Small Firms as International Players

Tomás O. Kohn

ABSTRACT. In this paper, using aggregate data from the U.S Bureau of Economic Analysis, the author explores the strategies small U.S.-based foreign investing firms follow in their international activities. The aggregate study supports the findings of an earlier study of a few small firms with international activities. These firms have a lower-than-expected tendency to form minority-owned affiliates abroad. An analysis of the industries in which these small foreign investing firms operate supports the notion that these firms follow specific strategies uncovered in the small-scale study. Finally, the paper ties the findings to alliance strategies of small firms.

1. Introduction

As Gomes-Casseres points out in the introduction to his "Alliance Strategies of Small Firms" paper (1995): "students of international business have traditionally believed that success in foreign markets requires large size." Given this traditional view, if a firm is not large yet wishes to compete globally, it has two less-than-pleasant options: The first one, give up on its dreams and stay frustrated in its domestic market. The second one, give up on its independence and seek help from other, larger, players. If these were the only options, managers of small firms in "global" industries would be either myopic (those not interested in the international arena), frustrated (those who wish to go abroad, but can't), or, good team players – not independent leaders (those who seek others' help). Yet as one looks at the ranks of small-firm managers, one could hardly characterize them this way. Something must be wrong with the analysis; the question is what? Does the problem rest in the "traditional" assumption, crisply stated by Chandler, that "to compete globally you have to be big," (1990) or does it rest in the way I have characterized small-firm managers?

The work Gomes-Casseres and I did (1994), based on a limited sample of small firms with international affiliates, suggested that the problem may rest on the "traditional" assumption. After all, 92% of the foreign ventures in our sample were majority-owned. The sample, however, was very small. While it allowed us to explore these firms' activities in depth, it did not enable us to generalize further. In this paper I will report on a study of all U.S. foreign investing firms that reported their activities in the U.S. Commerce Department's 1982 Benchmark Survey (1992) to see if the findings may be further generalized.

2. International activities of small firms

Evidence shows that small firms are, against the expectations of many traditional scholars, active players in the international arena. As can be seen in Table I, small and medium sized parent firms represented almost 50% of all U.S. foreign investing firms in 1982. I prepared Table I based on U.S. manufacturing firms' foreign investment behavior as reported by the Commerce Department's *U.S. Direct Investment Abroad: 1982 Benchmark Survey* (1985). I divided all U.S. foreign investing firms (parents) into four size categories, based on their employment in the U.S. (10–499 = small; 500–1,999 = medium; 2,000–9,999 = large; > 9,999 = very large). The 1,215 manufacturing parents and their 11,231 manufacturing affiliates are sample on which the data presented in this paper are based. The methods and data used are described in detail in Kohn (1988).

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School of Management
Boston University
Boston, MA 02215

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Table I
Size distribution of U.S. foreign direct investors – 1982 (number of manufacturing parents and of manufacturing affiliates)

	Parent size category				
	Small	Medium	Large	Very large	Total
Parents	214	382	372	247	1,215
Affiliates	331	1,038	2,672	7,190	11,231

3. Affiliate ownership practices

Clearly, many small firms are able to invest abroad. That being the case, one must establish what it is that enables these firms to operate where so many doubt that they may tread. The first answer that comes to mind is that they tread abroad when they are aided by others. Do the data support this answer? Surprisingly, no! I found that the tendency of small foreign investing firms to form affiliates that are minority-, as opposed to majority-, owned is actually lower than the tendency of large parents to do so. That being the case, those small firms that invest internationally must be able to go abroad with little help from others. But how?

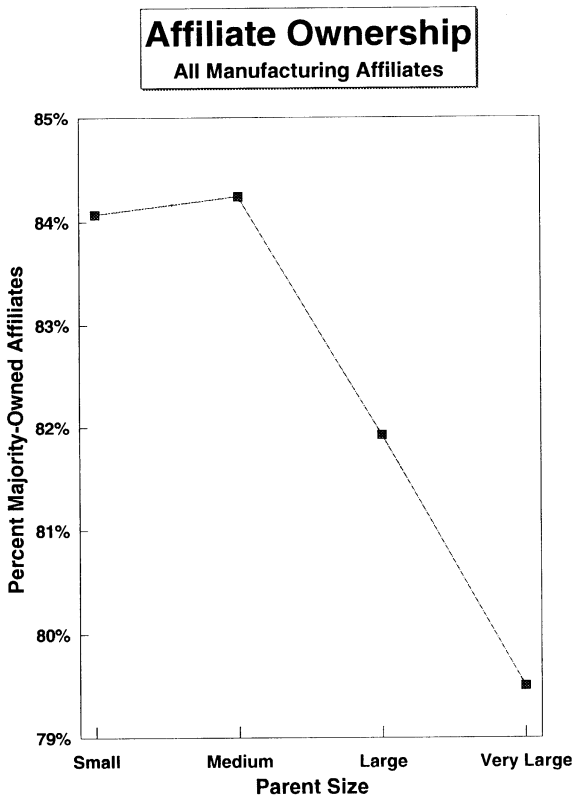

Fig. 1.

One may argue that the answer to this apparent anomaly lies in the type of activities small firms are engaged in when they venture abroad. Some parent firms may be involved abroad in a wide range of activities, going from research and development, to manufacturing and, finally, to marketing. Such activities would require substantial financial and managerial resources and would, in the classical view, be off limits to small firms without others' help. Other parent firms may be involved abroad only in marketing activities, and that would – at least in the case of producer goods where the task of adapting products to host-country consumer tastes is minimized – require relatively few resources. Given these arguments, one would expect – with traditional reasoning – that the observed ownership pattern could be explained if most small-firm foreign affiliates were devoted to marketing and not to manufacturing activities. To eliminate this possible explanation, I concentrated my analysis on the ownership pattern of different-sized parents firms' *manufacturing* affiliates. I found again the same tendency of smaller firms to have fewer minority-owned affiliates than large firms. (Figure 1).

Another possible explanation of the observed data could be that smaller U.S. foreign-investing firms tend to locate most of their affiliates in Canada; a place where the costs of doing business abroad are minimized, while larger firms operate in more diverse, and hence more costly-to-do-business-in, environments. To test this line of reasoning I looked at the ownership pattern of manufacturing affiliates in Canada. Once again the pattern (Figure 2) was repeated: smaller firms tend to have fewer minority-owned affiliates than larger firms.

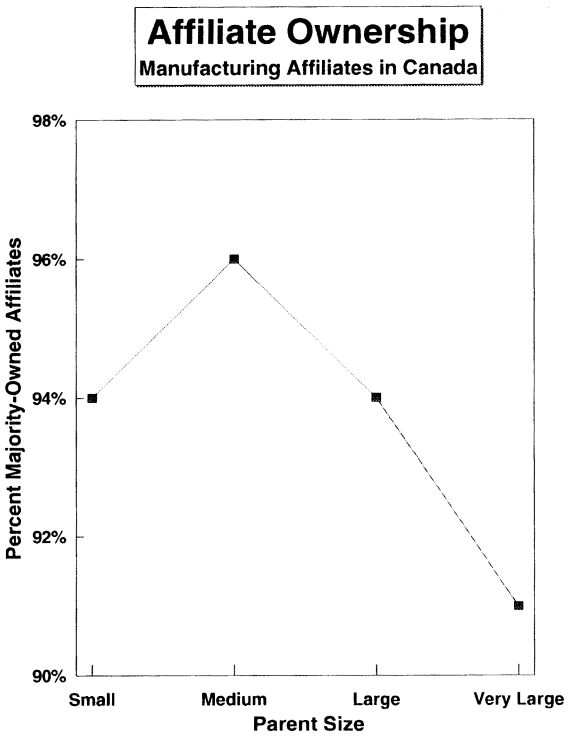

Fig. 2.

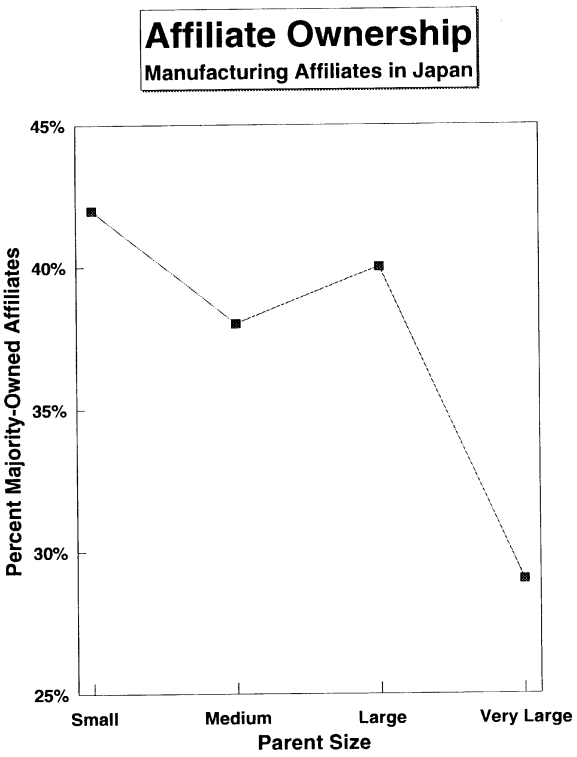

Fig. 3.

To further explore the possibility that affiliate location may be a driver of affiliate ownership by small firms, I repeated the test for manufacturing affiliates located in Japan, where the arguments about the cost of doing business for U.S. firms would essentially be the opposite than in Canada. Again, the same pattern was evident (Figure 3).

It seems that the affiliate-ownership practices of the few firms Gomes-Casseres and I studied are representative of the population of small U.S. firms that reported their international investments in the 1982 Benchmark Survey.

The consistency of the patterns one observes in the preceding figures effectively lays to rest the idea that small firms are able to invest abroad because they compensate for their lack of size by seeking, more so than large firms, partners for their international activities. If this idea is laid to rest, then so must the argument behind it; namely, that affiliate ownership policies are driven by these firms' difficulties in covering the costs of doing business abroad. Given that, in fact, these difficulties are likely to be great, one must ask what arguments may explain the observed patterns? I argue that one way to explain the patterns is to explore these firms' strategies.

4. Firm strategy

Gomes-Casseres and I found that the firms we studied followed what we call a "deep niche" strategy. These firms' behavior was characterized by positions of market dominance and technological leadership, and by a focus on producer goods. I will explore these findings using, once again, the aggregate data of the Benchmark Survey.

Market dominance

One would expect that the industries in which a small firm can be a dominant player are limited. Specifically, one may surmise that in emerging industries, before the consolidation that tends to occur in more mature industries has taken place, firms do not have to be very large to be dominant players. That being the case, one would expect that

if small foreign investing firms are dominant players in their industries they will tend to be concentrated in emerging industries.

To test this hypothesis, I constructed an industry-maturity index and plotted the weighted average maturity of different size firms' industries against firm size. I did so for all manufacturing firms in the U.S. and also for those firms that have direct investments abroad. The results are shown in Figure 4.

The pattern one expects if these small firms are dominant players is present: small, and even more so medium-sized, foreign-investing firms come from the least mature industries. It is in these emerging industries that small firms can be active international players. As Gomes-Casseres suggests, these firms may be small in absolute terms, but probably large within their industries. Being, therefore, industry leaders, these firms resist sharing affiliate ownership; something others have found (Stopford and Wells, 1972; Gomes-Casseres, 1985) in their ownership strategies studies.

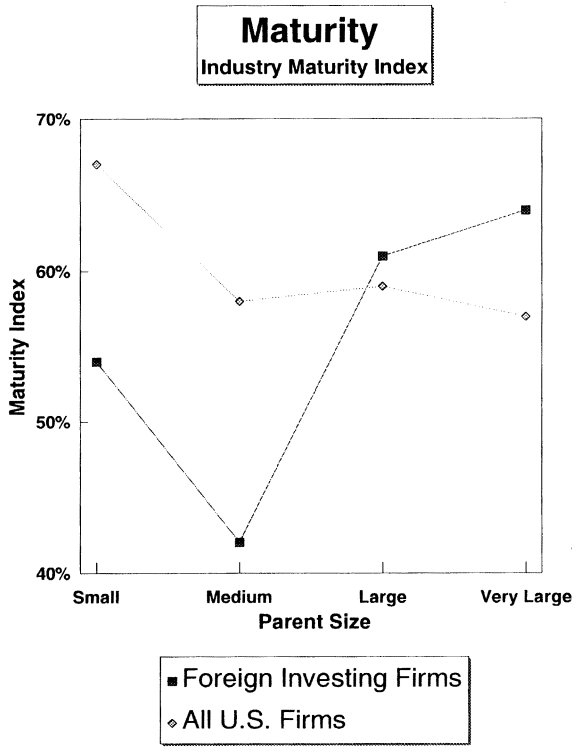

Fig. 4.

One can learn more about the characteristics of small foreign investing firms if one analyzes the differences between the industries from which foreign investing and all U.S. firms originate. One observes that while small and medium sized foreign investing firms originate in industries whose maturity index is substantially lower than the index for their domestic counterparts, the opposite is true for large and very large firms. One can understand these differences by exploring the strategic motivations that lead firms to invest abroad.

For large and very large firms, these motivations have been explained at length by proponents of the product cycle theories of foreign direct investment (Vernon, 1966 and 1979; Wells, 1972; Stopford and Wells, 1972; Davidson, 1980; Knickerbocker, 1973; and others.) In this model, foreign direct investment is mostly a defensive move to protect the firm against loss of export markets and against competition from low-cost foreign producers; producers that spring up once the technological advantages of the firm are eroded. Such defensive moves are likely to be a major factor in relatively mature industries where technology has become wide spread and standardized.

For smaller firms, the motivations that lead to foreign investment are likely to be quite different. Small firms operating in emerging industries face unique threats and opportunities. The threats revolve around the frailty of the technological leadership they may possess. Such leadership is frail because of the risk that their technology will be copied or that new developments may make the technology obsolete. The opportunities revolve around the possibility of gaining first-mover advantages that will give them the desired leadership position in the, as yet unstructured, industry. Gaining such advantages abroad is particularly important for a small, highly focussed firm. It must preempt, as far as possible, the emergence of competitors within its narrow area of expertise. Given the technological parity between many developed countries, competitors are likely to emerge both at home and abroad.

Still, the desire to gain first-mover advantages is likely to be only one of several forces that may motivate the small firm in emerging industries to invest abroad. Maybe more important is the

contribution that a manufacturing affiliate abroad may make to the firm's sources of competitive advantage. As has been pointed out (Schmookler, 1966, and others.), innovations are the result of the interplay between the firm and its environment. In view of this, a firm operating in various environments will be more likely to generate a variety of innovations related to its core technology than a firm operating only in its home country. For a small firm, with all its eggs in one basket, remaining at the forefront of its narrow technological niche is vital. Such a firm can ill afford to miss out on the innovations that may result from the interplay between its activities with different environments. The same argument does not apply to larger firms. Since they are likely to have their eggs in many baskets, their competitive advantages are not so vulnerable to innovations elsewhere and, therefore, they are not so singularly driven to invest abroad so as to stay alive.

These arguments suggest that investing abroad represents a valuable move for a small firm in an emerging industry. An option that may, when incorporated into the firm's strategy, result in the market dominance that Gomes-Casseres and I observed in our limited sample.

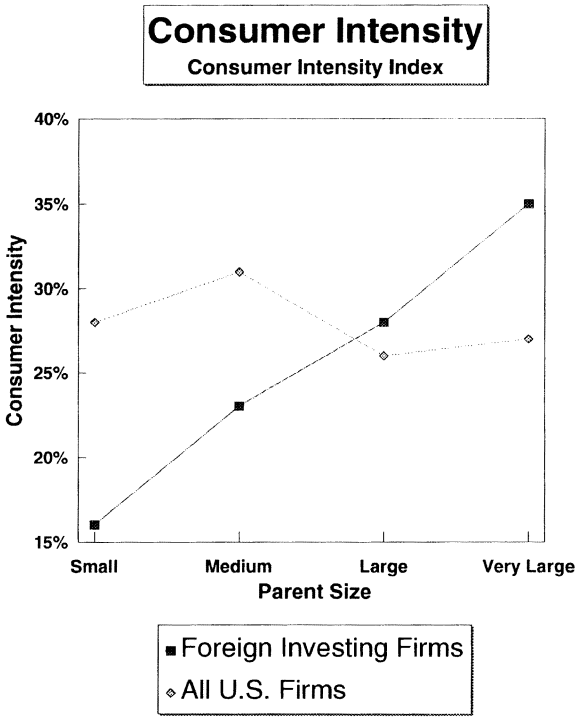

Fig. 5.

Focus on producer goods

To find out if, on average, small foreign investing firms tend to focus on producer goods, I constructed a "consumer intensity" index and plotted the weighted average consumer intensity of different size firms' industries against firm size. (Figure 5) The index provides a measure of the extent to which products from a given industry are sold directly to consumers and allows me to refine on the dichotomous world of consumer- and producer-goods. Once again, I did so for all manufacturing firms in the U.S. and for firms with direct investments abroad.

Clearly, the aggregate data support the small-sample results Gomes-Casseres and I observed: small foreign investing firms tend to concentrate in producer goods. Given the observed patter, the question arises: why should small firms that invest abroad concentrate in low consumer-intensity industries while those that operate in the U.S. do not? The answer may lie in small firms' ability, or lack thereof, to deal with the costs of modifying their products when they sell them abroad. It is reasonable to state that the higher an industry's consumer intensity, the more likely it is that the industry's output needs to be modified to conform with host-country tastes and marketing methods. Domestically, on the other hand, product and marketing adaptation are not an issue. Therefore, within the U.S. there is no reason to expect differences between small- and large-firms' tendency to operate in either high or low consumer intensity industries.

In foreign environments, however, the situation is quite different. Only large firms are able to absorb the costs of making the product and marketing modifications necessary in high-consumer-intensity industries. Given their lack of resources, small firms – unable to bear the adaptation costs mentioned earlier – will be limited to low-consumer-intensity industries.

Technological leadership

Yet, even if small firms avoid the high costs of adapting products and marketing methods when

they invest abroad, one must still inquire into what advantages, if any, these small firms have over their host-country competitors. As has been argued extensively (Buckley and Casson, 1976; Caves, 1982; Hennart, 1980; Stopford and Wells, 1972; Vernon, 1966; and others.), such advantages are necessary to compensate for the costs of doing business abroad. Companies that are the technological leaders in their industries would, certainly, have the necessary advantages to compete internationally. Therefore, it was not surprising when Gomes-Casseres and I found that the firms in our small sample fit this description.

At an aggregate level, therefore, one would expect to see that most small firms investing abroad rely on R&D-based technological advantages. (They are not likely to rely on advertising-based advantages because these would have to be adapted to host country environments, and that would be costly.) Large firms, on the other hand, may rely on either advertising- or R&D-based advantages in their international operations.

While the aggregate data of the Benchmark Survey do not lend themselves to a direct test of this idea, they do provide some insights. As can be seen in Figure 6, a comparison of the R&D intensity of the industries in which small foreign investing firms operate shows that these firms come from industries whose R&D intensity is much greater that the R&D intensity of the industries in which small firms operate domestically. Additionally, the difference in R&D intensity between small- and large-foreign-investing firms' industries is less that the equivalent difference among firms operating domestically. These facts lend support to the idea that, in general, small firms that compete abroad are able to do so because of their technological capabilities.

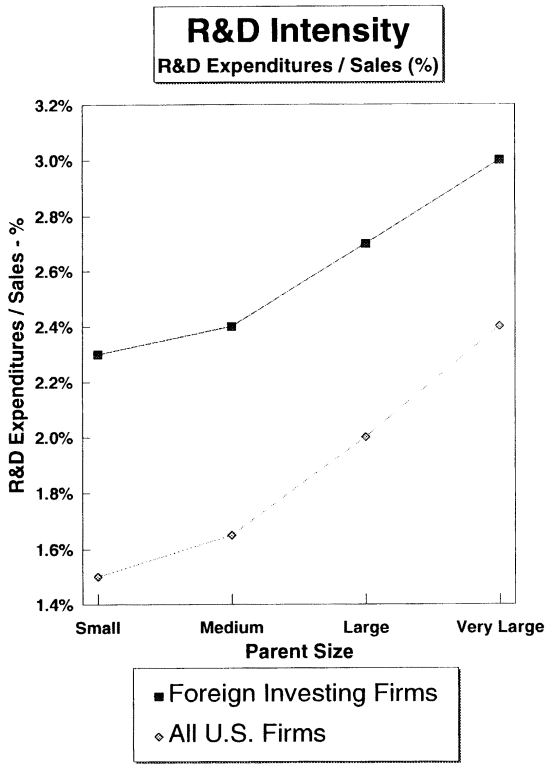

Fig. 6.

5. Conclusion

In his analysis of Alliance Strategies of Small Firms, Gomes-Casseres identified what appears to be a bi-modal distribution in the propensity of small firms to collaborate with others. One group of small firms' propensity to collaborate with others is higher-than-average while others' is lower-than average. Regarding both groups of firms, Gomes-Casseres bases his findings on a limited number of observations. Are these anomalies, or do they really represent a broader population of small firms? In this paper I have shown that, based on an analysis of aggregate data. we can confidently state that there are large numbers of small firms who, in fact, "go it alone." I have also shown that their behavior is consistent with the "deep-niche" strategy Gomes-Casseres and I described as characteristic of these firms. These firms tend to be dominant players in their markets, be technological leaders, and operate mostly in producer goods industries. What I have not shown is whether the other group of small firms, those that are alliance-prone, also represent a broad population of firms. That issue remains to be answered.

Regarding the go-it-alone firms, Gomes-Casseres highlights the importance of these firms' ability to find markets where there are no large rivals so they may survive as "small" players. I would question whether such markets are, in fact, out there to be found. Maybe part of these firms' success rests on their ability, based on a combination of technological prowess and management

skills, to create such markets. Large firms may, in practice, stay away from activities where capable small players are fully satisfying their customers' needs.

It would be interesting to apply Gomes-Casseres's context-capabilities-control framework, to these go-it-alone firms to see if they may, in fact, be likely candidates for membership in alliance networks. One could argue that the context in which these firms operate – mostly producer goods industries – requires that they be the best suppliers their industrial customers can find. This requires two capabilities: (1) extreme levels of expertise and (2) close supplier-customer collaboration. By following the "deep-niche" strategy that characterize the go-it-alone small firms they acquire the first of these capabilities. Therefore, at least in this regard, these firms need no alliances. However, how are these firms to acquire the second of these capabilities? I surmise that one way to do so is for these firms to structure alliances. These alliances, however, would be practically devoid of any equity participation, and would rest more on long-term supply or other types of joint decision-making arrangements, somewhat akin to arrangements that exist within Japanese Sogo-soshas.

It may be interesting to point out that my analysis of small foreign investing firms led me repeatedly to the conclusion that these firms must be endowed with the creative managerial practices often associated with entrepreneurial firms. The thoughts expressed above, again bring up this topic. It would be consistent with the management practices of entrepreneurs to follow what may appear to be two contradictory strategies at the same time: To insist on establishing wholly-owned operations while at the same time structuring alliances. This makes sense if they shun others' help in those activities that are at the core of their sources of competitive advantage while they seek alliances in the rest of their activities. The kind of disaggregation of the value chain implicit in such behavior has been talked about much in recent management writings.

Finally, it is interesting to speculate on the motivation for alliance formation by these firms. On the one hand, it may be aimed at acquiring the capabilities they lack, following Gomes-Casseres model. On the other hand, it may be designed as a defensive move to fend off backward-vertical integration by their large customers. Customers who could easily become rivals or who would swallow them up if they were not totally satisfied with the products and services they receive from these small independent firms.

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