

INTERNATIONAL DIVERSIFICATION AND PERFORMANCE IMPROVEMENT IN PORTUGUESE SMES: THE MEDIATING ROLE OF INTERNATIONAL LEARNING

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ABSTRACT

International operations, with its multiplicity of objectives, can be seen as a diversification strategy, sometimes even as a strategic option taken as an effective alternative to product diversification. This work, focusing on a sample of SMEs of Portuguese manufacturing industries, analyzes the mediating role of experiential knowledge arising from the international learning, on the relationship between the international diversification strategies and performance. Data used were collected in 390 companies through an online questionnaire. Data analysis suggests the existence of this mediating effect, stressing therefore its importance as a potential source of competitive advantage. These results provide guidelines for managers and generate directions for future research.

KEY WORDS: international diversification, intensity, scope, international learning, international performance, mediating role.

1. INTRODUCTION

Enhance performance through international intervention, developing various strategies to achieve this goal, has become a crucial, if not critical, task to many managers around the world, even for those running smaller enterprises (Hymer, 1968; Dunning, 1980; Lu and Beamish, 2001; Hitt *et al.*, 2006a; Cavusgil *et al.*, 2012). International diversification of a company can be defined as the phenomenon of expansion beyond borders of countries and global origin regions, aiming at different locations or markets (Hitt *et al.*, 1997). It is a concept that refers to the geographical scope of the international presence of the company (Goerzen and Beamish, 2003) and it reveals the extent of their dependence on external markets (Thomas and Eden, 2004). According to Contractor (2007), the use of “international diversification” instead of “degree of internationalization” should be avoided, unless it is a reference to an explicit purpose of global risk reduction of the multinational company. However, researchers in the area of strategic management have a richer perspective of international diversification than the simple risk reduction strategy (Hitt *et al.*, 1994), considering it a way to strengthening competitiveness, which is why the research area has dedicated so much attention to the study of the relationship between international diversification and performance (Hitt *et al.*, 2006a). This is the prevailing perspective in this study.

2. THEORETICAL BACKGROUND AND HYPOTHESES DEVELOPMENT

International performance

Despite the diversity of topics and subjects studied in the context of international diversification (Buckley and Casson, 2009; Buckley, 2011), undoubtedly one of the most targeted by this investigative stream has been the relationship between this type of strategy and performance achieved. However, despite numerous and important contributions to the understanding of the relationship between international diversification and performance (DI-P), this enormous diversity of work has proved inconclusive, inconsistent, if not contradictory (Chao and Kumar, 2010; Beleska-Spasova *et al.*, 2012). While some of these studies point out to the existence of a positive relationship between international diversification and performance (e.g., Grant *et al.*, 1988; Delios and Beamish, 1999a; Pangarkar, 2008), other works report the existence of different type of relations, for example, “U-shaped” (Lu and Beamish, 2001; Ruigrok and Wagner, 2003), inverted “U-shaped” (Hitt *et al.*, 1997; Kotabe *et al.*, 2002), “Horizontal S” (Contractor *et al.*, 2003; Lu and Beamish, 2004), pointing, still others, for a linear and negative relationship (Fatemi, 1984; Collins, 1990). Not integrated into any of the above mentioned situations,

some studies (Siddharthan and Lall, 1982; Hoskisson and Hitt, 1990) didn't find any kind of relationship. However, from a business point of view, as revealed by the attitude of thousands of companies worldwide, the expectation is always that there are advantages in strengthening their internationalization processes. And, indeed, from an academic point of view, most of the studies show that these expectations are often confirmed (Contractor, 2007). This is obviously the basic assumption that supports all research work in international business (Contractor *et al.*, 2003). Several authors have advocated the dependence of ID-P (International Diversification-Performance) relationship to aspects such as the industry in question, company factors, foreign markets cultural, political and institutional aspects (Contractor, 2007) or even contextual factors from the home market (Nachum, 2004). Stressing the argument that the reality of origin or host markets have also an influence on the ID-P relationship, (Barkema *et al.*, 1996) researched and confirmed an influence of the cultural factors in destination countries, having Nachum (2004) recognized the existence of a significant effect of the company's origin region on that relationship.

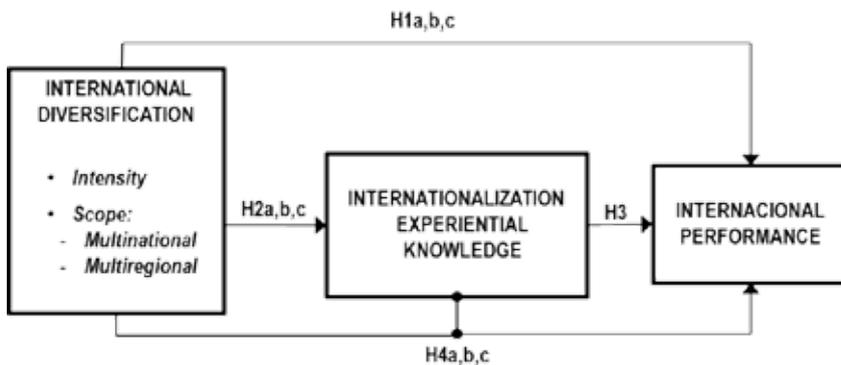
International learning

Organizational learning through experience is enhanced by the degree of diversity of that experience (Penrose, 1959). Exposure to diversity of contexts, events and ideas has positive influence on the degree of knowledge, whether technological or administrative in nature or even in adopting a more innovative approach (March, 1991).

Thus, a firm acting in several countries and therefore facing a greater diversity of environments is potentially more-prone to the development of knowledge when compared to other companies operating only in their local market or in very few countries (Barkema and Vermeulen, 1998). Organizational knowledge and learning are interconnected (Eriksson *et al.*, 1997; Petersen *et al.*, 2008). Organizational learning mechanism is developed as a process of transformation of accumulated experience into useful knowledge for the organization (Petersen *et al.*, 2008; Sandberg, 2014). Through the experience gained in the course of its international operations, the firm, subjected in this context to an intense learning process, will acquire experiential knowledge to its international business, not only at international generic level, but also in terms of specific local markets as well as in what international individual relationships is concerned (Sandberg, 2014). One of the most important experiential knowledge categories in the international business setting is the internationalization knowledge (Eriksson *et al.*, 2000a; Hilmersson, 2012) or, to use the designation suggested by Sandberg (2013; 2014), the internationalization experiential knowledge. This kind of experiential knowledge refers to the ability of a company to carry out research of various kinds in markets outside its home base, although having nothing to do with aspects or specific details of this or that market in particular (Blomstermo *et al.*, 2004a). Internationalization experiential knowledge stemming from international learning is object of study in this research work.

Figure 1 presents the conceptual model of this study.

Figure 1. Conceptual model



International diversification and international performance

Depending on the priority given to intensity and scope dimensions of company's international intervention, this may occur more by concentration or diversification of international markets (Ayal and Zif, 1979; Saarenketo *et al.*, 2008). Also in this context, Cieřlik *et al.* (2012) refer to alternative strategies of balance or, to use author's words, ambidextrous international strategic options. Not being conclusive on which strategy has a more intense effect on performance, results from different studies in this field (e.g., Cooper and Kleinschmidt, 1985; Crick *et al.*, 2000;

Katsikea *et al.*, 2005), instead, generally have revealed positive influence in both cases. Thus, we propose the following hypotheses:

Hypotheses 1a, 1b, 1c: International diversification, in terms of (1a) intensity, (1b) multinational scope and (1c) multiregional scope, has a positive effect on international performance.

International diversification and internationalization experiential knowledge

According to Yeoh (2004), the international diversification of a company can be envisaged as an organizational

learning process and, therefore, a means of knowledge accumulation through experience acquired with the internationalization process. This interpretation, in line with the same author, is based on the fact that this type of strategy, favoring exposure to a wider range of markets, enhances the chances of occurring organizational learning. The potential raise of opportunities for knowledge acquisition derives from this greater exposure that, influenced by cultural diversity, takes place through the “coexistence” with new and diverse ways of doing business in the various markets in which the company operates. One kind of experiential knowledge developed by the companies during their internationalization process is experiential knowledge of internationalization (Johanson and Vahlne, 1977; Eriksson *et al.*, 1997; Sandberg, 2013). Inasmuch as the reinforcement in any dimension of the international diversification strategy, both in intensity or scope, enhances exposure to diversity and favors international learning, the following hypotheses are formulated:

Hypotheses 2: International diversification, in terms of (2a) intensity, (2b) multinational scope and (2c) multiregional scope, has a positive effect on internationalization experiential knowledge.

Internationalization experiential knowledge and international performance

Experiential knowledge is identified in several studies as an antecedent of international performance (e.g., Katsikeas *et al.*, 2000; Yeoh, 2004). The level of experiential knowledge of internationally more experienced companies may leverage superior performance (Delios and Beamish, 1999a; Blomstermo *et al.*, 2004a). Or, even more specifically, international learning can be analyzed as a complex resource to use in strengthening or development of competitive advantage and, therefore, in getting high performance in international business (Yeoh, 2004). Based on this discussion, the following hypothesis is formulated:

Hypothesis 3: Internationalization experiential knowledge has a positive effect on international performance.

Efeito mediador do conhecimento experiential de internacionalização na relação “diversificação internacional-desempenho internacional”

According to Buckley *et al.* (1988), company’s international performance is the result of competitiveness level, past or present, achieved by the company through its choices and initiatives in the context of its international activities. The entry in international markets enables the company to acquire knowledge through which it develops new capabilities to carry out value creation activities (Ghoshal, 1987; Zahra *et al.*, 2000). On the other hand, Hsu and Pereira (2008) argue that companies engaged in learning through their international intervention continuously strive to create competitive advantage in international markets and, thus, improve their performance. International diversification strategies, either with priority to intensity or scope, normally require the need of dealing

with diversity in terms of countries, markets and market segments, which can lead to significant organizational learning and knowledge accumulation. This learning process arising from the confront with all that diversity, allowing, for instance, the exploitation of scope or scale economies resulting from higher international presence (Ayal and Zif, 1979; Zahra *et al.*, 2000; Saarenketo *et al.*, 2008), may become an important basis for strengthening and sustaining competitive advantage and, therefore, to achieve superior performance. Consequently, we propose the following hypotheses:

Hypotheses 4a, 4b, 4c: The relationship between international diversification, in terms of (4a) intensity (4b) multinational scope and (4c) multiregional scope, and international performance is mediated by internationalization experiential knowledge.

3. METHODOLOGY

Sample

Sample selection was based exclusively on a database (of Portuguese exporter companies) from the AICEP - Agency for Investment and Foreign Trade of Portugal. As basic profile in terms of firm size, we adopted the SME definition according to the European Union and, thus, the minimum number of 10 employees and a maximum turnover EUR 250 million were defined as requirements. Besides, in line with Beleska-Spasova and Glaister (2010), we established, as additional conditions, the involvement in international business at the time, and that this involvement should be, in terms of minimum previous temporal period, of at least five years, nevertheless, without defining a minimum value for the foreign sales to total sales ratio. The five years minimum period of involvement in international business was considered sufficient to assess the impact of international diversification in performance (Beleska-Spasova and Glaister, 2010; Beleska-Spasova *et al.*, 2012). After adjusting the original database to the requirements, a list of 2895 companies was then compiled, and, thus, the sampling frame used in the study was established. As final result of the data collection process, we obtained 390 valid questionnaires, corresponding to an effective rate higher than 16%, which can be considered a satisfactory rate, since the average percentage level of response in case of questionnaires sent to top managers is typically between 15 and 20% (Menon *et al.*, 1996).

Measures

The following measures were adopted for this study’s independent, dependent and control variables.

International diversification.

International diversification strategies were investigated along the two following dimensions: intensity and scope. In order to assess the first dimension, the intensity, we used the foreign sales to total sales ratio. This is an international

engagement indicator widely used in the literature (e.g., Lu and Beamish, 2001; Kafourous *et al.*, 2008; Hsu *et al.*, 2013). Regarding the scope of international diversification, it was measured in two different perspectives: (1) the level of presence in multinational terms, measured by the number of countries where the company operates and (2) the distribution of these operations for a set of predefined globe regions. The measure of international diversification strategy's scope in a multinationality perspective, originally used by Vernon (1979) and since then also widely used in the literature (e.g., Tallman and Li, 1996; Zahra *et al.*, 2000; Lu and Beamish, 2006; Yeoh, 2014), aims at evaluating the overall geographical distribution of activities, without, however, consider any other quality of this distribution. Due to this feature of the scope's measure through the number of countries, some authors have been criticizing its use, since it assumes the absence of differences between countries in terms of cultural, institutional and business practices (Yeoh, 2004). Therefore, for measuring the dimension "scope", we also used an entropy measure, developed by Hitt *et al.* (1997), which considers both the number of global market regions in which a firm operates and the relative importance of each one. According to those authors, international diversification can be calculated by the following expression:

$$ID = \sum_i^n [P_i \times \ln(1/P_i)]$$

In this expression, P_i is the company's sales volume in the region i and $\ln(1/P_i)$, ie, the natural logarithm of the inverse of this sales volume, represents the sales weight of region i . In this study, the following regions of the world were considered: European Union PALOP (African Countries of Portuguese Official Language), NAFTA (North American Free Trade Agreement), Maghreb, MERCOSUR (Southern Common Market) and Rest of World.

Internationalization experiential knowledge

Internationalization experiential knowledge was measured based on a scale used by Sandberg (2014) (for further details see Appendix).

International performance

For the assessment of international performance we used the EXPERF scale developed by Zou *et al.* (1998). Data collected through this scale reflected the perception of the informants on the company's international performance in the previous three years (see Appendix).

Control variables

Since other factors may have an effect on the relationships presented in the hypotheses, five control variables were included: age, international experience, international business assistance, size, and host countries pulling factors. Age – measured in terms of years in business (natural logarithm). International experience – number of years of international activity (natural logarithm). International business assistance – forms of support translated into specific measures of the government or other entities (Lages and Montgomery, 2005) (for further details see Appendix). Size – number of fulltime employees (natural logarithm). Host countries pulling factors – attractiveness factors related to markets to where companies seek to expand their operations (Etemad, 2004; Pangarkar, 2008; Cavusgil *et al.*, 2012) (see Appendix).

4. RESULTS

To assess the goodness of fit of the measurement model, absolute measures as the chi-square statistical significance (χ^2) and the RMSEA (Root Mean Square Error of approximation) were used. The overall chi-square was found significant ($\chi^2 = 332.64$; d.f.= 171; $p < 0.000$) and the RMSEA = 0.046, which is an indicative factor of a good fit. Additionally, three incremental measures of fit were assessed: Comparative Fit Index (CFI=0.95), Incremental Fit Index (IFI=0.96) e Tucker-Lewis Fit Index (TLI=0.96).

Structural equation model

The conceptual model was tested using structural equation model. Results of this test suggest an acceptable fit of the model to the data: $\chi^2 = 383.68$; d.f.=176; $p < 0.000$; RMSEA = 0.052; CFI = 0.95; IFI = 0.96; TLI = 0.96. Table 1 depicts the estimates of the parameters and the T-values obtained for the various tested hypotheses.

Table 1. Structural model results

Hypotheses	β	T	Supp./Not supp.
H1a: International Diversification (Intensity) → International Performance	0,29	3,75***	Supported
H1b: International Diversification (multinational scope) → International Performance	0,22	2,27*	Supported
H1c: International Diversification (multiregional scope) → International Performance	0,21	3,54***	Supported
H2a: International Diversification (Intensity) → Internationalization Experiential Knowledge.	0,29	5,5***	Supported
H2b: International Diversification (multinational scope) → Internationalization Experiential Knowledge.	0,27	4,87***	Supported
H2c: International Diversification (multiregional scope) → Internationalization Experiential Knowledge.	0,12	2,39*	Supported
H3: Internationalization Experiential Knowledge → International Performance	0,39	6,79***	Supported

* $p < 0,05$; ** $p < 0,01$; *** $p < 0,001$. Two-tailed test.

Table 2. Effect of the control variables

Control Variables	β	T
Age → International Performance	0.01	0.22
Size → International Performance	0.09	1.85
International Experience → International Performance	-0.11	-1.69
International Business Assistance → International Performance	-0.04	-0.53
Host Countries Pulling Factors → International Performance	0.13	2.76**

* $p < 0,05$; ** $p < 0,01$; *** $p < 0,001$. Two-tailed test.

Regarding the control variables used, as presented in Table 2, only “host country pulling factors” revealed a significant influence on international performance.

To assess the existence of the mediation effect of internationalization experiential knowledge in the

relationship between international diversification and international performance we used the methodology adopted in Anderson and Gerbing (1988) and Lu *et al.* (2010). For that purpose, several nested models were analyzed (see table 3).

Table 3. Mediation effect of internationalization experiential knowledge in the “international diversification-international performance” relationship

	Model	χ^2	df	$\Delta\chi^2$	Δdf
A	Full model: direct and indirect effects (through the internationalization experiential knowledge) between international diversification and performance.	383,68	176	-----	-----
B	Full mediation; canceling all direct paths from international diversification to performance.	399,89	179	16,21*	3
C	No direct path from international diversification (intensity) to performance	394,29	177	10,61*	1
D	No direct path from international diversification (multinational scope) to performance.	388,97	177	5,29*	1
E	No direct path from international diversification (multiregional scope) to performance.	394,11	177	10,43*	1
F	No path from international diversification (intensity) to internationalization experiential knowledge	420,51	177	36,83*	1
G	No path from international diversification (multinational scope) to internationalization experiential knowledge	386,13	177	2,45	1
H	No path from international diversification (multiregional scope) to internationalization experiential knowledge	390,59	177	6,91*	1
I	No path from internationalization experiential knowledge to performance.	447,59	177	63,91*	1

* $p < 0,05$. Two-tailed test

According to table 4, the “international diversification - performance” relationship is partially mediated by the internationalization experiential knowledge when it comes

to the “intensity” and “multiregional scope” dimensions of international diversification, but, surprisingly, not in the case of “multinational scope”.

Table 4. Mediation effect - hypotheses

Hypotheses - mediation effect:	Result
H4a: International Diversification (intensity) → Internationalization Experiential Knowledge → International Performance	Supported (partial effect)
H4b: International Diversification (multinational scope) → Internationalization Experiential Knowledge → International Performance	Not supported
H4c: International Diversification (multiregional scope) → Internationalization Experiential Knowledge → International Performance	Supported (partial effect)

5. DISCUSSIONS AND IMPLICATIONS

Results, significantly, suggest that more intense international diversification strategies or higher level of (multinational or multiregional) scope have a significant and positive effect on firm's international. That is, despite the inevitable costs and benefits entailed by the strengthening of international diversification (Contractor, 2007), this strategic option usually contributes to the optimization of the cost-benefit ratio, thus resulting in better international performance (Pangarkar, 2008; Beleska-Spasova and Glaister, 2010). Consistent with the conceptual model, the result analysis seems to enable the conclusion that a higher exposure and needing to deal with diversity in terms of countries, markets, market segments etc. enhances learning through international experience,

reinforcing, therefore, the firm's internationalization experiential knowledge. I.e, company, during the process of its international learning, will turn the international experience gained in each market into internationalization experiential knowledge. This knowledge, getting embedded in routines and company structures, enhances problem-solving ability and the alternatives selection capacity, in the context of its international operations (Hsu and Pereira, 2008). Thus, this study supports and reinforces the findings of Eriksson *et al.* (2000a) and (Blomstermo *et al.*, 2004a).

On the other hand, results also suggest that internationalization experiential knowledge developed by the company through its international learning positively and significantly contributes to the strengthening of

international performance. Meaning that, by increasing its experiential knowledge of internationalization, the firm will perfect their skills to research, identify and embrace opportunities, either in new markets or in those in which the company has already been active (Eriksson *et al.*, 2000a; Blomstermo *et al.*, 2004a), resulting in a significant influence on performance. Hence, this confirmation contributes to an important line of research which includes studies such as Makino and Delios (1996), Autio *et al.* (2000) and Villar *et al.* (2014), since all of them concluded by the existence of a positive and significant relationship between organizational knowledge (studied in various forms) and firm performance.

Finally, we confirmed the existence of the mediation effect, even if in partial terms, of the experiential knowledge of internationalization in the relationships between both intensity and multiregional scope of international diversification and international performance of the company: However, such mediating effect, was not confirmed, neither full nor partially, when it comes to scope dimension in multinational terms. Thus, in general terms, it seems it can be stated that, in the case of the sample investigated, the effect on performance will be significantly more effective if the strengthening of international diversification is translated into a higher degree of experiential knowledge of internationalization, which, in turn, will influence performance more successfully. This conclusion is in line with the arguments of Buckley *et al.* (1988), since, here too, is concluded that international performance, more than direct and automatically stemming from “choices” made, it is the outcome of the competitiveness gains resulting from those ‘choices’, triggering, in turn, a performance improvement.

In conclusion, as generally accepted in the literature (e.g., Ghoshal, 1987; Vermeulen and Barkema, 2002; Beleska-Spasova *et al.*, 2012), our findings also remain an important support base to suggest that SMEs managers should start or strengthen the international diversification processes of their firms. In addition, this study also points out to the need for SMEs to leverage learning opportunities during their international business – in this study assessed by the accrual of general knowledge of internationalization - as a major net input to performance improvement.

Two main limitations of the study should be noted. First, its cross-sectional nature, since for many of the studied variables, involving processes over time, the use of longitudinal data, therefore (related to a time-series), would allow a more appropriate assessment of relations between the main variables. Second, studying international learning exclusively based on the acquisition of internationalization experiential knowledge can also be a limitation to the study, since, alone, this construct does not capture the diversity of aspects of the company’s international learning. Concurrently, two suggestions for future studies are presented. First, a longitudinal study, also focusing on SMEs, once the scarcity of research work on the current theme is the major note. Second,

other forms of organizational knowledge resulting from international activity, such as social knowledge (associated with relational firm’s capital), technological expertise, market knowledge, institutional knowledge or customers knowledge could be studied (Eriksson *et al.*, 2000a; Yeoh, 2004; Sandberg, 2014).

APPENDIX – measurement scales

Internationalization experiential knowledge (Adapted from Sandberg, 2014)

Question: Please indicate the extent to which your company, in the course of your international operations, has gained new knowledge/new skills in:

(1 – Limited knowledge or skills; 5 – Extensive ...)

- Supplying foreign customers.
- Adapting our products and services to meet the needs and wants of foreign customers.
- Marketing and sales of our products abroad.
- Adapting our organization to meet the needs and wants of foreign customers.

International performance (Adapted from: Zou *et al.*, 1998; Beleska-Spasova *et al.*, 2012)

Question: Please indicate the extent to which you agree with the following statements

(1 – Strongly disagree; 5 – Strongly agree)

- Has contributed significantly to our overall profitability
- Has generated a high volume of sales
- Has achieved rapid growth
- Has improved our international competitiveness
- Has strengthened our strategic position in the international market
- Has significantly increased our international market share
- Has been very successful
- Has fully met our goals and expectations.

International business assistance – control variable (Adapted from: Lages and Montgomery, 2005)

Question: Over the last five years, how would you rate the support to your company's international activities received from:

(1 – None; 5 – Substantial)

- European Union
- Government (excluding EU support)
- Trade associations.

Host countries pull factors - control variable (Adapted from: Pangarkar, 2008; Etemad, 2004; Cavusgil et al., 2012)

Question: Please indicate the degree of importance assigned, in overall terms, to the following factors as elements weighed in the decision to enter the various countries in which your company operates:

(1 – Not significant; 5 – Absolutely crucial)

- Attractiveness in the medium / long term of the host country markets.
- Favorable government policies of the host country markets.
- Lower intensity of the competitive environment in the host country markets.
- Existence of capable partners in the host country markets.
- Access to resources (financial, natural, knowledge, etc.) in the host country markets.

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