

# Multinational corporation internationalization in the service sector: a study of Japanese trading companies

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## Abstract

This paper extends Chang's (1995) sequential investment theory to include multinational corporations (MNCs) in service industries, given this sector's large and growing impact on the global economy. To facilitate an examination of service MNC internationalization patterns, we develop a new typology of service investment (i.e., *core-global*, *related-local*, *unrelated-global*, and *unrelated-local*) based on business relatedness and location-specificity. We test this typology on a sample of large Japanese trading companies; our results suggest that the initial investments of service MNCs are closely related to their core businesses and are less location-specific, but that subsequent investments are less related to firms' core services and are more location-specific - a pattern similar to the traditional view on manufacturing MNCs. We extend our analysis to examine several case studies to provide a richer context for these findings. In addition, we examine the performance implications of internationalization. Our findings suggest that firms that internationalize through early investments that are closely related to their core activities outperform those in unrelated businesses over time, but that this performance gap between related and unrelated foreign investments diminishes in more advanced stages of internationalization.

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## Introduction

Chang's (1995) work is an important contribution that extends Johansson and Vahlne's (1977, 1990) sequential investment theory by combining it with resource-based theories in the study of foreign direct investment (FDI). By focusing on the sequence in which firms add lines of business, Chang (1995) examines the foreign entries of Japanese electronics manufacturers in the US between 1976 and 1989. He discovered that Japanese manufacturers first internationalized their core businesses and those in which they had a strong competitive advantage over local firms; learning from these early entries enabled them to launch further entries into non-core businesses and into areas of weaker competitive advantage. Thus, in contrast to Western firms that often make big investments in a short period (Rosenzweig, 1993, 1994), Japanese companies appear to favour an 'evolutionary' approach (Kagano *et al.*, 1985) by making frequent small investments made over a long period.

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In Chang's (1995) theoretical framework, firms sequentially approach foreign entry with learning gained from prior entry experience. As observed by many scholars, however, the majority of research on multinational corporation (MNC) foreign entry has focused on extractive or manufacturing firms (e.g., Boddewyn *et al.*, 1986; Enderwick, 1989, 1992; Habib and Victor, 1991; Li and Guisinger, 1992; Campbell and Verbeke, 1994; Li, 1994; Aharoni, 1996), despite the fact that the service sector has become increasingly important in world trade. In fact, one of the most important international business trends is the growing proportion of trade in services: in the 1990s, for example, over 50% of global FDI was in the service sector (Wirjanto, 1997). Further, according to the World Bank, 'the internationalization of services is at the very core of economic globalization. Service industries provide links between geographically dispersed economic activities and thus play a fundamental role in the growing interdependence of markets and production activities across nations' (Braga, 1996: 1). Yet 'little is known about the pattern and determinants of international expansion strategies in service industries' (Li, 1994: 218). As suggested by Capar and Kotabe (2003) as well as Hitt *et al.* (2006), to improve our understanding of this key sector of the global economy, research is needed that focuses specifically on MNCs engaged in the delivery of services.

Although previous research has examined service MNCs from various perspectives, including their characteristics<sup>v</sup> (Cho, 1987; Balabanis, 2000), motives for foreign expansion (Li and Guisinger, 1992) and correlates of performance (Katrishen and Scordis, 1998), very little research has directly examined the patterns of service MNC internationalization (for an exception see Hurry *et al.* (1992), who focus on Japanese high-tech venture capital firms). To address this gap, therefore, this paper will unfold as follows. First, we will review prior theoretical work on service *vs* manufacturing firms. Then, following Chang's (1995) approach, we will develop a conceptual framework on service MNC internationalization patterns by combining Johansson and Vahlne's (1977, 1990) sequential investment theory with Kogut and Zander's (1992, 1993) theory of knowledge transfer. Subsequently, we present a sequential order of five major Japanese trading firms, using the empirical method developed in previous research (Davidson, 1980a,b), followed by a discussion and conclusion with limitations, managerial implications, and suggestions for future research.

## Previous literature on service vs manufacturing MNCs

A current debate among international business scholars concerns the extent to which MNCs engaged in the delivery of services are different from those involved in manufacturing. Several scholars have suggested that the international expansion strategies of service MNCs may differ from those of manufacturing MNCs, because of the unique characteristics of service industries (e.g., Habib and Victor, 1991; Li, 1994; Aharoni, 1996; Aung and Heeler, 2001; Capar and Kotabe, 2003). These unique characteristics have been discussed by many authors (e.g., Boddewyn *et al.*, 1986; Enderwick, 1989, 1992; Hirsch, 1993; Campbell and Verbeke, 1994), and therefore only a very brief review is necessary here. According to scholars of the service industry, there are several key dimensions of services, as summarized in Table 1. Of the key attributes indicated in Table 1, the most prominent differences involve the intangible nature of services and the simultaneous production and consumption processes due to the impossibility of inventory in services (Habib and Victor, 1991; Gummesson, 1997).

Notwithstanding these differences, however, several studies have found that there are many important parallels between the delivery of services and the production of manufactured goods. For example, Li and Guisinger's (1992) analysis of the international behavior of 168 large service MNCs in nine service industries between 1976-1980 and 1980-1986 in Japan, Western Europe, and the US suggested that service MNCs follow their competitors (both domestic and international) in

**Table 1** Key service attributes

Characteristic	Description
Intangibility	Skills-based competence; proprietary assets are difficult to transfer to third party
Inseparability	Production and consumption occur simultaneously; close consumer interaction
Heterogeneity	Consumer participates in tailored production; quality is difficult to control
Perishability	Supply/demand asymmetry leads to capacity underutilization; service cannot be placed in inventory to meet future demand
Regulation	Services have long been highly controlled and regulated by governments

going abroad as a defensive strategy - a result that is consistent with findings of the international behavior of manufacturing firms (Mitchell *et al.*, 1992; Martin *et al.*, 1998; Chan *et al.*, 2006; Chan and Makino, 2007).

Thus service MNCs may use internalization to overcome imperfections in the markets for their services, in much the same way that manufacturing MNCs create internal markets to overcome imperfect world good and factor markets (Rugman, 1981: 89; also Gray and Gray, 1981; Pecchioli, 1983; Wells, 1983; Yannopolous, 1983). Although current theories of FDI and the MNC may have broad applicability to the service industry, Boddewyn *et al.* (1986), Aharoni (1996), and others have cautioned that this must be done with extreme caution, because in recent years service sectors have grown and changed; specifically with respect to the internationalization process, global service MNCs may have become multinational for different reasons and in different ways than manufacturing firms (Lovelock and Yip, 1996; Katrishen and Scordis, 1998; Capar and Kotabe, 2003).

In general, MNCs can choose from three basic modes to serve overseas markets: exporting, FDI, and various non-equity arrangements including licensing and management contracts. There is a great deal of evidence to indicate that creating a local presence in a given host country is much more common for service firms than for manufacturers (Enderwick, 1989). There are several reasons for the propensity of service MNCs to choose FDI: the primary reason is that, in many cases, providing their service from afar is not a viable alternative. The underlying reason for this is that a key attribute of services, as summarized in Table 1, is that of inseparability, given that production and consumption occur simultaneously, requiring very close customer contact. Thus, for most services, a local presence is necessary.

A second reason why FDI is more common among service MNCs is that non-equity arrangements are not very efficient, often because all service skills are intangible, making them difficult to transfer to third parties without significant transaction costs. Moreover, within information-intensive service businesses such as banking, for example, valuable knowledge is generated in the course of doing business, making it imperative to remain closely involved in location-bound activities on an ongoing basis. Further, in other businesses such as car rental and advertising, for

example, the critical importance of maintaining quality to protect the brand makes third-party involvement less desirable.

Whereas the typical sequence of foreign expansion in manufacturing starts with *ad hoc* exports, progressing to exports via an intermediary, then a sales subsidiary, and finally FDI, service MNCs must often skip over the first several stages, since the nature of service output often does not lend itself to gradualism in overseas operations. Service MNCs are therefore unable to gain overseas market experience without establishing a local presence. This need is compounded by the requirement to establish strict and immediate quality standards for many services. Thus it may be that 'some services require FDI ... from the very beginning' (Boddewyn *et al.*, 1986: 43), rather than following the well-researched pattern of manufacturing MNCs.

Sharma and Johansson (1987) provided some evidence of the difference between service and manufacturing MNC internationalization in their examination of the internationalization of two Swedish technical consultancy firms. Their results indicated that manufacturing MNCs are less mobile and versatile, given that their typically large fixed asset investments in a particular location create a significant and specific commitment to the manner of production. Sharma and Johansson (1987) suggest that, in contrast, the market specificity of service MNC investments is relatively low: the production of many services can therefore be moved rapidly, and at comparatively low cost. Similarly, Katrishen and Scordis (1998) indicated in their study of multinational insurance firms that service firms are liable to suffer from diseconomies of scale as multinationality increases. Part of the reason that underpins this finding may be the greater local adaptation that is required of service firms compared with manufacturers (Patterson and Cicic, 1995; Knight, 1999).

Taken together, prior theoretical and empirical work implies that the patterns of incremental resource commitment of service MNCs may not follow the well-researched patterns of manufacturing MNC internationalization, and that service MNCs face quite different strategic challenges from those faced by their manufacturing counterparts (Campbell and Verbeke, 1994). Thus this research examines the empirical question of whether the opportunities and constraints that shape service MNC internationalization lead to different patterns from those that have been found among manufacturing MNCs. From this perspective, we will

examine service MNC internationalization in the section below, developing a testable hypothesis on their patterns of foreign expansion.

### **Sequential investment theory of service MNC internationalization**

Internationalization theory (Johansson and Vahlne, 1977, 1990), the dominant theoretical perspective on MNCs' foreign investment growth, has focused on the interplay between international resource commitment and learning. The assumptions that underlie this perspective are that:

- (1) the lack of knowledge about foreign market constitutes 'psychic distance' in the minds of managers between the host and home countries;
- (2) local knowledge is acquired primarily through the accumulation of direct experience through current business activities in the foreign market; and
- (3) psychic distance becomes smaller as firms accumulate local knowledge through experience.

On this basis, this theory suggests that a firm's engagement in a foreign country (i.e., the internationalization sequence) typically starts with irregular exports, progressing to exports via agents, with the subsequent establishment of a sales subsidiary and then a manufacturing subsidiary. While Johansson and Vahlne (1990) have suggested that there may be certain exceptions,<sup>1</sup> internationalization theory has nonetheless been shown to be robust over time and across cultures (e.g., Johansson and Wiedersheim-Paul, 1975; Sharma and Johansson, 1987; Erramilli, 1991; Andersen, 1993).

An alternative perspective on the internationalization process is that it is a sequence of resource transfers, primarily of tacit knowledge, that in itself constitutes a key competitive advantage in a given foreign market (Kogut and Zander, 1992, 1993). This perspective is underpinned by three assumptions:

- (1) Firms can be viewed as social communities where knowledge is created, stored, and transferred.
- (2) The efficiency of knowledge transfer is determined by the extent to which it is tacit.
- (3) The firm's FDI depends on its capability to transfer tacit knowledge transfer across borders.

On this basis, Kogut and Zander (1993) suggest that the more tacit (i.e., less codifiable) knowledge is, the more likely it is that the transfer will be via internal means, for example, through a wholly

owned subsidiary. Zander and Kogut (1995) extend these ideas by suggesting that the degree of codifiability and teachability has a significant influence on the speed and efficiency of transfer.

Internationalization and knowledge transfer theories examine different, but complementary, elements of the internationalization process. Internationalization theory suggests that foreign expansion involves incremental commitments of resources due to the location-specific nature of operations, while assuming the effects of firm-specific characteristics of resources being transferred to be constant. Knowledge transfer theory, on the other hand, suggests that foreign expansion depends on the relative efficiency with which firm-specific knowledge is transferred within an MNC, while assuming location-specificity in foreign activities to be constant. Both of these theoretical perspectives suggest that a firm's process of FDI can be viewed as a logical, coherent sequence of incremental investments rather than as a more tentative process of discrete investment decisions.

To aid our analysis of service MNC internationalization, our study extends the concept of internationalization by combining these perspectives, postulating that firm internationalization is a function of the complementary process of discrete investments influenced by the transfer of firm-specific knowledge and the accumulation of location-specific knowledge. Transfer of firm-specific knowledge concerns the extent to which the core services of the source (i.e., a parent firm) and the services being transferred to the recipient (i.e., a foreign subsidiary) share common firm-specific characteristics. Acquisition of local knowledge concerns the extent to which the operations of the services being offered in a host country require location-specific experience.

In line with this reasoning, we propose that the internationalization process of service MNCs is dependent upon the combination of the relatedness and location-specificity of the services as key factors that define the relative efficiency with which knowledge can be transferred across borders. Thus we suggest that service MNCs first enter core businesses on which their initial competitive advantages are based; then they subsequently enter less related and more location-specific businesses as they accumulate local tacit knowledge.

The relatedness of services is based on the extent to which the services transferred to a foreign subsidiary are part of the core business of the firm.

Services firms could enter any of the following six major groups of business:

- production of a product (e.g., manufacturing, mining and resource, agriculture and fishery, and infrastructure development including construction/engineering, telecom, and power/gas);
- production of an independent customer service (e.g., insurance, professional services, hotel/restaurant, leisure/entertainment, transportation, warehousing/logistics);
- sale of products and services from retailers to consumers (e.g., retail);
- intermediary service between suppliers and retailers (e.g., trading firms, banking, investment office, and real estate trade);
- after-sale services (e.g., computer system and building maintenance);
- internal coordination (e.g., holding company and regional office).

In this study, we consider service firms' entry into the same business area as an entry into a core (related) business, and entry into different business areas as an entry into an unrelated business.

These six groups of business involve distinct activity patterns. The first two involve a 'creation' of new business. The next two groups involve different levels of 'transaction': the third a sale of goods (and services) to ultimate consumers, and the fourth a sale of goods to retailers for resale to the ultimate consumers. The fifth group involves the 'retention' of customer relationship. The sixth group involves an 'administrative' service used only within a firm. In the case of Japanese trading firms, since their core business (i.e., general trading) is part of intermediary service, those services that are classified as intermediary services are considered as their related businesses.

Location-specificity addresses the extent to which the services are difficult to transfer across borders owing to location-specific transactions and additional learning necessary in a given country. In this study, we define the extent of business location-specificity in terms of whether the users and/or suppliers of the business are found only in particular locations in a host country or whether they can be found anywhere (i.e., not tied to a specific location). Some services, such as trading of commodity goods, are less location-specific because suppliers (e.g., commodity producers) and customers (e.g., retailers) can be located anywhere. By contrast, in other services such as real estate, suppliers (e.g., owners of land) and customers

(e.g., property developers) are limited to certain locations and thus are location-specific. In services such as retail and commercial banking, suppliers (e.g., manufacturers and investors) are less location-specific, but customers must locate in the areas where the providers of these services locate their outlets (e.g., retail shops or bank branches). In services such as restaurant and building maintenance, both suppliers and service users tend to reside in nearby areas, and hence are location-specific.

Unfortunately, the list of service attributes developed by prior researchers (as shown in Table 1) does not identify the extent to which the knowledge that underpins these services is readily transferable across borders. Therefore, to understand the process of internationalization of service MNCs, we address this shortcoming by developing a new framework of service characteristics based on the degree of relatedness, varying from related to unrelated, and the degree of location-specificity, ranging from global to local. Based on these two dimensions, we propose four categories of services: *core-global*, *related-local*, *unrelated-global*, and *unrelated-local*.

Internationalization theory suggests that a firm's FDI occurs first in the lines of business that are less location-specific and subsequently in those that are more so. The knowledge transfer perspective, on the other hand, suggests that a firm's FDI occurs first in the lines of business that are close to its core business, and subsequently in unrelated lines of business. Building on these perspectives, we hypothesize that firms invest first in core-global services (i.e., those services that are close to the core business of the firm and less location-specific), subsequently into related-local services (i.e., those services that are location-specific yet close to the firm's core businesses) and unrelated-global services (i.e., those services that are unrelated to the core business of the firm yet are less location-specific), and ultimately into unrelated-local services (i.e., those services that are both location-specific and unrelated to the firm's core businesses), as depicted in Figure 1.

## Methods

### Research sample

We used the year 2000 volume of *Kaigai Shinshutsu Kigyou Soran - Kaisha-betsu*, published by Toyo Keizai (referred to hereafter as the TK database) to compile the list of foreign market entries of the largest Japanese trading firms (i.e., *sogo shosha*). The

Japanese service firms used in our analyses are the five largest Japanese trading firms: Mitsubishi, Sumitomo, Mitsui, Marubeni, and Itochu (C. Itoh). These firms had 208, 204, 250, 282, and 366 foreign subsidiaries, respectively, as of the end of 1999. As presented in the parent company profiles in Table 2, total sales of each company exceeded ¥8 trillion. The sum of total sales of the five Japanese trading companies, as of March 2003, represented about 11% of Japan's 2002 GDP of ¥499 trillion. The total number of foreign subsidiaries formed by the five companies in our sample represented 6.8% of all reported Japanese FDI across the world (1310 out of 19,197 cases) as of 1999. Thus our sample constitutes a large proportion of the services transferred abroad from Japan.

The TK data set provides subsidiary-specific information such as the timing of establishment (year and month), the primary businesses, and the location of operation. We used the timing of

establishment to define the order of entry, and the primary business to determine the service category. Some subsidiaries were established but subsequently terminated before the observation period (i.e., 1999). These subsidiaries were not listed in the year 2000 volume of the TK database and therefore were not included in our analysis. A recent study estimated the proportion of the terminated cases among the Japanese foreign subsidiaries in wholesale trade that appear in the TK database to be 4.7% (Makino *et al.*, 2004). We therefore decided that the relatively small portion of missing cases caused by termination would not be a significant problem in the interpretation of our results. The TK data set also provides a three-point self-report performance measure, which is coded 'gain', 'break-even', and 'loss'. To identify performance trends, we used the percentage of subsidiaries in the 'gain' category over the total count. Ten-year volumes of the TK data set (1992-2000) were used to examine how the performance of each service category changed over the period 1991-1999.

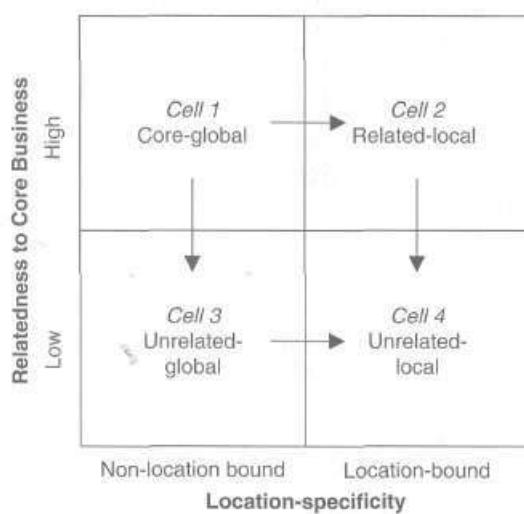


Figure 1 Classification of service category.

### Brief background information on Japanese trading companies

Japanese trading firms are involved in many different business activities. Their core business is general wholesale trading at different stages of the value chain, including market intelligence, raw materials purchasing, and final product marketing with an extensive range of export services (Yoshino and Lifson, 1986; Shao and Herbig, 1993). Japanese trading companies are most effective for undifferentiated products such as food commodities, raw materials, and standardized industrial goods (Roehl, 1982), and in many joint ventures OVs, these large-scale firms provide marketing and trading services and many other services such as financing, insurance, transportation, and warehousing (Maeda, 1990), with other firms supplying

Table 2 Sample company profiles (as of March 2003)

	Mitsubishi	Sumitomo	Mitsui	Marubeni	Itochu
Year of establishment	1950	1919	1947	1949	1949
Total sales (¥ billion)	13,328	16,139	17,035	14,918	16,670
Export sales (%)	61	n/a	60	53	39
Foreign sales (%)	31	31	43	50	35
No. of employees (HQs)	6,307	3,789	6,264	2,444	3,131
No. of employees (group total)	n/a	31,589	37,734	n/a	39,109
No. of subsidiaries <sup>a</sup>	208	204	250	282	366

<sup>a</sup>As of December 1999.

technical and production capabilities (Yoshihara, 1982; Kojima and Ozawa, 1984; Sarathy, 1985).

It is important to note that Japanese trading companies are involved in a wide variety of businesses. Yet even in cases in which they are invested in manufacturing ventures, for example, the role they play is one of purely service - primarily finance and marketing; whereas some of their various venture partners may be involved in the production of goods, the Japanese trading company role does not deviate from that of service provider. For this reason, we feel confident in characterizing Japanese trading companies as pure service firms across the wide range of their investments.

### Industry classification

Based on the information reported in the TK database, we identified 23 lines of services provided by Japanese trading companies. The list of the lines of businesses is provided in Table 3. These 23 lines of services are classified into one of our four service categories.

First, we classified wholesale trading in durable and non-durable goods as *core-global* services. Wholesale trade is the core business of Japanese trading companies, where they create the economic value by linking suppliers of goods with customers. Wholesale trade can be identified as a global (or non-location-specific) business, because the suppliers and customers involved in this activity can be found anywhere around the world.

Second, we classified trading for heavy/light/assembling industries, real estate trade, financing (i.e., banking), and investment office as *related-local* services. These services are related to Japanese trading companies' core businesses, as they involve the role of intermediary of goods, property, and financial assets between suppliers and customers (retailers). However, these services are location-specific in nature, as they are provided primarily to local production (e.g., trading for subsidiaries in heavy, light, and assembling industries) and local customers (e.g., trading partners operating in a host country, local property developers).

Third, we classified trans-Pacific transportation (air/sea transportation), warehousing/logistics, and holding office services as *unrelated-global* services. These services are unrelated to Japanese trading companies' core business, but the key transactions of these services are non-location-specific because the suppliers and/or the users of the services are not limited to particular locations, and the transactions

**Table 3** Service lines

Lines of services	Details
Trading	
Agriculture and fishery	
Mining and natural resources	
Trading for light/assembling industries	Trading for light manufacturing (food, metal products, pulp/papers, rubber/leather, stone/clay/glass, textile, timber/furniture) and assembling (automobile/parts, electronic products/parts, machinery, precision, shipbuilding)
Trading for heavy industries	Trading for heavy manufacturing (chemicals/pharmaceuticals, fabricated metal, metal products, oil/coal, steel), mining and resource, and construction/engineering
Financing	Banking, leasing
Real estate	
Retail	
After-sale services and maintenance services	
Insurance	Insurance carrier/broker/agent
Holding company	
Transportation: trans-Pacific	Air, sea transportation
Transportation: local	Bus, taxi, railway
Warehousing/logistics	
Investment office	
Regional HQ	
Professional services	Legal, accounting, consulting, market research
Telecommunication	
Power/gas	
IT/R&D	Information technology development, R&D office, computer software development, market planning
Leisure/entertainment	
Hotel/restaurant	

are made across borders. For example, services such as air and sea transportation services are provided either to customers who travel between countries or to customers who transfer goods from one country to another. Similarly, a holding office involves the coordination of geographically dispersed business units across borders.

Finally, we classified the remaining services - those services that are more location-specific and unrelated to their core business - as *unrelated-local* services. The nature of value creation in this type of service is based on the firm's capability to create

new, unrelated services for a particular local customer group. This category of services is self-sufficient in nature, because the creation and provision of these services are driven primarily by the subsidiary itself, and hence the transferability of the services across borders within an MNC would not be as efficient as for other service types. For example, services such as manufacturing and hotels are provided in a specific location and usually involve relatively a large resource commitment, which is less mobile across borders. Similarly, services such as retail trade, restaurants, and leisure/entertainment businesses target local and indigenous consumers, as do professional and personal services such as legal/accounting services and insurance agents. In this study, each

line of business was classified into one of our four service categories, as summarized in Table 4.

One critical methodological issue when classifying services is that the primary services engaged in by Japanese trading firms in their subsidiaries are not always consistent with the business description of these subsidiaries in the TK database. In manufacturing ventures, for example, Japanese trading firms are generally not directly involved in the manufacturing process. Typically, they form a JV with either Japanese or local manufacturing firms, playing the role of trading (purchasing raw materials and components and distributing final products) and capital supply within the JV. These subsidiaries should therefore be considered as entries into related-local rather than unrelated-local businesses.

**Table 4** Service classifications

Services	Relatedness	Location-specificity	Service category
<i>Production of a product</i>			
Manufacturing	Unrelated	Local	Unrelated-local
Mining and natural resources	Unrelated	Local	Unrelated-local
Agriculture and fishery	Unrelated	Local	Unrelated-local
Infrastructure development (construction/engineering, telecom, power/gas)	Unrelated	Local	Unrelated-local
Production of information and technology (information technology, R&D)	Unrelated	Local	Unrelated-local
<i>Production of independent services</i>			
Insurance	Unrelated	Local	Unrelated-local
Services (professional services, hotel/restaurant, leisure/entertainment)	Unrelated	Local	Unrelated-local
Transportation: local	Unrelated	Local	Unrelated-local
Transportation: trans-Pacific	Unrelated	Global	Unrelated-global
Warehousing/logistics	Unrelated	Global	Unrelated-global
<i>Sale of products and services to consumers</i>			
Retail	Unrelated	Local	Unrelated-local
<i>After-sale services</i>			
After-sale services and maintenance services	Unrelated	Local	Unrelated-local
<i>Intermediary services between suppliers and retailers</i>			
General trading	Core	Global	Core-global
Trading for heavy industries (heavy manufacturing, mining/resource, construction/engineering)	Related	Local	Related-local
Trading for light/assembling industries (light and assembling manufacturing)	Related	Local	Related-local
Investment office	Related	Local	Related-local
Financing (banking)	Related	Local	Related-local
Real estate	Related	Local	Related-local
<i>Internal coordination</i>			
Holding company	Unrelated	Global	Unrelated-global
Regional HQ	Unrelated	Local	Unrelated-local

To address this issue, we established the following procedure. First, we selected all subsidiaries whose core businesses were reported in the TK database as either heavy industry (e.g., chemicals/pharmaceuticals, fabricated metal, metal products, oil/coals, steel, mining/natural resources, and construction/engineering) or light and assembling industry (e.g., food, metal products, pulp/papers, rubber/leather, stone/clay/glass, textile, timber/furniture, automobile products, electronic products/parts, machinery, precision equipment, and shipbuilding). Then we selected the JVs in which Japanese trading firms held equity ownership of 5% or more. Using this group of JVs, we determined whether the trading firm's JV partner's core business was closely related to the reported primary business of the JV itself; if so, we considered the primary role of the Japanese trading firm to be that of providing purely trading services.

#### Order of entry

The order of entry was calculated using the foreign entry frequency method established in previous research (Davidson, 1980a, b). This method was used to identify firms' sequences of investment by industry and host country. The order of entry was determined based on the following procedure. First, the entry sequences of all investments (lines of business) were compiled. Second, the number of entries that were initiated in one line of business before others was calculated for every pair of entries in each host country. Finally, all lines of business were ranked based on the number of entries calculated above. Frequencies for each line of business were derived from the following formula:

$$F_i = \sum F_{ij} = \sum \left( \frac{A_{ij}}{A_{ij} + A_{ji}} \right), A_i = \sum A_{ij}, (i \neq j) \quad (1)$$

where  $F_{it}$  represents the ratio by which Japanese MNCs entered in industry  $i$  before industry  $j$ , which represents the priority in the entry sequence by industry;  $A_{ij}$  denotes the number of entries in industry  $i$  before industry  $j$ , and  $A_{ji}$  the number of entries in industry  $j$  before industry  $i$ ; and  $F_i$  denotes the sum of  $F_{i,-}$ , or the sum of the entry ratio for each industry row.  $F_i$  represents the priority in the entry sequence by industry where a larger (smaller) value indicates a higher (lower) priority in entry sequence. The sum of  $F_{i,-}$  represents the total number of paired combinations between industry  $i$  and industry  $j$ .<sup>2</sup>  $A_i$  denotes the sum of  $A_{ij}$ , or the total number of entries in industry  $i$  before each of the

other industries, which represents another measure of the priority in the entry sequence.

#### Results and discussion

Table 5 provides the frequency matrix of the Japanese trading companies invested abroad, in which industries are ranked by  $FI$  in descending order. Since  $F_{i,-}$  plus  $F/t$  sums to 1, only the former is presented in the matrix. Further, these tables indicate that wholesale trade exhibits the highest frequency, and receives priority over each of the other industries. Table 5 summarizes the sequential order of Japanese trading companies, showing that Japanese trading firms initiated 73.3% of entries in wholesale trading before trading for heavy industries, and more than 79.6% before any of the other businesses. This evidence suggests that the Japanese trading firms tended to initiate entries in core-global services before any of the other service types.

Table 5 also shows that the Japanese trading firms tended to enter related-local services (investment office, financing, and real estate trade) before unrelated-global services. For example, they initiated 74.4% in investment office (related-local) before warehousing/logistics (unrelated-global), 89.4% before insurance agent (unrelated-local), and 93.5% before retail (unrelated-local). Similarly, the Japanese trading firms tended to initiate entries in unrelated-global services before unrelated-local services. For example, they initiated 73.5% in trans-Pacific transportation (unrelated-global) before insurance agent (unrelated-local), and 84.3% before retail (unrelated-local). Taken together, these observations provide strong support for our hypothesis on service MNC internationalization, which was that Japanese trading firms tended to enter first in core-global services, followed by related-local, unrelated-global, and unrelated-local services, respectively.

Table 6 provides the frequency matrix by each trading firm. The priority in market entry is consistent among our sample firms. The correlation analyses (see Table 7) reveal that the values of  $F_i$  were highly correlated among the five trading firms, with the correlation coefficient ranging from 0.64 (Marubeni and Mitsubishi, and Mitsui and Mitsubishi) to 0.90 (Marubeni and C. Itoh). This evidence suggests that the five trading firms tended to follow a similar path for sequential entries in services through FDI.

Table 8 provides the frequency matrix by location. The priority in market entry is generally consistent between developed countries (DCs) and less developed countries (LDCs).<sup>3</sup> The correlation

Table 5 Investment frequency matrix<sup>a,b</sup>

		2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	$F_i$
1 General trading	CG	73.3	79.6	81.8	90.1	91.3	92.3	92.2	92.6	96.8	96.6	97.0	97.1	97.3	98.2	98.6	98.7	98.8	98.8	98.8	99.2	99.7	19.7
2 Trading for heavy industries	RL	58.9	60.9	77.1	79.0	81.2	81.4	81.7	91.0	91.8	92.0	92.0	93.1	95.3	96.0	96.2	96.4	96.5	96.6	97.7	99.0	17.8	
3 Trading for light/assembling industries	RL		52.7	70.5	72.9	75.4	75.3	76.2	87.9	88.5	89.0	89.3	90.5	93.4	94.5	94.8	95.2	95.2	95.3	95.3	96.8	98.6	16.9
4 Investment office	RL			70.2	71.9	74.4	76.0	75.5	86.7	89.4	88.8	88.1	90.7	93.8	93.5	94.0	94.0	94.2	94.3	96.8	98.2	16.8	
5 Financing	RL				52.9	57.7	57.0	57.0	75.5	77.3	77.1	77.8	80.7	86.4	87.8	88.9	88.9	88.9	89.4	92.6	96.5	14.2	
6 Real estate	RL					53.8	53.9	55.0	73.0	74.7	75.2	75.5	78.8	85.2	86.3	87.7	87.7	87.8	88.1	92.2	96.1	13.8	
7 Warehousing/logistics	UG						50.0	52.2	71.2	71.3	72.7	73.7	75.9	82.9	85.5	86.4	87.1	86.7	87.2	90.9	95.7	13.3	
8 Transportation: trans-Pacific	UG							50.8	70.3	73.5	72.1	73.0	77.4	82.8	84.3	86.2	85.8	86.0	86.8	90.8	95.7	13.3	
9 Holding company	UG								68.7	71.9	72.4	71.6	75.8	83.3	84.1	84.4	84.2	85.2	85.4	91.2	95.1	13.1	
10 Regional HQ	UL									56.5	56.1	55.3	64.8	72.4	70.5	72.4	71.9	70.9	72.4	84.0	88.2	10.1	
11 Insurance agent	UL										52.6	54.5	56.6	66.5	71.4	74.5	74.5	75.0	75.5	79.5	91.7	9.8	
12 IT/R&D	UL											51.0	58.3	66.5	67.3	70.0	69.5	70.9	71.4	80.8	89.0	9.5	
13 Telecommunication	UL												59.5	70.9	69.0	70.3	69.6	69.6	70.3	83.9	86.7	9.5	
14 Professional services	UL													62.8	66.7	68.2	68.2	68.6	69.0	76.9	88.9	8.7	
15 Agriculture/fishery	UL														57.3	58.5	58.5	60.4	61.1	69.6	84.6	7.1	
16 Retail	UL															55.6	55.6	55.6	60.0	78.9	78.9	6.7	
17 Hotel/restaurant	UL																53.8	55.3	52.5	70.0	80.8	6.3	
18 Manufacturing	UL																	50.0	55.6	90.9	71.4	6.3	
19 Mining/resource	UL																		55.6	83.3	71.4	6.1	
20 Leisure/entertainment	UL																			68.2	78.9	5.8	
21 Power/gas	UL																				71.4	3.6	
22 Transportation: local	UL																					2.4	
$F_i$ total																						231.0	

<sup>a</sup>Figure in each cell represents the ratio by which Japanese MNEs entered in industry  $i$  (in row) before industry  $j$  (in column);  $F_i$  represents the sum of the ratio for each industry row; and  $A_i$  represents the total number of entries in industry  $i$  before each of the other industries.

<sup>b</sup>CG, core-global; RG, related-global; RL, related-local; UG, unrelated-global; UL, unrelated-local.

Table 6 Sequential order: by firm<sup>3</sup>

Order	C	Itoh	f,	Marubeni	F,	Mitsui	F,
1	General trading	CG	19.7	General trading	CG	15.0	General trading
2	Trading for light/ assembling industries	UL	17.5	Trading for heavy industries	RL	13.3	Trading for heavy industries
3	Trading for heavy industries	UL	17.3	Investment office	RL	13.1	Investment office
4	Investment office	RL	15.8	Trading for light/ assembling industries	RL	12.5	Trading for light/ assembling industries
5	Real estate	RL	15.0	Financing	RL	10.7	Transportation: trans-Pacific
6	Financing	RL	14.6	Real estate	RL	10.4	Warehousing/logistics
8	Holding company	UG	12.7	Holding company	UG	8.5	Financing
7	Warehousing/logistics	UG	12.0	Transportation: trans-Pacific	UG	8.5	Real estate
9	Regional HQ	UL	11.5	Warehousing/logistics	UG	8.2	Holding company
10	Professional services	UG	10.7	Insurance agent	UL	7.7	Insurance agent
11	Transportation: trans-Pacific	UG	10.4	Regional HQ	UL	7.3	Agriculture/fishery
12	Insurance agent	UL	10.2	Telecommunication	UL	6.3	IT/R&D
13	Telecommunication	UL	8.5	Agriculture/fishery	UL	3.8	Professional services
14	IT/R&D	UL	8.2	Power/gas	UL	4.8	Manufacturing ».
15	Retail	UL	10.0	Mining/resource	UL	3.8	Regional HQ
16	Manufacturing	UL	7.7	IT/R&D	UL	2.0	Hotel/restaurant
17	Leisure/entertainment	UL	7.7	Hotel/restaurant	UL	0.2	
18	Agriculture/fishery	UL	4.4				
19	Hotel/restaurant	UL	6.5				
20	Transportation: local	UL	5.5				
21	Mining/resource	UL	3.3				
22	Power/gas	UL	2.0				
Ftotal			231.0		136.0		120.0
Order	Sumitomo		F	Mitsubishi	F,		
1	General trading	CG	14.8	General trading	CG	17.5	
2	Trading for heavy industries	RL	12.4	Trading for heavy industries	RL	15.2	
3	Trading for light/ assembling industries	RL	11.9	Trading for light/ assembling industries	RL	14.6	
4	Investment office	RL	11.9	Investment office	RL	14.0	
5	Holding company	UG	9.7	Warehousing/logistics	UG	14.0	
6	Transportation: trans- Pacific	UG	9.5	Transportation: trans-Pacific	UG	12.2	
8	Real estate	RL	9.3	Financing	RL	12.0	
7	Warehousing/logistics	UG	8.4	Real estate	RL	10.2	
9	Financing	RL	8.0	Hotel/restaurant	UL	11.7	
10	Telecommunication	UL	8.3	Professional services	UL	9.1	
11	IT/R&D	UL	6.9	Retail	UL	9.4	
12	Regional HQ	UL	6.6	Holding company	UL	8.4	
13	Mining/resource	UL	6.9	IT/R&D	UL	8.9	
14	Leisure/entertainment	UL	5.6	Telecommunication	UL	8.9	
15	Agriculture/fishery	UL	3.1	Regional HQ	UL	7.0	
16	Power/gas	UL	1.9	Insurance agent	UL	5.1	
17	Insurance agent	UL	0.8	Manufacturing	UL	6.7	
18				Leisure/entertainment	UL	2.9	
19				Power/gas	UL	1.8	
20				Agriculture/fishery	UL	0.4	
F total			136.0		190.0		

<sup>a</sup>CG, core-global; RG, related-global; RL, related-local; UG, unrelated-global; UL, unrelated-local.

analyses revealed that the values of  $F_f$  were highly correlated between LDCs and DCs, with the correlation coefficient 0.83 (again, see Table 7). These observations suggest that the sequential order of the Japanese trading firms is consistent across firms and locations.

### The process of international expansion in context

To improve our understanding of the nature of service MNC internationalization, it is important to

**Table 7** Correlations (a) Correlation in  $F_f$  among five Japanese trading firms; (b) Correlation in  $F_f$  between LDCs and DCs

	C. Itoh	Marubeni	Mitsui	Sumitomo
<i>(a)</i>				
Marubeni	0.90**			
Mitsui	0.80**	0.86**		
Sumitomo	0.81**	0.76**	0.75**	
Mitsubishi	0.82**	0.64**	0.64**	0.89**
<i>(b)</i>				
	LDC			
DC	0.83**			

\*\* $p < 0.01$  (two-tailed tests).

set out the historical context in which the process occurred. Using our typology of business relatedness and location-specificity summarized in Figure 1, below we outline the environment in which Japanese trading companies internationalized their operations.

### Entry into core-global businesses

A Japanese trading company's core business is wholesale trading. It is global in nature because its involvement in wholesale trade spans the world. The international expansion of Japanese trading companies' core businesses is associated with the international expansion of Japanese manufacturing firms - the major importers of commodity and the exporters of final products.

In early stages of the post-World War II economies in Japan, most manufacturers had limited or no direct access to local markets and knowledge. Japanese trading companies experienced in international trade and market knowledge therefore played a significant role in helping these manufacturers expand internationally into unfamiliar foreign markets. The relationship between Japanese trading companies and Japanese manufacturers eventually became highly co-dependent, and most

**Table 8** Sequential order: by location<sup>a</sup>

Order	LDC	$F_i$	DC	$F_i$		
1	General trading	CG	18.6	General trading	CG	17.9
2	Trading for heavy industries	RL	16.9	Investment office	RL	16.1
3	Trading for light/assembling industries	RL	15.9	Trading for heavy industries	RL	15.1
4	Investment office	RL	14.5	Trading for light/assembling industries	RL	14.6
5	Real estate	RL	13.6	Financing	RL	13.0
6	Warehousing/logistics	UG	13.3	Holding company	UG	11.7
7	Financing	RL	13.0	Transportation: trans-Pacific	UG	11.2
8	Transportation: trans-Pacific	UG	12.4	Warehousing/logistics	UG	9.9
9	Holding company	UG	12.3	Regional HQ	UL	10.3
10	Insurance agent	UL	12.3	Information/R&D	UL	9.6
11	Telecommunication	UL	10.0	Real estate	RL	9.1
12	Regional HQ	UL	9.1	Mining/resource	UL	9.7
13	Retail	UL	9.2	Professional services	UL	7.0
14	Professional services	UL	7.4	Insurance agent	UL	7.0
15	Information/R&D	UL	6.8	Agriculture/fishery	UL	6.7
16	Leisure/entertainment	UL	6.1	Power/gas	UL	5.4
17	Agriculture/fishery	UL	5.3	Manufacturing	UL	5.7
18	Hotel/restaurant	UL	5.1	Telecommunication	UL	5.0
19	Manufacturing	UL	4.4	Hotel/restaurant	UL	3.5
20	Transportation: local	UL	3.1	Leisure/entertainment	UL	1.6
21	Power/gas	UL	0.8			
$F_i$ total			210.0		190.0	

<sup>a</sup>CC, core-global; RG, related-global; RL, related-local; UG, unrelated-global; UL, unrelated-local.

of the Japanese trading companies' functions involved 'regular buyers and sellers on a recurring basis' (Yoshino and Lifson, 1986: 37). Hence early development of Japanese trading companies' international expansion through FDI is best characterized as follow-the-customer behavior, exploiting the existing ties with Japanese manufacturers in foreign countries, rather than as a search for new customers abroad.

Many Japanese trading companies set up their first trading subsidiaries in the US, Western Europe (e.g., UK, Germany, Belgium, France, Spain, Italy, Netherlands, and Switzerland), Asia (e.g., Thailand, Hong Kong, Malaysia, and Indonesia), the Middle East (e.g., Iran), and South America (e.g., Brazil and Argentina) in the period from the early 1950s to the 1970s. The role of these subsidiaries was to help Japanese manufacturing firms, especially those firms in industrial materials industries (e.g., steel, chemicals, and textiles), to import raw materials from LDCs and to export final products to DCs. These subsidiaries have subsequently played a transformed role as regional headquarters, establishing their own subsidiaries in respective host and nearby countries.

### **Entry into related-local businesses**

Related-local businesses represent those that are close to a firm's core business and are, at the same time, location-specific. A Japanese trading company's core business - wholesale trading - involves linking the suppliers of commodity or products to the industrial users. When a Japanese trading company's intermediary role in wholesale trading is limited only to the suppliers and users residing in particular locations, it is considered, then, as a related-local business.

A typical example in this category is financing. Financing provides intermediary services of financial assets that play complementary functions to wholesale trade. Japanese trading companies have traditionally offered two types of financial services to their trading partners: trade credits and long-term financing. Japanese trading companies often become net lenders of trade credit to the suppliers of commodities and final products, especially when the suppliers have limited financial resources (Uesugi and Yamashiro, 2004). Long-term financing is arranged for deferred payments, supplier loans, and financing for large-scale projects (e.g., project financing).

Traditionally, these financing services were handled centrally at Japanese trading companies'

headquarters in Japan. However, the opportunities for offshore financing rapidly increased along with the liberalization of international financial markets in the 1990s. Most Japanese trading companies then started expanding their financial business, especially in Singapore, Hong Kong, the UK, the Netherlands, and the US, offering a wide range of financing services including general banking, risk management, and investment management to their trading partners. Unlike the case in manufacturing sectors, many financing subsidiaries took the form of either wholly owned subsidiaries or JVs formed with Japanese trading firms' group companies.

### **Entry into unrelated-global businesses**

Unrelated-global businesses involve those that are unrelated to Japanese trading companies' core business, and are less location-specific. Typical examples of these businesses are transportation and warehousing. In the 1970s, along with the rapid development of the industrial materials industries (e.g., steel, chemicals, and textile) in Japan, Japanese trading companies' investments were directed along two avenues. One was towards the development of resource base in 'resource-rich' countries in which Japanese trading companies secured natural resources and materials for the Japanese manufacturers. The other route was into the development of distribution networks where Japanese trading companies marketed their final products to local and foreign markets.

The primary purpose of Japanese trading companies' entry into transportation and warehousing businesses was to develop efficient logistical systems for both imports of resources and exports of final products in these industries. In the mid-1980s to 1990s (especially after the Plaza Agreement), outward FDI from Japan grew rapidly, and Japanese trading companies invested heavily in these businesses to provide logistical support to the foreign operations of Japanese manufacturers.

Most Japanese trading companies had established independent subsidiaries in 1980s that provided air cargo, logistics, and warehousing services in major regions in North America, Europe, and Asia (e.g., Singapore). In the 1990s, emerging economies such as the former socialist countries and China opened their markets to foreign investors. To respond to rapidly growing demand, Japanese trading companies began investing in warehousing and transportation in these emerging economies. C. Itoh, for example, established a logistics center in Eastern Europe (i.e., Hungary) in the early 1990s and two

logistics centers in China in the mid-1990s. Similarly, Mitsubishi established an extensive logistics network across China during the 1990s through its domestic subsidiaries specialized in logistic and distribution systems businesses.

### **Entry into unrelated-local businesses**

Japanese trading companies entered a wide range of unrelated-local businesses - those businesses that are unrelated to Japanese trading companies' core business and are location-specific in nature. These businesses include major retail/services, as described below.

Japanese trading companies seem to have developed a more aggressive strategy in services sectors in their home country as compared with foreign countries. In the Japanese convenience store industry, for example, C. Itoh acquired an equity stake in Family Mart from Seiyu in 1998, and Sumitomo acquired an equity stake in Seiyu. Mitsubishi also acquired an equity stake in Lawson, a subsidiary of Daiei, in 2003. Mitsui formed an alliance with Seven-Eleven, the largest convenience store in Japan, and set up Seven-dream.com, an on-line shopping mall, in 2000. They have also entered into a variety of services sectors, such as health care, environmental management, temporary staffing, leisure and entertainment.

All five Japanese trading companies have developed a wider portfolio of service sectors in Japan. However, their direct investment in foreign countries in these sectors remained very limited. Part of the reason for this limited investment is that these services are highly location-specific in terms of the cultural content of the services offered and the medium of communications (i.e., language): hence the cross-border transfer of know-how and skills in these businesses is difficult and costly. Some Japanese trading firms also entered the manufacturing and mining/natural resource sectors in relatively late stages of internationalization. However, Japanese trading firms played only very limited roles in actual production and mining. Most entries were made either through buyout of the equity share of the JV partners or through acquisition of the existing firms.

Sequential entry decisions involved a process in which Japanese trading companies developed a network of subsidiaries. The above overview illustrates the general evolutionary process of Japanese trading companies' international expansion. It appears that their decisions for internationalization are neither *ad hoc* nor independent, but rather are

sequentially connected across respective stages of the internationalization of the economy and other firms. The key thrust here is that decisions for business diversification and those for international expansions are intertwined: Japanese trading companies entered first in related and less location-specific businesses and then in unrelated and location-specific ones.

### **Between-firm variation in the process of international expansion: some case studies**

As illustrated longitudinally in Figure 2, the proportion of the cumulative counts of related and unrelated businesses between 1970 and 1999 dropped over time to reach 10-20%, and those of global and location-specific businesses 40-50%, by the end of the 1990s. This suggests that the Japanese trading companies had diversified their business portfolios dramatically over that period. Although all Japanese trading companies followed the general process of international expansion described above, it is important to note that this process varied among individual companies, as there are several noticeable differences in the internationalization patterns. We therefore review several case studies below to provide sufficient detail to elaborate on this point.

First, Japanese trading companies differ in the timing of changes in the composition of businesses. C. Itoh, for example, had a relatively stable proportion of global over location-specific businesses (i.e., around 25%) up to the mid-1980s. After that, however, the proportion of global businesses began to drop sharply. Mitsui also followed this pattern in the composition of its location-specific V5 global businesses. In contrast, however, Marubeni, Sumitomo, and Mitsubishi each had a sharp drop in the proportion of global over location-specific businesses over the 1970s and 1980s, and had a relatively stable proportion after the late 1980s.

As for the proportion of related over unrelated businesses, Mitsui had a relatively stable proportion of related business over the observation period (i.e., 80-90%). Other trading firms had a constant decline in the proportion of related business over the observation period. Considering the fact that the Plaza Agreement came into effect in 1985 (which prompted a dramatic appreciation of the Japanese yen against the US dollar and a sharp decrease in exporting), the noticeable decrease in global businesses of C. Itoh and Mitsui might be better understood as rational responses to changes

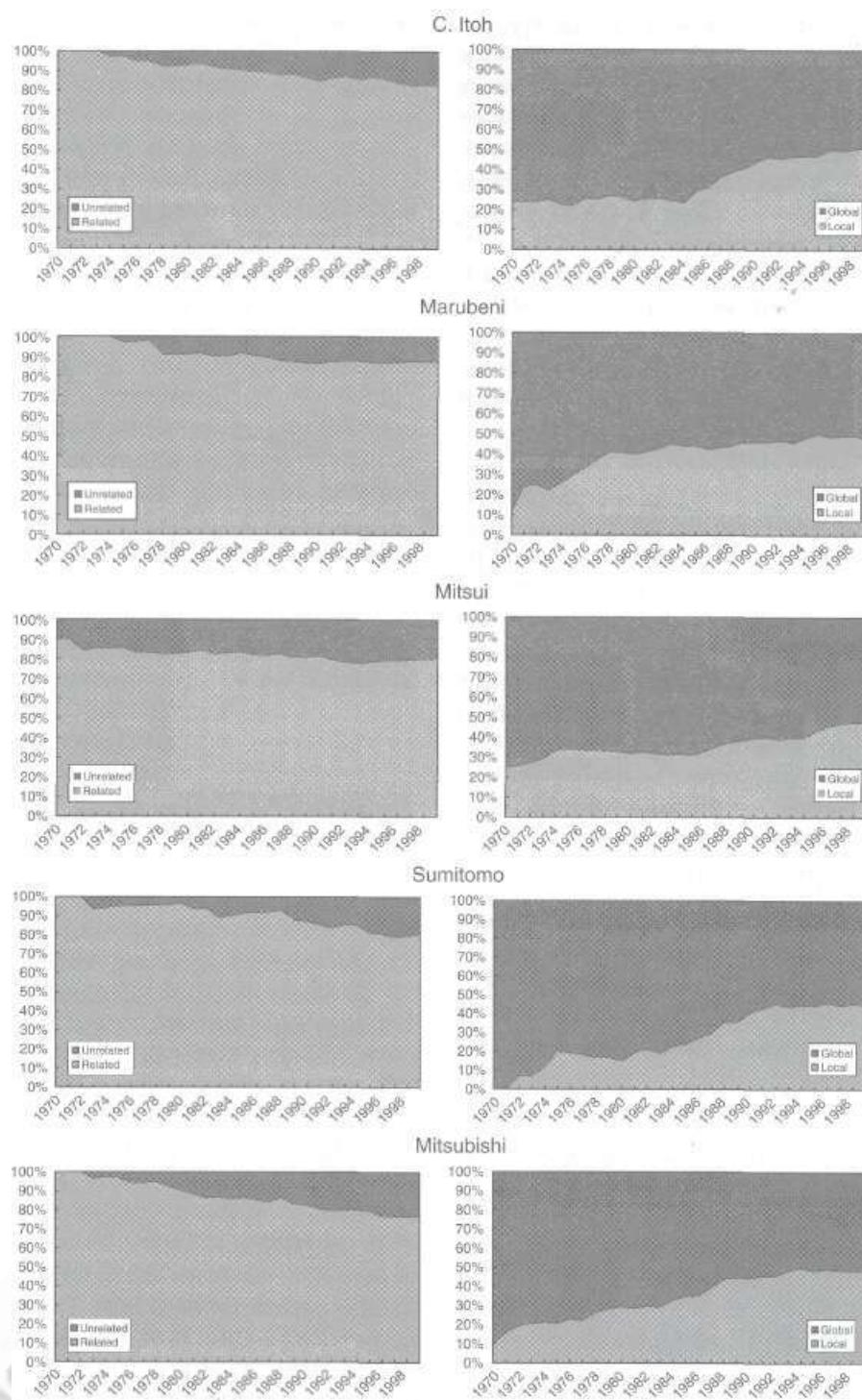


Figure 2 Proportion of international business, 1970-1999.

in the economic climate as a means of reducing their dependences on exporting, exploring instead new business opportunities that were location-specific in host countries.

Second, the trading companies differ in the magnitudes of change of business type. At the beginning of the 1970s Sumitomo, for example, had no proportion of related business (100%) and

global business (100%). However, these figures dropped sharply by the end of the 1990s. In the case of Sumitomo, 20% of the related businesses were replaced by unrelated businesses, and 40% of global businesses were replaced by location-specific businesses. In contrast, Mitsui had a relatively high proportion of both unrelated and location-specific businesses at the beginning of the 1970s and onwards, and had a relatively mild decline (around 20%) in the proportion of both related and global businesses. This evidence suggests that Mitsui was an early mover and Sumitomo a late mover in the process of diversification into the unrelated and location-specific businesses through international expansion.

In sum, these observations suggest that important variations exist in the process of international expansion among Japanese trading companies in terms of the timing and the magnitude of the changes in their portfolio of business. Yet it is an empirical question as to the performance implications of these differences. We take up this question in the section below to enhance our understanding of the relationship between the process of internationalization and performance.

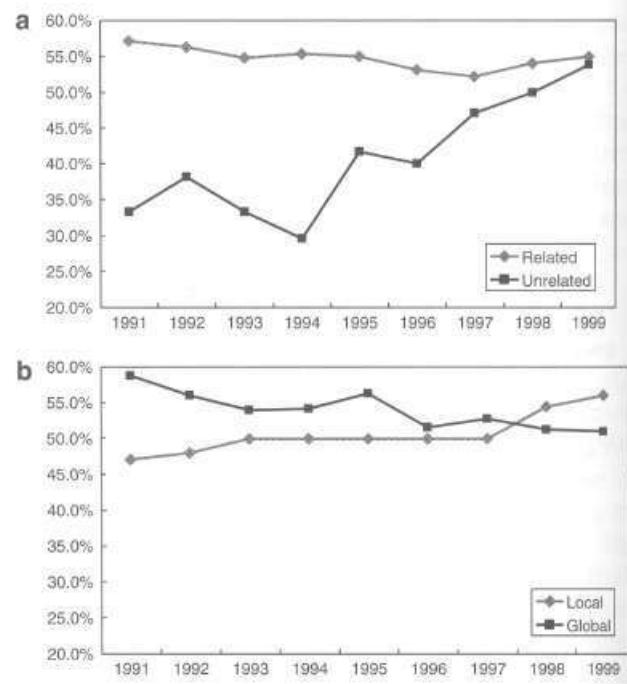
### Performance implications of the internationalization process

Figure 3 illustrates longitudinal changes in Japanese trading company performance. Figure 3a compares the performance of related and unrelated businesses and Figure 3b the performance of global vs location-specific businesses. From Figure 3 we can observe that:

- (1) subsidiaries in the related business category outperformed those in the unrelated business category across the years in our sample;
- (2) the performance of subsidiaries increased over time in the unrelated business category, and was decreasing in the related business category; and
- (3) the gap between the performance in the related vs unrelated business category became narrower over years.

Figure 3b shows that:

- (1) subsidiaries in the global business category outperformed those in the location-specific business category over the years;
- (2) the performance of the subsidiaries increased over time in the location-specific business category, and was decreasing in the global business category; and



**Figure 3** International expansion and subsidiary performance: (a) subsidiary performance in related and unrelated businesses, 1991-1999; (b) subsidiary performance in global and location-specific businesses, 1991-1999. (Performance is measured by the percentage of profitable subsidiaries over the total count.)

- (3) the performance gap between the global and location-specific business categories became narrower over time.

To confirm these observed patterns in performance trend across years statistically, we analyzed the following model using simple linear regression:

$$Y = B_0 + B_1(T) + B_2(Z) \quad (2)$$

where  $Y$  represents the percentage of subsidiaries whose performance is gain,  $T$  is time in years, and  $Z$  is a vector of control variables; and  $B_0$ ,  $B_1(T)$ , and  $B_2$  are the least-squares estimates of the intercept and slope coefficients. In this analysis, we used subsidiary counts and the average subsidiary size measured by the number of employees as control variables. We controlled these variables because the former may represent competition and the latter the liability of smallness, both of which might affect subsidiary performance.

To obtain the data for this analysis, we coded 10 annual volumes of the TK database (1992-2000),

yielding a sample of over 700 subsidiary-years. The results of our analysis indicated that the coefficient was positive and significantly different from zero in the location-specific and unrelated business categories at the  $P<0.05$  and  $P<0.10$  levels respectively, and was negative and statistically significant in the global and the related business categories at the  $P<0.05$  level.<sup>4</sup> This finding suggests that the subsidiaries in both the location-specific and the unrelated business categories were improving their performance over time, whereas those in the global and the related business categories experienced decreasing performance over time.

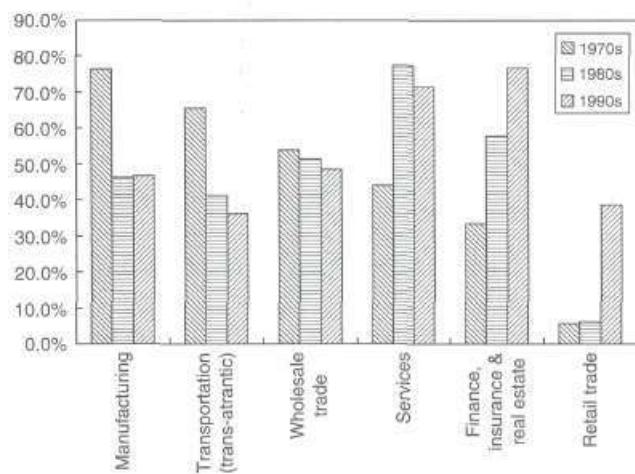
We also calculated the performance gap between the global and location-specific business categories and between the related and unrelated business categories. Using the performance gap as the dependent variable, we conducted a similar regression analysis. The results showed that the coefficient was negative and significantly different from zero at the  $P<0.05$  level for the performance gap between the global and the location-specific business categories, and  $P<0.10$  for that between the related and the unrelated business categories. Taken together, these results provide clear support for our observations of the performance trends in our sample.

These observations suggest that certain early entries into related and global businesses are justifiable in an economic sense because the relative contribution to performance is, on average, greater in these areas than in those that are unrelated and location-specific. Given that the assets transferred to related businesses are knowledge and know-how, our findings provide some support for Sapienza *et al.*'s (2006) theory that management experience and resource fungibility are key elements that influence the performance of international ventures. However, in our sample, the rate of improvement in performance is greater in the unrelated and location-specific businesses than in the related and global businesses, as indicated by the narrowing gap in performance between the two categories over time. In fact, as is shown in the chart, the subsidiaries in location-specific businesses often outperformed those in global businesses, especially in the late 1990s. These observations suggest that entries into unrelated and location-specific businesses appear to make greater contributions to performance over the long run than entries into related and global businesses.

Figure 4 provides a more detailed description, by industry, of the changes in performance. It shows that the performance of the subsidiaries in

the core-global business (i.e., wholesale trade) remained at the same level over the 1970s, 1980s, and 1990s. In contrast, the performance of subsidiaries in the unrelated global business such as trans-Pacific transportation dropped continuously over this time frame, whereas the performance of all subsidiaries except manufacturing (i.e., financing, retail, and services) in location-specific businesses (unrelated-local and related-local) increased constantly over time. These observations suggest that the key sources of competitive advantage of Japanese trading companies have gradually shifted from the traditional core businesses to more location-specific businesses in recent years, supporting the notion that the order of sequential entry has clear performance implications.

It is important to note that our results are subject to various limitations. Since our sample is of large trading companies, it may be that the experience of these firms is unique and not generalizable to other types of service firms. In addition, since our data are derived from Japanese firms, another caveat is that the nature of service internationalization may be different when comparing MNCs from other countries-of-origin. Furthermore, as discussed in the Methods section, the classification of services may need further refinement so that it can precisely delineate the service provided by the parent firm to its subsidiary, especially when the subsidiary is formed as a JV with other parent firms. These limitations may be resolved through future comparative research.



**Figure 4** International expansion and subsidiary performance by industry. (Performance is measured by the percentage of profitable subsidiaries over the total count.)

## Conclusion

This research addresses the gap in our understanding of the process of internationalization of service firms, given that the majority of prior work on MNCs has focused primarily on manufacturing firms. Our results suggest that the process of internationalization of service MNCs appears to be quite consistent with prior findings based on manufacturing MNCs (e.g., Chang, 1995): service MNCs tend to invest first in services that are close to their core businesses and are less location-specific; subsequent investments are more location-specific, and are also in services that are unrelated to their core activities.

A great deal of energy has been expended by researchers to isolate service firms and test novel hypotheses on these samples, based on the theoretical perspective that service MNCs are different from manufacturing MNCs. Our results, when taken with others such as Li and Guisinger's (1992) longitudinal analysis of the international behavior of 168 large service MNCs, clearly point to the conclusion that the international behavior of multinational service firms mirrors that of manufacturing firms as identified by Flowers (1976), Graham (1978), Knickerbocker (1973) and others. Li and Guisinger's (1992) results also indicated that service MNC growth has a positive and significant impact on firm FDI, consistent with previous findings on FDI by manufacturing firms (Horst, 1972; Grubaugh, 1987). Similarly, the conclusions on international diversification derived by Capar and Kotabe (2003) on their sample of German service MNCs are quite similar to those of Goerzen and Beamish (2003), who analyzed a large sample of Japanese manufacturing MNCs. In combination with this emerging stream of research on service MNCs, our research provides a significant contribution to this literature by providing clear support for Bodewyn *et al.*'s (1986: 54) assertion that 'no special MNC/FDI theories for international service firms are necessary. The existing ones can be readily accommodated through relatively simple qualifications and elaborations.'

Just as key service MNC assets are intangible (Enderwick, 1989, 1992; Hirsch, 1993; Campbell and Verbeke, 1994), some authors have suggested that a manufacturing firm's most valuable competences are also skills based and largely intangible (Penrose, 1959; Wernerfelt, 1984; Barney, 1991). Thus it may be that all MNCs are, in a sense, service MNCs, since the assets that underlie all types of internalization are intangible, and that there may not be a distinct dichotomy between the factors that underlie manufacturing and service firms' growth

and expansion.<sup>5</sup> Future research on internationalization could therefore focus more explicitly on the firm-specific concepts of age, management experience, and resource fungibility, as proposed by Sapienza *et al.* (2006), rather than focusing on the service-manufacturing dichotomy. This analysis could be extended, based on Hitt *et al.*'s (2006) perspective that human capital is a central aspect in the success of internationalization. In their study of US-based law firms, Hitt *et al.* (2006) showed that human capital and various forms of relational capital are critical to service firm internationalization.

Our results are also significant in that they suggest that a firm's internationalization may be a more complex phenomenon than described in previous literature. Traditionally, internationalization has been viewed as a way either to appropriate local knowledge or to exploit firm-specific advantages across borders: the former view is referred to as internationalization theory and the latter as the evolutionary perspective of MNCs. Our study suggests that the internationalization of service MNCs can be explained from a combination of both perspectives. Further, previous literature has neither sufficiently identified different characteristics of services nor explained how these different types of services would influence the process of a firm's internationalization. By investigating the internationalization process of service MNCs, we have proposed and tested that the nature of services should be identified with more precision, given that some forms of services are more location-bound than others and are provided to a particular group of local customers. Other services, such as wholesale trading, can be provided to customers across worldwide markets at the same time without diminishing their values through use.

Although we must be cautious when making normative statements to managers about the internationalization process based on the results of our study, our analysis suggests that there is a clear link between the sequence of internationalization and firm performance. Our performance comparisons indicate that entries into related businesses are positively related to performance when made early in the internationalization process. Thus managers may be well advised to stick close to their core activities in the early stages of their internationalization as management teams accumulate specific knowledge of foreign markets as well as more general experience in working abroad.

It is important to point out that our findings show that a great many foreign investments are

carried out through JVs. While the costs and benefits of JVs have been addressed elsewhere, it is important to note that foreign partners often add another dimension of foreignness (e.g., Makino and Beamish, 1998; Goerzen, 2005b; Goerzen and Beamish, 2005). As firms are challenged to deal with the nuances of foreign markets (e.g., suppliers, customers, regulators), the extra layer of foreign market acculturation brought on by foreign partners makes FDI significantly more challenging (Goerzen, 2005a, 2007). Therefore managers are well advised to identify the specific elements of investment complexity - particularly in the early stages of internationalization when experience is relatively low - to create better conditions for success.

Our results also show that, in a later stage of internationalization, firms appear to develop the ability to derive greater economic benefits from FDI that is less tightly coupled to the firm's original core activities. In line with this observation, once a threshold of international expertise is reached, managers can then begin to explore new location-specific competences in foreign markets in which their internal resources and capabilities add value.

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## Notes

<sup>1</sup> Firms with large resources may take larger internationalization steps, stable and homogeneous markets may allow the accumulation of knowledge other than through direct experience, and knowledge gained with some markets may be generalized to others without direct experience.

<sup>2</sup> Since we have 22 lines of services in total in our sample,  $F$ , in the total sample is 231 (i.e.,  $(22 \times 22-22)/2=231$ ).  $F_j$  varies across the firms and the locations, depending on the number of the lines of services observed.

<sup>3</sup>The classification of DCs and LDCs is based on the United Nations Systems of Country Classification. DCs include countries in Western Europe/North America, and Oceania (Australia and New Zealand).

<sup>4</sup>To conserve space, the detailed results are not presented here but are available from the authors upon request.

<sup>5</sup>Nucor Steel's senior management, for example, have for many years stated that their capital-intensive firm's competitive advantages are based on intangible assets.

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