

On the paradoxes of foreign expansion: the experience of Polish firms

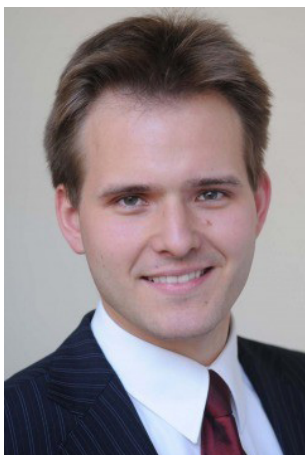
Some recommendations for policymakers

By Piotr Trąpczyński & Krystian Barłożewski

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By Piotr Trąpczyński, Poznań University of Economics and Business & Krystian Barłożewski, Warsaw School of Economics



Piotr Trąpczyński, PhD, is Assistant Professor at the Poznań University of Economics and Business, Director of the International Business Centre at the Knowledge Transfer Company, as well Vice-Chair of the CEE Chapter of the Academy of International Business. He is member of the AIB, EIBA and SMS. He serves as an experienced consultant for firms expanding internationally and MNEs operating in the CEE region. He has published extensively on topics related to subsidiary performance, entry mode choices or de-internationalization.

piotr.trapczynski@ue.poznan.pl



Krystian Barłożewski PhD, is Assistant Professor at the Warsaw School of Economics and the Head of Business Advisory Department at UHY ECA, a Polish member of international consulting company UHY International. He has been recognised as the author of the outstanding scientific paper at the 2nd AIB-CEE Chapter Conference in 2015. He is a member of ACCA and Polish Chamber of Statutory Accountants. His research interests focus mainly on international business and strategic management.

kbarlo@sgh.waw.pl

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Summary

Internationalization of companies has been regarded as one of the key avenues of corporate growth. In particular, for firms from countries which joined international markets with some delay, like in the case of Central and Eastern Europe, foreign expansion can be a strategy to close the competitiveness gap to firms from more advanced economies. However, for all firms in general, and for Central Eastern European firms in specific, the relationship between foreign expansion and performance is non-trivial. The results of our two complementary research projects completed in the years 2013-2015 clearly show that Polish companies even with more international experience and more developed foreign business activity do not necessarily register the highest performance. While our results hold for Polish multinationals, and to some extent to Central Eastern European multinationals given a common historical and economic context, we do believe that given the predominant focus of the bulk of international business debate on the ambiguous effects of experience and economic and institutional distance on firm performance, our findings are thought-provoking. Particularly, our studies can be a valuable starting point for a more informed debate on crafting the policy of public support for the international expansion of firms from Central and Eastern Europe.

In our conclusion, we warn business leaders not to be overly euphoric after earning the first successes on foreign markets. The experience gained by previous business contacts and the experience gained in apparently similar markets may discourage companies from the effort necessary to appropriately analyze and recognize the specifics of the new country. This in turn can negatively affect the final success of expansion. Hence, a company needs a clear strategy to enter foreign markets, which will be oriented on the one hand to achieve the necessary flexibility and, on the other hand, to reduce and control the complexity of its foreign operations within manageable confines. Thus, firms should be encouraged to diversify their mix of operating modes, such as both export and foreign subsidiaries, and their portfolio of foreign markets, so that there is a healthy level of geographic diversification. In fact, companies driven in their expansion by the motives of company growth and improved competitiveness, scored better results as compared to those companies whose expansion was motivated by a mere desire to reduce costs.

We also discuss the role of competitive upgrading of Central and Eastern European companies before they can build sustainable international presence, which is also a crucial role of economic policy in the region. Specifically, it seems inevitable to search for sources of competitive advantage in technological and managerial resources in the future, which may help to avoid "being stuck in the middle".

Keywords

International expansion, firm performance, competitive advantage, experience, managerial mistakes, Central and Eastern Europe, emerging multinationals

1. Introduction

Foreign expansion can bring a number of benefits to companies, but it also inherently raises a number of organizational and managerial challenges. Thus, its ultimate impact on a company's performance is far from evident. Our research shows that Polish companies with more international experience and foreign business activity do not necessarily achieve the best economic performance. We support our findings with concrete examples and discuss their managerial implications.

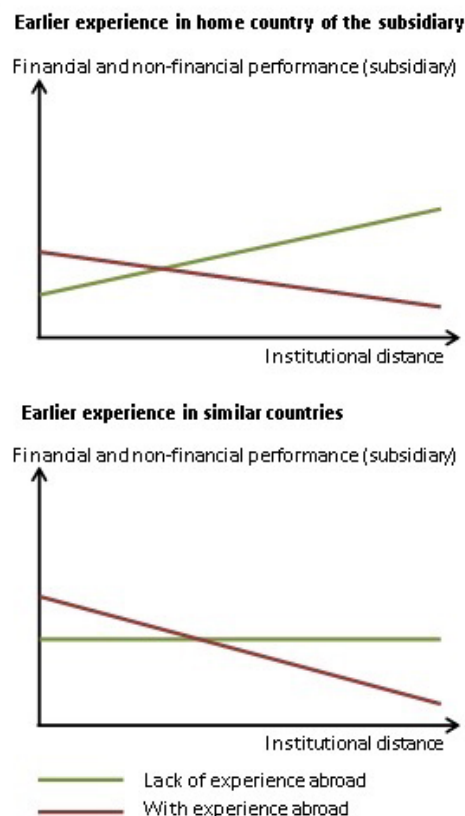
Firms are undertaking foreign expansion in the hope of achieving a number of objectives, from the motive of expanding markets to lowering production costs. The downturn in global markets, however, reminds us that nothing is irreversible and that companies close or sell foreign operations, or withdraw from export sales. This is due to the fact that international activity does not necessarily fulfill their initial assumptions. New results in this area are provided by the results of two complementary research projects completed in the years 2013-2014. The first survey was conducted by a survey of 100 Polish firms with subsidiaries abroad¹. The second study, which combined the survey method with the acquisition of secondary data, covered 97 companies listed at the Warsaw Stock Exchange and conducting international sales². In the first case, the analysis focused on factors related to the firm and its environment, influencing the performance of the largest foreign subsidiary of the firm. In the second case, the impact of the degree of internationalization (the share of foreign sales) on the financial performance of the companies undertaking foreign expansion was evaluated.

Therefore, we shall refer to the financial performance of companies at multiple levels. We shall start with the performance of foreign subsidiaries, then we will refer to the impact of these companies on the success of the entire firm, and finally we will go on to assess the impact of international operations on the performance of whole companies based on longitudinal data.

2. The illusion of experience

One of the common misconceptions about the success factors of foreign expansion is the positive role of learning through experience. Accordingly, thanks to experience companies not only enter more and more distant markets, but also commit more resources to each market than only through indirect or direct exports (e.g. in the form of acquisitions, joint ventures or the establishment of own subsidiaries).

Fig. 1. The role of experience in coping with the institutional environment of the foreign market (results for 100 Polish MNEs).



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However, our research indicates the potentially illusory character of experience gained by Polish firms before the establishment or acquisition of their subsidiaries in a given country (e.g., prior export sales to the same market) and experience gained in countries with similar business backgrounds (e.g. a hypothetical Polish company first invests in the Czech Republic, and later uses those experiences in Slovakia).

It turns out that companies with less experience are paradoxically coping better with the negative impact of a different business environment, manifested in aspects such as economic freedom, property rights, corruption, etc. (affecting altogether the institutional distance, see Figure 1). This is probably because they treat foreign markets with greater caution and do not allow themselves the lack of thorough preparation before entering a new country (Trąpczyński & Banalieva, 2016).

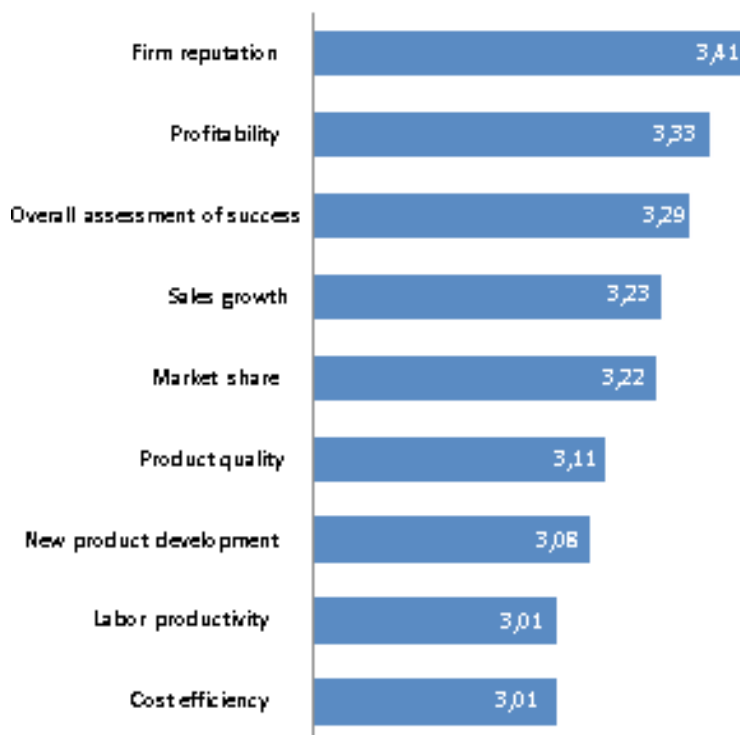
On the other hand, a great deal of foreign experience can lead to excessive self-confidence, falling into routine, and thus less attention to the different countries of expansion (O'Grady and Lane, 1996). The consequence thereof may be worse results, which we measured as a managerial assessment of a number of financial and non-financial measures of the company's foreign success.

3. Expectations vs. reality of expansion

Firms undertake foreign expansion for various reasons, and although research among Polish companies indicates the predominance of market-seeking motives, typical of the early stages of international development, our research indicates a broad spectrum of objectives for each FDI project. However, it turns out that not all are practically implemented to the same extent.

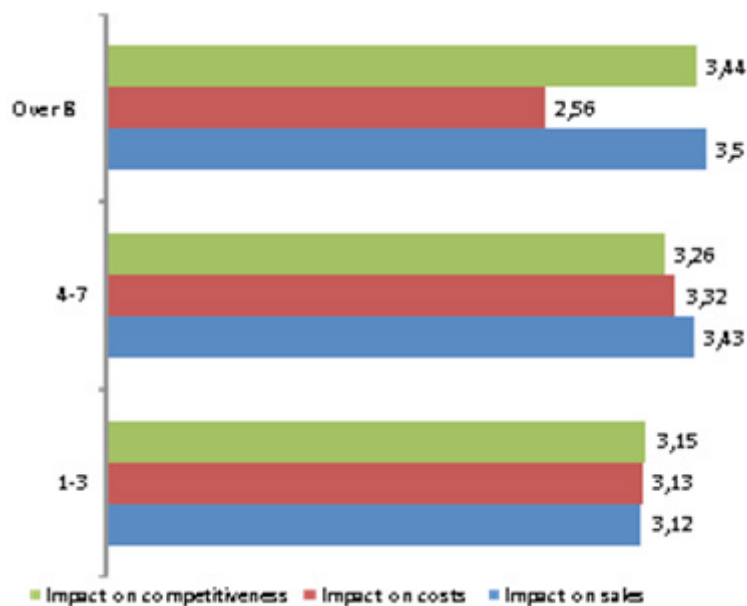
Figure 2 indicates that the initially formulated goals differ from the actual ones. In fact, among areas with the most noticeable influence on foreign expansion companies is the image effect (development of a "global" group) and profitability, while results related to market position and cost level take further ranks.

Fig. 2. The effect of international expansion on the performance of Polish MNEs (1 – highly negative; 5- highly positive; responses for 100)



However, the overall assessment of the success of foreign expansion for companies from different industries and features has inevitably led to simplification, because the performance of foreign subsidiaries and their contribution to the results of the whole company is influenced by many factors at the level of the company and its environment.

Fig. 3. The effect of foreign investment on the performance of Polish MNEs depending on the number of foreign subsidiaries (1 – highly negative; 5- highly positive; responses for 100)



One of the factors important for managers is the number of foreign companies controlled by the company. Our research again points to the lack of a simple, unequivocal relationship between the size of the international network of companies and their impact on the success of expansion (see Figure 3). While in the case of sales results intuitive seems to affect sales growth or global market share, our results indicate a lower assessment of cost effects of expansion for Polish companies with the largest number of foreign subsidiaries.

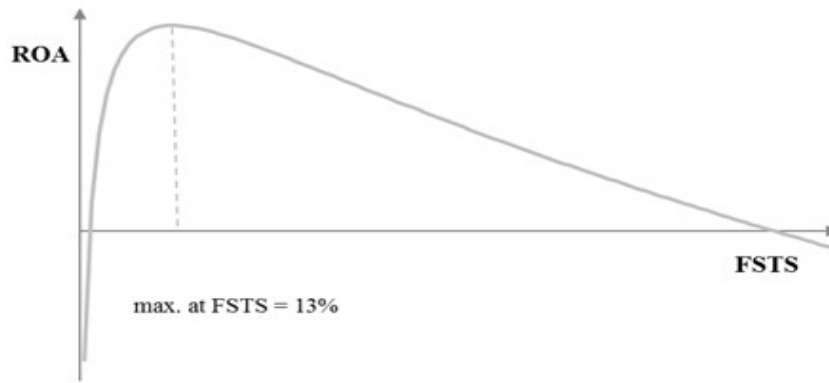
4. Illusion of the positive financial effect of foreign expansion

As we have mentioned, companies operating overseas can strive to achieve a number of benefits, but progressive expansion does not always translate into improvement of financial performance. Sometimes costs resulting from *liability of foreignness* dominate achieved benefits and vice versa (Contractor, 2012). Hence the multinationality-performance (M-P) relationship takes different shapes from linear positive or negative to S- or even M-curved (Matysiak and Bausch, 2012; Almodovar, 2012). Some scholars argue that the shape of the M-P relationships is contingent upon a set of contextual variables including country characteristics and firm specific advantages (Kirca et al., 2012).

Our research was based on a sample of Polish firms which represent a relatively low level of internationalization thus rather considered as to be on the cusp of larger expansion abroad and depicted as “new MNEs” (Hoskisson et al., 2013). The results show that the relationship between the degree of internationalization and the financial results for Polish companies takes the form of an inverted U-curve, as shown in Figure 4. Two key stages can be distinguished here:

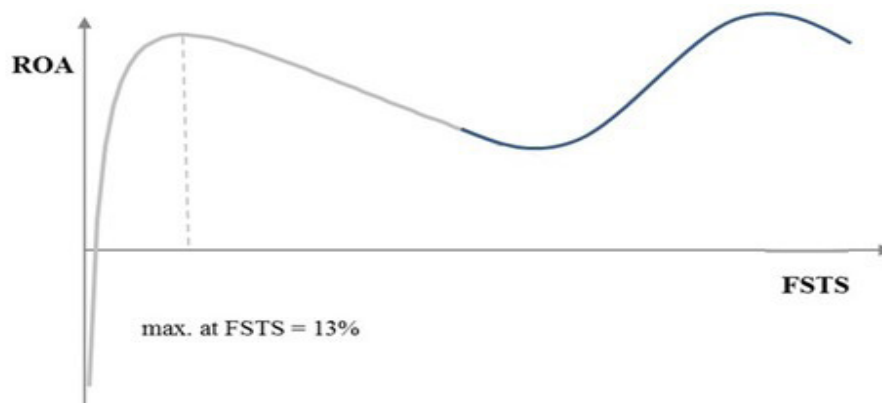
- Beginner exporters (shorter stage), where companies earn only a small part of their revenue overseas and financial performance is improving, which often prompts companies to continue to expand;
- Involved internationalists (longer stage), where companies significantly increase engagement abroad, but instead of expected further improvement of financial results, they gradually deteriorate, which in the context of the first stage can be described as the illusion of internationalization.

Fig. 4. Inverted U-shaped relationship between the degree of internationalization and firm performance



The experience of other dynamically developing countries gives some indications as to how this relationship may develop in the future, i.e. as their knowledge and skills of foreign companies grow. The example of Korean companies shows that over time this dependence can take the form of M-shape (Lee, 2010), as illustrated in Figure 5.

Fig. 5 Expected future M-shape relationship between the degree of internationalization and the performance of Polish companies



If this happens, it will mean that the experience accumulated by the company will not result in an increase in routine but will translate into better decisions about directions, ways of entering, and strategies for doing business on foreign markets.

5. Recommendations based on the Polish case

The results of our research indicate what actions were taken or what distinguishes Polish companies that achieved above-average financial performance by conducting foreign activities. This is the starting point for defining a number of suggestions and recommendations that we have outlined below. While our results hold for Polish multinationals, and to some extent to Central Eastern European multinationals given a common historical and economic context, we do believe that given the predominant focus of the bulk of international business research on the positive effects of experience and negative effects of distance, our findings are thought-provoking.

First of all, we suggest not to be overly euphoric after earning the first successes on foreign markets. Foreign expansion is not the only way to grow a business, and its advantage for the company depends, among other things, on the business sector.

Secondly, the experience gained by previous business contacts and the experience gained in seemingly similar markets to which the company intends to enter may discourage companies from the effort necessary to analyze and recognize the specifics of the new country. This in turn can negatively affect the final success of expansion. One solution at this stage would be to at least formalize the decision-making process for entry into foreign markets in order to gain the minimum needed knowledge and avoid even the most basic errors. Based on our business experience in the CEE context, this is rarely the case.

Thirdly, a company needs a clear strategy to enter foreign markets, which will be oriented on the one hand to achieve the necessary flexibility and, on the other hand, to reduce and control the complexity of its foreign operations within manageable confines. It turns out that companies that were able to find the right compromise in this respect (for example, expanding both with export and foreign affiliates) were significantly better than companies using only one or few forms of expansion.

Fourth, companies driven in their expansion by the motives of company growth and improved competitiveness, scored better results as compared to those companies whose expansion was motivated by a desire to reduce costs.

Fifth, expansion into developed markets, such as the European Union, although potentially easier due to lower institutional and political barriers, may entail more intense competition, making it particularly difficult for those firms competing with low prices (thanks to cheap labor force), not with innovative products. Due to the importance of European markets for CEE-based companies, it seems a reasonable solution to search for sources of competitive advantage in technological and managerial resources in the future, which may help to avoid "being stuck in the middle".

Sixth, CEE multinationals should reduce their dependence on European markets, which are characterized by lower growth than developing countries, where there will be a significant increase in middle class size or growth in demand for infrastructure goods in the years to come (especially in Africa and Asia). In fact, expansion to countries located in different regions reduces the risk of failure and significant deterioration, which can be explained by the diversification of the risks associated with foreign operations. Currently, the level of geographic diversification of CEE multinationals remains limited, which on the one hand reflects the explanatory power of conventional approaches to firm internationalization. On the other hand, however, the early stage of these firms' international operations constitutes a promising lab for testing the performance implications of decisions which have a tangible bearing on their overall functioning.

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