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Internationalization and firm performance: Exploring the moderating effects of regional diversification

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Previous studies provided mixed results on the impact of internationalization on firm performance. We argue that internationalization can be classified into two geographic dimensions: Country and regional diversification. This paper examines the configuration effect of country and regional diversification on firm performance. Using longitudinal data containing firm-level operation information during 2002-2005, the empirical investigation indicates that an inverted U-shaped relationship exists between regional diversification and performance. The study also finds that regional diversification has a moderating effect on the relationship between country diversification and firm performance. The results indicate that geographic configurations affect performance. For a lower level of regional diversification, a lower level of country diversification results in enhanced performance.

Key words: Internationalization, geographic configuration, country diversification, regional diversification.

INTRODUCTION

Businesses are experiencing enormous environmental changes and challenges due to the globalization of world markets and production. In order to gain a competitive advantage, organizations are expanding their business operations into different regions (Porter, 1986; Ramaswarmy, 1993). Internationalization is beneficial for business (Geringer et al., 1989; Hitt et al., 1994, 2006), due to cost-reduction, innovation, and knowledge sharing and acquisition. Taiwanese export-oriented manu-facturers were pioneers of this when they started to move to countries with relatively low costs in the 1980s, thus lowering their labor, energy, land, and capital expenses.

According to "The Report on Investigation in Performance of Taiwanese Firms Engaging in Foreign Investment in 2006", excluding mainland China, the top three investment destinations or countries are (1) Tax havens around the Caribbean, mainly the Virgin Islands and Cayman Islands (2) The United States, and (3) Singapore. Most of the investment in tax havens is reinvested in mainland China, and accounts for more than half of the total FDI each year. Thus, the interna-tional diversification of Taiwanese manufacturers shows a characteristic of a geographic configuration. Scholars refer to this as a dimension of regional diversification (Hitt et al., 1997). International diversification can be classified into country diversification (Dunning, 1996; Grant et al., 1988; Geringer et al., 1989; Sullivan, 1994a) and regional diversification (Hitt et al., 1997; Li and Qian, 2005). Li and Qian (2005) defined country diversification as the expansion into individual foreign countries, like Egypt or Vietnam; in contrast, regional diversification is seen as diversification into different global regions, like Africa or South-east Asia. These are two related but different concepts. Regional diversification can be defined as diver sification into a relatively homogeneous cluster of countries which are physically and culturally less distant. This concept is analogous to related and unrelated product diversification. The effect of regional diversification significantly influences the strategy of international diversification (Li and Qian, 2005).

Despite the significant influences of regional diversifIca-tion, little or no research exists about how the interaction of country diversification and regional diversification

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affects the diversification-performance relationship. Because of growing competition, manufacturing firms are internationalizing to seek lower cost for land, labor, and resources, while technology and service industry firms have also expended their markets to gain both awareness and profit. An investigation of the role of regional diversification thus offers substantial value to practitioners, and may refine conceptual understanding of the diversification- performance relationship. Consequently, this present study adds new elements of practical use to the international business management field. The purpose of this paper is to examine the influence of the interaction of country and regional diversification on performance. The remainder of the article is organized as follows. First, the theoretical background and literature review of the diversification-performance relationship will be provided. Second, this study presents the research methodology used to test the hypotheses. Third, the results of the data analyses will be discussed. Finally, the article concludes with the significance of the findings and managerial implications.

LITERATURE REVIEW AND THEORETICAL FRAMEWORK

Diversification, no matter the form, is considered a performance-enhancing strategy, and Internationalization is considered as offering new ways for value creation (Hitt et al., 2006). Therefore, much empirical research focus on the relationship between internationalization and performance, and a recent study indicates that internationalization has become one of the most popular research areas in international management in the top 20 management journals (Werner, 2002) Figure 1.

Internationalization and performance

Scholar who support the positive effects of internationalization point out that this business activity may reduce costs, extend innovation capabilities, aid knowledge acquisition, and thus produce competitive advantages (Geringer et al., 1989; Hitt et al., 1994; Hitt et al., 2006). In addition, the nature of the relationship between internationalization and performance has also been tested. Some scholars have proposed that the relationship between the two is positive due to the opportunities uncovered in other geographical regions (Delios and Beamish, 1999; Qian and Li, 2002; Tallman and Li, 1996), the influence of corporate entrepreneurship (Luo et al., 2005), and the increase of market power (Kim et al., 1993; Kogut, 1985). Another group of scholars found a negative or non-existent relationship between the two, and argued that global diversification represents a cost related to the agency relationship between managers and investors, which is widely known as the "diversification discount" (Denis and Yost, 2002; Fatemi, 1984).

The costs and benefits of internationalization are thus considered collectively in the literature, and a curvilinear relationship is formed. An inverted-U shape relationship is obtained by researchers (Geringer et al., 1989; Gomes and Ramaswamy, 1999; Hitt et al., 1997; Sullivan, 1994b), who stress that the benefit of internationalization will increase to a point, the so-called "internationalization threshold", and then the costs will eventually exceed the advantages of accessing new resources. Some scholars who posit a U-shape relationship between international diversification and performance have stated another possibility for this (Lu and Beamish, 2001; Ruigrok and Wagner, 2003; Thomas, 2006) . In the early stage, internationalization may increase a firm's costs because of newly generated complexity for governance. Nevertheless, performance will start to increase after firms get acquainted with the environment and acquire new knowledge and capabilities. Additionally, Riahi-Belkaoui and Picur (1998) proposed a more complex model to illustrate that international diversification is initially inimical to performance when firms enter a new market. Later on, the positive effects of internationalization appear in the middle level and then decline again. Using this rationale, Contractor et al. (2003) found a sigmoid-shaped relationship in knowledge-based service firms. Lu and Beamish (2004) also supported such a relationship and noted that liabilities and costs are reduced through learning, experiences, and economies of scale and scope.

The relationship between internationalization and performance remains inconclusive, because the scope of the related investigations covers diverse industries, time periods, and motivations. Different contextual effects, like different economic bases, different organization types, or different time periods, may thus alter this diversification-performance relationship (Geringer et al., 2000).

Joint effect of country diversification and regional diversification

We argue that internationalization can be classified into two geographic dimensions: Country and regional diversification. Thus, in order to clarify the impact of internationalization on performance, country and regional diversification should be considered together. The present study suggests that country diversification is negatively associated with firm performance, and the relationship between regional diversification and performance demonstrates an inverted U -shaped curvilinear relationship. Hitt et al. (1994) pointed out that increasing geographic dispersion will significantly increase transaction costs. In addition, the costs of transaction rise with geographic dispersion, and increasing the pressure of coordination costs create further challenges for the senior management team (Hitt et al., 1997). While internationalization gives firms the opportunity to generate advantages such as economies of scale and scope (Kim et al., 1993; Kogut, 1985), obtaining the benefits of these
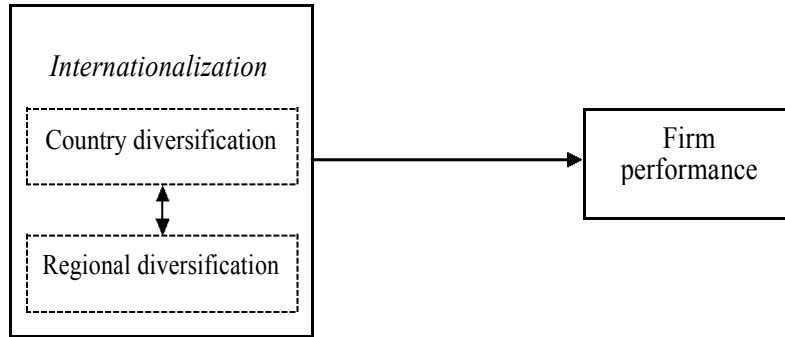
Figure 1. Theoretical framework.

can incur a high level of transaction costs and coordination efforts for international diversifying firms. Ravichandran et al. (2009) argued that the chances to exploit economies of scale and scope will decrease due to increasing national differences when firms expand into more countries. That is, if firms expand into international markets, the costs associated with geographic dispersion then start to outweigh the benefits. This suggests that country diversification is negatively associated with firm performance. Country and regional diversification do not achieve equal outcomes from internalization opportunities. Nor do they generate the same costs of transaction and coordination through geographic dispersion. Regional diversification can be defined as diversification into a relatively homogeneous cluster of countries which are physically and culturally less distant, which should lead to lower costs of transaction and coordination (Sushil, 1991).

Multinational firms face high costs related to cultural differences which are associated with difficulties in transferring competitive advantages and knowledge between different regions (Kogut and Singh, 1988). However, at the lower level of regional diversification, the divergence of culture may be minimal. For example, multinational firms that operate in countries clustered in a homogeneous region may face lower cost than countries clustered in several heterogeneous regions. Moreover, multinational firms that expand into countries clustered physically close to each other should have lower transaction and coordination costs (Grant, 1987). The similarities of homogeneous areas can thus affect a multinational's ability to earn profits.

In addition, multinational theory suggests that standardization of products and production is possible when operating in markets within a homogeneous geographic region (Tallman and Li, 1996). The reason is that countries in a homogeneous region share the same market characteristics, and therefore, the possibility of launching the same products and services is more likely. Standardization saves costs and makes economies of scale and scope possible. Moreover, it is easier for firms to exploit synergy (Hitt et al., 2006), as competencies

developed in one country can be easily applied to another in the homogeneous region (Tallman and Li, 1996). Resources can also be delivered within a reasonable distance. Consequently, a lower level of regional diversification that can deliver economics of scope and synergies is expected to exhibit higher performance. Nevertheless, with continued expansion, as firms achieve a higher level of regional diversification, transaction and coordination costs escalate to the point where they can outweigh the benefits, and firm performance will start to diminish. The arguments presented above indicate that the relationship between regional diversification and performance is nonlinear. Regional diversification will enhance firm performance up to a certain point beyond which the transaction and coordination costs associated with managing extensively scattered operations outweigh the advantages. We argue that internationally diversified firms may be affected by the joint effect of country and regional diversification. An important implication is that, at lower levels of country diversification, costs will be canceled out by the benefits of regional diversification. The regional diversification will significantly influence the linear relationship between country diversification and firm performance.

Consequently, the joint effect of regional and country diversification forms a curvilinear relationship between internationalization and firm performance. This study summarizes the arguments aforementioned in the following hypothesis.

Hypothesis 1: An inverted U-shaped relationship exists between internationalization and firm performance.

Geographic configuration and performance

A high level of country diversification may increase cost and risk, but this may not be necessarily true when companies expand their operation in restricted areas, that is, when they undertake a low level of regional diversification. On the other hand, a low level of country diversification but a high level of regional diversification

may be more risky and costly because of the difference in consumer taste and behavior in a relatively more complicated context. Therefore, this research probes the interplay of country and regional diversification, and the influence of internationalization on performance. To more clearly state the relationship between regional and country diversification, this research addresses three theories to set up the research framework: The multinational theory, the transaction cost theory, and the organizational learning theory. Multinational theory suggests that standardization of products and production is possible when operating in similar markets within a region (Tallman and Li, 1996). The reason is that countries in the same region share the same market characteristics, and therefore, the possibility of launching the same product and service is more likely. It is also easier for firms to exploit synergy (Hitt et al., 2006), as the competencies developed in one country can be easily applied to another in the same region (Tallman and Li, 1996).

International diversification offers a way to overcome market imperfections across different countries (Buckley and Casson, 1976). However, there may be transaction costs (Williamson, 1985). While a firm diversifies into a wide variety of world regions, it will have to manage different cultures, new competitors, and complex environment factors, like political or legal regulations. Kogut and Singh (1988) argue that the transaction costs, like communication, coordination, control, and motivation, will lead to many problems. However, Williamson (1985) pointed out that according to transaction cost theory, similarity reduces coordination costs, distribution costs, management costs, and information searching costs. Due to the similarity of markets, the complexities of management, technology, and coordination decrease and communication improves. International diversification can enhance a firm's competencies and reduce its costs through learning, but this takes time. Organizational learning theory suggests that institutional and cultural factors are challenging elements of transferring marketing and product knowledge between different regions (Kogut and Singh, 1988). In addition, learning will be hampered by information overload if the firm has an increased proportion of foreign businesses located in a great number of different regions (Delios and Beamish, 1999). Habib and Victor (1991) suggested that, from an organization learning point of view, a similar environment within a region will facilitate learning and reduce risks. This is because knowledge from similar countries is easily integrated, and hence it is relatively easy to create new competencies (Eisenhardt and Martin, 2000). The relationship between regional and country diversification examined in this work will be developed with the integration of the above theories, and based on these we present our second hypothesis:

Hypothesis 2: The degree of regional diversification moderates the relationship between country diversification and firm performance in such a way that low levels

low levels of regional diversification increase performance.

RESEARCH METHODS

Sample selection

The sample for this study was drawn from the business groups in Taiwan databank published annually by China Credit Information Service Ltd. The sample was selected according to the following criteria: (1) Publicly listed companies in the Market Observation System, and (2) Business consortia that operate in the manufacture industry. This study used both corporate-level and subsidiary-level data from the business groups in Taiwan databank. Samples with missing information were removed, leaving a total of 51 business consortia and 281 subsidiaries which contained longitudinal data from 2002 to 2005.

Dependent variable

Performance

Accounting information is the most widely used measurement of performance in diversification research (Li and Qian, 2005). Therefore, this study first considered three accounting-based measures for indicators of firm performance: Return on Assets (ROA), Return on Sales (ROS), and Return on Equity (ROE), as previous diversification research applies these indexes (Geringer et al., 2000; Grant et al., 1988; Hitt et al., 1997; Kim et al., 2004; Yang et al., 2010). ROE is one of the most widely used accounting measures in the international business research (Qian, 1997), and can reflect the productivity of capital employed (Varadarajan and Ramanujam, 1987). This study thus chooses ROE as the dependent variable.

Independent variables

Country diversification

Previous studies have used several measures of international diversification for this construct. The most commonly used form is the single-item measure (Hitt et al., 1997), and the majorly used form is the measure of foreign sales to total firm sales (FSTS) (Capar and Kotabe, 2003; Grant, 1987; Habib and Victor, 1991), and foreign assets to total firm assets (FATA) (Ramaswamy, 1995). However, due to the lack of subsidiary-level employment data, FATA is removed. In the present study, the degree of country diversification is calculated using the method suggested by Capar and Kotabe (2003), and uses only FSTS.

Regional diversification

For regional diversification, this research applies the entropy measure suggested by Li and Qian (2005). The entropy measure was initially a way of assessing a firm's degree of product diversification proposed by Jacquemin and Berry (1979). Following the empirical concept, regional diversification is defined as [$P_i \ln (1/P_i)$], where P_i is the sales of global market region, i attributed to the total sales within a firm and $\ln (1/P_i)$ is the weight given to region i. This measure considers the number of global market regions in which a firm operates and the relative importance of each region to total sales (Hitt et al., 1997). To calculate the entropy measure, this study classifies the regions into the Americas, South

east Asia, North-east Asia, Europe and other regions, and tax havens.

Control variables

Firm size

Firm size relates to the resources under managerial control, including both physical and financial resources (Ito and Rose, 1999). Small firms are usually more resource-constrained and vulnerable to market competition (Doukas and Lang, 2003), but large firms may incur greater coordination cost, which may reduce the synergy of diversification (Chang and Wang, 2007) . Additionally, firm size is usually related to diversity level (Geringer et al., 2000) and influences the international diversification of a firm (Dass, 2000). Therefore, this study includes this measurement and measures it by taking the natural logarithm of a firm's total assets.

Debt ratio

The financial structure of the firm plays an important role in its performance. The debt ratio is capable of measuring the resource availability and constraints of each firm. This ability will naturally affect the capability of a firm to diversify and use resources for business group enterprises (Chang and Hong, 2002), and thus the debt ratio significantly affects firm performance (Palich et al., 2000). Here, this study measures debt ratio by using the ratio of long-term debt plus current liabilities divided by common equity.

RESULTS

Table 1 shows the descriptive statistics and correlations for the dependent, independent, and control variables in this study. The software used in this study is STATA v.9.0. When using some statistical techniques, a number of assumptions are typically made. One of these is that the error term has a constant variance, that is, the regression disturbances are homoshedastic (Baltagi, 1995), and heteroscedasticity is a violation of this assumption. In order to eliminate the possible influence of a heteroscedastic data, a likelihood ratio test is conducted on the panel data, and the results indicate that there is no problem with heteroscedasticity (Table 1). To test for the presence of autocorrelation, the study followed pro-cedures that Wooldridge (2002) outlined. The Wooldridge test was conducted to examine an autocorrelation problem in cross-sectional time-series data. Under the null hypothesis of no first-order autocorrelation, the results indicate that there is a first-order autocorrelation within this study's panel data. This research then changed the regression model into linear ones with an AR (1) disturbance. Using the Hausman test (Baltagi, 1995), this study determined the coefficients in both fixed and random effects and calculates the different values between them. The results failed to meet the asymptotic assumption, and so were not viable. Consequently, the effect built from the following principles: (1) The time period of the dataset is not long. (2) The random effect is suitable for examining differences between individual

elements, and this agrees with the main purpose of this research which is to uncover differences between business consortia. Therefore, the present study prefers this estimation method to random-effect estimations.

Table 2 shows the results of regression analysis. Model 1 is the baseline model that includes only the two control variables. This research used Model 1 to test the effects of the control variables on firm performance, and then added the main effect of country and regional diversification in Model 2, 3 and 4. Model 2 examines a negative linear relationship between country diversification and performance. The result is statistically significant ($p < 0.05$), and shows that country diversification has a negative effect on firm performance. This research tested the relationship between regional diversification and performance using Models 3 and 4, and then built the test of the inverted U-shaped relationship by adding the linear term and the squared term of regional diversification. The results are statistically significant (Model 3, $p < 0.01$; Model 4, $p < 0.05$), and show an inverted U-shaped relationship. We expect that internationalization may be affected by the joint effects of country and regional diversification, and that the latter acts as a significant determinant of these. Consequently, the results show an inverted U -shaped relationship between internationalization and performance, with the slop positive at low levels of internationalization, and negative at high levels. These results support Hypothesis 1.

In Model 5, the results show the components based on Model 4, but with the addition of interaction terms which represent the configuration of the main internationalization variables. Model 5 includes the interaction terms of the country and regional diversification. The changes in R ^{2} are significant. These variables increase the explained variance by 3.4% more than that obtained with Model 4. Hypothesis 2 suggests that the degree of regional diversification moderates the relationship between country diversification and firm performance in such a way that low levels of regional diversification increase the performance. The results from Model 5 show that country diversification has a positive effect on firm performance when regional diversification is low (= 33.77, $p < 0.01$), supporting Hypothesis 2.

CONCLUSION

Although our findings suggest that an inverted U-shaped relationship exists between international diversification and performance, the findings for the two dimensions of the geographical diversification measurement present different outcomes. For country diversification, a negative linear relationship with performance indicates that with increasing levels of country diversification, firm performance will gradually decline. This could be explained using transaction cost theory. When a firm heavily diversifies into many countries, the different behaviors, tastes, cultures, and contexts derived from various

Table 1. Means, standard deviations, and correlations.

Variable	Mean	S.D.	1	2	3	4
Performance	8.6	14.54				
Country diversification	0.7	0.47	0.05			
Regional diversification	0.6	0.37	0.07	0.17*		
Debt ratio	0.4	0.17	−0.05	0.09	−0.10	
Firm size [a]	7.6	0.60	−0.04	−0.04	0.28**	−0.43**

[a]Log-transformed variable; * $p < 0.05$; ** $p < 0.01$.

Table 2. Results of regression analysis.

Variable	Geographic configuration				
	Model 1	Model 2	Model 3	Model 4	Model 5
Intercept	26.84(1.32)	27.03 (1.28)	33.15 (1.51)	34.53 (1.60)	37.76[†] (1.77)
Debt ratio	-4.17 (0.53)	-1.34 (0.17)	-0.26 (0.03)	-4.32 (-0.53)	-2.95 (-0.37)
Firm size	-2.22 (−0.89)	-1.92 (−0.74)	-3.47 (−1.26)	-3.77(-1.39)	-2.80 (-1.04)
Country		-5.23*(−2.07)	-6.56*(−2.45)	-2.77 (-0.87)	-5.16 (-1.31)
Regional diversification			9.86** (2.77)	19.48** (3.30)	-35.46* (-2.07)
Regional diversification (^{2})				-11.60* (-2.06)	34.93* (2.29)
Country diversification × regional diversification					33.77** (3.39)
Country diversification × regional diversification (^{2})					-34.37** (-2.99)
R²	0.010	0.004	0.003	0.008	0.042
Prob > chi^2	0.660	0.173	0.007	0.003	0.000
F-Statistic	0.83	4.99	13.96	18.03	32.40

†$p < 0.10$, *$p < 0.05$, **$p < 0.01$.

various backgrounds will increase the cost for the management team. For regional diversification, an inverted U-shaped relationship indicates that in the low level of regional diversification, a firm's cost might be increased due to newly generated complexity for governance. Nevertheless, performance will start to increase after firms get acquainted with the environment and acquire new knowledge and capabilities as suggested by the organizational learning theory. Firm performance is also affected by the configuration effect of country and regional diversification. For a low level of regional diversification, the similarity of the demands and culture may increase knowledge of the market, and thus increase performance. An important implication is that transaction costs will cancel out the benefits of economies of scale when firms diversify into different countries (Li and Qian, 2005). The configuration effects utilized with different diversification variables were highly significant compared to the single effect of the individual ones. Therefore, the moderating effects of a diversification dimension exist.

Contributions to scholarship

Recent research investigated the relationship between internationalization and performance but has given little attention to the configuration effect of country and regional diversification. The primary contribution of this paper is that it represents the first attempt to empirically examine the configuration effect of country and regional diversification, and finds that the different configuration between country and regional diversification do indeed moderate performance. Additionally, our results support the conclusions of Hitt et al. (1997) and Gomes and Ramaswamy (1999) that there is an inverted U-shaped relationship between international diversification and performance.

Applied implications

The results of this study have several implications for businesses that extend their geographic operations. Internationalization provides opportunities for firms to grow and is beneficial for firms to integrate resources. Country diversification and regional diversification are correlated, and managers should consider the pros and cons of the different arrangements. From the results of our study, increasing country diversification might degrade firm performance due to increased differences between nations. Thus, whether operating in a single or multiple regions, managers must be aware of the scope of expansion and

they must try to balance the costs and benefits. The fit between the environment, communication, and management as well as the configuration of regions and countries are related. A high level of country diversification will often be harmful to firm performance due to increasing transaction costs, so firms will experience a performance downturn. The empirical results presented in this work can be used as a reference for firms when developing their multinational strategy.

LIMITATIONS AND FUTURE RESEARCH DIRECTIONS

Although our research contributes to the body of knowledge regarding the relationship between internationalization and performance, this study also suffers from limitation. It is important to recognize limits to generalisability, as our study was based on the high-technology industry only, and thus its applications to other industries should be made with caution. A broader investi-gation of different industries, like service industries, will be suggested for future researches, as this would let us to examine whether the inverted U-shaped relationship would also apply to other industries.

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