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To Be Footloose or Committed to Local Markets?

Firms can exploit location-specific advantages or they can obtain operational flexibility to reap changing advantages from multinationality – but they cannot do both at the same time

by Torben Pedersen

The literature on the advantages of multinationality points to a number of potential benefits coming with the internationalization of the firm, i.e. sources of competitive advantage that are not available to domestic firms. These benefits include different ways to leverage diversity across borders when firms expand internationally. One type of benefit is associated with risk reduction, as internationally diversified firms have the opportunity to swap their activities between locations as a response to asynchronous business cycles, changes in currency or regulation etc. (1). International diversification will also enable firms to cross-subsidize activities across locations through tax planning and transfer pricing (2). Furthermore, multinational firms will be able to

(1) B. Kogut, «Designing Global Strategies: Comparative and Competitive Value-Added Chains», *Sloan Management Review*, 26(4), 1985, pp. 15-28.

(2) A.M. Rugman, «Risk Reduction by International Diversification», *Journal of International Business Studies*, 7(2), 1976, pp. 75-80.

exploit differences in comparative advantage and endowments of production factors across countries, e.g. through access to cheaper materials and labor costs (3). Finally, international diversification might also provide access to specialized resources in foreign locations (4). The underlying argument is that a location's particular profile provides its firms with different opportunities and exposures that can be leveraged by firms that expand into the particular location. In his classic twin articles on designing global strategies, Kogut elaborates on both these mechanisms of gaining operational flexibility and acquiring location-specific advantages (5).

Theoretically, the advantages of multinationality have been conceptualized to include these two broad – and largely inconsistent – benefits: increased operating flexibility to respond to external shocks, and access to new resources by tapping into location-specific advantages. While each of these arguments is appealing to scholars and managers, and accordingly well established in the literature (6), I posit that they are inherently contradictory as they make implicit and divergent assumptions about the configuration of the firm's international activities. If a firm wishes to reap the full benefits of diverse location-specific advantages, it must strive to eliminate redundancies and concentrate each activity in the one location where it is performed most efficiently and effectively – in other words, it must pursue a high degree of *specialization* of specific activities to certain locations. However, if it wishes to achieve operational flexibility, it is vital that each activity is performed in multiple locations, and that each location contains multiple activities, so that business can be shifted from one location to another in response to external fluctuations and shocks – suggesting that it applies a strategy of *replication* of its productive activities across locations. The configurational requirements for the two strategies are divergent since an activity cannot at the same time be specialized to a certain location and replicated across locations.

A key point is therefore that firms cannot pursue all these potential benefits at the same time, since the configurational requirements differ. In order to reap the benefits of risk reduction and cross-subsidization, a firm needs to build a global network so it can easily swap its activities between different locations, an approach that entails a replication strategy where each activity is performed in multiple locations. While aiming to exploit differences in factor endowments and accessing unique knowledge in foreign locations require that firms concentrate their activities in these specific locations and avoid redundant activities in their global network, entailing a specialization strategy where each activity is conducted in separate locations. The trade-offs between the different strategic goals of international diversification strategy were already highlighted by Ghoshal:

«A global strategy requires that the firm should carefully separate different value elements, and should locate each activity at the most efficient level of scale in the location where the activity can be carried out at the cheapest cost […]. Such a strategy may, however, increase both endogenous and exogenous risks for the firm […]. Similarly, consideration of the learning objective will again contradict some of the proclaimed benefits of a global strategy» (7).

In a typology of global strategies, Porter distinguished between two alternative ways in which the international firm could configure its value chain: a concentrated configuration where each activity is consolidated in one or a few locations, and a dispersed configuration where each activity is conducted in many locations and potentially everywhere the firm has operations (8). I posit that this distinction reflects a more general choice between two fundamentally different strategies of international diversification that I call *replication* and *specialization*, and demonstrate how the choice between these strategies moderates the performance effects of internationalization.

Replication and flexibility

International diversification offers the potential for obtaining operating flexibility as the presence in different locations allows firms to

(3) B. Kogut, «Designing Global Strategies: Profiting from Operational Flexibility», *Sloan Management Review*, 27(1), 1985, pp. 27-38.
(4) J.H. Dunning, «The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions», *Journal of International Business Studies*, 19(1), 1988, pp. 1-31.
(5) B. Kogut, «Designing Global Strategies: Comparative and Competitive Value-Added Chains» cit.; Id., «Designing Global Strategies: Profiting from Operational Flexibility» cit.
(6) *Ibidem*.
(7) S. Ghoshal, «Global Strategy: An Organizing Framework», *Strategic Management Journal*, 8(5), 1987, p. 437.
(8) M.E. Porter, *Competition in Global Industries*, New York, Free Press, 1986.

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International diversification enhances the firm's ability to gain access to diverse but specialized resources

change their configuration on relatively short notice and at low cost in order to adapt to or take advantage of uncertainty (9). This might be a response to asymmetric changes across locations (e.g. in political regulations, currencies, interest rates, taxes, input costs and prices, wage rates, and natural disasters etc.). Further, by operating in markets whose economic cycles are uncorrelated, firms should benefit from lower volatility in returns and thus lower risk (10). Basically, the international diversification provides firms with an easier option to opt in or out of the different locations, by scaling their local activities up or down. The main assumption behind this is obviously that firms' international activities are relatively footloose, so they can easily substitute one location for another. As the main benefit of operating flexibility is to make firms less exposed to one (or a few) location(s) and provide valuable real options to swap away from less attractive locations or industries as a response to external changes, the benefits of flexibility should mainly emerge as a driver of firm value in terms of reduced risk.

Specialization and location-specific advantages

The mechanism of tapping into location-specific advantages is almost the opposite, as it is argued that firms benefit from local embeddedness and from committing an activity to a specific location so as to enable it to tap into the specialized resources of that particular location (11). The location-bound resources might be in the form of unique (cluster) knowledge, highly talented people, cheap labor, or access to new markets. Here the advantages arrive through committing irreversible investments to particular locations that offer attractive resources and learning opportunities, since exposure to a different basis of competition gives firms an opportunity to adopt, recombine, and leverage new ideas for their own advantage. The assumption is that the more engaged and embedded the firm is in the particular location, the easier it will be able to get access to the diverse and specialized resources provided by this location. Combined with local commitment, international diversification enhances the firm's ability to gain access to diverse but specialized resources and increase its learning opportunities across locations and industries (12). The benefits of tap-

(9) B. Kogut, «Designing Global Strategies: Profiting from Operational Flexibility» cit.
(10) W.C. Kim, P. Hwang, W.P. Burgers, «Multinationals' Diversification and the Risk-Return Trade-Off», *Strategic Management Journal*, 14(4), 1993, pp. 275-86; A.J. Mauri, «Influence of MNC Network Configuration Patterns on the Volatility of Firm Performance», *Management International Review*, 49(6), 2009, pp. 691-707.
(11) B. Kogut, «Designing Global Strategies: Comparative and Competitive Value-Added Chains» cit.
(12) R. Nobel, J. Birkinshaw, «Innovation in Multinational Corporations: Control and Communication Patterns in International R&D», *Strategic Management Journal*, 19(5), 1998, pp. 479-96.

ping into location-specific advantages, which may serve to support the competitive advantage of the firm, are therefore expected to emerge as better firm profitability.

Essentially, I argue that by internationalizing, firms can exploit location-specific advantages or they can obtain operational flexibility to reap changing advantages from multinationality, but they cannot do both at the same time simply because the configurational requirements make these two mechanisms of internationalization mutually exclusive. Hence, the challenge for managers is to determine which of these aspects is most important for the industry and the strategic situation that they find themselves in, or perhaps to strike an optimal balance between these opposing objectives in the sense that their firms are specialized enough to exploit the most important location-specific resources while at the same time being replicated enough so as to not to be too exposed to the specific risk factors in those locations. ■

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In sintesi

- La letteratura ha tradizionalmente riconosciuto alle imprese multinazionali **due diverse tipologie di vantaggio competitivo** rispetto a quelle presenti in un solo paese: da un lato una maggiore flessibilità operativa nel rispondere alle fluttuazioni e agli shock esterni e dall'altro la possibilità di ottenere accesso a nuove risorse location-specific. Queste due tipologie di vantaggio sono tra loro mutualmente esclusive e implicano due distinte configurazioni d'impresa. Per questa ragione, un'impresa multinazionale non può perseguire contemporaneamente tutti i potenziali benefici dell'internazionalizzazione: è necessario scegliere se attuare una strategia di specializzazione o al contrario una strategia di replicazione.
- Per sfruttare al meglio le opportunità legate a risorse location-specific (come la presenza di unique cluster knowledge, di individui altamente qualificati, di forza lavoro a basso costo ecc.), **l'impresa deve perseguire una strategia di specializzazione**, concentrando ciascuna attività in un solo sito, laddove essa può essere svolta con la massima efficacia ed efficienza, in modo tale da garantire una migliore profittabilità. Questa strategia presuppone che tanto più un'impresa è radicata in un determinato contesto, tanto meglio potrà sfruttarne le specifiche risorse e opportunità.
- Per godere di flessibilità operativa, **le attività produttive devono invece essere replicate in più siti**, garantendo così all'impresa la possibilità di spostarle rapidamente e a basso costo da un sito all'altro in risposta a shock esterni (a livello di quadro regolamentare, di tassi di cambio, di tassi di interesse ecc.), contribuendo di conseguenza a una riduzione del rischio. Questa strategia presuppone che le attività dell'impresa siano libere da vincoli che possano ostacolarne la replicazione e lo spostamento da un sito all'altro.
- **La strategia di specializzazione si associa a una configurazione d'impresa concentrata**, per cui ciascuna attività viene svolta in uno, o al massimo pochi siti, mentre **quella di replicazione si associa a una configurazione d'impresa dispersa**, per cui ciascuna attività viene portata avanti in più (se non in tutti) i siti dove la multinazionale è presente.
- La sfida per i manager è quindi determinare **quale delle due opzioni sia la più appropriata rispetto al proprio settore di riferimento e alla propria situazione strategica**. Una strada potrebbe essere quella di avere un'impresa sufficientemente specializzata da poter sfruttare le principali risorse location-specific, e contemporaneamente di garantire un livello di replicazione delle attività tale da far sì che l'impresa non sia troppo esposta ai fattori di rischio specifici dei diversi paesi in cui opera.