

ORGANIZATIONAL LEARNING BY CHINESE FIRMS INVESTING ABROAD

by

Marjories Lyles and Dan Li
Kelley School of Business
Indiana University

Paper prepared for the conference, “US-China Business Cooperation in the 21st Century: Opportunities and Challenges for Entrepreneurs,” Indiana University, Indianapolis and Bloomington, Indiana, April 15-17, 2009.

Since the early 1990s, there has been an upsurge in outward FDI by emerging market firms (Luo & Tung, 2007; UNCTAD, 2008). In the United States, for example, Mexican building materials company CEMEX acquired the Balcones plant in 1994; Chinese white-goods manufacturer Haier Group set up a wholly-owned factory making mini-refrigerators in 2000; Chinese firm Lenovo acquired IBM's personal computer business in 2005; and Indian Tata Group acquired Eight O'Clock Coffee in 2006. Whether and how the multinational firms from emerging markets will become globally competitive are of great interest to scholars from many disciplines.

Theorists have suggested that the most important asset for firms is knowledge and the most important capabilities are how to learn and to utilize that learning (e.g., Grant & Baden-Fuller, 1995; Petersen, Pedersen & Lyles, 2008). Both the resource-based view and international business literature have recognized firm-specific resources and advantages as critical determinants of firm internationalization (Barney, 2001; Dunning, 1980). However, as latecomers to the internationalization process, emerging market firms face substantial challenges, arising from lack of capabilities of managing foreign subsidiaries, unfamiliarity with local customs and regulations, lack of legitimacy in the host country, and liabilities associated with weak institutions at home (Bartlett & Ghoshal, 2000). One possible rationale for emerging market firms' decision to take on all the challenges is to learn about advanced technologies, managerial skills, and/or global markets.

Our understanding of the learning process by multinationals originating from emerging markets remains limited. It is unclear what learning emerging market firms achieve in their internationalization. What factors reduce the knowledge gap of these latecomers in the

international markets and assist them to survive and possibly become globally competitive? What implications does the new knowledge have for their performance in and outside of China?

Our project focuses on China, the largest and latest emerging market to begin to move outside its borders. We investigate the organizational learning processes (absorptive capacity and innovation processes) by Chinese enterprises as they move abroad. Specifically, we ask what have Chinese firms learned/intended to learn from their internationalization, what factors can significantly reduce the knowledge gap for Chinese firms operating in foreign markets, and what kinds of learning experience improve the performance of Chinese firms entering developed vs. emerging markets. For this project, we argue that China's increasing direct investment abroad is increasingly economically than politically driven. We propose that the learning experiences of the Chinese enterprises with foreign firms both inside and outside China will impact their performance and innovativeness abroad.

THEORETICAL FRAMEWORK

Experiential vs. Experimental Learning by Chinese Multinationals

International knowledge (i.e., knowledge about international markets and operations) and the efficiency by which international knowledge is learned remain important determinants of internationalization. As stated by Autio, Sapienza and Almeida (2000: 911), firms must “apprehend, share and assimilate new knowledge in order to compete and grow in markets in which they have little or no previous experience.” The critical role of learning such international knowledge has been widely recognized in the international business literature. Johanson and Vahlne (1977) drew upon the works of Cyert and March (1963) and Aharoni (1966) and developed a process model best known as the “Uppsala model.” This model postulates that firms internationalize incrementally and international business knowledge or “foreign organizing

knowledge” is an experience-based accumulation. Since the development of the Uppsala (experience-based) model, research on internationalization processes has attracted enormous scholarly attention. The *experiential learning* perspective is exemplified by numerous scholarly studies (e.g., Eriksson, Majikgard, & Sharma, 2000; Gankema, Snuif, & Zwart, 2000; Johanson & Vahlne, 1977; Kwon & Hu, 2001) and innovation-related models (e.g., Bilkey & Tesar, 1977; Cavusgil, 1980, 1984; Czinkota, 1982; Reid, 1981). Although these traditional models of internationalization have been challenged by the emerging literature on international entrepreneurship examining why so many entrepreneurial firms “leap through” stages of internationalization and go international at very early ages (see for example Brush, 1992; McDougall, Shane, & Oviatt, 1994; Oesterle, 1997; Oviatt & McDougall, 1994, 1997), the role of learning about international markets and internationalization process remain influential.

The lack of experience and knowledge of Chinese firms in foreign operations creates a high liability of foreignness for Chinese firms in the foreign markets, especially in developed countries such as the U.S. It hinders their ambition to establish themselves with foreign consumers. Therefore, although we may expect more outward investment flow from China to the United States and other developed and developing countries, it may take the Chinese firms longer than their Japanese or Korean counterparts such as Toyota and Samsung to become main players in corporate America because of their lack of experience and their lack of partnering skills that might have allowed important knowledge to be transferred. In fact, our early research suggests that although the Chinese are fast learners, it may take as long as twenty years for the Chinese outward investments in business ventures to pay off.

We argue that *experiential learning* is one type of learning mechanism that Chinese firms adopt to prepare for internationalization. Learning about international markets and operations

starts prior to Chinese firms' first step abroad. First, joint ventures, contractual alliances and outsourcing with foreign firms in China enable Chinese firms to learn about product information for international markets and about business practices of foreign firms. Second, China's history of investing in less developed markets such as Vietnam, South America, Romania and Africa has accumulated knowledge about managing and coordinating foreign subsidiaries. Although such knowledge may be locally bounded to the weak institutional environment in these countries, the experience of operating in two or more countries challenges Chinese firms to address issues such as subsidiary-headquarters relationships and alternative governance structures. Third, with the Chinese government's directive for more firms to "go global," central and local governments and trade/investment institutions now offer seminars, training sessions and even a small amount of financial support for Chinese firms to acquire knowledge about international market demands, regulations by host governments, business environment (e.g., culture, infrastructure, labor market, etc.) etc. All these experiences within China contribute to the Chinese firms' knowledge base for going abroad, that is, to build upon the international knowledge base that they have already established from "international experience in China."

***Hypothesis 1:** Prior learning structures and mechanisms, organizational flexibility and formal learning goals are positively associated with new learning by the Chinese firms as they move abroad.*

***Hypothesis 2a:** Past and current interactions and partnerships with firms from developed countries is positively associated with learning by the Chinese firms abroad.*

***Hypothesis 2b:** Deeper relationships such as specialization of partner roles, managerial involvement with foreign partners (vs. simply outsourcing), and foreign parent training in China is positively associated with learning by the Chinese firms abroad.*

Hypothesis 3: *Previous outward FDI experience is positively associated with learning by the Chinese firms.*

Hypothesis 4: *Chinese firms who have prior outward FDI experience in developed countries will find it easier to do outward FDI in developed countries than those which have outward FDI experience in developing countries.*

Hypothesis 5: *Chinese firms with outward FDI in developed countries will have knowledge transfer back to the Chinese headquarters and will show improved performance within China and with its future outward FDI strategies.*

We further argue that some Chinese multinationals also learn through *experimental learning*. We define experimental learning as learning through experimentation, improvisation, or even mistakes. For latecomers into the internationalization process, timing is critical for Chinese multinationals. However, some emerging challenges may take a long time for Chinese firms moving globally to overcome, such as how to manage headquarter-subsidiary relationship, how to implement alternative governance structures, how to synthesize knowledge obtained from different countries, how to effectively run global teams for product design, development, and markets, and how to adapt to foreign culture in a timely manner. Thus, Chinese firms may “jump in” and improvise what to do. Experimental learning requires these Chinese firms to be spontaneous in nature and innovative in real time. Such experimental learning is riskier than experiential learning and takes more resources to be successful. Our early interviews have indicated this type of learning mechanism by internationalizing Chinese firms exists, and it seems that firms with a strong entrepreneurial orientation have experienced this type of learning. Also having experiences with foreign firms in China and the encouragement of government support means that they are more likely to be “adventuresome” than their counterparts.

Hypothesis 6: Entrepreneurial orientation is positively associated with Chinese firms' experimental learning abroad.

Hypothesis 7: Prior experience with foreign firms (through joint ventures or alliances) is positively associated with Chinese firms' experimental learning abroad.

Hypothesis 8: Government support is positively associated with Chinese firms' experimental learning abroad.

Empirically, we investigate the learning outcome by Chinese multinationals by examining the learning of technology, managerial skills, host market, and general international business.

Performance Implications

The internationalization and firm performance relationship has been addressed extensively in the literature (for recent contributions, see for example Capar & Kotabe, 2003; Contractor, Kundu & Hsu, 2003; Lu & Beamish, 2004; Ruigrok & Wagner, 2003; Thomas & Eden, 2004; Annavarjula, Beldona & Sadrieh, 2005). Different forms of relationships have been reported – downward slope, “J” shaped, or “S” shaped. We argue that one critical factor of the internationalization-performance relationship is learning. The Uppsala model for instance is based on the assumption of successful past experiences what would enable the next step toward internationalization. However, learning may or may not take place or be successful. For Chinese firms, we argue that learning outcome mediates the internationalization-performance relationship and propose the following hypotheses.

Hypothesis 9: Learning of technologies abroad is positively related to Chinese firms' performance in China.

Hypothesis 10: Learning of managerial practices abroad is positively related to Chinese firms' performance outside of China.

Hypothesis 11: Learning about host markets is positively related to Chinese firms' performance outside of China.

Hypothesis 12: Learning mechanisms affect Chinese firms' performance abroad in that experiential learning is likely to be associated with short-term performance while experimental learning is likely to be associated with long-term performance.

RESEARCH DESIGN

We started our project in late 2007 and proposed two phases to meet the research goal. We proposed Phase One was composed of structured-interviews in China that assess organizational learning and absorptive capacity in Chinese firms making outward foreign investment decisions. We conducted interviews in Jiangsu Province, Zhejiang Province, Shanghai, and Beijing in September 2008: 10 interviews with executives of Chinese firms with overseas investment; 5 meetings with government officials at the county, city and provincial levels to gain the comprehensive picture of Chinese firms' outward investment; and 3 interviews with institution candidates for data collection. Executives interviewed are either former-expats or in charge of their companies' international business.

This phase made important contributions of its own by adding eight detailed case studies of Chinese firms making the FDI decisions and beginning the process of establishing subsidiaries outside of China. It assessed the learning, unlearning and innovation processes from data collected about the firm's past experiences of the firms, their partnering activities, and their decision-making process of moving outward. Chinese firms seem to be having strong learning

intent when investing in developed markets, yet have experienced extremely high hurdle of learning achievement. As we have theorized, experimental learning seems to be occurring often in firms with strong entrepreneurial orientation and/or government support. Some companies have even developed formal routines/practices to absorb what has been learned through their overseas operation. We also found that motivations for Chinese firms to invest abroad are much more complicated than those for developed country firms, and that government support, particularly financial support, does not seem to be as prevalent as prior research has suggested, particularly for medium-sized firms. We completed this phase at the end of October, 2008. We thank the gracious support from the *CIBER* at Indiana University, the *Office of VP of International Affairs* and *Zhejiang University*, China, during this phase of our research.

Phase Two consists of surveying Chinese firms from Zhejiang, Jiangsu and Wuxi provinces, Beijing, and Shanghai that have made outward foreign investments. One of the challenges when researching organizations in transitional or emerging markets is the absence of reliable archival data on those organizations. There is no Compustat equivalent nor is reliable firm-level data available from the government. Researchers examining those organizations must collect their own data through surveys or interviews. We are now in the middle of Phase Three and expect the completion of this stage by the end of May, 2009. Financial support from the *Research Center of Chinese Politics & Business* at Indiana University is essential during this phase of our research.

REFERENCES

- Aharoni, Y. 1966. *The Foreign Investment decision Process*. Boston: Division of Research, Graduate School of Business Administration, Harvard University.
- Annavarjula, M., Beldona, S., & Sadrieh, F. 2005. Corporate performance implications of multinationality: The role of firm specific moderators. *Journal of Transnational Management Development*, 10(4), 5-33.
- Autio, E., Sapienza, H.J., & Almeida, J.G. 2000. Effects of age at entry, knowledge intensity, and imitability on international growth. *Academy of Management Journal*, 43: 909-924.
- Barney, J.A. 2001. The resource-based view of the firm: Ten years after 1991. *Journal of Management*, 27: 625-641.
- Bartlett, C., & Ghoshal, S. 2000. Going global: Lessons from late movers. *Harvard Business Review*, 78(2): 132-142.
- Bilkey, W.J., & Tesar, G. 1977. The export behavior of smaller-sized Wisconsin manufacturing firms. *Journal of International Business Studies*, 8(1): 93-98.
- Brush, C. G. 1995. *International Entrepreneurship: The Effect of Firm Age on Motives for Internationalization*, New York: Garland Publishing, Inc.
- Capar, N., & Kotabe, M. 2003. The relationship between international diversification and performance in service firms. *Journal of International Business Studies*, 34 (4): 345-355.
- Cavusgil, S.T. 1980. On the internationalization process of firms. *European Research*, 8(6): 273-281.
- Cavusgil, S.T. 1984. Differences among exporting firms based on their degree of internationalization. *Journal of Business Research*, 12(2): 195-208.
- Contractor, F.J., Kundu, S.K., & Hsu, C-C. 2003. A three-stage theory of international expansion: the link between multinationality and performance in the service sector. *Journal of International Business Studies*, 34 (1): 5-18.
- Cyert, R. M., & March, J. G. 1963. *A Behavioral Theory of the Firm*. Englewood Cliffs, NJ: Prentice-Hall.
- Czinkota, M. 1982. *Export Development Strategies*. New York: Praeger.
- Eriksson, K., Majkgard, A., & Sharma, D. D. 2000. Path dependence and knowledge development in the internationalization process. *Management International Review*, 40: 307-328.
- Gankema, H., Snuif, H., & Zwart, P. 2000. The international process of small and medium-sized enterprises: An evaluation of stage theory. *Journal of Small Business Management*, Oct.: 15-27.
- Grant, R. M., & Baden-Fuller, C. 1995. A knowledge-based theory of inter-firm collaboration. *Academy of Management Journal*. 17-21.
- Johanson, J., & Vahlne, J.-E. 1977. The internationalization process of the firm - A model of knowledge development and increasing foreign market commitments. *Journal of International Business Studies*, 8(Spring/Summer): 23-32.
- Kwon, Y., & Hu, M. Y. 2001. Internationalization and international marketing commitment: The case of small/medium Korean companies. *Journal of Global Marketing*, 15 (1): 57-66.
- Lu, J. W. & Beamish, P. W. 2004. International diversification and firm performance: The S-Curve Hypothesis. *Academy of Management Journal*, 47 (4): 598-609
- Luo Y, Tung R. 2007. International expansion of emerging market enterprises: A springboard

- perspective. *Journal of International Business Studies*, 38: 481-498.
- McDougall, P. P., Shane, S., & Oviatt, B. M. 1994. Explaining the formation of international new ventures: The limits of theories from international business research. *Journal of Business Venturing*, 9: 469-487.
- Oesterle, M.J. 1997. Time span until internationalization: Foreign market entry as a built-in mechanism of innovations. *Management International Review*, 37 (2): 125–149.
- Oviatt, B. M., & McDougall, P. P. 1994. Toward a theory of international new ventures. *Journal of International Business Studies*, 25: 45-65.
- Oviatt, B. M., & McDougall, P. P. 1997. Challenges for internationalization process theory: The case of international new ventures. *Management International Review*, 37: 85-99.
- Oviatt, B. M., & McDougall, P. P. 2005. Defining international entrepreneurship and modeling the speed of internationalization. *Entrepreneurship Theory & Practice*, September: 537-553.
- Petersen, B., Pedersen, T., & Lyles, M. 2008. Closing Knowledge Gaps in Foreign Markets. *Journal of International Business Studies*. 39(7): 1097-1113.
- Reid, S.D. 1981. The decision-maker and export entry and expansion. *Journal of International Business Studies*, 12(Fall): 101-112.
- Ruigrok, W. & Wagner, H. 2003. Internationalization and performance: an organizational learning perspective. *Management International Review*, 43 (1): 63-83.
- Thomas, D. E., and Eden, L. 2004. What is the shape of the multinationality-performance relationship? *Multinational Business Review*, 12 (1): 89-110
- UNCTAD. 2008. *World Investment Report*. Geneva: UNCTAD.