, which emphasizes relationships, is therefore an appropriate starting point for studying SMEs since this approach provides a comprehensive framework for understanding these firms operating in business networks (e.g. Johanson and Mattsson, 1990; Christensen and Lindmark, 1993; Sharma and Keller, 1993). The surrounding network represents, for a small- or mid-sized firm, a source from which external resources and information are gained. With these connected partners the firm can also share risks. As the risks generally increase as the firm becomes international, the importance of having partners to share the risks with also increases (e.g. Kaufmann, 1994). Other driving forces behind cooperation in international operations can be to find new customers and markets, to gain new knowledge and to increase revenues and profits, for instance.

There are many possible driving forces behind a firm's internationalization pattern. These factors are generally divided into two categories: proactive and reactive motivating factors (Czinkota and Ronkainen, 1988). The former group consists of management's perceived benefits or opportunities. For instance, increased revenues or profits may motivate the firm to enter the international arena. The second group, i.e. the reactive motivators, refers to a set of motivators caused by the firm's response to environmental changes. For instance, overproduction, declining domestic sales, excess capacity and saturated domestic markets may cause the firm to turn to new markets, that is to foreign markets to find new possibilities. Proximity to customers has forced particularly service firms to get involved in international business as a response to international activities undertaken by their customers. For example insurance companies and banks have followed their customers when these have become international in order not to loose them to foreign competitors (e.g. Engwall and Wallenstål, 1988; Erramilli, 1990; Hellman, 1996).

## EMPIRICAL FINDINGS

The research was carried out during December 2001 and March 2002. The target group was Finnish SMEs with less than 500 employees. The companies were mostly within manufacturing industrial and/or consumer products, and services industrial or consumer. The sample was drawn from a national database and all the companies within the selected business areas were chosen. About 3.000 questionnaires were sent out and 438 usable were returned. The low response rate may be explained by a too extensive questionnaire and the time chosen for carrying out the survey. The questionnaires were answered by the CEOs and marketing/sales managers. The first questionnaires were sent out in November and a reminding letter in December. As the response rate was rather low a third round by calling the respondents was carried out in the end of January and the beginning of February. At the same time we were able to analyze the companies not attending in the survey.

The average number of employees was 60 and the average turnover about 900.000 euros. The turnover gained from foreign business activities was in average 38,6 percent. The vast majority of the firms (87%) were manufacturing companies, while only 13% were organizations offering industrial services. The largest groups within the manufacturing companies were wood and paper industry as well as metal industry. Of the 438 companies analyzed 230 were family owned, 114 were part of a larger group while the rest represented some other kind of organization mode.

### THE BEGINNING AND ROLE OF FOREIGN SALES

Of the 438 companies 15% would characterize companies foreign sales activities during the last five years as occasional, 22% would describe it as quite regular and the majority (61%) describe their foreign sales activities during the period 1997-2001 as highly regular and continuous. For about 100 of the answering companies the foreign inward business operations had started before the year 1980, while 94 of them started during the 80's and about 115 companies started during the 90's.

The most important in the beginning import countries for the companies were Sweden and Germany, accounting for 20% each. The third most important is the U.K. (5.7%), followed by Russia and the U.S., indeed falling behind with 3.9% each. Today the foreign share of imports is about 33% of total purchases, and the most important import countries are Germany (22%), Sweden (13.4%), Italy (6.6%) and the U.S (5%). A slight change can be noted in the importance of Italy, which has increased and the importance of Sweden as an import country has decreased. In addition, imports from both the UK and Russia have decreased. In general 63 per cent of the studied firms import from 1 to 5 countries, 30% from 6-10 countries and 7% from 11-30 countries.

The most popular country to start exporting to is according to the survey Finland's neighbor country Sweden. The second most important country is Germany followed by Russia, Estonia, Great Britain, Norway, and the U.S. Noteworthy is the difference between the two major export countries Sweden and Germany and the rest of the countries is substantial. These findings are very much in line with earlier findings (Holmlund & Kock 1998, Kock & Laine 2000). The Finnish companies obviously follows the step model of internationalization.

About 230 of the companies had started their foreign sales within three years after the company's foundation and the share of foreign sales at that time was at least 25 % for 85 of the companies.

Most impact on the company's decision to start operating internationally had the management's interest in internationalization, foreign enquiries about the company's products or services and the inadequate demand on the home market.

The three most important target countries answered for an average of 70 % of foreign sales. The operation modes used in the beginning of foreign sales were mostly direct export to the end customer, secondly selling through an importer or a reseller and thirdly through a foreign agent.

**Table 1: Operation Mode in International Outward Activities in the Start-up**

| Operation mode | First country |
|---|---|
| Direct export to the end customer | 137 |
| Foreign agent | 62 |
| Domestic agent | 23 |
| Importer / reseller (distributor) | 77 |
| Sales office | 17 |
| Joint venture | 8 |
| Other, which: | 84 |
| Other, which: | 12 |

From Table 1 we can see that direct export to the end customer is by far the most popular operation mode. Secondly we have importer or reseller and thirdly foreign agent. These results support the findings from earlier studies that Finnish SMEs usually engage in operation modes that are not too costly. The commitments to the foreign markets most be regarded as low, and the same goes for the investments. Knowledge about foreign markets is gained when using direct export to the end customer. When using importers or foreign agents the knowledge about the end costumer and the market is low.

**Table 2: Average Number of Export Countries**

| Number of countries | Companies |
|---|---|
| 1 | 32 |
| 2-4 | 125 |
| 5-9 | 113 |
| 10-24 | 117 |
| 25 or more | 33 |

The total number of countries in which the companies conducted foreign sales in 2000-2001 can be seen from Table 2. Most common are exports to 2-4 countries, followed by 10-24 countries.

**Table 3: Operation Mode in International Outward Activities at Present**

| Operation mode | Most important country |
|---|---|
| Direct export to the end customer | 131 |
| Foreign agent | 48 |
| Domestic agent | 9 |
| Importer / reseller (distributor) | 86 |
| Sales office | 35 |
| Joint venture | 12 |
| Other, which: | 12 |

As can be concluded from Table 3 the present operation modes seem to be quite stable (compared to Table 1, operation modes at start up). The only observable difference was a duplication of the number of sales offices. However, since the time frames are not considered here, no further analyze of the duration or order of the stages can be made.

**Table 4 Operation Mode Development**

| Operation mode | Sweden | At present | Germany | At present |
|---|---|---|---|---|
| Direct export to the end customer | 63 | 192 | 8 | 100 |
| Foreign agent | 30 | 68 | 5 | 63 |
| Domestic agent | 7 | 14 | 1 | 5 |
| Importer / reseller (distributor) | 33 | 153 | 14 | 121 |
| Sales office | 7 | 44 | 1 | 36 |
| Joint venture | 2 | 15 | 2 | 8 |
| Other, which: | 43 | 102 | 13 | 66 |

However, an interesting notion is the development process that has occurred. When the companies started to export to the two most important countries; Sweden and Germany, direct operation modes were the most popular. Today they are still common but the interest for FDIs has increased. From Table 4 we can follow this development.

**Table 5: Number of Buyers in the Domestic Market and Abroad**

| Number and type of customer | In the home market | In the foreign markets | In the most important country |
|---|---|---|---|
| a) 1-4 | 28 | 93 | 150 |
| b) 5-10 | 37 | 63 | 67 |
| c) 11-20 | 41 | 67 | 37 |
| d) 21-49 | 62 | 58 | 26 |
| e) 50-100 | 68 | 51 | 18 |
| f) > 100 | 166 | 50 | 26 |
| g) public sector | 15 | 13 | 8 |
| h) private sector | 160 | 175 | 119 |
| i) other, which: | 102 | 41 | 29 |

As visualized in Table 5 the companies most often had over a hundred customers in the home market, 1-4 customers in the foreign market and also 1-4 customers in the most important foreign country. Hence the home market still seems to be of great importance for the companies in general. 15 of the companies sell to the domestic public sector and 13 to the public sector abroad, while 160 companies sell to the domestic private sector and 175 to the private sector abroad. 175 companies sell to both the public and private sector in the home country and 188 companies sell to both public and private sectors in foreign countries.

**Table 6: Management's International Experience Before the Company Started to Operate in Foreign Markets**

| | No one | One of the management personal | Many of the management personal |
|---|---|---|---|
| a) has lived abroad | 233 | 89 | 54 |
| b) has studied abroad | 279 | 58 | 34 |
| c) has worked in another Finnish company in international assignments | 195 | 105 | 89 |
| d) has worked in a foreign company in international assignments | 293 | 41 | 29 |
| e) other experience, what: | | | |
| f) other experience, what: | | | |

143 companies answered that one or several persons in management position had been living abroad and in 194 of the companies one or more persons of the management personal had been working for another Finnish company in international assignments abroad before the company started to operate on foreign markets. Thus it seems like the management of the companies have not had much international experience before going abroad. On the other hand one can assume that only one or a few need to have international experience in a company before starting international activities. We can also see from Table 6 that the experiences commonly come from earlier working experience in other Finnish companies.

**Table 7: Connections between the Three First Export and Import Countries**

| | | **First export country** | | | |
|---|---|---|---|---|---|
| **First import country** | | Sweden | Germany | Russia | UK |
| | Sweden | 55 | 7 | 5 | 3 |
| | Germany | 49 | 7 | 10 | 4 |
| | Russia | 3 | 3 | 4 | 3 |
| | UK | 12 | 1 | - | 2 |

A test of correlations between the three first import countries and the three first export countries did not show any strongly significant results. These findings will consequently support the second assumption made that there is now connection between the country from where the company starts to import and the country to where they start to export. However, there seem to exist some kind of connection in the specific case of Sweden. As seen from Table 7, Sweden was indeed the target for both importing and exporting for 55 of the companies when engaging in international activities.

**Table 8: Factors that Affect the Company's Decision to Start Operating Internationally.**

| **Triggering factors** | **Mean** (extremely minor impact =1 and extremely major impact = 5) |
|---|---|
| a) internationalization of customer | 2.47 |
| b) internationalization of competitors | 2.29 |
| c) success of competitors in international markets | 2.29 |
| d) management's interest in internationalization | 3.99 |
| e) management's international experience | 2.81 |
| f) competitive foreign sub contactors | 2.12 |
| g) inadequate demand in the home market | 3.65 |
| h) increasing competition in home market | 2.82 |
| i) foreign enquiry about the company's products / services | 3.72 |
| j) lack of sub contactors in the home market | 1.73 |
| k) the company has never considered its home market as the only market | 3.16 |
| l) export subsidies / subsidies for international operations | 2.04 |
| m) contact from the chamber of commerce/ other support organization | 1.60 |

The most common reason for engaging in international business activities is management's interest in internationalization. Secondly we have enquiries from abroad about the company's products/services. The third trigger is a small home market, i.e. the company is forced to engage in international business if they want to grow. The fourth reason is that the company has never considered the home market as their only market. In other words one can assume that international business activities are part of the company's business mission.

Interesting to notice is that the companies do not regard contact from the chamber of commerce or other support organizations important for getting their international activities started.

When asked to characterize the development of the companies' field of business in the three focal foreign markets over the past three years the following statements reach the highest scores (1) companies compete mainly in narrow product lines (2) the networks in this field are international (3) markets have evidently grown.

## CONCLUSIONS

From the empirical findings we can conclude that there is no obvious relationship between the country from where a company starts importing and the country to where the company starts exporting. The study also indicates that the initial export markets chosen by the companies are closely situated both culturally and geographically. A direct export mode is preferred by the vast majority of the SMEs, because it is a rather inexpensive operational mode that does not require any substantial commitments. When using an agent, the companies risk losing the close direct contact with the buyer, and in that case it may be difficult to solve different kinds of problems. In addition, based on the study no clear connections between inward and outward flows can be identified. Important factors when internationalizing seem to be the management's interest in international activities, as well as enquiries from abroad about the products.

More studies are needed in order to discover the nature and extent of connection between import and export activities. For instance, empirical information covering both qualitative and quantitative data from case studies and in-depth interviews would shed more light on this complex relationship and its underlying structure. Consequently both in-depth and in-process research methods are needed. Another area of interest is how firms increase commitment to foreign markets and what hinders them to proceed in their internationalization process.

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