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**The Hidden Costs Of Going Global:
Insights From Firms' Entry Into Foreign Markets**

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Abstract

Recent literature on strategic decision-making highlights the role of hidden costs, i.e. costs that firms are not able to predict *ex-ante* (Larsen et al., 2012). This paper analyses the hidden costs of going global, i.e. unanticipated costs that emerge in the implementation of market entry strategies. Foreign market entry requires firms to assess the potential attractiveness of different locations, select an appropriate entry mode, and organize their international value chain. When taking such decisions, firms can make evaluation mistakes. We propose that cultural distance is one factor that generates “blind spots” in a firm’s strategic analysis, thus affecting its ability to evaluate the actual challenges of entering foreign markets. Firms can offset distance-driven hidden costs by building international experience and relational capability.

Keywords: Hidden Costs, Estimation, Internationalization, Distance.

JEL Classification Numbers: M160

INTRODUCTION

Recent literature on strategic decision-making highlights the role of hidden costs, i.e., “*unanticipated costs of implementation that arise in strategic decision-making processes*” (Larsen et al., 2012, p. 1). Hidden costs emerge when the implementation of a strategic decision gives rise to costs that were not estimated *ex-ante*. This can be attributed to conditions that limit decision makers’ ability to make predictions (Kahneman and Tversky, 1984; Das and Teng, 1999), thus generating “blind spots” in an organization’s strategic analyses (Prahalad and Bettis, 1986). In the context of offshoring, Larsen et al. (2012) have pointed out that – under conditions of high complexity – decision makers are unable to accurately evaluate the actual costs of service offshoring. In this paper, we suggest that hidden costs may emerge also in the implementation of market entry strategies, i.e., when the firm has to face the challenges of a new and unfamiliar demand. Foreign market entry is an important step in a firm’s growth process. It encompasses several delicate analyses and decisions. Firms have to assess the potential attractiveness of the foreign market, select an appropriate entry mode, organize its international value chain and gain legitimacy in the host country (Erramilli, 1991; Isobe et al., 2000). Within a firm’s decision-making process, these activities absorb a huge amount of time and resources. Yet, such a commitment does not seem to ensure a firm’s success. Several studies suggest that firms often fail to survive in foreign markets (Delacroix, 1993; Mitchell et al., 1994; Li, 1995; Shaver et al., 1997). Especially in developing economies, western firms are often unable to achieve satisfactory results. As an example, in 2010, the largest companies headquartered in developed countries earned just 17 percent of their total revenue from emerging markets (McKinsey Global Institute, 2012).

To shed some light on the reasons underlying this phenomenon, in this paper we seek to understand the impact of cultural distance on the ability of firms to estimate the actual challenges of going global. Cultural distance can be defined as the difference between national culture systems, in terms of education, religion, language, values and political economy (Ricks et al., 1990). The construct of cultural distance has been used to understand several aspects of a MNC’s organizational and strategic behavior, such as entry mode (Barkema et al., 1996), international diversification (Grosse and Trevino, 1996), MNC and subsidiary performance (Gomez-Mejia and Palich, 1997; Chang, 1995). A common assumption in this research is that cultural distance increases the costs of doing business abroad (Bartlett and Ghoshal, 1989; Palich and Gomez-Mejia, 1999). In this paper, we aim to show that – beyond increasing such “explicit” costs – cultural distance also increases the hidden costs of going global. We propose that cultural distance acts as a filter to decision makers’ ability to accurately understand the challenges posed by foreign markets, thus generating *ex-ante* estimation errors (Larsen et al., 2012).

The aim of this paper is, therefore, to explore how cultural distance between a firm’s home and host country affects the occurrence of hidden costs, thus influencing the performance of foreign market entry. We will scrutinize whether and how this effect is amplified by the firm’s international experience and by its relational capability. We will test our hypotheses on a sample of Italian firms that have investments in foreign markets. We believe that this empirical setting is particularly appropriate for our topic, given the limited average size of Italian firms. For these firms, which typically lack substantial amounts of resources, the *ex-post* emergence of unanticipated costs may generate irreversible consequences.

The remainder of this paper is as follows. In the next paragraph, we will introduce the relationship between distance and the hidden costs of going global, by identifying the dimensions of distance considered relevant for a firm’s entry and performance in a foreign country. Consequently we will put forward the two main hypotheses related to the firm’s international experience and its relational capability. In the Methodology section we will describe the data collection procedure and the variables included in the regression. We finalize the paper with the discussion of the preliminary results and some indications for the future developments of the analysis.

THE HIDDEN COSTS OF GOING GLOBAL AND THE ROLE OF CULTURAL DISTANCE

The impact of national culture on multinational firms' strategy has been widely recognized. Deep differences in norms and values between the home country of firm and the host country of its foreign operations often create operational difficulties and increase the efforts and the costs required to enter a foreign country. The "national character" (Hofstede, 1980) theory suggests that countries vary systematically in 'psychological' characteristics: for instance, country level characteristics affect the decision regarding the ownership structure of its subsidiary. A similar approach links differences between national characteristics and transaction cost theory; the success of international operations relies on the knowledge of local conditions. If high transaction costs exist, firms may prefer sharing equity with local partners (Hennart and Larino, 1998). The influence of culture on firms' international decisions has also been captured by the concept of 'psychic distance', namely, the distance in institutional, cultural and political factors that makes it difficult to understand foreign environments. Psychic distance has been identified as the basis of two main features of the internationalization pattern, i.e. the establishment chain and the liability of foreignness.

In sum, international business literature agrees that differences between foreign and home country cultures increase entry costs, decrease operational benefits and affect competencies transfer (Bartlett and Ghoshal, 1989; Palich and Gomez-Mejia, 1999). In this paper, we propose that - when entering foreign markets - cultural distance does not only create explicit costs for firms' management. Rather, it may also be the source of hidden costs, i.e. costs that arise from inappropriate estimates of challenges and opportunities. As an example, previous literature has highlighted that cultural distance hampers the acquisition and interpretation of information about foreign partners' behavior (Gomez-Mejia and Balkin, 1992). Cultural distance creates knowledge barriers that challenge the achievement of an effective understanding of the foreign market (Anand and Delios, 1997). In sum, cultural, social and linguistic distance causes information asymmetry. Whereas this information asymmetry has usually been considered as affecting foreign market entry *ex-post* (that is, after the entry into the foreign country), we suggest that information asymmetries arising from cultural distance also occur *ex-ante*, that is, in the preliminary stage of evaluating the expected outcomes of going global. Asymmetry of information in the stage prior to the foreign market investment prevents managers to fully evaluate the challenges and opportunities that the firm will face once it starts its foreign activities. This might result in a gap between expected and actual performance of foreign market's entry. In this perspective, cultural distance causes prediction uncertainty and the complexity of information flows, thus generating a biased evaluation of the firm's potential foreign performance:

Hypothesis 1. *A higher degree of cultural distance between a firm's home and host country is likely to increase the gap between expected and actual performance of foreign market's entry.*

THE MODERATING ROLE OF EXPERIENCE

Hidden costs of going global depend on the decision makers' ability to estimate the impact of strategic decisions when entering culturally distant markets. This ability could be related to the international experience that allows firm to accumulate knowledge to successfully enter new markets. Previous research has highlighted different facets of knowledge arising from experience, which might have dissimilar effects on a firm's internationalization process and on its perceived costs. Classical U-models (Johanson and Vahlne, 1977) postulated that, once initiated, internationalization proceeds incrementally, regulated by the experience-based accumulation of "foreign organizing knowledge", and the so-called "generic market knowledge" may be transferred between organizational units supporting the internationalization process. Also in the revisited version of the model (Johanson and Vahlne, 2009), experiential knowledge is an important variable, which firms may develop by

leveraging the relationships with the network in which they operate. The model also claims that, as the psychic distance increases, it is difficult to collect and process information properly. Previous research (Eriksson *et al.* 1997; Suh, Bae, and Kundu, 2007) found that high experiential knowledge reduces the likelihood of mistakes in forecasting due to wrong cost perceptions. In fact, previous experience in international markets allows firms developing abilities and routines that help to properly analyze and interpret signals from distant and unfamiliar external environments. By accumulating experiential knowledge, firms learn how to correctly evaluate potentially misleading information regarding culturally different consumers, partners and modes of doing business. Building on these insights, we argue that firms with prior international experience can better cope with distant countries due to the accumulated ability in understanding foreign markets.

Some could argue that the phenomenon of born global firms (Knight and Cavusgil, 2005) downsize the role of previous international experience and knowledge, as these firms start to go global from the very early stage of their internationalization process. The reason could be related to the different scenario in which they operate: globalization, Internet and the ICT in general play an important role in spreading information, making it easier to diffuse information about the company and its products to the stakeholders and to distribute and sell them even without establishing a physical presence in the foreign country. Therefore this does not mean that managers have become able to provide correct forecasts about costs and benefits related to the new markets firm are entering; it only means that the process is faster than in the past, but experiential knowledge still affects expected costs and, hence, performance.

We therefore posit that:

Hypothesis 2. *The positive association between cultural distance and the gap between expected and actual performance of foreign market's entry is negatively moderated by firm's international experiential knowledge.*

THE MODERATING ROLE OF THE RELATIONAL CAPABILITY

Entering a culturally distant foreign market exposes firms to hidden costs that emerge from the poor ability to screen and accurately understand the challenges of a different business environment. We have posit that international experience helps firms to narrow the extent of hidden costs, through the development of capabilities and routines that allow to “read” the foreign market with more practiced lens. However, experience is something that arises from a firms’ international investment cycle, which in turn is the result of the firm’s strategic planning. In short, it is unlikely that firms will build up experience specifically to react to hidden costs of going global. Conversely, we propose that firms may use other, more direct and problem-specific remedies to reduce the extent of distance-driven hidden costs. Relational capability refers to a firm’s ability in building linkages of different types (Andersson *et al.*, 2002). When firms are able to tap into the local context and develop a valuable network of business and non-business relationships, the process through which they accumulate knowledge about the local market and culture speeds up. Local relationship partners represent an incredibly rich channel for knowledge sharing/exchange, as well as a very important training ground where firms can test their ability to relate to the local markets. We therefore posit that:

Hypothesis 3. *A firm's relational capability negatively moderates the relationship between the degree of cultural distance and the gap between expected and actual performance of foreign market's entry.*

METHODOLOGY

Our empirical analysis is based on questionnaire data from a sample of Italian firms located in the northern regions (mainly Veneto and Lombardia). A list of firms was first compiled gathering information from the local divisions of the most important associations of Italian firms operating in manufacturing and services. From this list, we selected all export oriented firms operating in three of the most important Italian industries: textile, furniture and machinery.

Before starting questionnaire administration, we realized a pilot study based on face-to-face interviews with the firms' respondents (convenience sample) in order to test our instrument. This allowed us to modify questions that were not clear and to include items that we did not consider in a first step. Since we need variance in terms of foreign market characteristics, we asked our respondents to indicate three foreign markets in which the firm is operating: the most different, the most similar and one that could be defined as moderately different from Italy

We are currently in the process of collecting data. Questionnaires have been sent out to our firms sample (1113 firms) by email, and we are now in the process of recall firms that have not answered yet. .

Dependent variable

The *gap between expected and actual performance* will be measured by comparing two items in the questionnaire. First, respondents will be asked to rate the profits they expected before entering a given market. Second, they will be asked to rate actual extent of profits they obtained in the foreign market. Both items will be measured on Likert scale ranging from 1 to 5. Notice that our theoretical definition of hidden costs includes not only cost-estimation errors, but also revenue-estimation errors. In other words, we believe that hidden costs of going global do not arise only because of firms' poor ability to anticipate costs, but also because of firms' poor ability to estimate revenues (i.e., an Italian firm might think that the engineering architecture of its product is so advanced that a big share of Chinese consumers will buy it, without considering cultural barriers that might work against the commercial success of the product).

Independent variables

Our main dependent variable, *cultural distance*, will be measured by using the Kogut & Singh (1988) index of distance between the home location and the foreign market. We have also included in our instrument a question regarding the perceived cultural distance, in order to be able to conduct further tests on the impact of this variable, as well as to ascertain whether objective and perceived measures of this construct have different effects on our independent variable. Regarding our interaction effects, our first moderating variable - *international experience* - is measured by asking the respondent to indicate the number of years they have been operating in foreign markets (Erramilli, 1991; Larsen et al., 2012). On the other hand, *relational capability* is measured by asking the firm's respondent to rate - on a 5 point Likert scale - the extent to which the firm was able to develop linkages with local partners or institutions.

Control variables

Several control variables will be applied to our models. First, we will control for the number of months since the specific entry in the foreign market was initiated. This is made in order to capture potential biases related to the reduced ability of respondents to evaluate the deviation between expected and actual results of older investments (Larsen et al., 2012). Second, we will control for the dimension of the foreign market, as measured by the national gross domestic product, in order to account for the differences that may exist – in terms of opportunities – among different foreign markets. In order to control for the potential effects of the foreign investment characteristics on firms' performance on a given market, we will also

include variables that capture the entry mode (Brouthers, 2002), as well as the amount of resources invested in the specific foreign market.

PRELIMINARY RESULTS

The first step of our research, i.e., the in-depth discussions with firms' managers, suggests that hidden costs do exist and that they represent a threat for businesses. Two are the firms behavioral patterns related to this kind of costs: firms that are aware about this issue and firms that deny the hidden costs problem while recognizing that they had to cope with unexpected obstacles during the internationalization process.

Firms that are aware about hidden costs report their existence in different area of their businesses, from distribution to communication, from production to logistics:

“When we first entered the German market, our distribution partner demanded us to organize a trade show. We had no agreement regarding a trade show, and it turned out to be very costly for a small entity like our firm, but we couldn't really refuse to do that.” (Export manager of a fashion firm).

“We did not expect to have to deal with such a great amount of complaints from our distributor. The first time we sent their orders, we spent a lot of time to struggle with them about almost everything. Now we know how to do to have them satisfied...” (Export manager of a food company).

Firms operating in emerging countries are more likely to report higher hidden costs. Since emerging countries are usually perceived as more distant compared to developed ones, this provides some initial clues on the role of cultural distance and its hypothesized positive effect on hidden costs. The higher the distance between the home and the host market, the higher the difficulties of screening and properly understanding the opportunities and challenges posed by entry into the foreign market.

Thanks to their previous international experience, firms become more aware about the existence of hidden costs in the internationalization process and try to counteract them. issue - The export manager of a furniture firm stated:

“There are always hidden costs in the process of entering a new foreign markets”.

In some case, firms do not perceive the hidden cost of internationalization. Our face to face interviews suggested hidden costs in these case may be not perceived by firms, since they have a non-monetary nature. Managers deny the existence of hidden costs when they take place in the form of missed opportunities (i.e. entering in other more profitable markets), human resource's time spending and other non-monetary costs.

In relation to the moderating role of relational capability, this seems to be is particularly crucial in peculiar markets as the Chinese or Indian ones:

“Chinese employees are quick to engage in job-hopping and have a formidable ambition. It is important to build a stable and reliable local staff, training and retaining it. We were able to reduce risks involving expats and local managers” (Chief Executive officer of a manufacturing firm).

Relationships with partners are another important issue emerging from interviews:

“If we do not succeed in potentiality high potential market we do not exit this market, but rather change distributor. Wedo not know the market but our local partner has to be familiar with it and tell us what we can do” (Export manager of a machinery firm)

Partners provide information related to the market so they could help firms to plan their costs. In addition, they seem to be more important in distant market where firm's knowledge is low. Interviewed managers reveal that companies that only export often follow some customers or choose the market without effectively analyzing opportunities and threats. This could be one explanation for the hidden costs phenomenon.

DISCUSSION AND CONCLUSIONS

This study tries to shed light on the hidden costs of going global focusing on emerging and distant markets. Our preliminary results provide us with some clues on how our hypothesized mechanisms work. In particular, face-to-face interviews with export managers of some of our sample firms seem to suggest that in two situations firms are able to narrow distance-driven hidden costs: first, when they have already accumulated sufficient experience on international markets, as their routines and capability of analysis and market interpretation help them to better detect the real extent of opportunities and costs the firms will incur in; second, when firms are able to effectively relate to different types of local partners (suppliers, distributors, institutions, etc.), as this speeds up the process of local market knowledge accumulation thus allowing them to readily adjust their expectations regarding the results they will obtain in the specific foreign market.

Even if our research is still in progress, we believe that it explores a very important aspect of firms' internationalization process. In fact, in current years, it is very common for firms to invest into emerging countries, fascinated by prospects of large, growing markets and high revenue opportunities. However, empirical evidence suggests that such opportunities often do not materialize, thus leading firms to have to amend their expectations. By exploring the reasons behind this phenomenon and the tools firms can use to limit this effect, we believe this research will contribute to the literature on entry in emerging countries, as well as give managers intuitions on how to improve their ability to make predictions on their entry strategies' performance.

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