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International diversification measurement: The consideration of international involvement and diversity in global strategic planning

Quinton, Alfred Peter, D.P.S.

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U·M·I
300 N. Zeeb Rd.
Ann Arbor, MI 48106

INTERNATIONAL DIVERSIFICATION MEASUREMENT: THE CONSIDERATION OF INTERNATIONAL INVOLVEMENT AND DIVERSITY IN GLOBAL STRATEGIC PLANNING

by
Alfred Peter Quinton

Pace University
Lubin Graduate School of Business
New York, NY

Doctorate of Professional Studies Program

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Committee Members
Dr. Warren J. Keegan, Chair
Dr. Eli Seggev
Dr. Nikolai Wasilewski
Dr. Joao S. Neves
Dr. David Prensky

The dissertation of Alfred P. Quinton has been approved:

WARREN J. KEEGAN DISSERTATION CHAIRPERSON

NIKOLAI WASILEWSKI

ELI SEGGEV

JOAO S. NEVES

DAVID PRENSKY

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Abstract

INTERNATIONAL DIVERSIFICATION MEASUREMENT: THE CONSIDERATION OF INTERNATIONAL INVOLVEMENT AND DIVERSITY IN GLOBAL STRATEGIC PLANNING

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Three broad questions were addressed in this study. First, should management consider the diversity in a firm's international operating environment when planning further international diversification? Second, why does the diversity factor deserve consideration? Third, how does one measure the amount of diversity in a firm's international operating environment? The objectives of this study were: (1) the introduction of the diversity construct into the measurement of international diversification, and (2) to obtain a better understanding of the relationships between international involvement, international diversity, and profit performance.

To reach these objectives, four relationships were investigated: (1) the relationship between the level of international involvement and the level of international diversity, (2) the relationship between international involvement and profit performance, (3) the relationship between international diversity and profit performance, and (4) the relationship between international diversity and profit performance while controlling for the level of international involvement.

International diversification was measured by gauging two factors: (1) the firm's degree of international involvement and (2) the firm's degree of international diversity. A firm's degree of diversity was measured as the sum of the home/host differences and the host/host differences using Hofstede's country specific index of differences in work-related values. The relationships between levels of international diversification and levels of profit performance were examined for 310 US manufacturing firms for a five-year period (1986-90).

A significant and positive correlation between involvement and diversity was found. There was no significant difference between the influence of involvement or

diversity on profit performance. Diversity had a negative relationship to profit performance in low involvement firms and a positive relationship to profit performance in highly involved firms. It appears that larger, more internationally involved firms are better prepared to handle higher levels of diversity in their international operating environments. When operations in diverse international environments are attempted by firms with low international involvement, profit performance appears to suffer. When operations in more diverse international environments are attempted by firms with higher levels of international involvement, profit performance is likely to improve. Strategists should measure and evaluate both involvement and diversity to gain a fuller picture of a firm's level of international diversification.

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Chapter I

Introduction

The purpose of this study was to increase our knowledge of the consequences of international expansion strategies utilized by United States (US) firms. This study showed that the level of diversity within a firm's international operating environment is a valid consideration when planning international diversification strategies. International diversification was defined as the extent to which a firm's business activities are conducted outside the home country and the extent to which these activities are divided into disparate international environments. International diversification was measured in this study by gauging two factors: (1) the firm's degree of international involvement and (2) the degree of diversity within a firm's international operating environment.

Two relationships are the important issues examined in this study, i.e., the relationship between the international diversity and international involvement and the relationship between the involvement/diversity construct and a firm's profit performance. These issues are important to strategic decision makers in US firms because of the continued growth and expansion of the global economy. The increasing importance of international competition is continually drawing more US firms into multinational operations. This international expansion of US firms is occurring in a world that may be moving toward greater heterogeneity among nations rather than the homogeneity of a global marketplace. The research questions explored in this study will help international strategists in deciding the future paths of US firms as they move toward successful international diversification.

These same issues are also of interest to academic researchers because prior studies have not specifically measured the level of diversity within a firm's international operating environment. Prior studies have relied primarily on the involvement measure to represent a firm's degree of international diversification. In this study, a firm's degree of international diversification will be measured by both a firm's level of international involvement and its degree of diversity within foreign operating environments.

A. Objectives of the Study

In today's global economy, the planning and conducting of international operations is important to key decision makers. This process and its possible outcomes are referred to in this study as an "international diversification strategy." This strategy has been the subject of extensive research for more than two decades. The association between a firm's international diversification strategy and its profit performance is considered as a key research area (Chatterjee and Wernerfelt 1991). In the current study, international diversification is defined using two factors. The first factor is the ratio of a firm's international business to a firm's total business, which is called "international involvement" or "involvement." The second factor is the degree of diversity within a firm's international operating environments and is called "international diversity" or "diversity."

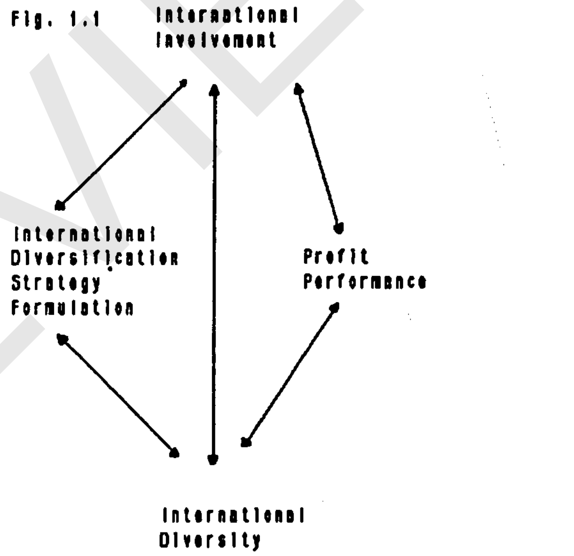
The degree of differences in foreign operating environments, i.e., diversity, is important because the existence of diversity adds to the complexity of management's tasks. The differences in foreign operating environments are most often viewed as cultural, social, political, legal, economic and technological perspectives. These environmental factors are frequently acknowledged as possible contributors to increased complexity within the international management and marketing environment (e.g., Taoka and Beeman 1991 pp. 303-311, Cateora 1990 pp.12-29). Increased environmental complexity is an added burden to managers when carrying out their responsibilities in the real world of today's global yet diverse business environments. Therefore, it is the position of this researcher that diversity should be considered a key factor in any strategic assessment of future international expansion. If the differences within a firm's foreign operating environments are ignored when evaluating international strategic alternatives, then the complete consequences of increased international diversification will not be understood or appreciated.

The introduction of diversity into the international diversification equation was the primary focus of this study. When strategists are planning increased international diversification, they make operational expansion choices and new location choices that affect both levels of involvement and diversity. To understand the consequences of these international diversification decisions, three subjects are examined in this study. First is the relationship

between a firm's level of international involvement and its level of international diversity. Second is the relationship between a firm's level of international involvement and its profit performance. Third is the relationship between the degree of a firm's international diversity and its profit performance. These relationships are illustrated in Figure 1.1.

This study questions whether diversity influences profit performance. It has been suggested that the profitability of multinational operations can be influenced by the relatedness or unrelatedness of international operating environments (Vachani 1991). Earlier studies (Hirsch and Lev 1971, Miller and Pras 1980) referred to unrelatedness of international geographic diversification as an influence on firm performance. However, prior measures of international diversification did not focus on diversity, but concentrated on the level of a firm's international involvement (e.g., Wolf 1975, Geringer et al. 1989). International involvement is measured through endogenous information. Therefore, a measurement of international diversification using only involvement as a measure is considered incomplete as it does not reflect the influence of the external environments in which the firm must operate. A single factor measure of international diversification does not consider any exogenous factors, particularly the differences between national operating environments. The external factors include the social, cultural, political, legal, economic and technological environments that are a reality to managers controlling the operations of foreign subsidiaries in various countries around the world. These external factors can influence profitability and are often called the "uncontrollable environments" in which the multinational firm operates.

Fig. 1.1



Relationship Being Considered In This Study

This study relates profit performance to a broader measure of international diversification that consists of a firm's level of international involvement and the degree of diversity

existing among a firm's foreign operating environments. This broadened measure approach follows the recommendations made by Green and Cunningham (1975), Madura and Rose (1991) and Vachani (1991). They suggest that future research should move beyond the narrow confines of endogenous measurements that have been employed in most prior studies.

B. Terms and Definitions

International diversification was defined as the extent to which a firm's business activities are conducted outside the home country and the extent to which these activities are divided into disparate international environments. International diversification describes the extent and dispersion of a firm's business activities through investments of tangible and intangible assets across national borders. When operating in many international locations, the extent to which national environments differ from each other is an important consideration. This importance is because most of management's international experience is environmentally specific. For example, experienced gained in Canada may be useful in the United Kingdom, but a great deal of that Canadian experience may not be applicable to operations in China or Chile because of major differences in cultural, social, economic, political and technological environments.

Based on this example, it is logical to assume that managers will initially bemore efficient and effective in new international operating environments if those operating environments are similar to operating environments in which management's experience was gained. If managers are required to operate in foreign environments that are significantly different from those environments that provided the background for their experience, then the level of efficiency and effectiveness of the firm may suffer. The degree of difference in the firm's inter- national environment does add an important aspect to the evaluation of a firm's level of international diversification. International diversification defined as both involvement and diversity is a more comprehensive idea for the evaluation of a particular international diversification strategy.

The term "international diversity" was defined in this study as the degree of differences existing within the regional or national environments in which the multinational firm

operates. It was measured as the sum of two factors: first, as the degree of difference between the firm's home and host country environments, second, as the degree of difference existing between the firm's host country environments themselves. A measurement of both home/host differences and host/host differences is considered necessary because of the management complexity that can arise due the dynamics of relations between headquarters and foreign subsidiaries also between foreign subsidiaries themselves. For example, the environment of the United States can be quite similar to a host country, as with our neighbor, Canada. On the other hand, a host country can be very dissimilar to the US, as with China. Each country environment is composed of a set of physical, social, cultural, political, legal, economic and technological conditions existing in that particular country. Host countries can also be very different from each other as well as different from the US. These two differences make up the diversity existing within a firm's international operating environments.

The following comparison of two US multinationals is an example. Company A operates in Canada, Ireland, the United Kingdom, and Germany. Company B operates in Italy, Chile, Turkey, Indonesia and India. Company A has 20 percent of their total business operating in four host countries (5 percent each). Company B has 50 percent of their total business operating in five host countries (10 percent each). There are several key differences in the international diversification level of these firms. (1) Company A's international involvement amounts to one fifth of its total business while Company B has half its total business involved in international environments. (2) Company A has four host country environments to consider while Company B has five host country environments to consider. (3) Company B has a larger degree of difference between the home country environment and the host country environments. Italy, Chile, Turkey, Indonesia and India have greater differences from the US than does Canada, Ireland, the United Kingdom, and Germany. (4) Company B also has a larger degree of difference existing between the host country environments themselves. Italy, Chile, Turkey, Indonesia and India have greater differences from each other than do Canada, Ireland, the United Kingdom, and Germany.

This example illustrates that the international diversification levels of these two firms can be measured by evaluating several aspects of their internationalization status. First

is the level of involvement. Second is the number of foreign environments. Third is the difference from the home country. Fourth is the difference among the host countries. Based on these factors, Company B has a greater level of international diversification.

C. Significance of the Study.

An important question then is: How do these international diversification factors relate to strategic decision making and profit performance? This section discusses the importance of these international diversification factors as a research topic. Researching international diversification as a business strategy is important because global competition increasingly requires US firms to expand beyond their existing domestic or limited international operations.

Although many U.S. firms concentrate on their home market, expansion outside the United States has become increasingly important as the global economy continues to emerge. Many US firms are currently considering expansion into operating environments that contain a widely diverse set of physical, social, cultural, political, legal, economic and technological conditions. As the globalization of international business increases, U.S. firms are likely to increase their level of international involvement to take advantage of new opportunities. This increased involvement is likely to increase the amount of diversity existing among a firm's international operating environments. Consequently, a clearer understanding of the influence of increased international diversification on profit performance is important when planning international strategic alternatives.

Firms may develop global products and marketing strategies to serve homogeneous global market segments. However, actual business operations such as production, sales promotion and distribution must take place within individual national operating environments that are more heterogenous in nature. In the near future, US firms will be constantly reaching out to more unfamiliar regions of the world. The focus of this expansion may be shifting from the more familiar markets of Europe to the fast paced high growth opportunities in Southeast Asia. The international marketplace has become important to smaller firms as well as the Fortune 500 firms. Therefore, it is reasonable to expect that increased

international diversification will continue as a high priority for many US firms.

As more US firms increase their level of international involvement, the degree of diversity in their foreign operating environments is likely to increase for several reasons. (1) Only a few countries, such as Canada, the United Kingdom and Ireland, offer US firms the opportunity to operate within international environments that are physically close as well as culturally, economically and politically similar to the US. (2) US firms tend to trade and invest in countries that are similar in tastes to their home country (Linder 1962). (3) A "disproportionate share of direct investment activity" by US firms was directed toward Canada and the U.K.(Davidson 1980). (4) A global workforce of skilled workers is developing in the emerging newly industrialized countries such as India, Mexico and Thailand (O'Reilly 1992). (5) International diversification is relevant to the business strategist despite a firm's international organizational focus, i.e., multinational (decentralized) or global (centralized). Global strategy does not exclude a need to recognize the differences between foreign operating environments (Buhner 1987).

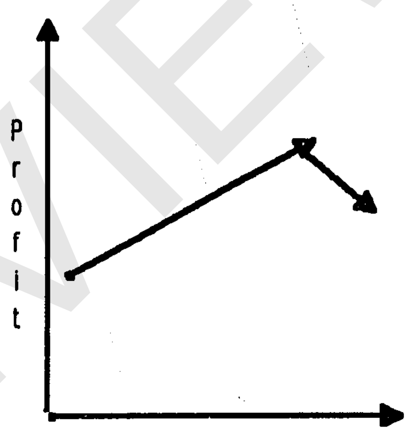
Continued expansion and growth are a common goal shared by many US firms. The global or transnational firm is frequently described as a firm that scans the globe for new opportunities with little or no concern for national boundaries or borders. In describing the multinational corporation, Rahman (1983) states the following: "The need of a constantly expanding market in order to maximize global interests chases the transnational corporation over the whole surface of the globe. The whole world is its hunting ground. It will settle everywhere, nestle everywhere, and establish connections everywhere-provided these actions result in maximisation of overall benefits to the corporation (p.4)."

If diversity increases with greater international involvement, this change can influence the firm, in both positive and negative terms by affecting both the efficiency and effectiveness of management and marketing activities. Examples of the positive influences include: increased experience in foreign operations, the benefits of economies of scale, and the spreading of economic risk over a broader base. Negative examples include: increased operating costs because of greater geographic dispersion among operations, greater management complexity because of increased cultural divergence, and the added intricacy to organizational structures. These examples illustrate the possibility that both positive and

negative influences are likely to affect firms. The net influence on firm performance depends on management's ability to control the negative aspects and take advantage of the positive influences.

The interaction of positive and negative influences has been explored in international diversification studies to a limited extent. For example, Geringer, Beamish and daCosta (1989) reported a positive relationship between increased international involvement and profit performance up to a peak or threshold, at which point certain negative factors overcame and reversed the positive trend to a negative one (see Fig.1.2). They argued that geographic dispersion of a firm's activities was the significant negative influence, but did not actually measure the degree of dispersion. It is argued in this current study, that geographic dispersion (physical distance) is not the single cause of this threshold phenomenon, but that additional factors such as cultural, social and economic differences, generate a total level of diversity within a firm's international operating environment. It is this more complex diversity that can tax management's ability to deal with the increased differences in operating environments. This complex diversity may develop a negative influence that begins to limit the positive effects of increased international involvement. If a firm's management experience is limited to the home market or familiar foreign operating environments, then increased international diversity may have a negative influence. On the other hand, if management is given the opportuni-

Fig. 1.2



The Threshold Effect reported by Geringer, Beamish and daCosta 1989

ty to recognize the difficulties of operating in diverse international environments, then they may be able to control these negative influences. The recognition that diversity has both positive and negative potential is a key factor in controlling those influences. Management can only control those factors that it recognizes. The recognition of diversity and the ability to understand the influences of diversity will enable the firm to benefit morefrom increased international expansion opportunities.

D. Diversity and its Ramifications

Kolde (1985) provides a discussion of the environmental contrasts confronted by management when operating within and across many national borders. He points out that environmental differences lead to behavioral and managerial differences. Although the strategic objectives of the firm may be focused by strategists at the highest (corporate) level, individual organizations, strategies, policies and operating practices undergo a multitude of adjustments or even complete revisions when the firm expands its operations beyond its home country. He says that: "International expansion confronts management with new problems as well as new possibilities in each host economy (p.18)." He adds: "Therefore, management must broaden the base of its expertise by developing the proficiencies necessary for an in-depth analysis and interpretation of contrasting, and often conflicting, environmental factors of different countries (p.19)." His implications for management include: "The increasing heterogeneity requires organizational and managerial changes that pervade the whole company. Directly affected are such important functions as financing, marketing, purchasing, tax liabilities, ownership policies, education requirements for executives, and even the philosophical outlook of corporate planners and policy makers (pp. 22-23)."

When a firm's international operating environments consist primarily of unrelated cultures, varied economic conditions, complicated legal restrictions and considerable physical distance, a more complex management situation is likely to exist. On the other hand, the performance of transnational firms depends on how well management can simultaneously optimize efficiency, effectiveness and learning transfer within the firm international operating environment (Sullivan and Bauerschmidt 1991). When management decides to operate in a

more complex diverse multinational environment with differing cultural, social, political, economic and technological conditions, this diversity becomes an important strategic consideration. According to Cateora (1990): "To adjust and adapt a marketing program to foreign markets, marketers must be able to effectively interpret the influence and impact of uncontrollable environmental elements on the marketing plan for each foreign market in which they hope to do business (p.15)." Taoka and Beeman (1991 pp. 303-304) warn against the dangers of ethnocentrism, lack of cultural empathy and insufficient cultural adaptability that normally exist among inexperienced international management. According to Sethi (1970), the relationship between management and the environment is one of mutuality, reciprocity and interaction. He says that management and environment have a dynamic relationship, influencing each other and changing their respective identities.

This dynamic relationship favors those firms with higher levels of international involvement and more experienced international managers. More involved firms, with a larger pool of experienced international management, are likely to have a strategic advantage in terms of international diversification and expansion. The larger the international management pool, the greater the likelihood of having managers whose experience closely matches the firm's targeted areas for new international expansion. This is an important consideration because experience gained in one foreign environment may not be readily transferred into another foreign environment because of differences in social, cultural, economic, political and technological conditions.

A higher level of international management experience is needed when increased diversity within new foreign operating environments is planned. Since the number of opportunities in foreign environments similar to the United States is limited, international diversity is likely to increase for many US firms as higher levels of international involvement are reached.

The international diversification strategist should evaluate a firm's current level of involvement and plan increases in diversity at a coordinated pace with appropriate management experience. This type of planning and coordination is important because increasing international diversity can influence profit performance either positively or negatively (see Figure 1.3, p. 11) depending on the firm's level of international management experience that