

# **Internationalization is based on a long-planning, optimization or on the features of the network?**

for Work-in Progress / Competitive paper

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## **Abstract**

Purpose of the paper and literature addressed:

This paper highlights the differences between small and medium sized firms and multinational companies according to internationalization possibilities and processes. The literature review presents the main findings of the last 20 years. The normative strategy theories focus on revenue optimization and synergy searching. But small and medium sized firms have limited possibilities to choose any location for expansion. Other factors should be more relevant for them. This paper focuses on the determinant factors of the first expansion strategy.

This paper presents three case studies based on semi-structured in-depth interviews. Those companies have already more subsidiaries and could compare the different decision making situations with each other.

The proposition made from the cases is that for an SME at first expansion the network was determinant. The more trust is built the more chance that the opportunity come to move together to a new location. The cooperation enables SME to reduce risk of the first period.

The main contribution is that these cases highlight the importance of networks, embedded cooperation and trust for the internationalization process. These imply that managers should focus more on the business relations. For verifying these ideas quantitative research is needed.

## **Key Words:**

Internationalization, Network, Small and medium sized enterprises SME, Strategy, Hungary

## **Introduction**

The normative, optimizing schools of strategy explain the internationalization of firms by market imperfection (Hymer 1976), comparative differences (Andersen 1997, Hunt 2002) and transaction costs (Williamson 1985, Eramilli and Rao 1993). Dunning (1980, 1983 a,b) conformed these theories in his eclectic paradigm where he defined owner, location and internalization advantages. Firms have to possess these advantages to be successful in internationalization. The objectives to move to foreign countries are market seeking, resource seeking, efficiency seeking or a strategy target. These theories states that the election among the countries for the new subsidiaries should be based on the evaluation of the former stated advantages. When a company follows these theories, then it evaluates the possible countries by all considerations then chooses the optimistic, the best scored ones.

Are the subsidiaries founded by this way? These models were created for the multinational companies. Are the results relevant for the small and middle sized enterprises (SME) as well?

Coviello and McAuley (1999) felt that this process is less structured and formalized. The network of interorganizational and interpersonal relationships defines the opportunities for internationalization. Especially relevant these feature for the SMEs where even one investment failure could undermine the sustainability of the firm. They need more partners and more trust to open a new subsidiary. Optimization of the country advantages is not as relevant as the trust among his partners. In this way the firms can minimize the risk. Knowledge, culture and the features of the network has significant relevance in the SME management (Ruzzier, Hisrish, Antoncic 2006).

In this paper I would like to emphasize the importance of networks, connections and serendipity beside the strategy focused company management. I will highlight the differences among the decision rollers of the first subsidiary and the later ones. To demonstrate these ideas I present in-depth interviews with Hungarian SMEs who have already established more subsidiaries in different countries.

## **Background and relevance**

Since the Socialism failed and the integration started among the western and the eastern world the globalization speeded up, and the foreign direct investment shaped the world economy. The fresh capitalist markets needed western capital and knowledge to catch up with the western trends.

Beside the positive effects of the fast change and development a hostile environment was formed for the national SMEs where they had to face tough competition to survive, and high pressure to find the possibilities to constantly improve quality and maintain growing. The SME sector went through a cultural change and from 1999 more and more company could join to supply networks and meet the western standards. (Tesar, Boter and Bohman 2003). This opened wider opportunities for SMEs.

The liberalization, the EU membership and the opened boundaries enhanced the fast development of technologies and facilitated value creation for customer. The multinational companies (MNC) could exploit their economies of scale and their cumulated business

knowledge so the national small and medium enterprises are at a disadvantage. On the other hand the SME sector is the most relevant part of a stable national economy. This sector employs approximately the 60% of the employees, so their survival is a crucial part of the country long term development (Pitti 2010). To compete successfully with the MNCs constant development and growing is needed in SME sector. But the market is limited. So for a long run development regional internationalization is necessary. Based on Pitti's (2010) research companies with international focus (export, subsidiaries) created in average more value and GDP than the domestic focused SMEs. To improve the overall economy capacity an efficient instrument would be to facilitate SMEs to move abroad.

Therefore understanding the process and the facilitators of internationalization is a key issue for long-term competitiveness of the firms and also of the country itself.

### **The conceptual framework**

The internationalization strategy is in the focus of investigation of many researchers since Hymer (1976). After the Second World War during the extensive development many firms invested in foreign markets, and more and more multinational companies established their market leading position. "His theory implies that the existence of imperfect markets and firm's unique advantages are catalysts for FDI." (in Malhotra, Agarwal and Ulgado, 2003, pp.4) The firm has owner specific advantages and knowledge and these enable the company to exploit the market differences among countries.

Most of the studies were focusing on these questions:

What are the motivations to internationalize?

What are the obstacles?

What are the relevant factors, which shape the environment and the possibilities of the company?

How companies choose location?

How do they decide among the expansion methods? (From export to green field investment)

How the process is conducted?

The first studies investigated MNC companies and their subsidiaries.

The transaction cost theory (Williamson, 1985) focuses on the costs of conducting economic exchange. Beside the production the company has to face other costs (such as cost of negotiation, cost of controls etc.) it is because there is lack of information and the possibility of opportunistic behavior of third parties. To reduce these costs the firm has the incentive to internalize them and chooses FDI instead of exporting.

Dunning (1980, 1983ab, 1988) evolved the eclectic paradigm to harmonize the different approaches. He argued that there are three types of advantages what can be exploited by the internationalization and the combination of them is needed for a successful strategy.

- The ownership specific advantage comes from the company knowledge, scale, technology, brands etc.

- The location specific advantage is generated from the differences of countries according to prices, regulations, infrastructure, taxes etc.
- The internalization advantage comes from the decision to handle market imperfection inside the organization.

According to the strategy of a company the management could detect the advantages and combine them to find the best suited location in this way the synergy could be exploited by the company.

Dunning (1994) defined four types of strategy goals what could be reached by internationalization. The first is the resource seeking goal when a firm focuses on the location advantages. The second is the market seeking goal when the company tries to benefit its ownership and location advantages. The efficiency seeking goal is focusing on to extend economics of scale and reach internalization and ownership advantages. The strategy asset seeking target exploits location internalization and ownership advantages.

The model suggests that the firms could consider all the possibilities, advantages and barriers during the decision making to move to foreign country, and based on the strategy vision they could choose the optimal location for the subsidiary.

But the models assumed that the companies have infinite capital, and they have the processes to handle the foreignness of the new market. But for a small or medium sized company expansion strategies are riskier than for the MNCs.

Johanson and Vahlne (1977, 1990) observed the internationalization as an incremental process and not as a one-point decision making action. They said that the formalized evaluation is valid only for the experienced multinational companies, while they have the needed persons, knowledge and capital to consider many options for a new subsidiary, but it does not explain the process of the SMEs when they move to foreign countries. They have limited funds and risk more than the MNCs. They argued that the lack of information of the new markets and culture makes the company watchful. First they keep the commitment low and later when more knowledge and experience are accumulated they invest more. At the end they open subsidiaries and start looking for new opportunities. This incremental internationalization process describes better the SME's behavior, but still does not explain the situations when firms skip stages of development.

A more complex perspective is spread in the last 20 years which does not only focuses on the individual company but the surrounding environment and business network as well. Håkansson and Snehota (2006) summarized the importance and achievements of network theory. The interactions and business relations are not a static structural context but a living and determinant part of the company environment. Any action taken by one firm affects its all network and participants. The business relations are usually important on long run and determined by the persons who are in charge. Trust and cooperation is the base of this relation. The network usually determines the possibilities of the company.

Björkman and Forsgren (2000) highlighted that from this aspect the resource commitment is not the indicator of internationalization but the network of a company should be investigated. The more internationalized is the network the more the company is embedded in the international business. Coviello and McAuley (1999) suggested that formal and informal relations are equally relevant and should be considered when the internationalizing

opportunities are in focus. Any strategy action of one firm affects the other firms of the network. (Hertz and Mattsson 2001) Complex interdependency shapes the market.

Also the importance of the attitude, know-ledge, and the age of the decision makers could facilitate or deter the initiatives to go abroad. (Caughey and Chetty 1994)

Dunning (1995) modified his eclectic paradigm to connect with the network paradigm. He argued that the all the ownership advantages are common advantages in strong cooperations. The needed knowledge or resource is available through the alliance. The locations of the partners are part of the location specific advantage, and information and knowledge sharing is important. The whole alliance has to be seen as one organization to understand the importance of internalization advantages. The alliances needs less capital and spread the risk so FDI could be avoid. But trust is the base of this system.

These models describe better the SME sector and collect those determinant factors which are more relevant for them. This sector lacks capital so wrong decisions could debilitate the core business as well. As EU research<sup>i</sup> showed in Hungary the lack of capital is the bigger constrain to internationalize. On the other hand the growing companies usually try to exploit market seeking goal, 75% of them focuses on that, and other 56% felt the strategy asset seeking relevant as the research of Incze (2005) indicates. The decision makers have a more influential role then in MNCs as most of the strategy decisions depend on one person not on a board.

The problem with the normative strategy is that SMEs does not have time, knowledge and many scenarios to evaluate and choose among them after an accurate analysis. The interdependent network models gives a better understanding on the context and possibilities what SME sector faces. The incremental steps and network connections development are valid in most of the cases. But these models rarely covered the question how the SME decide beside the first movement, and how can facilitate the chance to have opportunities.

Investigating service firms Majkgård and Shamra (1998) shown that sometimes service firms “hitch hiking” with their customer to foreign countries. It implies that beside the endogenous factors the exogenous ones are determinant as well during internationalization. Axelsson and Agndal (2000) highlighted the importance of firms and individual connection during the internationalization. They argued that these networks form an opportunity network, where the firm could find partners for development strategies.

### **Three case studies about the internationalization process**

To indentify and highlight the determinant factors of the SME internationalization process in-depth interviews were made with executives of Hungarian firms. Three companies were chosen based on the recommendation of a national Association of Entrepreneurs. Criteria were that the company should have more subsidiaries in different countries, because then the differences between the expansions could be investigated. The generally two hours long interviews were taken with the executives of the company.

In the first part of the interview they were asked to summarize the company history and the steps what were taken during the first internationalization process. They had to highlight the

determinant conditions and circumstances what were affecting that process. In the second part the questions followed a semi-structured questionnaire and reflected on the previously heard story. The focus was on to find the similarities and the differences among the described process and the relevant MNC and SME theories. In the third part they were asked to compare the first internationalization process and the following ones. Could he highlight any differences according the process and the determinant factors?

### **First case**

A refrigerator manufacturing Hungarian middle size firm has already subsidiaries in five neighboring countries. In the '80s the company realized a lack for high capacity refrigerators in the HORECA sector. As tourism flourished the company had more revenues and capital for research and development. One of the lead products was its bier-cooler system. The maintenance service had to be well organized as the MNC partners required standard and reliable high quality. The company product portfolio was specialized for high quality, and the adjunct service network had the know-how and IT systems to reach customer satisfaction. They realized the importance of MNC partners and after the long-term relation trust between the partners were established. The company realized that there is a need for its products and know-how in the other Central-Eastern European countries as well. The opportunity came when the MNC partner also decided to move to these countries. As they needed the high-quality service also in those countries they brought the firm with themselves.

The leader of the company felt the domestic market small and was open for further development. He saw the potential on the CEE market, but they did not analyze the feasibility of them and did not compare the scenarios. They were waiting for an opportunity, when they can move without risking the domestic market.

The partnership offered stable demand on the new market so the risk of feasibility of the first period was highly lowered. The foreignness was also lower as the main partner were already well-known and had experience of internationalization. The first period was financed by the fixed demand, and with the partner it was easier to handle any problem. The risk for fiasco was marginal. But the base of this opportunity was the trust among the partners.

Market and strategy asset seeking could be seen in this process, but the opportunity was independent of the possible advantages. It could be only exploited by this cooperation.

After the first subsidiary the company had experience to move abroad, handle the processes, and harmonize the domestic and foreign operations. So the next time when they saw further development opportunities they dared to move alone.

The relevant factors were: specific knowledge/product, long-term business relation, serendipity (to have a more experienced partner who moved abroad), trust, partners are in the new country, openness to move abroad (firm culture), fix demand in the new market, reduced risk.

## **Second case**

The accounting and tax advisory company was established by consultants ten years ago. From the beginning they had the goal to create an international company. First they had to gain a large and stable customer base in Hungary. Some of his partners had subsidiaries so they had to handle international cases but they always needed foreign consultancy partners to do that part of the job. As the customer base was growing they had more and more international cases. After a while it reached a critical level and they decided to open a foreign subsidiary because there were already work for them to maintain an own office. By this they had the opportunity to move. Most of the partners from abroad were joined the new company and the trust and long term relation among the domestic and foreign partners reduced the risk to move abroad. On this base the new subsidiary could start to find new customer with that security that they already had work.

The whole company culture and attitude was to move to foreign countries as soon as possible. They had many potential targets, but they were not evaluating them. The location was not selected by the potential of that market. The first country was selected based on the existing network. Where they already had the partners and the demand they opened the office. After the first expansion they developed the integrated systems, and had the know-how to open new subsidiary they dared to move to countries with less fixed demand as well.

The relevant factors were: to move abroad (firm culture), long-term business relation, partners are in the new country, trust, fix demand in the new market, reduced risk.

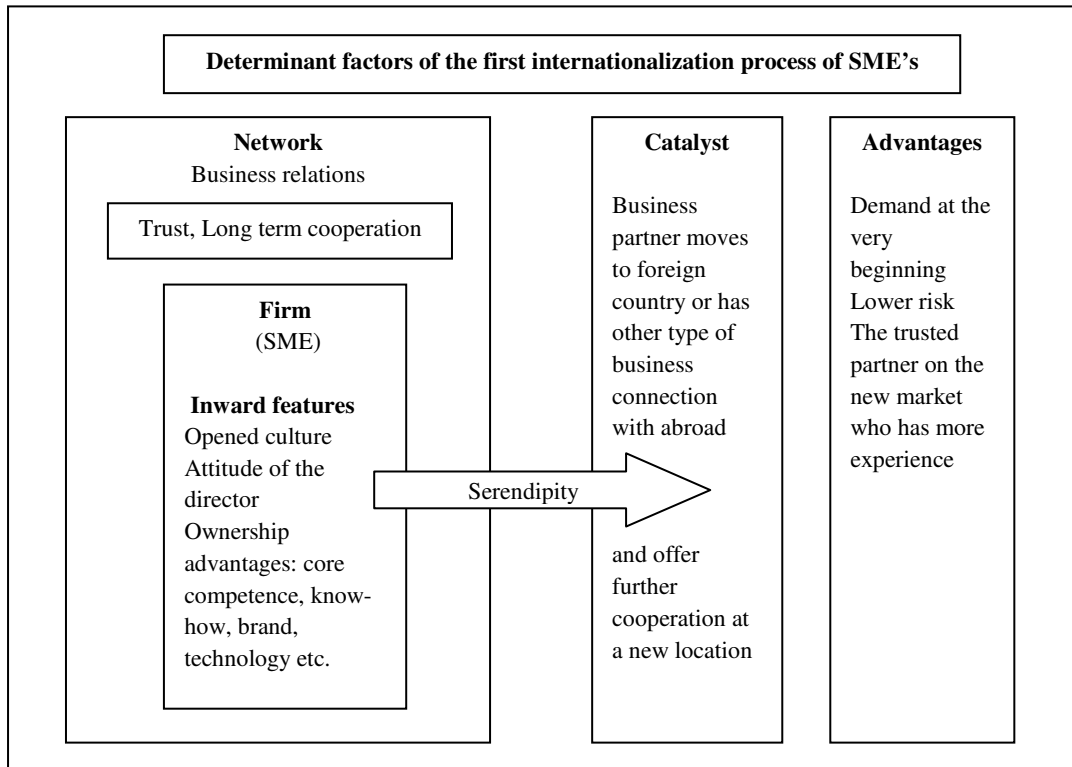
## **Third case**

The third company profile is to plan and construct bathing-pools and fountains. The complete implementation service and the distribution of the connecting instruments gave good recognition for the company which started 20 years ago as a family enterprise and now they are the relevant distributors and the most innovative constructors in Hungary. There were no initiative to move abroad just to create long-term business relations. They were the suppliers of an international hypermarket. When that firm decided to move to Eastern Europe they were asked to be the suppliers there as well. They had to decide to move forward or risk the supplier position at the domestic country as well. After having the subsidiary for distribution all the portfolio was opened there. Now the company operates in three Eastern-European countries.

The company culture was not focusing on internationalization but constant innovation was a core value of the company, so changing was accepted. The long-term relation was a base for further cooperation and that was catalyzing the expansion process.

The relevant factors were: specific knowledge, long-term business relation, serendipity (to have a more experienced partner who moved abroad), trust, partners are in the new country, openness for innovation and change (firm culture), fix demand in the new market, reduced risk.

## Propositions



**Figure 1: Determinant factors of the first internationalization process of SME'** *(figure made by the author)*

The determinant factors of the first internationalization process are seen on Figure 1.

The first element is that, the company inner capabilities should be appropriate for an internationalization process. These are the ownership advantages (Dunning 1980) such as the product, the know-how and the processes etc., what should be competitive on the new market as well. Also company culture is relevant because it determines how the company can fit in the culture of the new country. Many research on the SME sector focus on the roll of the executive. As the firm is small and the strategy creation is highly centralized in his hand, the decision strongly shaped by his personal attitudes and beliefs. In the three cases the attitude of the leaders were highlighted. They were not afraid of the different culture. Usually spoke foreign languages and were opened for other cultures. For them this openness was important during the process. Otherwise they would not exploit the opportunity.

The environment in which the company operates should be understood to see the possibilities for expansion. This environment is defined by the network built around it. The connection with the suppliers, customers, government, stakeholders, competitors shape the borders of the actions of the company. The longer is the cooperation the more trust is built. This is the second element.

If the constellation of inner capabilities and the trusted partners are given, then can serendipity catalyze the internationalization process. The interviewed companies were eager to grow but they would not dare to move abroad alone. But when the opportunity can they moved along.

The MNC has capital and experience of foreign expansion to move to any country which is lucrative for it. The strategy formatting method scenario creation and feasibility evaluations can show the company the optimal locations for further development. The decision making process takes time because they compared the possibilities.

For SME internationalization is much riskier. They have no time and knowledge to create such studies. They can facilitate the circumstances to move abroad, but they can reduce risk by their network. The partner helps the first steps on the new market. They do not face the question where to go (as MNC); but they should answer go there or not to go there (where the opportunity is seen).

So the push effect there was the serendipity. The network should have one or more partners with foreign interest and they offered a possibility to move abroad using them as a background. It could be real cooperation or just an agreement for demand on the new location. But these opportunities could be exploited only when the company is ready to change.

These cases showed that not always exporting is the first step, and the incremental model is not proper at these situations. The firms are ready to start with a subsidiary but only if they can count on an agreed demand just from the beginning. In this case the risk is much lower, the first period does not consume so much financial support and the partners in the new location are ready to help, so foreignness is not so crucial as if they would go abroad alone.

“The entry process is an interactive and long-term unpredictable evolution, during which the firm reacts and adapts to events” (Ciabuschi 2002). If the firm has already known partners in the new environment its network helps to handle any problem more easily.

After the first subsidiary the company collects experience how to open a new office, how to get know the regulations, customs, how to integrate the new subsidiary into the former organizational structure etc. At the first time network, trust and partners, countable demand is needed to move abroad. With the experience other strategy considerations come forward and the next expansion is easier and the company has more possibility to choose the locations.

From the cases a proposition could be developed. For SMEs to have the chance for long term development and regionalization a proper way is to be embedded in a network with international potential. In this way the firm could highly lower the risks of fiasco of the expansion.

In management this perspective could be used to form growing strategy. If the company has internationalization among the long term goals, then building and developing a proper network generates the opportunities to move abroad with low risk exposure. They should focus on MNCs, or other SMEs already with subsidiaries. If the firms become their supplier later the opportunity could rise. Also hiring persons with international connections helps the company to find these chances.

## Conclusion

This paper focused on the difference of the SME and the MNC internationalization process. In the first part the literature review highlighted the main results of the last 20 years according to the internationalization theories. Researchers underpinned the importance of external and internal factors and highlighted that the SME faces different opportunities as the multinationals.

The main difference between SME and MNC is that SME lacks resources and risk more at any expansion as the fiasco could bankrupt the whole company. The importance of decision makers is higher and they have less possibility to choose from.

In the second part three cases were presented. The focus was on the determinant factors of the first foreign expansion. The common features were that all of them went abroad when they had previous demand there and when they were sure, that also in the first period would be financeable. This resulted less risk exposure, and the companies could handle the challenges of the new market.

These cases highlighted the importance of networks. The more the SME is embedded in an internationalized network, the more possible is that the SME will have an opportunity to extend with one of its partners.

As this three cases support only to raise ideas and questions further qualitative investigation is needed. The nature of external business environment and networks need to be examined to highlight the relevant feature and steps what help to build trust and interdependence among partners which facilitates further growing and internationalization.

After that the management could use the results to build and manage relationships with the focus of further expansion.

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