International diversification and firm performance in Mexican firms: A curvilinear relationship?

Douglas E. Thomas*

*Tel.: +1 505 277 8892; fax: +1 505 277 7108.
E-mail address: thomas@mgt.unm.edu.

Y Anderson Schools of Management, University of New Mexico, MSC05 3090, 1924 Las Lomas NE, Albuquerque NM 87131-0001, USA

Received 15 November 2004; accepted 26 August 2005

Abstract

This study examines the relationship between international diversification strategies and performance in emerging market firms. Using a longitudinal sample of Mexican firms, it finds that there is a U-shaped curvilinear relationship between international diversification and firm performance. Mexican firms initially experience negative performance as they expand internationally due to the liability of foreignness; however, over time, through gaining experience and through organizational learning, they eventually reap the positive benefits from international expansion. Contrary to expectations, our study finds no support for geographic distance as a moderator of the international diversification–performance relationship. Managers of emerging market firms should exercise patience as they initially face challenges to international expansion and should consider expanding to a diverse set of destinations, including those that are more distant.

D 2005 Elsevier Inc. All rights reserved.

Keywords: International diversification; Emerging markets; Mexico; Firm performance; Internationalization

While most management research has focused on developed market firms, companies from emerging markets are increasingly receiving more attention (Hoskisson et al., 2000). Emerging market firms such as Cemex and Lenovo (from Mexico and China, respectively) are increasingly globalizing their sales and operations and have attracted the attention of scholars. However, we still know relatively little about emerging market firms’ (EMFs) strategies and how these strategies affect their performance. For example, the international diversification–performance relationship has been amply studied in developed market firms (Qian and Li, 2002) but produced mixed results (Contractor et al., 2003; Thomas and Eden, 2004). Some studies find a positive linear relationship while others find that it is curvilinear; some research indicates that it is initially positive and then negative and other research finds an initially negative relationship that eventually becomes positive (Lu and Beamish, 2004). Hence, we still know very little about the international diversification–performance relationship in developed market firms and even less about it in the context of emerging market firms (Wan, 1998). The current study examines the effect of international diversification strategies on performance in emerging market firms using a sample of the largest Mexican firms over 8 years.

1. Theory and hypotheses

Researchers have long been interested in international diversification, “defined as [firms’] expansion across the borders of global regions and countries into different geographic locations, or markets” (Hitt et al., 1997: 767). One line of research on the relationship between international diversification and performance has argued that international diversification offers numerous advantages that result in increased firm profitability and found evidence of a positive, linear relationship (Grant, 1987; Grant et al., 1988; Han et al., 1998; Miller and Prass, 1980). Most research has invoked internalization theory (Rugman, 1981) (or the related eclectic paradigm (Dunning, 1980) to explain the impact of international diversification on performance. Internalization theory explains that multinational firms exist because they optimally internalize international transactions within the boundaries of the firm and increased performance results from such an organizational form.
Researchers have argued that international diversification allows firms to spread risks, achieve economies of scale and scope, sell to new customers, and reap additional returns from investments in marketing and innovation (Kobrin, 1991). Firms that operate in more than one country are able to reap benefits that are not available to purely domestic firms. Operating in multiple environments allows firms to leverage locational differences that exist in each of them. Firms that have operations and sales in more than one country can shift them from less-profitable ones to more-profitable ones as markets fluctuate (Thomas and Eden, 2004). Operating in multiple locations also offers increased opportunities for learning and knowledge acquisition (Hitt et al., 1997). Given these advantages, firms across the globe have greatly increased their international sales and operations during the last half of the twentieth century. Further, the empirical research previously cited indicates that there are clear advantages to increased international diversification.

More recently, researchers have increasingly used the resource-based view (Barney, 1991) and organizational learning theory to explain the effects of international diversification on firm performance (Barkema et al., 1997; Barkema and Vermeulen, 1998; Hitt et al., 1997; Kogut and Zander, 1993). Organizational learning theory argues that knowledge and experience are important predictors of firm performance; the degree to which firms acquire knowledge through experience determines their success (Fiol and Lyles, 1985). The resource-based view argues that firm success is related to successful acquisition and leveraging of unique, valuable, and rare resources, including knowledge (Grant, 1996). Researchers have found that as firms expand internationally they often face unique challenges for example in the form of initial high costs related to the liability of foreignness (Hymer, 1976; Zaheer, 1995). Reaping the benefits from international diversification strategies is not automatic, particularly as firms are in the early stages of international expansion.

According to this view, foreign firms initially face a disadvantage relative to domestic ones because of their lack of knowledge of and experience of the target market (Johanson and Vahlne, 1977). Hence, researchers have also argued for and found a U-shaped international diversification–performance relationship (Qian, 1997; Ruigrok and Wagner, 2003). The initial costs related to lack of knowledge and inexperience in international expansion can result in negative performance during the early stages. However, this research finds that, over time, firms learn to operate in foreign environments and develop strategies and organizational structures to manage and overcome the challenges of increased internationalization. Experience in foreign markets allows firms to overcome the costs related to the liability of foreignness and to reap the aforementioned benefits to internationalization.

Other research has argued for and found an inverted U-relationship between international diversification and performance (Daniels and Bracker, 1989; Geringer et al., 1989; Gomes and Ramaswamy, 1999; Hitt et al., 1997). This line of research found that firms initially experience the positive returns to internationalization, albeit the initial challenges due to the liability of foreignness; the continued positive benefits induce managers to continue expanding internationally. Eventually the positive benefits can reach an optimal point; negative performance results from increased international diversification because of the increased organizational costs related to managing a high degree of international diversification, beyond the optimal point (Roth, 1992).

The most recent research merges the preceding arguments and findings and indicates that there may be a sigmoid relationship between international diversification and performance (Contractor et al., 2003; Lu and Beamish, 2004). The sigmoid or three-stage model indicates that firms do initially experience negative returns because of the liability of foreignness as they expand internationally; then, as they gain knowledge and experience, positive returns result from the aforementioned advantages to internationalization, up to an optimal point. However, eventually negative returns set in as the organizational costs outweigh the benefits of international diversification, past the optimal point. Additionally, one stream of research indicates that there is a different sigmoid relationship between international diversification and firm performance (Thomas and Eden, 2004). It argues and finds that as firms initially expand internationally they experience positive returns; however, over time international diversification results in overly complex managerial problems and negative performance. Finally, that study finds that over the long-run very high levels of international diversification can be managed which results in positive performance.

In summary, research on the international diversification–performance relationship in developed market contexts has produced mixed results. The latest research finds a complex relationship exists; the effects of increased international expansion on performance are both positive and negative depending on the temporal stage being considered. The positive benefits to performance from increased internationalization are clear and have received consistent empirical support; at the same time, internationalization is not cost-free as firms do face organizational and managerial challenges during different stages of the internationalization process.

All of the previous research cited was conducted in the context of developed market firms. However, it is unclear what the nature of the international diversification–performance is in emerging market firms. “Emerging economies are low-income, rapid growth countries using economic liberalization as their primary source of growth” (Hoskisson et al., 2000: 249). Emerging economy or emerging market firms have traditionally developed strategies focused on their local environments and competition. Only recently have emerging market firms begun to diversify internationally. Because of the newness of this phenomenon, and as was previously mentioned, very little empirical research has been conducted on the relationship between international diversification strategies and firm performance in emerging market firms. One study that did examine international diversification in emerging market firms did not find support for either a positive or an inverted-U relationship with performance (Wan, 1998).
The emerging market context offers a different economic and institutional environment for the international diversification strategies of firms. This study focuses on one of the largest emerging markets, Mexico. Until the late 1980s, Mexico’s economic environment was one of protectionism and was inward focused. Import Substitution Industrialization (ISI) development strategies emphasized raising barriers to foreign entry so that domestic firms could develop indigenous technology and not become dependent on imports. In the early 1980s, the Mexican government defaulted on its debt obligations and the economy fell into crisis. Beginning in the late 1980s, Mexico began introducing economic policies that allowed for and encouraged both increased inward competition in the domestic sector and outward internationalization on the part of its firms. For example, Mexico became a signatory to the General Agreement on Tariffs and Trade (GATT) and the North American Free Trade Agreement (NAFTA) and a member of the Organization for Economic Cooperation and Development (OECD) during the 1980s and early 1990s. Hence, for the most part, Mexican firms have begun their international expansion since this period. Further, during this period most Mexican firms have faced enormous competitive pressures as industries have been regulated, state-owned enterprises have been privatized, and the rules governing foreign entrants have been relaxed.

We argue that given Mexico’s recent economic opening, most Mexican firms have just begun to expand internationally and will likely face high costs of foreign entry initially due to their collective inexperience in operating in international environments. Because of the inexperience of most Mexican firms in international markets, they will face initially high costs related to cultural differences, managerial inexperience in operating in competitive environments, transportation and logistical challenges, and marketing, brand and technological disadvantages (Hitt et al., 2000). These are challenges that all firms generally face when expanding internationally; however, the challenges are exacerbated in Mexican firms because of their general inexperience operating in foreign markets.

In addition, research indicates that emerging market firms have a critical need for resources (Hitt et al., 2000). The institutional environment in emerging markets has made it difficult for firms to develop the necessary managerial and technological competence to operate in foreign markets, especially developed markets (Thomas, 2001). Therefore, emerging market firms enter foreign markets to acquire resources as well as to exploit resources (Hoskisson et al., 2004). At the same time, many of the largest emerging market firms have protected home market positions; they have slack resources and can therefore afford to incur short-term losses for learning purposes. Because of their critical lack of resources, learning is especially important to EMFs. Hence, initially, emerging market firms will focus on exploration of knowledge and acquisition of new resources in foreign entry. Emerging market firms also have experience operating in turbulent environments; risk is inherent in their corporate DNA (Samor, 2005). The uncertainty, costs and short-term risks of internationalization are, therefore, tolerated by EMFs because of the prospects of long-term learning and exploitation benefits. The focus on exploration and acquisition of resources does not mean that EMFs will not also simultaneously attempt to exploit existing resources and advantages in foreign markets. It does mean that there is a relative emphasis on acquisition of knowledge and resources initially, which coupled with their inexperience in foreign markets, will incur short-term losses and lower performance.

Over time, most Mexican firms will overcome the initial challenges and costs related to internationalization and will begin to reap the benefits of international diversification. As Mexican firms gain experience operating in foreign markets, the resulting organizational learning will facilitate future increased international diversification. Having overcome the challenges of the liability of foreignness, Mexican firms will be better able to exploit existing advantages that they possess and have acquired and experience positive returns; these advantages may include but are not limited to low-cost advantage resulting from lower labor costs and ethnic advantage in certain markets (i.e., brand name recognition because of large Mexican populations in the foreign country) (Wells, 1983), as well as new sources of advantage including new managerial and advanced technological knowledge acquired initially through foreign experience. With increased experience in foreign markets, managers of Mexican firms will gain new skills to operate in diverse and competitive environments. This will allow Mexican firms to experience positive performance from increased internationalization. Other research has found evidence for such a relationship in small and medium-sized enterprises that lack inexperience in foreign markets when engaging in international diversification strategies (Lu and Beamish, 2001). Over time, emerging market firms will focus much more of their efforts on exploitation rather than exploration of resources. Knowledge and resources which they have acquired in foreign markets will be assimilated throughout the firm and can be leveraged across its subsidiaries.

Given that Mexican firms are generally in the initial stages of their international expansion process, it is likely too early to find instances of Mexican firms which have gone beyond the optimal point of internationalization; therefore, we do not make any hypotheses with respect to the aforementioned sigmoid or three-stage relationships. Further, given our previous arguments with respect to the newness of international diversification strategies in emerging market firms, we do not argue for an inverted U-relationship between international diversification and firm performance. Instead, we argue that there is a curvilinear relationship (U-shaped) between the level of international diversification and firm performance in Mexican firms. The relationship is initially negative and then becomes positive.

**Hypothesis 1.** There is a curvilinear relationship (U shaped) between international diversification and performance in Mexican firms.

During the period 1994–2001, the percentage of sales by Mexican corporations targeted at the U.S. or Canada to total foreign sales (exports) averaged approximately 89% (INEGI).
Indeed, exports from Mexico have increased dramatically over the recent past, from $26.8 billion in 1990 to $164.9 billion by the end of 2003. Exports to the USA totaled $18.5 in 1990 and had reached $146.6 billion by the end of 2003. In summary, the Mexican economy is very dependent on the U.S. economy. Because so many Mexican firms have experience in the U.S., knowledge about the U.S. market is widely dispersed throughout the economy. Because of both direct and vicarious knowledge and experience with the geographically proximate U.S. market, Mexican firms generally face lower liability of foreignness when entering the U.S. Geographic proximity facilitates Mexican firms’ acquisition of knowledge and experience about the U.S. market.

However, some Mexican firms are closer to the U.S. than others; hence the degree to which they may benefit from geographic proximity and the diffusion of knowledge depends on the geographic distance between the company’s Mexican operations and the U.S. Firms that are located closer to the border with the U.S. are more likely to have more frequent interaction with the U.S. firms and customers. In addition, there are still many Mexican firms whose primary foreign sales destination is not the U.S. Geographic distance will make acquiring knowledge about these foreign markets and managing there more costly because of transportation and communication costs. The further these foreign sales markets are away from Mexico, the more difficult it is for Mexican firms to quickly overcome the costs related to distance and foreignness (Zaheer, 1995). Geographic proximity facilitates Mexican firms’ acquisition of knowledge of foreign markets; in addition, transportation, communication and coordination costs are lower because of geographic proximity.

Research indicates that geographic distance is negatively related to other forms of outward internationalization including foreign direct investment (Grosse and Trevino, 1996; Thomas and Grose, 2001). In addition, research indicates that firms tend to enter proximate (both geographically and psychically) first precisely because the costs are lower; hence, Mexican firms have generally focused on the U.S. market historically. Hence, we argue that geographic distance negatively moderates the relationship between international diversification and performance. Firms that expand into more distant markets and that have a higher percentage of foreign involvement there, will experience more negative initial performance and for a longer period of time. Firms that expand into more proximate markets and that have a higher percentage of foreign involvement there will experience less negative initial performance and will begin to experience positive performance in a shorter period of time.

Hypothesis 2. Geographic distance negatively moderates the U-shaped relationship between international diversification and firm performance.

2. Methods

Studying emerging market firms is difficult because data are scarce and expensive (both financially and in terms of time) to collect. The sample for this study was based on the annual list of the largest 500 Mexican firms in Expansión, one of the leading business publications in Mexico. Our sample initially included all firms that were included in this annual list during the period 1994–2001. Firms with missing data for relevant variable, that had majority (50% or greater) foreign ownership, that had no foreign sales, or that were state-owned or grupo holding companies were excluded. The final sample included 386 firms over the period 1994 and 2001 and 850 firm-year observations; the number of years in which a firm appears in the sample varies. The time period that we have chosen coincides with the beginning of the NAFTA era in Mexico. During this period, both inward and outward trade and investment in Mexico increased dramatically; prior to this period trade and investment from Mexico was more limited.

The dependent variable, Firm Performance, was measured using return on sales. Our key independent variable, International Diversification, was measured by the ratio of foreign sales (exports) to total sales. Previous research argues that international diversification is a multi-dimensional construct (Sullivan, 1994; Thomas and Eden, 2004). Fortunately, we were able to obtain data on foreign sales; unfortunately, despite our best efforts, we were unable to obtain other data (e.g., foreign assets) which would have allowed us to measure multiple dimensions of international diversification. In order to test our curvilinear hypothesis, we also included a measure of International Diversification Squared. We measured Geographic Distance using location data in the Expansión survey where each firm reports up to three country export destinations. We measured geographic distance from the firm’s headquarters to the first location that the firm reports (either the closest (geographically) city in the United States or for countries other than the United States, the largest city in the country) using data from Expedia.com and www.indo.com/distance. Of the 850 observations in the sample, 598 listed the U.S. first as an export destination. In addition of the 850 observations, 591 do not report a second or third destination.

We controlled for Firm Size which was measured by the natural logarithm of total assets and level of Foreign Ownership, measured by the percent of total equity owned by foreign capital sources (maximum = 49%). In addition, Technological Intensity was controlled for and was measured by the percentage of personnel involved in technical activities. Typically, this construct is measured by patents or R&D spending. However, technology and innovation reside in the human capital of the firm. No measure completely captures the construct, and we recognize the limits of single item measures; we employed the best measure available. In addition, we included a dummy variable for the type of firm structure, Independent (“1”), or Subsidiary of a Grupo (“0”) listed in the Expansión 500. We also controlled for industry participation (using the Mexican industry classification system, the Sistema de Cuentas Nacionales) by including a dummy variable for firms primarily focused on manufacturing (“1”) rather than services (“0”). Because our sample includes multiple firms over multiple years, a fixed effects statistical model was
employed based on the results of a Hausman test. In addition, to control for firm-specific effects and heteroskedasticity, we used robust standard errors, clustering on each firm. We used Stata 8.0’s “absorb” technique to control for period effects which is equivalent to including year dummy variables. Each of the continuous independent variables was centered with a mean of zero.

3. Results

Table 1 presents the means, standard deviations, and correlations for the variables. The average level of foreign sales to total sales for sample firms is 23%. 42% of the firms are independent and 58% are subsidiaries of grupos. Average foreign ownership of equity of sample firms is 6.7%. Approximately 85% of the firms are primarily focused on manufacturing and 15% on services.

Table 2 reports the results of hierarchical regressions testing our hypotheses. The F-statistics for each model indicate that they are statistically significant (Models 1 and 2, \( p < .10 \); Models 3 and 4, \( p < .05 \)). The negative, statistically significant coefficient (in both models 3 and 4, \( p < .05 \)) for international diversification indicates that as Mexican firms initially expand they face negative performance returns. However, the positive, statistically significant coefficient for international diversification squared (in both models 3 and 4, \( p < .05 \)) indicates that over time Mexican firms experience positive performance from further international expansion. Hence, strong statistical support is found for Hypothesis 1. As Model 4 indicates, we do not find support for Hypothesis 2; neither of the coefficients for the interaction terms is significant. Geographic distance does not moderate the internationalization–performance relationship.

Interestingly, only one of the control variables, firm size, is statistically significant and positively related to firm performance. As a post-hoc analysis (results available from author upon request), we tested and found no support for a sigmoid (S-curve) relationship between international diversification and firm performance. Additionally, we performed a sub-sample test for robustness; the results for both hypotheses were the same when we only included firms that listed the U.S. first as an export destination.

### Table 1
Descriptive statistics and correlations

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mean</th>
<th>St. Dev.</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firm performance</td>
<td>0.038</td>
<td>0.173</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Technological intensity</td>
<td>0.122</td>
<td>0.174</td>
<td>-0.010</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign ownership</td>
<td>0.065</td>
<td>0.149</td>
<td>0.019</td>
<td>-0.051</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Firm size</td>
<td>2,200</td>
<td>5,560</td>
<td>0.053</td>
<td>-0.027</td>
<td>0.010</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Independent firm</td>
<td>0.422</td>
<td>0.494</td>
<td>0.064</td>
<td>0.069*</td>
<td>0.035</td>
<td>-0.331*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Manufacturing industry</td>
<td>0.845</td>
<td>0.362</td>
<td>0.045</td>
<td>-0.382*</td>
<td>0.081*</td>
<td>-0.080*</td>
<td>-0.067*</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Geographic distance</td>
<td>1386.395</td>
<td>1987.666</td>
<td>0.027</td>
<td>0.061</td>
<td>0.039</td>
<td>-0.089*</td>
<td>0.135*</td>
<td>-0.048</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>International diversification</td>
<td>0.233</td>
<td>0.269</td>
<td>0.014</td>
<td>0.027</td>
<td>0.165*</td>
<td>-0.108*</td>
<td>0.165*</td>
<td>0.017</td>
<td>0.137*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>International diversification²</td>
<td>0.127</td>
<td>0.244</td>
<td>0.033</td>
<td>0.007</td>
<td>0.191*</td>
<td>-0.130*</td>
<td>0.180*</td>
<td>0.002</td>
<td>0.137*</td>
<td>0.947*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>International diversification × distance</td>
<td>396.167</td>
<td>1070.184</td>
<td>0.050</td>
<td>0.033</td>
<td>0.117*</td>
<td>0.033</td>
<td>0.050</td>
<td>-0.02</td>
<td>0.331*</td>
<td>0.179*</td>
<td>0.209*</td>
<td></td>
</tr>
<tr>
<td>International diversification² × distance</td>
<td>241.619</td>
<td>905.41</td>
<td>0.053</td>
<td>0.026</td>
<td>0.135*</td>
<td>0.037</td>
<td>0.059</td>
<td>-0.022</td>
<td>0.290*</td>
<td>0.195*</td>
<td>0.230*</td>
<td>0.964*</td>
</tr>
</tbody>
</table>

\( ^a p < .05. \)

\( ^b \) Firm size reported in millions of Mexican pesos; distance reported in miles, other non-interaction variables are percentages.

### Table 2
Regression of international diversification–firm performance relationship

<table>
<thead>
<tr>
<th>Variable</th>
<th>Model 1</th>
<th>Model 2</th>
<th>Model 3</th>
<th>Model 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Technological intensity</td>
<td>-0.016</td>
<td>-0.016</td>
<td>-0.008</td>
<td>-0.009</td>
</tr>
<tr>
<td></td>
<td>(0.050)</td>
<td>(0.050)</td>
<td>(0.050)</td>
<td>(0.050)</td>
</tr>
<tr>
<td>Foreign ownership</td>
<td>0.048</td>
<td>0.052</td>
<td>0.041</td>
<td>0.038</td>
</tr>
<tr>
<td></td>
<td>(0.040)</td>
<td>(0.043)</td>
<td>(0.043)</td>
<td>(0.043)</td>
</tr>
<tr>
<td>Firm size</td>
<td>0.006</td>
<td>0.006</td>
<td>0.007†</td>
<td>0.006†</td>
</tr>
<tr>
<td></td>
<td>(0.004)</td>
<td>(0.004)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Manufacturing industry</td>
<td>0.030</td>
<td>0.030</td>
<td>0.034</td>
<td>0.034</td>
</tr>
<tr>
<td></td>
<td>(0.029)</td>
<td>(0.029)</td>
<td>(0.029)</td>
<td>(0.029)</td>
</tr>
<tr>
<td>Independent firm</td>
<td>0.019</td>
<td>0.020</td>
<td>0.020</td>
<td>0.019</td>
</tr>
<tr>
<td></td>
<td>(0.014)</td>
<td>(0.014)</td>
<td>(0.014)</td>
<td>(0.014)</td>
</tr>
<tr>
<td>Geographic distance</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>International diversification</td>
<td>-0.013</td>
<td>-0.175*</td>
<td>-0.171*</td>
<td>0.183*</td>
</tr>
<tr>
<td></td>
<td>(0.025)</td>
<td>(0.070)</td>
<td>(0.070)</td>
<td>(0.075)</td>
</tr>
<tr>
<td>International diversification²</td>
<td>0.191*</td>
<td>0.191*</td>
<td>0.191*</td>
<td>0.191*</td>
</tr>
<tr>
<td></td>
<td>(0.075)</td>
<td>(0.075)</td>
<td>(0.075)</td>
<td>(0.075)</td>
</tr>
<tr>
<td>International diversification × distance</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>International diversification² × distance</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
</tr>
<tr>
<td></td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
<td>(0.000)</td>
</tr>
<tr>
<td>Constant</td>
<td>0.005</td>
<td>0.004</td>
<td>0.001</td>
<td>0.001</td>
</tr>
<tr>
<td></td>
<td>(0.029)</td>
<td>(0.029)</td>
<td>(0.029)</td>
<td>(0.029)</td>
</tr>
<tr>
<td>Observations</td>
<td>850</td>
<td>850</td>
<td>850</td>
<td>850</td>
</tr>
<tr>
<td>F-statistic</td>
<td>2.07†</td>
<td>1.80†</td>
<td>2.52*</td>
<td>1.98*</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.07</td>
<td>0.07</td>
<td>0.06</td>
<td>0.06</td>
</tr>
</tbody>
</table>

\( ^a \) Significant error in parenthesis.

\( ^† \) Significant at 10% level \( (p < .10) \).

\( ^* \) Significant at 5% level \( (p < .05) \).

\( ** \) Significant at 1% level \( (p < .01) \).

\( *** \) Significant at .1 level \( (p < .001) \).
4. Discussion and conclusion

This paper represents one of the first attempts to study the performance effects of international diversification in emerging market firms. It finds that Mexican firms initially experience negative performance as a result of international expansion as they face the costs of foreignness due to their inexperience in foreign markets and the institutional constraints of emerging markets; however, our results indicate that, over time, they are able to reap the benefits from increased international diversification which results in positive returns because they gain knowledge and experience in foreign markets. These results are important given that previous research on has focused on developed market firms and has found widely varying results. Further, the limited literature on international diversification and performance in emerging market firms has found no support for a relationship (Wan, 1998). Hence, this research indicates that although emerging market firms face challenges when expanding internationally, they are overcome in time and with experience. The results from this paper indicate that emerging market firms can reap enormous positive benefits from international diversification including the ability to spread risks over various countries, achieve economies of scale and scope in operations, sell to new customers, and earn additional returns from investments in marketing and innovation; however, these benefits only occur after the firm has engaged in initial resource exploration, incurring short-term costs. The benefits from both exploration and exploitation of resources through increased international diversification result in higher profitability over time.

We argued that emerging market firms initially will focus on exploration of resources which are related to their incurring initial short-term costs. Our results support this argument and the related implication that emerging market firms subsequently focus on exploitation of resources in their international diversification strategies. Previous research has suggested that such is the case; our results offer one of the first tests of such a relationship using these arguments (Thomas, 2001). Our post-hoc finding for no sigmoid or three-stage relationship indicates that Mexican firms (and most likely, the majority of emerging market firms) have not yet reached the levels of internationalization to experience such a change in performance. Hence, research on the international diversification—firm performance relationship which finds support for a sigmoid relationship, does not apply yet to emerging market firms (Lu and Beamish, 2004; Thomas and Eden, 2004).

In addition, in this study, we do not find support for distance as a moderator of the relationship between internationalization and performance. Focusing more of a firm’s foreign sales on more proximate markets does not cause performance to decrease or increase. This is in contrast to previous research which has found evidence that increasing geographic distance does affect internationalization (Grosse and Trevino, 1996). This result should be approached with caution; they may be sample-specific and related to Mexican firms which have a high percentage of foreign sales targeted at the U.S. Additional research should continue to examine the moderating effect of distance on international diversification and performance before the results can be generalized to other emerging market contexts. In addition, this result can be explained in part by our focus on exports. Exports, compared to other forms of international diversification (e.g., foreign direct investment), are much less costly to manage. In addition, transportation and communication costs have steeply declined over the past decades, facilitating knowledge acquisition about and management of foreign markets. This result also implies that managers of Mexican firms and policymakers in Mexico consider focusing on increasing exports in nations other than the U.S. Because geographic distance does not impact performance, Mexican firms will potentially benefit from decreased dependence on the U.S. economic cycle and performance. Mexican policymakers have already begun to influence this by signing numerous trade agreements with other foreign countries.

One of the main implications of this paper for managers is that the benefits from international diversification require patience to achieve. Many EMFs are still in the early stages of the international expansion process. The early challenges that they face will eventually be overcome and the rewards from international diversification will eventually be achieved. Understanding this, managers in emerging market firms should take opportunities to learn from other firms which have engaged in international diversification strategies; doing so may shorten the learning curve and decrease the time necessary to overcome the initial costs of foreignness and to earn positive returns from international expansion.

This study is not without its limitations. The data utilized provide one view using quantitative measures of a real-world phenomenon. Future research should utilize other measures of some of the key variables including international diversification, perhaps to distinguish between foreign direct investment and exports. Further, researchers should continue to examine case examples of the internationalization of emerging market firms to better understand how foreign expansion affects performance. In addition, some of the measures are admittedly rough; however, the benefits of their use given the paucity of data on emerging markets firms outweigh the disadvantages. Finally, since this study focuses on one emerging market, Mexico, the results may not be generalizable to other emerging markets; hence, more research is needed on the international diversification strategies of emerging market firms in other contexts. The results of this study should be considered in light of these limitations.

Future research should continue to study the performance effects of EMFs’ international diversification strategies. Over time, it may be that EMFs will over-internationalize, as has been suggested to occur in some developed market firms, which could have a negative impact on performance. Future research should also examine the performance effects of international diversification in other emerging market contexts. This line of research is important to follow because the international competitiveness of an emerging market’s firms is related to its economic development (Porter, 1990). In addition, future research is needed because such varied results have been found in different developed market contexts: positive and
linear, U-shaped, inverted U-shaped, and sigmoid relationships have been supported in empirical studies. Studies in diverse emerging market contexts are needed to see if other relationships beyond the U-shaped found in the present study exist. Future research should also examine the locational advantages of international expansion into developed markets versus other emerging markets (Vasquez-Parraga and Felix, 2004).

In conclusion, this paper examines a neglected topic in international management research: the international diversification of emerging market firms. It finds that although initially challenging, international diversification eventually enhances the performance of emerging market firms. This study represents an initial step in our understanding of this phenomenon and we urge future research on emerging market firms’ international diversification strategies.

References


Samor G. Votorantim mines for growth. Wall Street J 2005 [January 18].


