

**Faculty of Business**

**Internationalization Strategies of Firms:  
An Empirical Study of EU Companies' Expansion into China's  
Environmental Protection Sector**

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Doctor of Philosophy  
of  
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## Declaration

To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgment has been made.

This thesis contains no material which has been accepted for the award of any other degree or diploma in any university.

**Ethics:** The research presented and reported did not include humans or animals.

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## ABSTRACT

China's rapid growth and industrialization has made it necessary to face and resolve a multitude of environmental problems. European companies have competitive advantage in the environmental protection (EP) sector due to a long history of government regulation and support structures for uptake. Though there are opportunities for European Union (EU) companies in China, a very different institutional context is likely to be a challenge.

Using qualitative research methodology, this study investigates the entry and development strategies EU companies deploy when internationalizing into the EP sector in China. It examines the extent their strategic choices have been constrained by the liability of foreignness (LOF) arising from the institutional dissonance between home and host country contexts. It identifies the strategies that cope more effectively in overcoming the LOF. This study contributes to a deeper understanding of corporate strategies in highly differentiated institutional settings both from theoretical and practical perspectives.

Case studies of six EU companies were conducted in China in 2014 and 2015 showed that prior network connections, managerial experience, *guanxi* with a state-owned enterprise (SOE) and following clients to China played key roles in formulating development strategies and accelerated their entry. The main challenge faced by all companies is discriminatory hazards that disadvantage foreign companies in the host government's effort to develop and promote their SOEs.

The research has shown that the inward learning and experience gained by the SOEs and other local companies has become an impediment to growth opportunities for foreign companies resulting in loss of intellectual property and increase in product imitation. This finding leads to the theoretical contribution that learning and experience does not always result in reducing LOF if the institutional context is inherently biased towards local actors, and firm-specific assets (FSAs) are not sustainable as local technological capacity increases over time. This study shows that LOF has increased because the assets of foreignness (AOF) they used to enter China have been eroded over time.

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## **LIST OF ABBREVIATIONS**

AD – Associate Director

AOF - Asset of Foreignness

AOM – Asset of Multi-nationality

APEC - Asia-Pacific Economic Cooperation

BDHC – Beijing District Heating Company

BUDI – Business Unit Director, Incinerator

CBDA – Cost of Doing Business Abroad

CBM – Cubic Meter

CEC - Commission of the European Communities

CJV – Contractual Joint Venture

CMOST - Chinese Ministry of Science and Technology

CNPC – China National Petroleum Corporation

COO – Chief Operating Officer

CRD – Commercial Regional Director

CSA – Country-Specific Advantages

DIR - Director, Regulatory EIA services

EC – European Community

EG – Environmental Goods

EIA – Environmental Impact Assessment

EJV – Equity Joint Venture

EM – Emerging Market

EMNE – Emerging Market Multinational Enterprise

EP – Environmental Protection

EPL – Environmental Protection Law

EPB – Environmental Protection Bureau

EU – European Union

FDI - Foreign Direct Investment

FM – Finance Manager

FMC – Ford Motor Company

FSA – Firm-Specific Assets

FSD – Firm-Specific Disadvantages

FSAD – Firm-Specific Advantages

FYP – Five-Year Plan

GDFDI – Guiding Directory on Industries Open to Foreign Investment

GEN – Global-Meta Environment

GHG – Green House Gas

GM – General Manager

GMA - GM's assistant (GMA)

G1 - Program Team Leader

G2 - Communication Expert

G3 - Assistant Country Director

G4 - Senior Climate Change Advisor

G5 - Attaché, Science, Technology & Environment Section

G6 - Counsellor, Environment and Climate Change

G7 - Policy Officer, Trade and Sustainable Development

G8 - Senior Manager, Environment

G9 - Senior Manager, Environment

G10 - Policy and Law Department

G11 - Coordinator, Environment

G12 - Consultant, China Environmental Management Program

G13 - Senior Managing Consultant, Environment

G14 - Marketing Manager, Building, Energy & Environment

G15 - Researcher

G15 - International Partner

G16 - Trade and Commerce

G17 - China Manager

HOS - Head of Sustainability and Energy

HPM - Heat Pump Manager

HQ - Headquarters

HS – Harmonised Code

HWI – Hazardous Waste Incineration

IB – International Business

IBE – International Business Environment

ID – Institutional Distance

IJV – International Joint-Venture

INV – International New Venture

JSC – Joint Stock Company

JV – Joint-Venture

LDI – Local Design Institutes

LEED - Leadership in Energy & Environment Design

LOF – Liability of Foreignness

LOH – Liability of Home

LOM – Liability of Multi-nationality

LTO – Long Term Orientation

M&A – Merger and Acquisition

MD – Managing Director

MEP - Ministry of Environment Protection

MNE – Multinational Enterprise

MSW – Municipal Solid Waste

NDRC – National Development Reform Commission

NEPL – New Environmental Protection Law

NETA - Nantong Economic and Technology Development Area

NGO – Non-governmental Organization

NOx – Nitrogen Oxide

NPC – National Party Congress

OFDI – Outward Foreign Direct Investment

OLI - Ownership, Location and Internalization

PD – Power Distance

PDM – Project Development Manager

PM – Plant Manager

POREEN - Partnering Opportunities between Europe and China in the Renewable Energies and Environmental iNdustry

PRM – Project Manager

R&D – Research and Development

RE – Renewable Energy

RHQ – Regional Headquarters

RIM – Research and Innovation Manager

ROA – Return on Assets

SEPA - State Environmental Protection Agency

SEZ – Special Economic Zone

SINOPEC – China Petroleum and Chemical Corporation

SOE – State Owned Enterprise

SSH – Socio-economic Sciences and Humanities

TiSA – Trade in Services Agreement

TT – Technology Transfer

UNDP – United Nations Development Programme

VAT – Value Added Tax

WFOE – Wholly foreign-owned enterprise

WFOS – Wholly foreign-owned subsidiary

WOE – Wholly owned enterprise

WOS – Wholly-owned Subsidiary

WTO – World Trade Organization

# CHAPTER 1

## INTRODUCTION

### 1.1.Purpose of this Study

In 2013, the Commission of the European Communities (CEC) awarded funding to a joint EU-China research network, Partnering Opportunities between the European Union and China in Renewable Energy and Environmental iNdustry (POREEN) which sought to explore EU-China trade and investment links in environmental industries and highlight potential areas of difficulty and opportunity.

The CEC in a Memo dated 18th July 2013 announced the framework for working with China to explore the benefits of green growth. The EU's environmental industry, and its well-developed expertise has a lot to offer China (CEC, 2013a). On the Chinese side, the concept of "ecological civilization" was formalized in its National 12<sup>th</sup> Five-Year Plan (FYP) (2011-2015). This concept was proposed by President Hu Jintao in 2007 to balance economic and environmental growth (China Daily, 2007).

Increasing governance in terms of accountability and public disclosure of pollutant emission is newly incorporated into the new environmental protection law (NEPL) (article 26 and 27) which came into force on 1<sup>st</sup> January 2015 (Vella & He, 2016).

The tightening of China's legislation towards environmental protection (EP) underscores the dire need of expediting China's trade and investment policy to be inclusive of environmental impact. In this case, the EU's expertise in green technology and its deep commitment to a greener Europe and greener world (as narrated in the EU 2020 package) (CEC, 2016b) will create vast opportunities for EU EP firms to engage in the eradication of damaged ecological conditions as China transition into green development.

In the context of POREEN, this research studies EU companies operating in the EP sector in China. The research context outlines the institutional distance between the EU and China. The research investigated six EU companies and evaluated their entry and

development strategies identifying difficulties faced over the years of their operations, and discerning strategies used to cope with these difficulties over time.

A theoretical framework comprising internationalization and institutional theories serves as a construct for analyses and discussions of the six case study companies. This will help to advance knowledge between the expected strategy postulation of international business (IB) theories and the practical strategies that companies have used or are using in their operations in China.

## **1.2. Outline of the Thesis**

This study begins with introducing the research project under the POREEN framework providing a brief account of the theoretical research objective and the research topic in the market context between the EU and China. It includes a synopsis of China's degrading environment in a wider context, and how the existing EU-China strategic relationship could accelerate "Green China" because of EU's expertise in green technology and sustainability management.

Chapter 1 seeks to formulate the research context of the entire thesis. It introduces the impact of globalization on industrialization and environment with emphasis on the EU and China. This is followed by a brief description of the institutional distance (ID) between the EU and China. To put the EU and China strategic relationship into perspective, the trade and investment figures from the EU to China between 2002 and 2015 were analysed. Finally, the regulatory environment in China is reviewed in the context of the evolutionary foreign direct investment (FDI) and the EP laws.

Chapter 2 provides an extensive literature review that covers topics on internationalization, entry mode decisions, liability of foreignness (LOF), EU companies operating in China, the legislative development of the EP sector in China and the rapid expansion of China's renewable energy (RE) overseas investments. Finally, gaps in the literature are highlighted that lead to the research questions.

Chapter 3 explains the choice of methodology and introduces the research design. Semi-structured face-to-face interviews with key respondents in EU companies and background interviews with gatekeepers (governmental approved authorities, NGOs, trade

associations and embassies in China) were the principal method of data collection. The next three chapters (4, 5 and 6) present a cross-case analysis based on the theoretical/analytical framework developed.

Chapter 4 analyses and discusses of the EU companies' entry and development strategies in China and why they were adopted.

Chapter 5 encompasses analysis and discussion of the difficulties that the EU companies faced as a result of institutional dissonance between the home and host country contexts.

Chapter 6 analyses and discusses the coping strategies that the EU companies used to overcome their difficulties.

The final chapter concludes this thesis. The novel contribution to theory and literature is the main highlight, followed by an acknowledgement of the limitations of the research and recommendations for future research.

### **1.3 Introduction**

The globalized world is now entering a new era associated with challenges of sustainable development. In the next few decades urbanization of emerging economies is expected to increase rapidly and this is likely to be associated with increased in pollution of land and water. Hundreds of millions of households will have problem in accessing energy if no progress is made on such accessibility (United Nations, 2013). Carbon emissions by emerging economies is expected to reach 51% by 2020 (Elzen, Olivier, Hohn, & Janssens-Maehhout, 2013). Ecological degradation is a global issue and cannot be solved purely at a national level.

China, the biggest and fastest growing emerging economy needs to eradicate extreme environmental issues that are threatening the health of its citizens (Leal-Arcas, 2012). Of the 20 most polluted cities in the world, 16 are in China. The capital city, Beijing is ranked the 2<sup>nd</sup> most polluted of all global cities (Chauhan, 2014). The current situation that is faced by China today could probably be attributed to the "race to the bottom" argument which asserts that the attraction of 'dirty' industries to a country with lower environmental regulatory enforcement creates a "pollution haven" (Walter, 1982; Low, 1992; Daly, 1993;

Wilson, 1996; Lofdahl, 1997; Xing & Charlesd, 1998; Copeland & Taylor, 2004). The degradation of the environment can be explained by the Environmental Kuznets' Curve which posits that the environment of a developing economy with lower income level tends to degrade. Over time, the environment tends to improve as a result of higher income (Brock & Taylor, 2005) when the post-reforms generation that constitutes the middle class recognizes the demand for quality lifestyle choices (Pew Research Centre, 2013).

The EU, the biggest economic community in the world, has been a global leader in instituting successful environmental policy since the 1990s becoming a globally recognized advocate in environmental treaties and having effected 12 agreements since then (Kelemen & Vogel, 2009). This is reflected in EU trade policy which supports economic growth, social development and environment protection. As a result, EU expertise in green technology and sustainable development management is well positioned to fulfil China's ecological demand. On the other hand, the EU has sustained very low economic growth (less than 1% and sometimes negative growth) since the 2008 global financial crisis. Forecast growth in 2016 is below 2% (CEC, 2016a). European companies have considerable expertise and experience in processes such as energy-conservation and energy-efficiency, expertise in which Chinese industry tends to be less capable and which is in great demand (Chen, Fu, & Wang, 2013). Hence, the Chinese market provides excellent business and growth opportunities for existing and new European companies to expand their business.

#### **1.4 Background**

The history of trade between Europe and China is rooted in bilateral relations that can be traced back to 1949, when China became independent and some European countries recognized the "People's Republic" as the only government in China. In 1975, its independence was legitimized by the European Community (EC) which led to the establishment of the first diplomatic relationship. In 1978, a trade agreement was enacted and China was granted preferential trade status (Shambaugh, 1992). As a result, between 1980 and 2015, bilateral trade rose from €3.9 billion (Lu, Yan, & Deng, 2014) to €520 billion which is indicative of significant progress China made in economic reforms following the WTO agreement (WTO, 2001) liberalizing trade.

Environmental awareness has grown in China as economic growth has an impact on both environmental quality and capacity to pay. Dramatic economic and political reforms have transformed the country to an economic power house of the 21st century (CCICED, 2013). The success of China's industrialization is reflected in increased urbanization and decreased poverty (CCICED, 2013), but there have been attendant social costs. China is the biggest carbon emitter in the world (WB, 2013b). Today, China's greenhouse gas (GHG) emission escalated from 10% of the world's total in 1990 to 30% in 2015. Such degradation of the environment has had harmful effects on the health of its citizens (Reuter & Men, 2014) who have become increasingly fearful of the air and water pollution.

The environmental challenges faced by China are at a crossroads between balancing the economic well-being of its citizens in terms of physical health and economic wealth as well as adopting measures to ensure green economic growth. To achieve this balance, the government has recognized the reality that China's economic development has entered a critical period of green shift (CCICED, 2011). The addition of ecological civilization into the economic framework in the 18<sup>th</sup> National Congress underscores the dire need of ensuring that China's trade and investment policy incorporates "environmental consciousness" at the country and firm-level into economic and corporate planning.

In light of China's ecological movement and the EU's economy's predicament of slow growth, the EU and China need one another to fulfil their respective growth agenda. Environmentalists from public institutions, local and international non-government organizations (NGO), as well as increasing environmental awareness of citizens have exerted combined pressure on the Chinese government to commit to a green development agenda that encompasses openness toward policy-change. One example is the enforcement of the NEPL in January 2015. Thus, this new enforcement has created an opportunity for growth in the Chinese EP sector that is now regulated by a more stringent law that advocating greater clarity in terms of punishment. All businesses are compelled to adhere to processes that would meet compliance standards.

On the other hand, it is important to recognize the institutional distance (ID) between the EU and China. The EU's support of China's accession to the WTO was an indication that both parties acknowledged their trading potential and political power in the world (Algieri,

2002). Decades of cultural policy and cultural diplomacy have caused an institutionalized change and have had an impact on political and economic relations between the EU and China (Meissner, 2002). The ID determines the extent of challenges that EU companies would face in anticipation of China's domestic policy that might affect business operations in China. This in turn, influences the investment climate in China significantly. EU-China investment has stagnated and only accounted for just 2% to 3% of overall European investment abroad (EC, 2014d).

### **1.5 Institutional Distance (ID) between the EU and China**

Kostova (1996) defines ID as the extent of dissimilarity between the three institutional pillars (regulatory, cognitive and normative) of two countries. In the context of the EU and China, institutional distance is high. Table 1.1 and 1.2 below highlight the extent of dissimilarities that are associated with the regulatory pillar (governance and institutional environment) between the EU and China.

The low score of China in all the governance indicators (except political stability) implies a relatively weak institutional environment compared to the EU (Table 1.1). On the other hand, the institutional environment is influenced by the values and beliefs system that are culturally embedded in a given society. These in turn guide the behaviour of individuals and firms. Recent empirical evidence has shown that a supportive institutional environment eases the way for Chinese firms to seek strategic assets in developed economies despite the institutional variance (Deng, 2009; Luo, Zhao, Wang, & Xi, 2011). As a result, Chinese firms investing in the EU benefited from the stable institutional environment (Luo & Tung, 2007; Klossek, Linke, & Nippa, 2012). On the opposite direction of investment, the challenges faced by EU companies entering China are likely to be substantially different from those of Chinese companies investing in the EU. In relation to other variables in the context of the institutional environment, although relatively close in terms of favouritism and transparency in policy making, they are rather far apart in several others, most notably ethics.

**Table 1.1 Worldwide Governance Indicators 2016**

<b>Worldwide Governance Indicators</b>	<b>EU Average Score</b>	<b>China Score</b>
Political Stability and Absence of Violence/Terrorism	81.64	27.01
Government Effectiveness	94.86	46.83
Regulatory Quality	94.04	42.58
Rule of Law	94.96	39.81
Control of Corruption	94.42	46.89

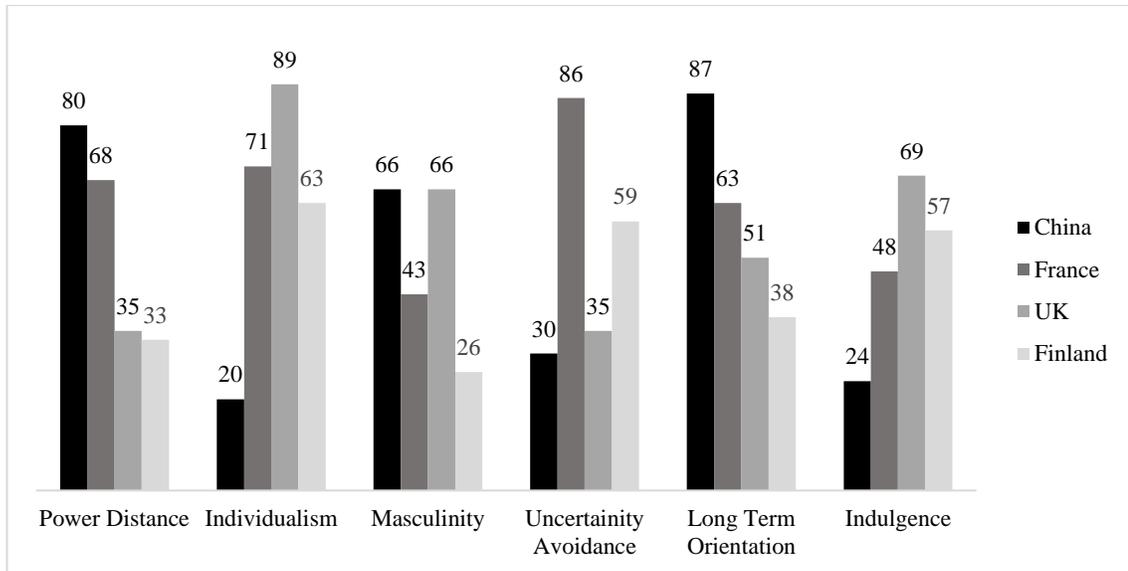
*Source:* Adapted from The World Bank 2016.

**Table 1.2 Institutional Environment (Regulatory Pillar)**

<b>Selected Variables</b>	<b>EU Ranking</b>	<b>China Ranking</b>
Favouritism in decisions of government officials	15	22
Efficiency of legal framework in settling disputes	18	49
Efficiency of legal framework in challenging regulations	17	47
Transparency of government policymaking	25	33
Ethical behaviour of firms	13	55

*Source:* Adapted from World Economic Forum. The Global Competitiveness Report 2014-2015

In terms of the ID relating to the normative and cognitive pillars, Hofstede's six-dimensional model of national culture can be used to explore national cultural dissimilarity between France, UK, Finland (the home countries of the case study companies) and China. The salient merit of this model is that the dimensions identified sought to address basic problems pertinent to all societies (Minkov & Hofstede, 2011).



Source: Adapted from Hofstede and Minkov (2010).

**Figure 1.1: Hofstede's Six-Dimensional Model of National Culture between France, UK, Finland, and China**

The scores of each cultural dimension do not show a consistent pattern between the three EU-member states although the institutional and administrative structures may be quite similar. France is more culturally similar to China in terms of submission to authority and adaptation to changed conditions, as reflected in the higher scores in power distance (PD) and long-term orientation (LTO) compared to the UK and Finland. The UK, on the other hand, is as equally driven by high success as China, scoring the same in masculinity. Finland scores are diametrically opposite to China in all dimensions. In other words, the contrasting national culture may inflict relational difficulties because societal norms and expectations differ.

In terms of the most contrasting cultural dimension between the east and the west, China is a collective culture (low score in individualism) that has a “herd” mind-set that follows the leader. As a result, individual opinions and expressions will be seen as disharmonious and damaging to group cohesiveness. Thus, a low score in individualism corresponds to a higher acceptance of an authoritative style of governance and a more restrained society reflected in the low score in Indulgence. The highest score in LTO indicates that China has a greater propensity to adapt traditions and changes easily as compared to France, the

UK and Finland. One salient example is that prior to the official enactment of the Wholly Owned Foreign Enterprise Law (WOFEL) in 1986, the Chinese government allowed the formation of wholly foreign-owned subsidiaries (WFOS) on an experimental basis in different industries (Li, Yang, & Yue, 2007; Papyrina, 2007). This phenomenon indicates the pragmatic view of the Chinese government in response to the market before the law was officially enacted.

Related to the LTO score, is the low score in uncertainty avoidance. It implies that China has a higher tendency to sway from regulatory compliance to solve problems as they happen. This could be explained by the lower efficiency in executing the legal framework (Table 1.2). As a result, the EU companies would tend to face greater challenges in trying to cope with a less transparent legal framework. This is exacerbated by the fact that China is geographically vast, so that traditions and values differ across the provinces in the country. For example, the governance of environmental protection bureaux (EPB) in terms of practices and priorities across the provinces in China differ because of this heterogeneity in traditions and values (Lo & Fryxell, 2003). This is also intimated by a case study informant that the people from the first-tier cities (Beijing, Shanghai, Guangdong and Shenzhen) are more open. Second tier cities (Tianjin, Chongqing, Chengdu, Wuhan and Xiamen) and beyond are more traditional. As a result, it is apparent that the governance of these cities is shaped by their traditions and values.

Finally, in terms of the legal framework, the business environment for foreign companies in China is regulated by the FDI Law. In the case of the EP sector in China, there is extensive relevant regulation. Companies have to comply with the overarching Environmental Protection Law (EPL) and the various environmental laws applicable to the respective EP industry. Moreover, regulations can vary between local governments. Sometimes, they can change over time (Niu, Dong, & Chen, 2012). This regulated condition increases the interaction between the institutions and the companies to ensure compliance in a very dynamic environment.

In essence, the EU and China differ in geography, culture, language, political and economic regimes. These differences have an impact upon the degree of institutional distance between them and may affect the profitability and survival of firms. Given the

high institutional distance across all the dimensions, it is logical to expect quite extensive difficulties to emerge when EU companies invest in China. The next sections provide an overview of the evolution of the institutional context of trade and investment.

### **1.6 The Context in the EP Sector in China: The Evolution of the Institutional Context and Trade**

The institutionalization of China's environmental sector is evidenced from the number of policies that have been instituted from the time the transition to a market economy took place. This is reflective in the role of the governing institution which was then assigned a coordinating role to the present day Ministry of Environmental Protection (MEP) empowered with administrative authority over environmental polluters. Between 1979 and 2015, 825 polices were issued by the MEP (Yin, Spigarelli, Zhang, & Zhou, 2016). Of these, command and control policies were usually associated with high cost of implementation and incentive issues to reward and punish businesses were the most dominant. However, the effectiveness of polices implementation should include the expansion of economic policies (Yin et al., 2016) that were linked to trade and investment. Trade between the EU and China hovered at an annual rate of 21% between 1996 and 2011 largely due to bi-partisan policies advocating environmental trade in the EU and increasing competitiveness of China's environmental goods (Qu & Zeng, 2016). As a result of this competitive China's market, total outward FDI (OFDI) from China into the EU increased rapidly (Zhao, Dai, Zhang, & Wen, 2016). Drawing from one province study using firm-level data in Jiangsu, it was found that Jiangsu had zero OFDI in 2004. By 2013, it accounted for 45% of China's total investment in the EP sector to the world indicating a tremendous potential for investment between the EU and China (Zhao et al., 2016).

In light of the environmental policies that are commonly linked to trade and investment, this section will highlight the important changes which have occurred in the regulation of FDI on the one hand, and the EP sector in recent years, on the other. It is followed by an overview of trends in bilateral trade.

### **1.6.1 The Regulation of FDI in China**

China's receptivity to foreign investors is evidenced by the evolution of the various laws pioneered by the then leader Deng Xiaoping (First Vice-Premier of China). In 1979, the *Equity Joint Venture Law* was the first foreign investment law established to prevent the state from nationalizing revenues of foreign investment. Foreign businesses were protected by limited liability in the event of a failed business in China. When China entered into the intermediate stage of market reform, this law was amended and it permitted foreign chairmanship on the board of directors.

By 1986, foreign businesses were permitted to invest as WFOS under the Wholly Owned Foreign Enterprise Law. However, WFOS were obliged to adopt advanced technology and equipment or export a majority of their products. Arguably, during that time, China did not have the economic capacity to consume the goods it was capable of producing. Despite these conditions set, China was an attractive investment country largely due to the abundance of cheap and skilled labour, developed special economic zones (SEZ) that provided transportation mobility, human capital infrastructure and FDI tax incentives. An influx of foreign investments from the US, Japan, and Western European firms explicitly exploited these advantages (Tse et al., 1997). At the end of 2001, FDI in the manufacturing sector accounted for over 70% of total FDI in China, while FDI in the service sector was mostly due to the demand in services in real estate constructions.

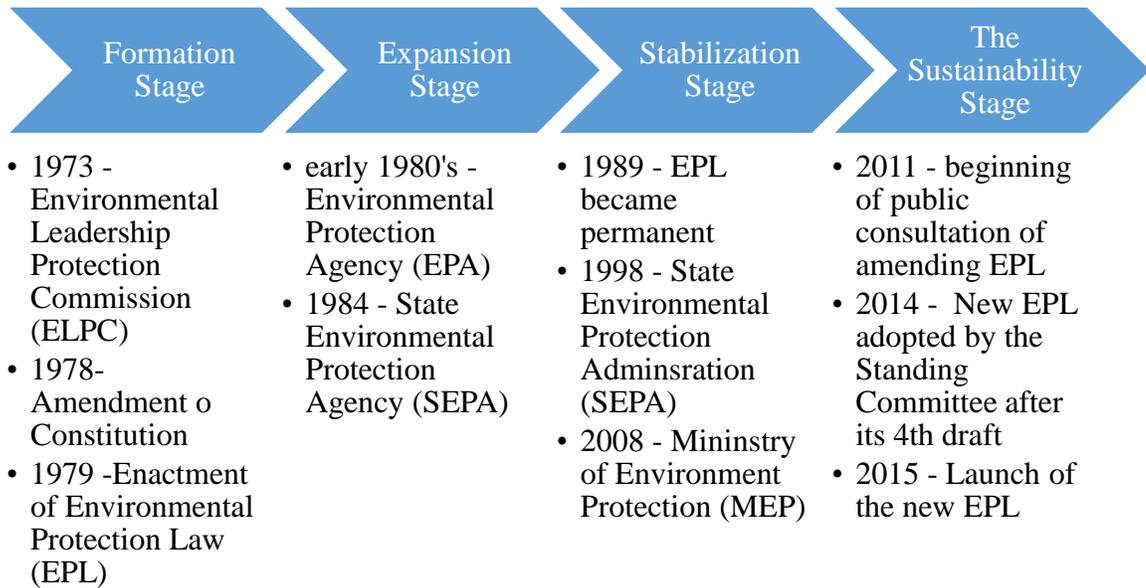
In 1995, the Provisional Regulations upon the Guiding Directory on Industries Open to Foreign Investment (GDFDI), now known as the FDI catalogue was promulgated. It specified FDI projects into four categories: projects that are encouraged; allowed; restricted; and those prohibited. In 2001, the GDFDI was revised in preparation for China's accession to the WTO. Shortly after joining the WTO, certain FDI conditions such as exports proportion, local content requirements, balance of foreign exchanges, technology transfer (TT) and creation of research and development (R&D) centres were abolished. Entry mode by WFOS replaced joint-ventures (JV) as the most favoured mode of FDI in China. By the end of 2003, China had an accumulated FDI of \$500 billion (Long, 2005).

China's accession to the WTO has undoubtedly shaped its FDI policies to increase international trade through limited or zero tariff barriers. For example, prior to joining the WTO, in 1982, the average tariff level was 55.6% and 43.2% in 1992. In 1992, China aligned its laws towards international practices. For example, it signed several international agreements on property rights protection (Papyrina, 2007). The types of entry into China have since changed from exporting to WFOS due to government efforts in promoting economic development and integrating China into the global economy. Recent studies have lent support to this change so WFOS is the most favoured mode of entry into China (Xia, Tan, & Tan, 2008; Li & Li, 2010). Real-estate, land-use rights, patent, copyright, trademark, removal of JV duration requirement, as well as an equitable taxation system of all foreign enterprises are changes that boost two-way growth and benefits for investors and China.

### **1.6.2 The Regulatory Framework of the EP Sector in China**

China's encounter with EP related matters on an international level began when it hosted its first National Environmental Protection Conference in 1973 in conjunction with the United Nations' announcement of the Human Environment Declaration. As a result, the Environmental Leadership Protection Commission was formed to coordinate and handle environmental tasks. Since then, the regulatory framework has gone through three stages of changes before the first EPL was finally enacted in 1979. It was a milestone set to traverse China into focusing on sustainable methods towards economic development governed by a regulatory framework. Subsequently a series of complementary laws have been established as China faces international pressures to regulate the environment. The governance in EP has heightened from being an organizationally weak institution deficient of staff and lacking in bureaucratic status to an integrated government enforcer possessing real administrative authority, which is now known as the Ministry of Environmental Protection (MEP) (Qiu & Li, 2009). The creation of the MEP in 2008 was to assign the Ministry a legal authority to vote in the State Council and to increase its voice when it reviews, monitors, controls and implements pertinent measures to preserve the environment. As such, environmental considerations are likely to be taken seriously in major decisions-making in China (Qui & Li, 2009).

The figure below shows the evolution of China’s EP framework adapted from Qiu and Li (2009). “The Sustainability Stage” is incorporated to show the trajectory towards the enactment of the new EPL which is discussed in the next section.



**Figure 1.2 Evolution of the Regulatory Framework in China**

*Source: Adapted from Qiu & Li, 2009 (from formation to stabilization stages)*

### 1.6.3 The New Environmental Protection Law (NEPL)

As illustrated in Figure 1.2, the EPL has not been amended (since 1979) even though the socio and economic development in China had experienced a series of changes. Within this similar developmental context, FDI polices had been revised numerous times. On 24th April 2014, the NEPL after its fourth draft was adopted by the Standing Committee of the National Party Congress (NPC) and took effect on 1<sup>st</sup> January 2015 (EGP, 2014).

Most importantly, the NEPL is a result of public participation such as contribution from the citizens, professionals, educators, NGOs and more. Public participation is possible because of information disclosure and increase transparency that allow the public to monitor firms (Marquis, Zhang, & Zhou, 2011). This indicates China’s administration has transformed to a level of openness to engage a two-way dialogue with the public to create

an effective EP law. This action is consistent with the incorporation of “ecological civilization” into the 12<sup>th</sup> FYP towards a Green China. The highlight of the new law is a steep increase in the stringency of governance on local governments and the polluters. The local governments are mandated to report their environmental progress to the State which implies that they must engage in sustainable economic activities to avoid penalty. On the other hand, recalcitrant polluters who continue to use equipment/machinery/processes that pollute the environment are subject to fines on a daily basis until the day that their old practices are amended. For example, within the first two months into the NEPL, over 350 polluters had received severe punishment, with 17 companies hit by daily fines totalling over RMB 7 million (Zheng, 2015).

The NEPL redefines the responsibility of the State, local governments, operators, NGOs, media and citizens. It clarifies the consequences of violation by the economic actors. For example, two days before its enactment, a Chinese court fined six companies in Jiangsu province a total of \$26 million and demanded they pay within 30 days. They were charged for releasing chemical waste into rivers (BBC, 2014). Nevertheless, the NEPL is expected to level the playing field between local and foreign economic actors since the law applies to all economic actors regardless of nationalities (Li, 2014). As a result, according to the Legal Firm, foreign companies would see more opportunities and fewer difficulties in accessing the EP sector in China.

## **1.7 Overview of EU-China Trade Flow**

### **1.7.1 EU-China Trade**

The significance of EU and China’s cooperation and reciprocity on a bilateral level was seen when the EU supported China’s accession to the WTO in 2001. In 2004, the EU became China’s largest trading partner, while China became the EU’s second largest trading partner (Eglin, 1997; Peng, 2009). On the forefront of the global economy, the EU as a single market of 27 members (in 2010) had the highest share of world GDP at 25.8% while China was ranked top in its share of world GDP at 9.1% among the emerging markets in 2010 (Eurostat, 2013). Together the EU and China form the second-largest economic cooperation in the world trading at more than €1 billion a day. Total bilateral trade between the EU and China since 2002 increased 316% by 2015. As shown in Table

1.3, the EU's trade deficit with China has been persistent since 2002 although some observers are optimistic that the increase in China's middle class will result in an increase in Chinese demand for EU imported goods, which would thus reduce China's trade surplus with the EU in the coming years (The European Union's FWC COM, 2013).

### 1.7.2 Analysis of EU-China Bilateral Trade in Goods

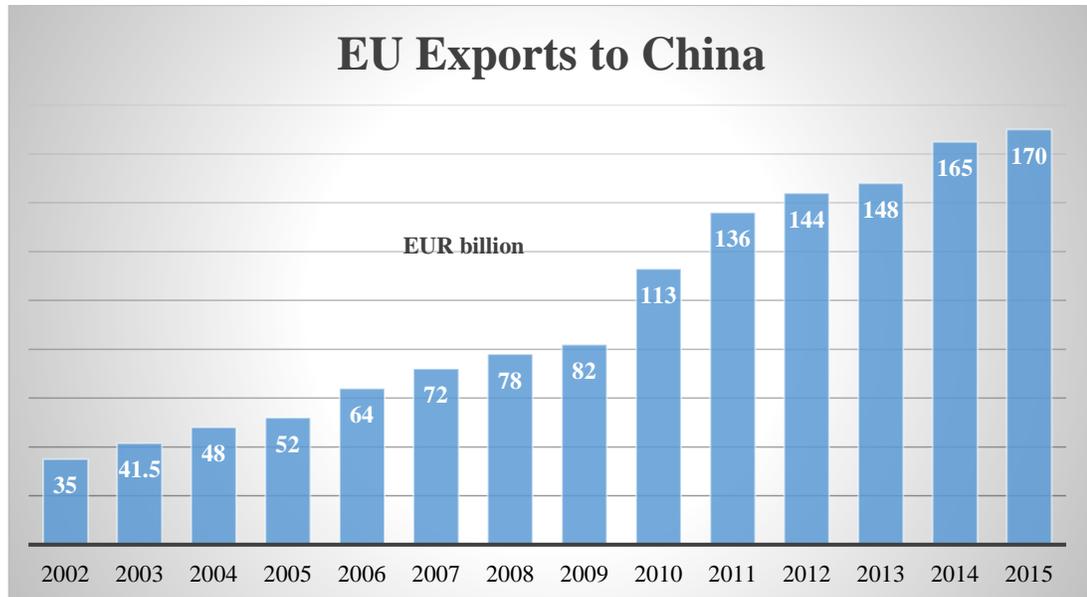
Table 1.3 shows that China's total trade in goods with the EU had more than trebled over a decade from €125 billion to €520 billion. The bilateral trade started to recover slowly in 2010 after the 2008 financial crisis. Since then, it has increased by about 31% in 2015.

**Table 1.3 Overview of bilateral EU-China Trade in Goods between 2002 and 2015(€ bn)**

Overview of Bilateral Trade between EU and China														
EUR billion	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
EU exports to China	35	41.5	48	52	64	72	78	82	113	136	144	148	165	170
EU imports from China	90	106	129	161	196	234	249	215.3	284	295	292	280	303	350
EU-China Trade Deficit	-55	-64.5	-81	-109	-132	-162	-171	-133.3	-171	-159	-148	-132	-138	-180
Total Bilateral Trade (BT)	125	147.5	177	213	260	306	327	297.3	397	431	436	428	468	520

*Source:* Adapted from the European Commission. Directorate-General for Trade. European Union, Trade in goods with China. Retrieved October 6, 2016 from [http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc\\_113366.pdf](http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf)

A closer analysis of the import and export trade between 2002 and 2015 revealed a different phenomenon. After China joined the WTO in 2001, EU exports to China increased fivefold and EU imports from China increased fourfold. In other words, the EU has been exporting more to China after China joined the WTO. Since 2011, the speed of EU exports decelerated showing marginal increase up to 2015. Although bilateral trade between 2002 and 2015 increased by over 300%, this did not narrow the trade deficit over the years. In 2015, the trade deficit stood at € 180 billion, down by 5% compared to 2010.

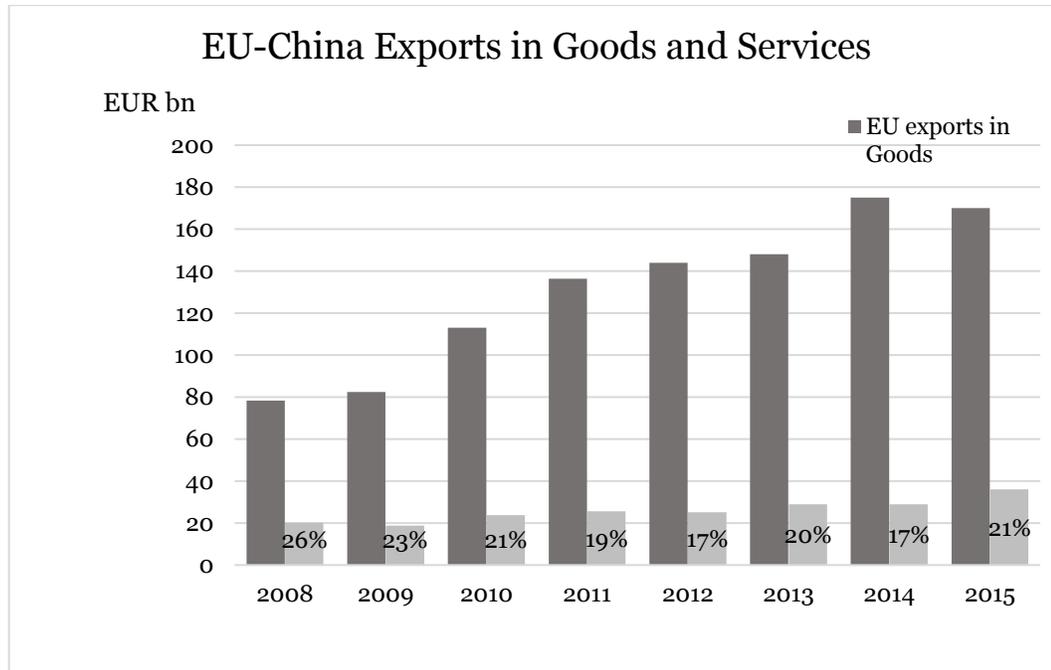


**Figure 1.3 EU-China Exports in Goods between 2002 and 2015 (€bn)**

*Source:* Adapted from the European Commission. Directorate-General for Trade. European Union, Trade in goods with China. Retrieved October 6, 2016 from [http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc\\_113366.pdf](http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf)

### **1.7.3 Trade Potential in Environmental Services**

To assess the potential in environmental services export, export trade data on goods and services between 2008 and 2015 were used to determine the ratio of trade in services over trade in goods. Figure 1.4 shows that this ratio hovers around 20%. The difference of 80% indicates a potential in trade in services for EU in China. On the other hand, it implies market access barriers to the service sector in China (CEC, 2014c). The EU has recognized the potential in trade in services and has shown strong support for China to participate in the rounds of negotiation with regards to the Trade in Services Agreement (TiSA) that was launched in 2013 (CEC, 2014c). The TiSA is expected to conclude by the end of 2016 (Mucci, 2016). Should China decide to join the TiSA, (even though it did not participate in the negotiation) it would have to abide by the rules. European companies in the service sector would stand to gain as they would face fewer barriers to entering China which is positive for EU EP services companies seeking to expand into China.



**Figure 1.4 EU-China Exports in Goods and Services between 2008 and 2015(€bn)**

Source: Adapted from the European Commission. Directorate-General for Trade. European Union, Trade in goods with China. Retrieved October 9, 2016 from [http://trade.ec.europa.eu/doclib/docs/2012/march/tradoc\\_149251.pdf](http://trade.ec.europa.eu/doclib/docs/2012/march/tradoc_149251.pdf)

#### **1.7.4 Summary**

In summary, the trade analysis shows that EU-China trade has slowed since the 2008 financial crisis. Despite the ongoing trade deficit between the EU and China, the share of EU exports to China has increased more significantly than its imports from China. The EU trade in services to China averages about 22% of its trade in goods between 2008 and 2013. The EU has led the negotiation of the TiSA but it remains to be seen if China will be part of the TiSA. Any decision taken by China would have implications for trade development between these two partners. At the same time, EU and China are highly interdependent (Jing, 2015) and the potential to increase trade in services would help to narrow the trade deficit.

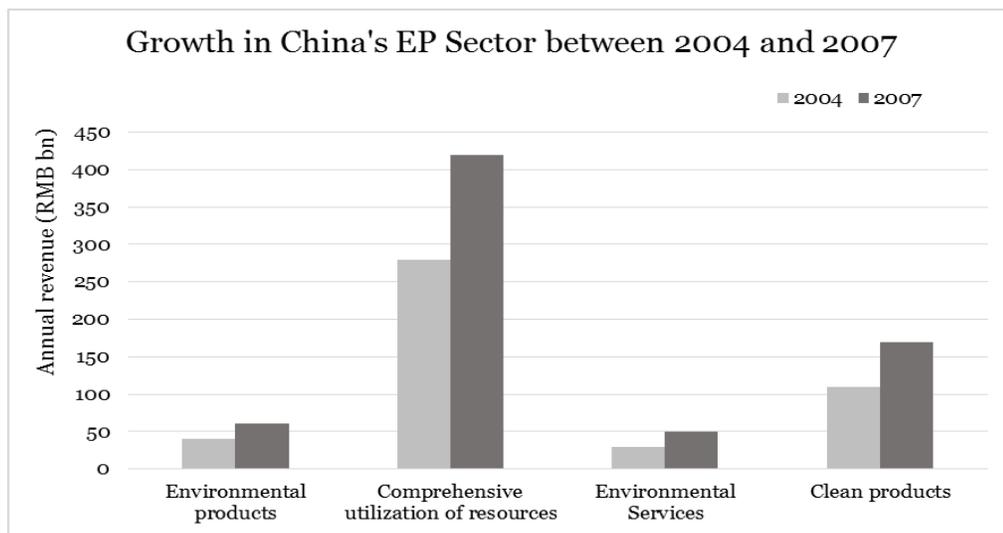
#### **1.8 Overview of the Environmental Protection (EP) Sector in China**

Four categories of goods and services are used specifically to define the meaning of EP in China. First are environmental goods such as equipment and material used for pollution

control, water treatment technologies and energy monitoring equipment. Second, is the comprehensive utilization of resources such as the waste management industry, industrial waste heat reuse projects, and recycling companies. Third, is environmental services such as environmental consulting and research institutes. Lastly, are clean products such as energy saving light bulbs and biodegradable materials (UNEP, 2013).

### 1.8.1 Growth and Potential

The EP sector’s revenue in China reached \$181.42 billion in 2010. According to China’s 12<sup>th</sup> FYP development program, it was estimated that the sector’s output would increase fourfold to \$725.67 billion in 2015. In addition, the value of services related to the EP sector was forecasted to reach RMB 500 billion or \$82.46 billion (China Daily, 2012). The EP sector employed over 3 million people in 2008, double the number in 2004. Parallel to the increase in employment, annual revenue in 2007 escalated to almost RMB 700 billion, up 51% from 2004 (Figure 1.5) (UNEP, 2013).



**Figure 1.5 Growth in China’s EP Sector between 2004 and 2007**

*Source:* Adapted from United Nations Environment Programme 2013. China’s Green Long March. A study of renewable energy, environment industry and cement sectors.

The sector continued to develop and grow in spite of global economic slowdown following the financial crisis. The Chinese government selected ecological and environmental protection as an important area of growth. In November 2008, shortly after the financial

crisis, it injected a total of \$586 billion to 10 sectors to boost domestic economic growth. The stimulus was the nation's largest expenditure (16% of GDP over a 2 year period) in history (*The Economist*, 2008). The combined expenditure for ecological and environmental protection, education and technical innovation loans projects, amounted to \$82 billion (Anbumozhi & Bauer, 2010).

In terms of potential, experts from Goldman Sachs (Zhu, Yan, He, & Wang, 2015) estimated the EP market to be worth RMB8.2 trillion in 2016-2020 up by 60% in 2011-2015. According to that report, China's environmental investment ratio against GDP was the lowest at 1.5% compared to the US, Germany and Japan when they were going through the same phase of curbing severe pollution. Sectoral potential lies in soil remediation because 16% of China's soil is polluted and beyond acceptable standards, while 19.4% of its total arable land was found to be contaminated with heavy metals.

The EP sector is very much less developed. In the light of the NEPL, growth potential includes replacing obsolete machinery and inefficient processes in the manufacturing sector. The urbanization rate is expected to reach 70% by 2030 (WB, 2013a) and this is an impetus to include eco-planning in developing new cities expanding emerging green industries such as the wind and solar photovoltaic energy generation industries (Tan et al., 2013). Before the NEPL, local companies could circumvent environmental pollution by not adhering to proper procedures due to their lack of knowledge as well as the extra costs in implementation. The enforcement of the NEPL has levelled the playing field between the local and foreign companies implying that local companies have to seek external expertise in environmental adherence in order to avoid the penalties imposed (EGP, 2014). In this instance, foreign companies operating in the EP sector welcome the NEPL as it will increase their business opportunities because they possess the technical skills and knowledge. Local companies are inexperienced in dealing with environmental issues. Thus, their existing competitive advantage is further strengthened and becomes sustainable in the context of the NEPL providing increased opportunities as well as enticing potential overseas investors.

### 1.8.2 EU-China Trade in Environmental Protection Goods

In determining “what constitute environmental goods (EG)” for the purpose of data collection and analysis (between 2002 and 2015), the Asia Pacific Economic Cooperation (APEC) list is used (APEC, 2012). This list was formalized at the 2012 APEC meeting in Vladivostok, Russia. The reasons for choosing the APEC list are several. Asia Pacific Economic Cooperation was the first to *single out EG “for trade liberation purposes as part of the Early Voluntary Sector Liberalization launched in 1997”* (Sugathan, 2013: 2). In 2012, APEC members successfully negotiated a tariff reduction for 54 EG to be enforced by the end of 2015. Second, there is an absence of an “agreed list” by many members of the WTO with regards to the “WTO list.” Which therefore lacks legitimacy and consistency for data collection and analysis purposes. Third, the APEC list is endorsed by countries such as the US, Canada, Australia, New Zealand, and Singapore (Sugathan, 2013). Fourth, the EU is expanding its list of harmonised codes (HG) for EG building on the APEC list (author interview, with informant G7).

Table 1.4 shows the total EU export to China in EG increased by 327% between 2002 and 2015 or from €1.8 to €7.7 billion in 2015 over the period. The top seven export of EG to China still were the same as in 2002 with machines relating to waste treatment continue to top the list. Export of wind turbines parts, instruments for measuring environmental impact and checking pressure of liquids and gases increased significantly to become the top seven export ranking in 2015. This indicates a new market potential of such products in China. In 2002, EU trade potential (China import from the world minus EU export to China) with China in EG was about €15 billion. It was estimated that EU trade potential would reach €77 billion in China. On the other hand, EU exports to China only accounted for 7% of total EU exports to the world in environmental goods. The export flow from EU to China, indicates a huge potential for growth of EU’s EG in China.

**Table 1.4 Top 7 EU Export of Environmental Goods to China in €'000**

APEC Environmental Goods HS Code and Description	EU Export of Environmental Goods to China (€'000)	
	2002	2015
847989 - Machines relating to waste treatment	438,647	1,326,504
847990 - Parts relating to waste treatment	209,437	505,710
903180 - Measuring or checking instruments for oxygen	172,122	987,650
850490 - Parts of electrical transformers from renewable energy to conventional energy	126,743	302,457
903289 - Automatic regulating/controlling instruments for temperature, pressure, flow, and level of humidity applications	66,346	350,005
842139 - Filtering or purifying machinery for gases, waste water	63,780	395,541
842199 - Parts for filtering or purifying machinery for gases, waste water	57,073	264,950

Source: Adapted from International Trade Centre. (2016). Trade statistics for international business development. Retrieved May 23, 2016 from [http://www.trademap.org/tbs/Bilateral\\_TS.aspx](http://www.trademap.org/tbs/Bilateral_TS.aspx)

## **1.9 Overview of EU-China Investment Flow**

### **1.9.1 EU-China Investment**

On 19<sup>th</sup> November 2013, discussion to create standalone investment agreement between the EU and China were announced by the two economic entities. The main objective was gradually to remove trade and investment barriers that would enhance market access into China by EU investors (CEC, 2014d). In a public consultation on the EU-China future investment in 2011, 81% of the respondents had expressed a need for this initiative because China is one of the most important countries for EU investors. Specifically, removing market access barriers was the most common request of respondents (CEC, 2013b). The majority also preferred to have one single EU investment agreement with China covering investment protection (CEC, 2011).

During the early China market reform in the 1990s, EU investments in China had increased steadily and between 2001 and 2010, EU investment stock quadrupled to reach €75 billion

(CEC, 2013b). However, EU-China investment growth has stagnated in recent years and only accounted for just 2% to 3% of overall European investments abroad. China continues to be the leading investment recipient in the developing economies despite a 2% decline in inflows in 2012 as compared to 2011. This decrease was explained by rising labour costs in China and competition from neighbouring countries in the manufacturing sector that has made such alternative locations more attractive. The other competitive force was due to the strengthening of the US manufacturing industry that encouraged local companies to produce domestically (UNCTAD, 2013). Despite this decline, in 2012, China's FDI inflow and outflow remained high and stood at \$121 billion and \$84 billion respectively (UNCTAD, 2013). In 2015, an improvement of the FDI climate in China was evidenced by a 4% increase of FDI flow attributable to the increase in service sector investment: total FDI flow to China stood at \$129 billion (UNCTAD, 2015).

### **1.9.2 Analysis of EU-China Investment**

Historically, EU investments in China have been higher than investments from China to the EU. European investments in China gradually declined since 2008 as shown in Table 1.5 reaching the low point in 2014, at slightly over €3 billion. The same year, China investments into the EU surpassed EU investments into China by over €500 million. Greenfield investment was the preferred mode of entry by the Chinese to enter the European market (Vaccarini, Spigarelli, Lattemann, Salvatelli, & Tavoltti, 2016). The drivers of Chinese investment in Europe to achieve market and strategic assets seeking objectives were found to be consistent in several studies (Lv & Spigarelli, 2015, Vaccarini et al., 2016).

In the Business Confidence Survey 2015 conducted by the EU Chamber of Commerce in China, the number of respondents indicating China as one of the top three investment destinations has dropped to 56% from 76% in 2012. European firms in China are less willing to expand their investments in China now, compared with 2012 (EUCC, 2015). At the same time, the EU share of total FDI in China declined drastically by 70% between 2011 and 2012. It started to pick up in 2013 and hovered at about 19.5% (Table 1.5). Interestingly, green-field investment is consistently the preferred choice of entry into China over and above mergers and acquisitions (M&A) (Table 1.7).

**Table 1.5 EU Foreign Direct Investment with China between 2008 and 2014**

EU Foreign direct investment with China							
€ billions	2008	2009	2010	2011	2012	2013	2014
FDI - China-EU	12.4	1	2	6.1	12.4	3.2	3.8
OFDI - EU-China	12	10.6	6.6	11.5	3.4	6	3.2

*Source:* Adapted from the ChinaObs fdiMonitor (COFM). (2015) Retrieved September 12, 2015 from <http://www.chinaobs.eu/?tab=eu>

**Table 1.6 EU-Share of Total Foreign Direct Investment into China between 2008 and 2014**

EU-Share of total Foreign direct investment into China							
€ billions	2008	2009	2010	2011	2012	2013	2014
Total FDI into China	55	57.5	34.6	43.5	24.8	31.2	16.2
OFDI - EU-China	12	10.6	6.6	11.5	3.4	6	3.2
EU share of FDI	21.8%	18.4%	19.1%	26.4%	13.7%	19.2%	19.8%

*Source:* the ChinaObs fdiMonitor (COFM). (2015). Retrieved September 12, 2015 from <http://www.chinaobs.eu/?tab=eu>

**Table 1.7 Types of FDI Inflows from EU into China between 2011 and 2014**

Type of FDI inflows from EU into China				
€ billions	2011	2012	2013	2014
Greenfield Investments	9.8	2.5	4.4	2.1
M&A	1.8	0.9	1.5	1.2
Total	11.6	3.4	5.9	3.3

*Source:* the ChinaObs fdiMonitor (COFM). (2015). Retrieved September 12, 2015 from <http://www.chinaobs.eu/?tab=eu>

China's investment into the EU has increased significantly and it has also responded positively to enact the EU-China investment protection agreement to protect Chinese investors in the EU (CEC, 2013b). Problems that have persisted over the years for EU investors in China are mainly the preferential treatment of national enterprises in particular the SOE, a lack of transparency and instability of the Chinese legal framework and market access barriers particularly relating to regulations (EUCC, 2015).

### **1.9.3 Summary**

In summary, the above has elucidated the ID between the EU and China and demonstrated that differences in the regulatory, cognitive and normative pillars buttress the distance by using selected key indicators. In the light of this distance, we would expect EU companies to be challenged when operating in China. Furthermore, China is heterogeneous in its traditions and cultures that are hugely diverse across provinces. In order to put the research context in perspective, the significant changes to the laws pertaining to FDI and the EP sector are presented. The laws are pertinent to understanding the institutional environment between trade and investment flows from the EU to China on the one hand, and the regulatory framework in China's EP sector on the other.

The analysis of trade figures over 13 years (2002-2015) after China's accession to the WTO in 2001, shows that significant trade deficit still exists, although it has reduced since 2010. Further analysis on trade using the APEC list of EG suggests tremendous potential for EU companies in offering their EG to China because China is only importing 10% of its total needs from the EU. In relation to the investment flow, China represents a mere 2% to 3% of total EU investments abroad. Several market surveys suggested that China is becoming less attractive as a destination for investment or expansion. The emerging causes are unfair treatment towards foreign companies relative to national companies, irregularities within the legal framework and market access barriers. However, the launch of the EU-China investment agreement is a concerted effort between these two economic powers to reduce the barriers and to enhance mutual investment benefits.

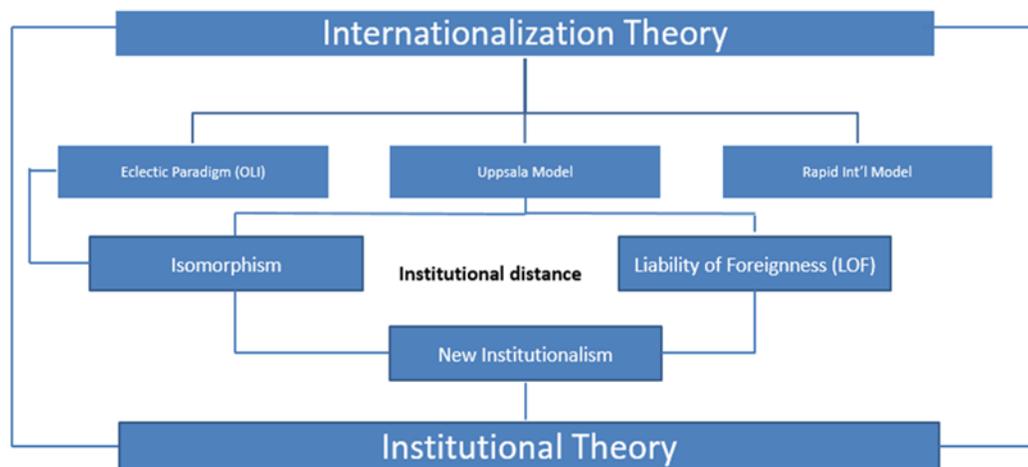
Against the backdrop of China's environmental degradation and anticipated expenditures to curb environmental-related problems, experts suggest the EP market will represent a RMB 8.2 trillion industry in the five years leading to 2020. Thus, the overall potential for EU trade and investment remains lucrative as China moves forward to sustain economic growth through clean technology investment. The government plays both a regulatory role through the MEP which has executive power to ensure provincial economic growth is tied to environmental performance, and as a policy making role promoting private investment in clean technology as a new source of economic growth.

# CHAPTER 2

## TOWARDS AN UNDERSTANDING OF FIRM- LEVEL CHALLENGES IN INTERNATIONALIZATION THEORY: THE RESEARCH QUESTIONS

### 2.1 Introduction

This chapter examines internationalization theory that seeks to explain why and how firms expand their businesses abroad. It examines the concept of liability of foreignness (LOF) and isomorphism that are linked to institutional theory in the internationalization of firms. The theoretical/analytical framework is shown in Figure 2.1.



**Figure 2.1 Theoretical/Analytical Framework**

The first section discusses the traditional internationalization models (OLI eclectic paradigm and the *Uppsala Model*) developed over three decades ago and highlights the current phenomenon of the internationalization pattern of emerging markets multinational enterprises (EMNEs) and born-global companies. This is then followed by a discussion of firms' selected entry modes consequent to their decision to internationalize.

The second section investigates pre-existing conditions inherent to foreign firms operating in an unfamiliar environment illustrated by the types of LOF they face. The last two sections focus on other EU companies' investment in China as well as the evolution of the EP sector in terms of China's legislation and the rapid expansion of China's solar and wind overseas investments.

## **2.2 Reasons for Internationalization**

Existing theories of firms' international expansion are built upon exploitation of managerial resources (Penrose, 1959), advantages of a firm (Hymer, 1976) and intangible assets (Caves, 1982). Penrose (1959) argued that managerial resources in terms of experiences and cumulative knowledge of other resources of the firm, provide the opportunities to use these resources in different ways, in turn creating incentives for further expansion as the firm organizes how to utilize its own resources more profitably. Hymer (1976) argued that the ability of foreign firms to maintain control in a foreign market and thus displacing local and foreign competitors motivates a firm's international expansion. The ability arises from the fact that the firm has advantages in a particular activity and may find it profitable to use these advantages to set up foreign operations. Caves (1982) argued that intangible assets developed at home influence investment decisions to expand abroad. These arguments are further conceptualized into various internationalization models that are discussed in the following sections.

## **2.3 Internationalization Theories and Entry Modes**

### **2.3.1 The OLI Eclectic Paradigm**

The eclectic paradigm examines the international involvement of multinational enterprises (MNEs) by looking at the inter-relationship between trade and production. It seeks to explain the ownership (O) advantage which is internal to firms and the location (L) advantage which is external to firms; and how they could become more salient and enhance MNEs' competitiveness when they adopt internalization (I-advantage). In essence, internalization is the MNE's capability to arbitrate between the transaction costs of engaging the services in the foreign market and the organization costs of managing a firm (Coase, 1937; Dunning, 2002).

Dunning (2002) argued extensively that international firms choose to allocate their own possession of superior resources in foreign markets because of the “*desire and ability of those enterprises to internalize the advantages resulting from this possession; and that servicing a foreign market through foreign production confers unique benefits of this kind.*” (Dunning, 2002: 59). Moreover, it is insufficient for MNEs to possess superior O-advantage, they must be able to internalize it in order to protect themselves against market failures, which may arise from government interventions and competition. In order to do so, MNEs must be large enough to enhance their opportunities to benefit from the internalized practice.

Firm-specific endowments or firm-specific assets (FSAs) in the form of tangible and intangible resources are ownership (O) advantages that firms exploit to function more effectively and efficiently than the competition does in home and host countries. In view of market imperfections which could be structural or cognitive, MNEs would tend to internalize their ownership resources in host countries. Structural imperfections thrive in an environment that has high transaction costs and high barriers to competition. Cognitive imperfections arise when information about a product or service is not easily accessible or where acquiring such information could be very costly. Market failures such as agent opportunism (moral hazard); bounded rationality; institutional voids and uncertainty; assets specificity and negotiation costs due to differences in culture and business practices; all result in transaction costs (Williamson, 1975, 1981; Markusen, 1995; Santangelo & Meyer, 2011) that increase the cost of a firm’s entry into the foreign market. Frequency, uncertainty and asset specificity are the three attributes that describe transactions within organization economics (Williamson, 1981). In relation to asset specificity, the level of internalization is high when assets are very specific to the trading parties and it would be less cost-efficient to contract the transaction through market exchange. High transaction cost will arise during the contract-writing and contract execution stages (Williamson, 1981).

On a home country level, MNEs have FSAs that could deter new entrants from entering the market and thus limit competition at home. Firm-specific assets such as size, better financial resources to invest, special access to markets, raw materials, or patented

technology, and their ability to internalize their managerial capabilities more effectively could be lacking from the competitors. Consequently, internalization protects the O-advantage because of a firm's own resources are deployed in a foreign market. In this way, misappropriation of the FSAs by foreign agents is less likely. In particular, Dunning argues that technology is the driver for internalization because MNEs want to reap benefits from costly investment and be the sole owners of that technology. Other benefits from internalization are taking advantage of different economic policies of national governments, which could offer R&D and tax incentives.

Dunning (2002) describes the L- advantage as the net benefit gained from producing goods and services in a given location. In this case, the O-advantage benefits foreign firms and the L-advantage favours the host country. The incentive for MNEs to produce in foreign markets is to utilize cheaper factors of production (labour and raw materials) or to avoid costs of transportation, as well as tariffs and quotas which can be imposed by host governments to discourage imports.

Dunning's (1979) traditional O-advantage of MNEs from developed economies encompasses a degree of visibility of that ownership, such as a product brand or a patent for the production process that is highly inimitable by competitors. However, literature on the O-advantage of EMNEs shows a different set of attributes that are related to their internal capabilities to respond to difficult business environments. Attributes such as their ability to produce an extremely low cost and reasonable standard product as a result of their deeper understanding of their customers' needs are considered to be O-advantage (Cuervo-Cazurra & Genc, 2008; Guillen & Garcia-Canal, 2009; Ramamurti, 2009; Govindarajan & Ramamurti, 2011).

Dunning (1979) had assumed that the O-advantage that arises from the home country is used to exploit the foreign market's availability of resources, but empirical evidence suggests that the availability of a host country's resources (knowledge-intensive assets) could be inherited as an O-advantage by the home country (Almeida, 1996; Cantwell, 1995; Dunning & Narula, 1995; Kogut & Chang, 1991). A recent study by Ying, Stucchi, Visholm, & Jansen (2013) supports this phenomenon of inheriting an O-advantage from Denmark as the motivation of Chinese MNEs to acquire Danish companies because of

their technological know-how and their R&D expertise that were brought back to China. Recent research shows that traditional MNEs have evolved to be ‘network-oriented’, including horizontal and vertical integrated activities and having non-equity relations with different actors along the global value chain. In other words, global production networks become borderless so the need to own physical production facilities is less compelling than the traditional L-advantage, which is location-bound (Merino & Grandval, 2012).

### **2.3.1.1 Summary**

In summary, the OLI eclectic paradigm explains how an established MNE’s existing resources at home (advanced economies), could be deployed to another foreign operation. It is due to market failures and market imperfections that foreign firms would seek to protect their O-advantage by internalizing their own resources to operate in a foreign market rather than engaging foreign agents who might misappropriate the FSAs. Particularly when the asset-specificity is high (patented technology), firms would choose to internalize much more.

On the other hand, in a host country, foreign firms would benefit from the L-advantage manifested from cheaper factors of production, attractive FDI policies, and strategic location enabling them to reach economies of scale and scope. The aggregate of the OLI advantages would still yield a net profit despite the higher costs of doing business compared to local firms. Thus, the OLI advantages are the firms’ competitive advantage that are superior to local competitors.

### **2.3.2 The Uppsala Model**

Johanson and Vahlne’s (1977) *Uppsala Model* is based on empirical observations of the internationalization pattern of Swedish firms. It seeks to explain why firms engage in a step-by-step process of internationalization as illustrated by the concept of “establishment chain” (Figure 2.2). The process dictates the flow of resource commitment from low to high level beginning from no export activity to opening a production plant. Conversely, more learning would take place in the process that leads firms to increase their resource commitments (Petersen, Pedersen, & Lyles, 2008).



**Figure 2.2. Establishment Chain, Johanson and Wiedersheim-Paul (1975)**

This sequential approach to internationalization is due to the “psychic distance” between home and host countries. “Psychic distance” is defined as the “*sum of factors preventing the flow of information from and to the market*” (Johanson & Wiedersheim-Paul, 1977: 24). Examples are differences in language, education, business practices, culture, political systems and industrial development. As a result of such difficulties that are related to risks and uncertainties, and lack of market knowledge, firms tend to enter a foreign country which is closer in proximity and is similar in context to the home country during the initial stage of internationalization. Hakanson and Ambos’s (2010) study found that geographical distance is a stronger indicator of psychic distance than cultural distance between two countries.

The *Uppsala Model* was built to explain the pattern of firms’ internationalization and what happens within firms in the foreign market over time (Johanson & Vahlne, 1977, 1990). The ‘establishment chain’ becomes the pattern of internationalization which is a result of firms’ incremental decisions mainly driven by “psychic distance” and subsequent changes that occur over time. Experiential knowledge and learning are changes that occur over a period of time and become assets-gained in the foreign market. These assets then become embedded into the firm’s strategic decision process. Over time, learning and experience influence a firms’ decision to increase or decrease resource commitment in response to market competition, or evaluate channel distribution (Johanson & Vahlne, 1977). Experiential knowledge possess by individuals in a firm is valuable because they can exploit that knowledge to assess the strategic fit of the firm’s current and future activities. Thus, leading to new opportunities and providing solutions to problems arising from existing activities. Objective knowledge can easily be acquired by hiring experienced personnel within the industry. The *Uppsala Model* uses risk (lack of market knowledge)

as the only factor to explain the commitment decision of the firm in its internationalization process.

A recent longitudinal study by Casillas and Moreno-Menendez (2014) assessed the role of diverse international activities and depth in experiential learning that had an impact upon the speed of internationalization of 889 Spanish firms. Experiential learning is a result of foreign market and institutional knowledge gained from the mode of operation. On the other hand, international knowledge is gained from the experience of international activities in different markets. Thus, the speed of internationalization of firms is dependent upon the types of accumulated experience gained from the depth of international activities and the modes of foreign operations used. Findings show that firms that have a high diversity in international activities and using different modes of operation to enter new markets would experience slower speed of internationalization. Such firms face risks in the form of LOF while seeking out new opportunities in new markets at the same time, tend to decelerate their internationalization process in the beginning. However, it would accelerate over time as firms gained more accumulated experience from past internationalizations.

In a study of 406 Swedish service firms, a causal relationship between firms' experiential knowledge and their perceived costs of internationalization was found. The evidence suggested that firms tended to perceive the costs of internationalization to be low when experiential knowledge was high (Eriksson, Johanson, Majkgard, & Sharma, 1997). The study concluded that such knowledge accumulation requires "*local presence, repetition and variation*" (Erikson et al., 1997: 354). As a result, firms' organizational routines and procedures tend to be enhanced by their multinational presence, confirmed by Sethi and Judge (2009) to be an asset of foreignness (AOF). Eriksson et al. (1997) also argued that the internationalization process of firms does not follow a prescribed doctrine. Rather it is a manifestation of a gradual learning about firms' capabilities and the needs of foreign markets (Petersen et al., 2008).

The original *Uppsala Model* focused on firms' behaviour towards the environment positing that the driver of internationalization is the consequence of a process of incremental adjustments to changing conditions of the firm and its environment. In other

words, firms' expansion into foreign markets was not a result of a strategic planning, evaluating and comparing the attractiveness of different foreign markets so as to allocate available resources in selected foreign markets (Johanson & Vahlne, 1977). Although Johanson and Vahlne assert that the process model is sceptical in relation to strategy, they also suggest that: "*internationalization processes are the result of a mixture of strategic thinking, strategic action, emergent developments, chance, and necessity. We believe it is worthwhile to analyse the internationalization of firms with an open mind with regard to these factors*" (Johanson & Vahlne, 1990: 22).

In congruence with Johanson and Vahlne's (1977) claim that the model applies only to firms in the manufacturing industry, less evidence has been found in the service industry. This claim is supported by studies in the Swedish banking industry (Tschoegl, 1982; Engwall & Wallenstfil, 1988), and among Swedish technical consultants (Johanson & Sharma, 1987). The explanation possibly lies in the unique characteristics of the service industry, which create different opportunities and constraints and hence different strategic challenges from those faced by the manufacturing sector (Habib & Victor, 1991; Li, 1995; Aharoni, 1996; Aung & Heeler, 2001; Capar & Kotabe, 2003).

However, findings from Goerzen and Makino (2007) support the validity of the *Uppsala Model* in relation to the internationalization process of the five largest Japanese trading firms in the service industry. The uniqueness of the Japanese trading companies is twofold. First, they are highly diversified in terms of business portfolios. Second, they serve Japanese manufacturing firms abroad. As a result, their internationalization occurs on the basis of following their customers. The study divided the business activities into this sequential order: 1) core-global services (wholesale trading in durable and non-durable goods); 2) related-local services (heavy/light/assembly industries, real estate, finance and banking); 3) unrelated-global services (trans-Pacific transportation, warehousing and logistics); 4) unrelated local services (location specific services and unrelated to the core business). The purpose of these classifications was to test empirically if these Japanese trading firms expanded abroad according to the *Uppsala Model*, following the sequential order of these activities. Their findings supported the *Uppsala Model* thereby refuting the claim that the model is not valid for the service sector.

The revised *Uppsala Model* incorporated business networks that would enhance learning and experience, cultivating trust and developing mutual commitment to increase resources from the partners. Johanson and Vahlne (2009: 1425) further reiterate that “*mutual trust and commitment are based not on formal agreements but on a common history of at least minimally satisfactory, if not successful, joint business experiences.*” They argue that the success of firm requires them to be in one or more well-established business networks. Thus, business activities are generated out of this relationship which they termed *insidership*. *Insidership* allows for quicker response to market opportunities and solving problems within the business networks tending to reduce the LOF during foreign market entry. In sum, the revised *Uppsala Model* incorporates the fact that relationship building cultivates trust and creates opportunities. Entering a foreign market without prior network connection causes the firm to be more vulnerable to *outsidership* and LOF (risk factors).

In furtherance of the role of international networks, the empirical findings of four case study firms (Coviello & Munro, 1995), found that participation in international networks with major network partners accelerated the firms’ internationalization process in selecting the market and entry mode. The expansion of these firms to other foreign markets was a result of a network linkage in a specific market that created the opportunities. Conversely, the empirical findings from Martin, Swaminathan, and Mitchell (1995) found that extended buyer-supplier links created in new locations were most likely due to an existing long-term buyer-supplier relationship. Other empirical findings highlight the significance of social networks which help in identifying new opportunities (Ellis & Pecotich, 2001) to enter foreign markets and to develop specific competitive advantages using the accumulated international knowledge and/or the development of formal business connections across borders (Styles & Ambler, 1994; Sapienza et al., 2005).

In terms of impact on firms’ performance, some empirical studies have validated the *Uppsala Model* and found a positive impact on firms’ performance by adapting to the sequential approach (Li, 1995; Barkema, Bell, & Pennings, 1996; Luo & Peng, 1999; Delios & Beamish, 2001).

### **2.3.2.1 Summary**

In summary, the *Uppsala Model* holds that risks and uncertainties and lack of market knowledge, are obstacles in gaining access to the local network, are determinants for firms to internationalize in a sequential manner. The knowledge gained in the form of business practices used in international markets, understanding formal and informal institutions and language nuances enable the firms to identify business opportunities and evaluating the inherent risks (Johanson & Vahlne, 2003). However, it posits an increase in resource commitment as a consequence of the knowledge gained in terms of business opportunity.

Since the inception of the original *Uppsala Model* in 1977, it has been widely used to test the proposition that firms in the manufacturing sector internationalize sequentially as a result of difficulties associated with risks, uncertainties and lack of market knowledge. Empirical findings show that the model applies mostly to the manufacturing sector as accurately posited by Johanson and Vahlne (1977); the model's application to the service sector has produced some ambiguous results. Johanson and Vahlne's (2009) revisit of the old model included *insidership* as a result of network connection in the foreign market, suggesting that this would help to reduce LOF and accelerate learning in the foreign market and thus accelerate the internationalization process. More empirical evidence has shown the effect of prior networks in the internationalization process. As a result, it is expected that the speed of internationalization will increase due to *insidership* within the local network. Better performance is expected to be seen from *insidership* because foreign companies that are in the local network will be better able to respond to any pre-emptive news promptly and effectively, to meet changing market needs.

### **2.3.3 Emerging Markets Multinational Enterprises (EMNEs)**

Fosgren (2002) criticized the simplicity of the *Uppsala Model* for using a limited number of organizational variables to explain the internationalization process of firms, arguing that perceived risk of a foreign market could be reduced by "following the client" (Goerzen & Makino, 2007) or mimicking established firms in the same industry (DiMaggio & Powell, 1983). As a result, firms enter foreign markets at an increasing pace using such short cuts, rather than through experiential learning to acquire market

knowledge as posited by the model. Furthermore, lack of market knowledge of a foreign market is compensated by the first mover's advantage (Loane & Bell, 2006) so that firms might be willing to take risk to exploit the benefit for short-term growth. This argument that firms internationalize rapidly will be discussed further in this section.

Similar to Fosgren's opposing argument of the traditional approach of the *Uppsala Model*, studies have revealed a different internationalization phenomenon by emerging markets MNEs (EMNEs). Luo and Tung (2007: 482) defined EMNEs as "*international companies that originated from emerging markets and are engaged in outward FDI, where they exercise effective control and undertake value-adding activities in one or more foreign countries.*" Emerging markets MNEs in particular, have often chosen rapid internationalization over the traditional iterative approach and have expanded through acquisitions, joint ventures and mergers with consequent high resource commitment (Mathews, 2006; Luo & Tung, 2007; Deng, 2009; Tsai & Eisingerich, 2010; Luo et al., 2011; Meyer & Thaijongrak, 2012).

Within the context of Dunning's (1979) OLI eclectic paradigm, EMNEs are not considered to have possessed any of the traditional OLI advantages compared to western MNEs (Mathews, 2006) which help to legitimize their presence so as to overcome LOF (Zaheer, 2002), newness (Mudambi & Zahra, 2007), 'emergingness' (Madhok, 2009), and outsidership (Johanson & Vahlne, 2009). On the contrary, Ying et al, (2013) show empirically that Chinese MNEs were able to internalize their operations in Denmark because of prior existing network relationships. For example, one Chinese MNE hired a former business acquaintance to accelerate their learning process, thereby easing the way of doing business in Denmark.

Mathews (2006) argued that the changing character of the world economy and its inter-connectedness explains a new internationalization pattern of small size firms. He studied the internationalization pattern of four companies in the Asia Pacific region finding that global inter-connectedness drew firms to be involved in cross-border transactions through contracting, licensing and exploiting the global network of opportunities and resources. The study concluded that limited resources are not constraints for small size firms to enter new markets opposing the proposition of existing theories and strategies of firms'

internationalization process. The interconnectedness of the world creates access to vast availability of resources for small sized firms exploiting to their advantage.

Luo and Tung (2007) used the springboard rationale to explain EMNEs' strategic asset seeking motives in their international expansion to avoid institutional voids and market constraints at home. They argued that EMNEs address their latecomer disadvantage by *springboarding* their internationalization to compensate for their competitive weaknesses. Faced by fierce competition from developed economies' MNEs in their home markets, EMNEs make up for the "home-market loss" by acquiring strategic assets and seeking new business potential in key markets such as the US, Europe and Japan. Home institutional hazards in the form of weak legal frameworks, unstable political and economic climate, corruption and bureaucracy motivate EMNEs to look to host countries that have sound institutional governance. In light of the market barriers imposed by developed economies to protect their home markets against cheaper imports from emerging economies, EMNEs use outward FDI to overcome these market barriers. Emerging markets MNEs are able to springboard their internationalization because of their government policies that provide preferential treatment, both in financial and non-financial form, to encourage outward FDI. This implies that EMNEs have financial advantage to increase their resource commitments from the beginning of their international expansion. However, EMNEs do still face challenges in developed markets. For example, they are perceived to lack operational transparency and accountability because they originate from a weak institutional environment so their credibility in the view of the foreign investors may be low.

Deng (2009) studied the OFDI strategy of three leading Chinese EMNEs in developed economies. The companies studied were well established local market leaders in electronics and digital products that compete on technology and innovation. The management was highly driven to become a global brand and world leader in their field of their business. Deng argued that institutional factors motivate the strategic assets-seeking Chinese firms to invest abroad successively. Their strategy in going abroad to acquire superior technology and brand legitimacy through M&A was a response to strong home institutional support, a lack of resources at home to pursue strategic assets and

positive corporate managerial experience accumulated from the inward international joint ventures (IJV) with foreign partners. The key driver was the Chinese government's policies and working together with local companies to help them reach the state of global competitiveness.

It is apparent from the case studies of Deng (2009) that the three leading firms have commonly sought M&A to expedite knowledge building in technology and innovation, quickly gaining legitimacy in foreign markets to become locally and globally competitive as brands and as management teams. Despite being well-established in the Chinese home market and having available resources to internationalize incrementally, the findings showed that these EMNEs' strategies were not to exploit their existing assets. Rather, by adopting a leapfrogging strategy (M&A), they could demand their foreign M&A partners to commit to updating their technology and transfer their intangible assets to the M&A. In this way, the EMNEs would benefit from these new resources gained (O-advantage) - post M&A.

Luo et al. (2011) studied a much wider range of companies as compared to Deng (2009). Their study looked at the motivations of internationalization of private firms in China. The data set used consisted of 1,355 private companies located in 31 provinces in China. Firms in developed economies are traditionally considered to have the competitive advantage of possessing firm-specific assets (FSA) that allows them to internalize operations when venturing abroad (Guillen & Garcia-Canal, 2009). Some scholars suggest that firms in developing economies lack competent resources to internalize operations abroad (Luo & Tung, 2007; Madhok & Keyhani, 2012). However, a study by Luo et al. (2011) suggested that the competitive advantages of firms in developing and transiting economies lie in their governance advantage; advantages from past connections with SOEs; and their inward internationalization gained. These advantages are unconventional and not prevalent in MNEs in developed economies (Ramamurti, 2012). Luo et al. (2011) show that private firms that have managerial capabilities in controlling and monitoring activities are likely to exploit this advantage when they venture abroad. Additionally, the accumulated experience learned through past connections with SOEs and foreign partners in their home country, may boost the confidence of private companies to internationalize their activities.

Unpredictable institutional regulations at home may be the impetus to venture abroad so as to avoid home country risk and at the same time to expand growth. This finding indicates that China's institutions are still considered "weak" which has a negative impact on inward FDI. This forms an institutional gap between firms in developed economies and emerging economies. The former has stronger governance compared with the latter. The empirical findings show that private firms become resilient in foreign operations further to experiencing the institutional hardships at home. In this case, these companies see the potential to leapfrog in the internationalization process by M&A despite the inherent risks arising from higher resource commitment.

Marinova, Child, and Marinov (2011) investigate the role of the Chinese government in the internationalization process of Chinese firms which were traditionally perceived to have limited OLI-advantages (Ramamurti, 2012). Their study used six cases to illustrate the evolution of firm-specific disadvantages (FSD) to firm-specific advantages (FSAD) in an environment flourished by country-specific advantages (CSA) offsetting their LOF. As a result of the strong institutional entrepreneurship, domestic firms leveraged these CSAs that would become their FSADs over time. This is contrary to the internationalization literature that FSAs are the driving force of firms' speed of internationalization reducing risks and uncertainties ((Johanson & Vahlne, 1977), and transaction costs (Dunning, 2002), The FSDs in the form of lack of experience and resources and the CSAs were enabling the internationalization of Chinese firms using licensing and INJ strategies, leveraging positive governmental policies and strong relational framework between government and corporations.

### **2.3.3.1 Summary**

In summary, the internationalization pattern of EMNEs shows a different trajectory to the path dependent *Uppsala Model* and the OLI eclectic paradigm. It is a rapid process and the traditional OLI advantages in the EMNEs' home country are less visible than those in the developed economies. Instead, EMNEs have a distinctive set of OLI advantages. As a result of their lack of competitive advantages, they will acquire the O-advantage through M&A in the host country and repatriate it to the home country. Other competitive advantages include learning from foreign international firms resulting in an inward FDI

experience gained. This has benefited them in building their capabilities as they interact with international firms. Their strong local networks and institutional support in outward FDI from their home country tend to help them to internationalize untraditionally.

The fact highlighted above that EMNEs have followed different internationalization trajectories from traditional MNEs, may simply be a function of the fact that they entered into the global economy at a time when business had become much more global (Ramamurti, 2012). If this were the case, then other newly formed MNEs from traditional markets like the EU may also need to adopt less iterative and more risky internationalization trajectories to succeed in the new global context. However, little research is available on whether firms from developed markets react to changes in the global economy by leapfrogging the internationalization process or on factors influencing their decisions. Rather theory on developed countries MNEs continues to be informed by research undertaken several decades ago. The exception to this is recent work on born-global companies.

#### **2.3.4 Born-Global Companies**

The internationalization of born-global firms or international new ventures (INV) seems to follow a similar pattern to those firms from emerging economies. They tend to internationalize rapidly within three years of inception despite limited financial, human and tangible resources (Knight & Cavusgil, 2004; Loane & Bell, 2006; Mudambi & Zahra, 2007; Tsing & Eisingerich, 2010). Rather, they leverage their innovation, knowledge and capabilities to achieve success in foreign market expansion (Knight & Cavusgil, 2004; Loane & Bell, 2006; Tsing & Eisingerich, 2010). They tend to have greater R&D intensity and to seek expansion in domestic and foreign markets simultaneously (Tsing & Eisingerich, 2010); or internationalize at an early stage (Knight & Cavusgil, 2004; Mudambi & Zahra, 2007); are small in size (Knight & Cavusgil, 2004; Loane & Bell, 2006); and are exporters (Knight & Cavusgil, 2004; Loane & Bell, 2006).

Knight, Madsen and Servais (2004) studied the key success factors in the internationalization of born-global firms in the US and Denmark using exploratory case studies and survey-based method. Interestingly, they found that the international

expansion of born-global firms in Denmark was highly skewed to the European region but born-global firms in the US, Europe, Asia and Latin America expanded to geographically diverse markets. On the basis of Ohmae's (1985) argument that firms are not considered to be global if they do not compete in the Triad region (US, Western Europe and Japan) the Danish born-global firms seemed to be regional (lower psychic distance) rather than international. This phenomenon supported the literature of the *Uppsala Model* which posits that firms tend to enter geographically proximate countries (Johanson & Vahlne, 1977) in the initial stage of internationalization because of regional bias (Rugman & Verbeke, 2007). Regional bias such as similarities in institutional governance, economic conditions (pace of growth) and awareness of products and services (brand proximity) would tend to reduce transaction costs.

The Knight et al (2004) study supported the born-global literature in finding that 71% of turnover of these firms was generated abroad. Whilst home market in Denmark is too small for born-global firms to be able to flourish otherwise, the possible imperative condition common for the success of born-global firms in US and Denmark was found to be the firms' marketing competence. How the firms marketed their products and services through products and services adaptation to local customers' needs was highly and positively associated with international performance. As a result, firms would likely to adopt marketing strategies that tend to maximize customer value.

The study explored the effects of product quality, marketing competence and product differentiation on the perceived international success of the born-global firms. The case studies revealed that by focusing on needs and converting feedback into actions, customization gave these firms a competitive advantage over bigger firms and consequently perceived their international performance to be higher. The overall study implies that age, size and limited resources are not impediments for early and substantial internationalization of firms, which is consistent with other empirical findings of born-global firms. As a result, firms do not necessarily follow an incremental approach to internationalization, which posits that lack of resources creates uncertainty and thus increases the perceived risks of bigger foreign investments. Rather, other marketing and product competencies and international orientation of managers could differentiate born-

global firms from bigger competitors in the market and enable them to compete strategically and internationally.

Knight and Cavusgil (2004) studied the early internationalization of born-global firms and the key organizational factors that drove their superior performance. A case-study approach was used to deepen the understanding of early internationalized pattern and to investigate the key orientations and strategies that tend to lead to international success among these firms. Their empirical evidence showed that born-global firms were mostly created by entrepreneurs who tended to seek foreign markets with a strong market orientation (managerial global mind-set), are small in size, are exporters, are highly innovative, possess international and entrepreneurial skills, apply business strategies based on technological competence, unique products development, quality focus, and leveraging foreign distributor competences. As a result of these characteristics, such firms were able to use technology to create unique superior quality products and focus on maximizing customer value to compete in the global market.

Knight and Cavusgil (2004) found that superior products and new technology created from knowledge developed within the innovation process to develop unique products were likely to allow them to target overseas market, high quality-focused and leveraging foreign distributors' competences tended to lead to superior performance despite having limited resources compared to the bigger competitors. Knight and Cavusgil hold that because these firms are small, they are not likely to be stifled by the bureaucratic structures found in traditional MNEs and thus were able to respond to feedback from their competent foreign distributors.

A study of small entrepreneurial firms from Australia, Canada, Ireland, and New Zealand by Loane and Bell (2006) found that these firms internationalized rapidly by using social and personal networks. Another critical finding was that these firms knew when and how to acquire new networks when old networks became obsolete. As a result, their organizational strategy was to recruit personnel who were competent to achieve their networking objectives. Empirical evidence showed that these small entrepreneurial firms were ambitious and had strong international visions, had limited international experience, had profound understanding of how to acquire new networks and had a high ratio of

exporting activities. In addition, each owner of the firm had a specific set of skills or competencies and their own personal network connections were synergetic with each firm's success.

Loane and Bell (2006) found that that rapid internationalization of these firms was not based on the firms' standalone resources but rather was due to the evolving global environment that magnified the importance of well-coordinated business relationships connecting the firms' specific capabilities into the embedded network of the market (Kuivalainen, 2001, 2003). Legitimacy was a major challenge to one of the firms studied which had little international experience so decided to expand into the US (the key market of its major clients) to legitimize its internationalized operations. Another finding revealed that business-to-business or personal-to-business recommendations through existing networks helped firms to obtain financial funding in foreign markets which was very crucial in the initial stage of internationalization. The findings showed that most firms interviewed relied on social and personal networks to obtain pertinent resources to overcome challenges such as governmental issues, finding competent personnel, developing successful strategies, and acquiring financial capital. Firms were aware that knowledge in a technology intensive industry becomes obsolete very quickly, hence they were constantly building new networks when required and exploiting existing networks whilst they remained useful.

Gleason and Madura (2006) studied the born-global phenomenon of American firms that engaged in FDI through network entry modes (non-equity joint venture or strategic alliance) and export strategies. These firms became public listed companies within six years. Findings showed that the born-global firms' size was relatively larger, had product-market diversity and venture-capital backing compared to purely domestic firms. The venture-capital backing tended to contribute to the rapid internationalization of born-global firms. Their founders, board members, and executive managers, all had more international experience. The born-global literature suggests that born-global firms tend to possess a high degree of intangible assets and are able to leverage them. However domestic firms were also found to have high levels of intangible assets. In this instance, it

seemed that the managerial ability to utilize these intangible assets through strategic networking was more important than owning these assets *per se*.

Andersson (2011) used a single case study to examine how and why a born-global firm decided to internationalize rapidly. Strong empirical evidence linked that decision to the fact that one of the founders (the CEO) had prior top management level international experience in the same industry, which led the firm to expand internationally at an early stage. The CEO formulated the firm's organizational and marketing strategy with an international mind-set. As a result, high calibre personnel with prior experience and complementary skills were hired, profits were re-invested into the business to maintain control of the firm (rather than to acquire capital from venture capitalists), and a differentiated product that was targeted at a niche market.

The rapid internationalization was a result of the existing local and international networks of the CEO. International distributors were found through trade exhibitions. One of the important findings accentuated the fact that born-global firms are resilient to adverse outcomes from wrong decisions or environmental conditions, because they operate in a non-bureaucratic environment that allows them to be open and respond to changes quickly (Knight & Cavusgil, 2004) In Anderson's (2011) study, the CEO was able to realize quickly that their products were suitable for markets other than the existing export markets at the time when growth slowed in the focused export markets. The CEO's realization was attributable to a biased view of limited business opportunities outside the focused export markets.

The key conclusion is the impactful entrepreneurial behaviour of the CEO, whose international experience and wide global networks directed the firm to opportunities that eventually helped the firm to expand simultaneously in multi-countries. Despite the risks from internationalizing rapidly into different markets, the CEO leveraged and controlled risks by forming alliances with reliable distributors, hiring personnel whose international experience would be likely to compensate for cultural and language differences in their international expansion (Anderson, 2011).

Another empirical study by Zhou, Wu, and Lu (2007) revealed the importance of home-based social networks which helped advance the internationalization of born-global SMEs in China quickly and profitably. Zhou et al. (2007) argued that home-based personal ties and connections built upon goodwill and trust, are an important channel for born-global SMEs to respond to the needs of global supply-chain networks. As a result of such networks, information could be obtained easily to help born-global SMEs to identify global opportunities and to extend connections with other foreign intermediaries. Empirical findings showed that home-based social networks characterized by informal managerial ties, or interpersonal relationships among managers and governmental officials are the competitive advantage that helped born-global SMEs to obtain information and acquire knowledge of a foreign market which should have been difficult due to the liability of newness and smallness. Risk and uncertainty tend to be reduced when access to foreign market information becomes easily available through social networks.

Mudambi and Zahra (2007) studied the survival probability of 275 international new ventures (INV) in different industries in the UK, finding that the survival probability tended to diminish when the firms' competitive advantages were considered. These INVs are firms that choose to increase their foreign presence in more than one country simultaneously. Such firms are well-endowed with technological infrastructure and managerial competence, exploiting these advantages by transferring them across international borders. Empirical findings suggested that INVs' international expansion through direct market entry tended to have a better chance of success than firms using other modes such as acquisitions. Being small in size and financially constrained, INVs relied on other competencies, such as FSAs in unique technological know-how and senior managers' international experience, to compete with bigger firms (sequential FDI) which tended to lead to a higher probability of survival. Mudambi and Zahra argue that firms need to evaluate their firm-level competencies as well as industry-level competition before selecting the strategy for international expansion. Such an exercise would tend to lead to a higher probability of survival in foreign markets.

Bangara, Freeman, and Schroder (2012) found that small emerging markets entrepreneurs pursued rapid internationalization purposefully by firstly having a developed global mind-set. Secondly they were proactive in developing aggressive strategies from the outset. A committed market entry strategy was adapted to access advanced markets that have a stronger institutional infrastructure. This was to build their legitimacy for their ventures in anticipation that success in particular advanced markets would provide opportunities for expansion in other advanced markets. Small emerging market entrepreneurs are not risk-averse. They rely on their managerial skills and past business relationship network to build legitimacy and accelerate their internationalization process. International experience of international new ventures founders has a positive influence on the firms' internationalization pattern and speed of new market entry (Coeurdero & Murray, 2008).

#### **2.3.4.1 Summary**

In summary, empirical studies of internationalization patterns of born-global firms confirm that age and size of firm, as well as lack of resources are no longer impediments to internationalization. Born-global firms are typically smaller in size and yet have internationalized successfully. Empirical evidence has shown that born-global firms tend to know how to capitalize on their limited resources and increase their exporting activities simultaneously. Uncertainty, risks, cultural and language barriers are not deterrents to entering foreign markets. Rather, the owners' and founders' global mind-set to compete on an international scale tends to be the factor that facilitates the formulation of effective marketing and organizational strategies that produce sustainable operating results.

Existing literature has focused mostly on the success factors that drive their rapid internationalization such as marketing efficiency, product differentiation, niche target market, customer focus, reliable distributors, international experience, and entrepreneurial skills, along with domestic and international social and professional networks. However, emerging evidence suggests that the most distinctive success factor is the existence of networks in the internationalization process of born-global firms (Kuivalainen, 2001, 2003; Loane & Bell, 2006; Zhou et al., 2007; Anderson, 2011). Personal, professional, social and international networks have played a critical role in enabling their rapid internationalization. Finally, the countries which were the focus of much of the research

on born-globals were mostly either small countries like Denmark, Norway, New Zealand and Ireland, or countries with a high intensity of born-global firms such as Australia and the US.

### **2.3.5 Entry Modes**

In continuation of the above internationalization theories, this section discusses the types of entry modes used in the internationalization process of firms. Studies of foreign market-entry strategies have employed a range of theories to explain entry-mode decisions. These include internalization theory (Buckley & Casson, 1976; Ying et al., 2013), transaction cost theory (Chen, 2010; Boeh & Beamish, 2012), institutional theory (Davis, Desai, & Francis, 2000; Durand, 2007; Santangelo & Meyer, 2011), network-based theory (Coviello & Munro, 1995; 1997; Tang & Liu, 2011), transaction-cost and institutional theory (Brouthers, 2002); and OLI theory (Brouthers, Brouthers, & Werner, 1999). Transaction cost analysis (Hymer, 1976; Davis et al., 2000) and organizational capability perspective (Kogut & Zander, 1993) are used to analyse the optimal entry mode to a particular foreign market (Sanchez-Peinado, Pla-Barber, & Hebert, 2007).

By definition, firms have to choose an entry mode to start their operations in a foreign market. The two main categories are equity and non-equity based. Equity-based modes include joint ventures (JV), equity joint ventures (EJV), wholly foreign-owned subsidiaries (WFOS), green-field, mergers and acquisitions (M&A). Non-equity modes include exporting, licensing and appointing local agents, franchising and contract manufacturing. Each choice of entry mode differs in its level of control and risk (Gatignon & Anderson 1988; Benito, Petersen, & Welch, 2009; Boeh & Beamish, 2012), availability and deployment of resources (Davis et al., 2000) and political and cultural awareness (Tihanyi, Griffith, & Russell, 2005; Coeurderoy & Murray, 2008). As a result, it has significant impact on a firm's cost minimization (Anderson & Gatignon, 1986; Dunning 2003) and its probability of survival (Papyrina, 2007).

Scholars have explored various factors arising from the host country environment to study their impact on choice between each entry mode. A study by Sanchez-Peinado et al. (2007) found that WFOS was preferred over JV in an environment with low political and

economic risks because the latter (JV) was more suited to a high-risk environment. On the other hand, a weak regulatory framework with a high level of arbitrary corruption will create a legitimacy problem for foreign firms. Hence, MNEs will tend to seek a local JV partner to enter the market (Yiu & Makino, 2002; Rodriguez, Uhlenbruck, & Eden, 2005). Similarly firms will tend to choose to enter a host country whose regulatory framework is similar to the home country (Coeurdero & Murray, 2008). The issue of intellectual property rights protection (IPR) is a major concern for firms which possess specific technology that will involve compliance to technology transfer (TT) regulations. Such firms face a higher threat to their proprietary intellectual assets in a more ambiguous and complex host country environment. Consequently, they are likely to choose to enter a foreign country with lower regulatory hazards (Coeurdero & Murray, 2008).

In a study of service firms' choice of entry modes between a JV and a WFOS, Sanchez-Peinado et al. (2007) found that knowledge-intensive service firms that have a global strategy and past experience in internationalization, prefer WFOS as an entry-mode of choice. This is congruent with earlier studies that the stakes of high technological firms are high because such firms risk losing the value of their assets if these assets are transferred to third parties. A WFOS safeguards assets by preventing opportunistic behaviour that might arise in external transactions (Williamson, 1981; Gatignon & Anderson, 1988; Guillen, 2003).

The local institutional context such as institutional readiness and reforms has an impact upon firms' choice of entry and the probability of survival. Empirical evidence has shown that foreign firms that entered China on a JV basis prior to China's institutional reforms (before 1979) were more likely to survive than firms that chose to operate as WFOS (Papyrina, 2007). This is consistent with transaction-cost theory which posits that a JV provides a shared mode of governance to reduce risks and uncertainties (Johanson & Vahlne, 1977). When the market and the institutions become more sophisticated and evolved, the advantage of having a local partner diminishes. This is because firms tend to internalize more successfully when the regulatory framework is more predictable and stable (Papyrina, 2007).

Variation in the regulatory environment between the home and host countries tends to have an impact upon the extent of institutional distance that creates risks and uncertainties. Thus firms would ascertain the maturity of the regulative environment to decide on the level of resource commitments related to the appropriate entry modes. Hernandez and Nieto (2015) studied the impact of regulatory environment on the choice of entry modes by examining a database of 3,703 firms from 32 countries. Adopting the transaction costs and institutional view, the study explored how firms responded to gaining legitimacy and maintaining control (Feng & Wang, 2009) in foreign operations. The transaction costs view will have a direct impact on the level of resource commitment while the institutional view that focuses on gaining legitimacy, is in turn influenced by the strength of the regulatory environment. Empirical evidence indicates that firms tend to choose higher control modes in foreign operations that have a more developed regulatory framework than the home country. Hernandez and Neito (2015) asserted that countries with a similar economic and regulatory environment to the home country, provide an impetus for firms to choose higher control modes. From the institutional point of view, obtaining legitimacy is less challenging in a mature regulatory environment where the “rules of the game” are more explicit and transparent. Conversely, firms would be confronted with greater challenges of legitimacy if the destination countries of entry have a weaker regulative framework. In this case, they tend to choose a lower resource commitment mode. Obtaining legitimacy could be through other means such as alliances with local partners.

Dow and Larimo (2009) investigated more deeply the concept of cultural distance and international experience on entry mode choice. Their findings show that three variables; religion, industrial development, and education are significant predictors of choice of entry mode. The low control and low risk type of entry (JV) is likely to be chosen when there is a high level of difference in these variables between the home and host country.

Dow and Larimo reinforce their argument that although empirical evidence shows that national cultural distance is a significant predictor of entry mode, differences in language and political systems are not. While general international experience does not influence entry mode, cultural-specific international experience does. In this case, firms are likely to choose a high-control mode when the host country shares similar cultural background.

As a result, firms are able to maintain control in a familiar environment that does not manifest uncertainties due to high cultural distance. However, some firms choose to enter a new market as a wholly-owned subsidiary even though there is a high national cultural distance (Daamen et al., 2007).

The size of firms has an impact on entry mode. MNEs are considered to have greater resources and as such are able to cope with the consequences of high-risk investment (Johanson & Vahlne, 1977). They are likely to accept higher transaction costs to enter a new country in view of expected future profitability (Coederoy & Murray, 2008). However, small and medium sized enterprises (SMEs) have to align their resources with their choice of market entry. This critical resource constraint is due to lack of internationalization knowledge, so SMEs tend to be more sensitive to changes in the external environment. Such factors are manifest as a result of their liability of smallness. Consequently, SMEs tend to be exposed to more obstacles in choosing equity entry modes even though they might be efficient in managing their resources (Erramilli & D'Souza, 1993).

Literature on the choice of entry modes has tended to focus on specific mode of entry by firms and neglected the reality that firms do change their modes of operation in foreign markets (Benito, Pedersen, & Pedersen, 2005; Fryges, 2005; Benito et al., 2009; Puck, Holtbrugge, & Mohr, 2009). Firms change their mode of entry in response to changing conditions in the political and economic environment. Empirical evidence shows that public policies and government-led initiatives of pro-inward FDI may cause MNEs to re-evaluate their mode of operation, so as to achieve optimal performance (Puck et al., 2009). The empirical study by Benito et al. (2009) shows that institutional factors such as cultural distance will tend to increase the risk of a MNE's entry into a foreign market, despite its ownership advantage. The findings also show that exporting its technology by way of licensing to a local partner helps in overcoming risk. In addition, institutional factors do have an impact on further business cooperation between the partners. As mutual trust is built in the relationship, both partners will begin to reciprocate and build upon their complementary assets for mutual benefits. In this case, the mode of operation is likely to change from an export-partner to a JV partner (Benito et al., 2009) or to a WFOS (Kogut

& Zander, 2003). Acquisition of local knowledge over time by the foreign JV partner reduces the dependency of local partners for country- and industry- specific information. Hence it makes the JV less meaningful at this stage of ‘information stability’ as compared to the commencement period of the JV. In this case, the likelihood of relinquishing the share of the local partner by converting the JV into a WFOS is highly positive (Papyrina, 2007; Puck et al., 2009).

Limited research has been done on the impact of entry mode on firms’ performance. Some scholars contend that firms which use theoretical models to inform their entry mode choice perform significantly better than other firms which do not use any theoretical models. For example, firms which select entry modes based on transaction-cost, institutional context, and cultural context (Brouthers, 2002) and the OLI framework (Brouthers et. al., 1999) perform significantly better than firms which do not prescribe to any theoretical model to inform their entry modes. Papyrina (2007) argues that the characteristics of the firm and the environment affect the firm’s decision on entry mode. Empirical observations by Johanson and Weidersheim-Paul (1975) on the internationalization patterns of four Swedish firms shed some light on the fact that firms do adjust their internationalization strategy when faced with difficulties.

### **2.3.5.1 Summary**

In summary, extra costs are incurred in the process of internationalization. Internationalization theory posits that low risk investment such as export mode at the initial stage of entering a new market will help to mitigate costs that might arise from uncertainty due to a lack of market knowledge and experience. The transaction costs theory posits that each type of entry mode varies in its organizational capabilities and investment/managerial control. The cost of control is monitoring costs, for example, the aggregate managerial travelling time includes time, food, and accommodation, costs in ensuring that subsidiary adheres to corporate routines, slower local responsiveness due to upward reporting bureaucracy. However, the total sum of such costs might be worthy of internalization because the risk of opportunistic behaviour (agency problem) is detrimental to the firms. Decisions on entry mode are influenced by the extent of institutional distance

between the home and host countries, so that firms could offset the differences with their capabilities to reduce risks and uncertainties.

### **2.3.6 Entry Modes into China**

Early studies of foreign firms' entry into China after it began to open up its market in 1979 cited JV as the oldest (Beamish, 1993) and most successful (Shenkar, 1990; Pearson, 1991) mode of entry. Research on investment into China has examined the impact of host country-specific factors (Tse et al., 1997; Wei, Liu, & Liu, 2005; Li & Li, 2010; Wu, Muller-Kahle, Arora, & Leseane, 2013), degree of diplomatic ties (Tse et al., 1997), institutional development in China (Papyrina, 2007; Chen et al., 2006), organizational factors (Gaba, Pan, & Ungson, 2002; Johnson & Tellis, 2008) on firms' choice of entry modes.

#### **2.3.6.1 Host Country-specific Factors**

Tse et al. (1997) examined the home and host country factors and industry-specific factors that influenced foreign firms' choice of entry into China. Findings showed macro-level relations to be important. In this case, diplomatic ties between host and home country had an impact on selecting an equity-based mode of entry. It also had an impact on the decision to expand into other less favourable parts of China, which had fewer incentives and less infrastructure than SEZ and Open Cities. Foreign firms from high power distance countries (Asia) would prefer to choose an equity-based entry mode to assert control, especially with lower level government. Thus, firms preferred to choose WFOS mode to enter China (Wei et al., 2005).

The investment condition set out in SEZ and open cities was an incentive for firms to locate their business in these regions. As a result of developed infrastructure, more trade experience and frequent interaction with international actors, as well as the availability of a pool of competent local staff, foreign firms tended to prefer to choose WFOS operation mode. This was because firms could realize the full benefit by internalizing the O-and L advantages (Wei et al. 2005).

Interestingly, in his work on Western European firms, Brouthers (2002) found that Western European firms preferred export mode over equity mode and preferred to deal

with the state, the highest level of government. The benefit of a high level of governance is in the lower investment risk. In this instance, firms were likely to choose to enter China as WOS. Brouthers asserted that foreign investors would be more likely to use alliances to enter China to reduce risks and uncertainties due to formal and informal institutional differences.

Li (2005) studied the relationship between high-relational-based countries such as China and the impact on its FDI. High-relational based countries are defined as countries that are lacking public governance. The market and the investors have to rely on private relationships to perform transactions. The results revealed that foreign investors tended to opt for direct investment as opposed to indirect investment (buying stocks) in countries that rely heavily on personal relationships. The study postulated that personal relationship replaced weak public governance. As a result, the private relationship tended to extend to protect foreign investors when public information was not easily available. In the case of China, Li (2005) suggested that foreign investors chose to enter China by direct investment because of its weak regulatory framework.

Li and Li (2010) argued that three industry factors: growth potential; investment irreversibility; and market competition; affect MNEs choice of entry modes into China. Their study analysed 5,000 new foreign investments in China's manufacturing industry between 2000 and 2006. Sixty four percent of manufacturing firms that entered China during this period were WOS, 14% entered as majority JVs and 22% selected minority JVs. Findings showed that MNEs were more likely to choose a minority JV (foreign share less than 50%) over majority JV (foreign share between 50% and 95%) or WOS (foreign share over 95%) when market conditions were unfavourable. Unfavourable market conditions such as technological uncertainties have remained high in China due to the evolving industry structures and technological standards. Furthermore, it was found that minority JV mode of entry would benefit even more in conditions of low growth potential, high investment irreversibility and low competition.

Wu et al. (2013) studied seven industries in China between 1979 and 2004; their data set comprised 17,000 foreign manufacturing firms. Industries included food manufacturing, garment manufacture, pharmaceuticals, general machinery, transport equipment, electrical

goods and electronic products. They used these independent variables: host country's experience; cultural distance; industry asset density; resource commitment; and location (coastal areas or inner lying areas) to assess their impact on entry modes of firms (dependent variable), specifically wholly owned enterprise (WOE), equity joint venture (EJV), joint stock company (JSC) and contractual joint venture (CJV). Their findings showed that firms which chose entry modes based on the cultural distance and location advantages performed better than firms that based their entry on industry asset intensity, size of investment and international experience.

### **2.3.6.2 Institutional Development in China**

The impact of the different levels of China's market reform on choice of entry-modes has been widely studied. Papyrina (2007) argued that the timing and choice of entry mode interact with each other and have an impact on likelihood of survival in the face of uncertainties during the different stages of market reform in China. Empirical evidence shows more Japanese WFOS were formed when the institutional environment in China became favourable to foreign investors during the later stage of market reform. As a result, the rate of survival of WFOS was higher than that of the JVs. Similarly, the rate of survival for JVs was much higher than WFOS during the early stage of market reform, when competition from SOEs was fierce. Foreign firms need local partners to expedite their operations in China. Hence, they do not incur the cost of learning by doing as a WFOS when learning and experience become obsolete quickly in a volatile institutional environment. Forming alliances with local partners eases the way of getting into local business networks in China which tend to rely very much on relationship building, so called *guanxi* (Su, Yang, Zhuang, Zhou, & Dou, 2009).

Chen et al., (2006) studied the impact of motivation of MNEs' market entry into China. Multinational enterprises from high and low LOF countries and their choice of entry-mode into China were examined. High LOF countries were geographically distant from China and did not share a similar cultural background. Hong Kong, China and Macau were defined as low LOF countries in their study. Their findings suggested that MNEs with low LOF entered China generally to exploit labour advantages (efficiency seeking) because they were able to relate with the labour more efficiently due to language similarity. As a

result, they were not likely to choose full control entry-mode. Multinational enterprises from higher LOF countries tended to be motivated by the size of China's market and thus had a market-seeking motive and adopted a full-control entry mode. Due to the substantial resources of MNEs, they believe that their internalization advantage can help them overcome the transactions costs (Dunning, 2002). Chen et al. (2006) argued that while high LOF MNEs are attracted to mass-market opportunities, low LOF MNEs are attracted to a specific segment of the market. Their arguments were based on the low psychic distance of the low-LOF MNEs over the high-LOF MNEs. Chen et al. (2006) claim that LOF is different for all foreigners. Institutional distance dictates the costs of market entry. Motives of internationalization influence the way MNEs exploit the host country's resources whether in terms of cheap labour for labour-intensive industries or market size for market seeking MNEs.

#### **2.3.6.3 Organizational Factors**

The need for managerial control has been found to be positively related to investment value. In other words, firms tend to prefer WFOS mode of entry when investment commitment is high. In this case, the multinational organizational resources of firms could be exploited more effectively to protect their investment and to ensure returns to pay off the debt (Wei et al., 2005).

The concept of firms gaining legitimacy in China leveraging their FSA as a success determinant has not been widely researched. Li, Yang, and Yue's (2007) study focuses on the process of how legitimacy was gained by wholly foreign-owned manufacturing subsidiaries (WFOS) in China between 1979 and 1995. Li et al., (2007) argued that each FDI community as shown below was shaped by the competition and Chinese attitudes towards the FDI, which in turn legitimized the foreign entry. In other words, a strong positive attitude toward the FDI entrant will strengthen its legitimacy in China

.Community 1	Community 2	Community 3
Same home country and industry	Same home country but different industries	Same industry but different home countries

The results show that foreign firms from the same home country and in the same industry have a higher legitimacy impact for new entrants as WFOS than firms from different industries and different countries. For example, new entrants that belong to community 1 will be attracted to enter that foreign country as a WFOS because of the existing legitimacy that has already been established in that community.

These findings reinforce the concept of institutional isomorphism (Davis et al., 2000; Di Maggio & Powell, 1983) that firms imitate one another to reduce uncertainty by conforming to external pressure to gain legitimacy. On the other hand, intense competition in the same industry has deterred WFOS entry. However, prior entry by these competitors tends to encourage firms to enter early into China by exploiting their FSAs (Gaba et al., 2002).

Regulatory factors, economic and political systems are used to determine the influence that they might have in forming WFOS. Access to a developed financial and labour market lowers the need for foreign firms to seek local partners to set up a business (Li et al., 2007). Furthermore, low country risk and a high level of geographic openness encourage foreign entrants to form WFOS. Li et al. (2007) found a positive relationship between greater country risk and lower formation of WFOS and geographic openness and FDI investment experience attract more WFOS. Acceptance of the WFOS is related to the level of positive public opinion coming from government agencies and the media. The higher the response rates from the public the higher the WFOS' entry into China.

Johnson and Tellis (2008) studied the success of market entry of firms since market liberalization in China between 1978 and 2005, and in India between 1991 and 2005. The dimension used to define success of market entry is related to firms' performance manifested from a few variables at the firm and country level. At firm level are strategies and size. At the country level are the country's level of risk and openness. They examined

the level of organizational control, early market entry, size of firms, differences in economic development and culture within each country and the level of country risk and governmental bureaucracy. The final archival data used was for 128 and 64 firms in China and India respectively. The dominant mode in China was JV at 41%, followed by wholly-owned subsidiary at 33%.

The research produced mixed findings on the success of entry into the top two largest emerging economies of the world. Firstly, the overall success of entry into China was greater than in India. An early history of capitalism and democracy prevalent in India has resulted in a pool of existing local private enterprises and inconsistent policies across the country: these create barriers for foreign entrants. China offers a strong transportation infrastructure platform (airports, roadways, railways and ports) that makes operations for foreign entrants much easier. Secondly, smaller sized firms were more likely to succeed than larger firms: for example, the struggles experienced by Toyota and General Motors compared with the success of Hyundai which had a smaller-scale operation.

As a result, Johnson and Tellis (2008) suggested that small foreign companies should not be deterred from entering big markets like China and India or be intimidated by bigger foreign players in the markets. Secondly, ease of foreign market entry will increase market competition (due to entry of more market players) which will lead to a higher failure rate. In this case, they suggested that firms should enter China earlier instead of waiting for favourable market entry conditions. The negative effect of easy entry, due to further deregulation will mean greater competition and less likelihood of success. Other findings in this study were: JV represented the most favoured mode of entry and success is higher when the economic and cultural distance between the home countries and China and India was lower. Johnson and Telli's (2008) study implies that legitimacy in a foreign country as inferred by firm size can be mitigated if firms do not use and control their critical assets (in this case, strong brand) effectively in China and India. This is contrary to Sethi and Judge (2009), who assert that foreign brand is an AOF in a host country because the locals perceive it as superior: this serves as a competitive advantage (FSA) over local firms and implies a higher success rate of entry.

Puck et al. (2009) studied the factors that influenced the change of operation mode from IJV to JV, finding that local knowledge was an important determinant that influenced the change of IJV mode to a WFOS. Acquisition of local knowledge over time by the foreign JV partner reduced dependency on local partners for country- and industry-specific information. Hence it makes the JV less meaningful at this stage of “information stability.” as compared to the commencement of the JV when lack of local knowledge was more pronounced.

Pan (2003) studied country-specific factors (home and host countries) that could have influenced the inflow of FDI into China between 1984 and 1996. The FDI of 30 countries were analysed to determine the type of country-specific factors that could have led to FDI into China. Home country-specific factors on a macro-level such as lower lending rate and high external or bilateral trade with China were found to have influenced higher levels of FDI into China. While cultural factors from home countries with low uncertainty avoidance and high power distance tended to have the same effect. However, higher level of GDP in home countries did not contribute to higher FDI into China. A negative correlation was found between length of diplomatic ties with China and geographical proximity.

Choi and Nailer (2005) studied the impact of using a price premium strategy by advanced economy MNEs (Europe, USA and Japan) entering the Chinese mobile handset industry. Foreign MNEs created the market for mobile handsets through differentiation in technology and price premium. Chinese consumers responded positively to mobile handsets and created a demand-side factor, so did the Chinese manufacturers that created a supply-side factor. As a result, the Chinese manufacturers “took over” the mobile handset industry with cheaper priced and simple technology mobile handsets and isolating the foreign MNEs in the share of sales, and eventually growth. Furthermore, some of the Chinese manufacturers were OEM/contract manufacturing and had been in joint partnership with foreign partners. The knowledge gained enabled them to produce similar quality products to compete on an international basis. They suggested that European MNEs could learn from other foreign MNEs by localizing products and services in the Chinese market. As a result, survival and profitability would tend to be sustainable through

lower price but high volume strategy. In addition, European MNEs must take cognizance of Chinese competitors, who are deemed to be highly responsive to local demand, and capable of producing substitutes to gain market share.

#### **2.3.6.4 Summary**

In summary, existing studies on firms' entry-mode strategies in China illustrate that entry mode has an impact on survivability and performance of foreign firms. Entry mode decisions are also related to company and host country factors such as the type of industry, level of institutional development, market growth potential and competition. Most studies used quantitative methods to examine the types of entry mode adopted by foreign firms between periods of entry (from 1979 to 2006) to assess their impact on survivability and performance.

#### **2.4 Summary of the Internationalization and Entry Modes**

In summary, the internationalization literature captures why (OLI eclectic paradigm) and how (*Uppsala Model*) MNEs decide to invest abroad. The OLI eclectic paradigm draws on firms' capabilities in the form of FSAs (Hymer, 1976) and managerial resources (Penrose, 1956) to internalize their operations abroad to reduce agency opportunism arising from structural or cognitive imperfections in the host market. Internalization is linked to a higher intensity entry-mode (for example, WFOS), to exert control and monitor risks in foreign operations. In contrast, the *Uppsala Model* uses perceived risks and uncertainties arising from psychic distance that firms would face abroad to explain how they could be reduced by taking sequential steps in their internationalization process. Another body of literature suggests that firms' experiential learning (to reduce risks and uncertainties) could be gained by following clients abroad.

The internationalization literature has expounded mostly the difficulties faced by EMNEs in their home institutions and their OLI disadvantages as reasons for venturing into developed economies and small-sized born-global firms' reliance on marketing competence and entrepreneurial skills to internationalize rapidly. Studies on the *Uppsala Model* were mainly on manufacturing firms from developed economies expanding into other developed economies. Several gaps exist in the literature. Firstly, limited studies

have examined the pertinence of all the internationalization models to investigate “why and how” MNEs internationalized. Secondly, few studies have focused on the expansion of developed MNEs into emerging markets. Thirdly, most studies conducted were quantitative and data were based on the size of the companies from various industries rather than on a particular sector. Fourthly, there is a knowledge gap in understanding practical issues that co-exist at the time when firms decide to deploy their resources abroad and their subsequent development strategies.

In addition, there are several knowledge gaps to be filled in the literature on entry mode. There is a lack of knowledge as to the specific reasoning behind the strategic decisions of firms from developed economies entering China. Furthermore, few studies have explored the interaction between institutional and economic actors in a high-relational based environment. In this instance, a qualitative approach would unveil how the process of interaction takes place to facilitate an understanding of the underlying factors that would lead to resolving difficulties in a meaningful way.

This research will address these gaps by investigating qualitatively the internationalization process at a firm-level with emphasis on the entry and development strategies deployed.

## **2.5 Liability of Foreignness (LOF)**

Hymer (1976) posited that foreign firms incur various costs when operating outside their home country – the costs of doing business abroad. The fixed cost relates to gathering information to understand better the country’s economy, language, law and politics. Discriminatory cost relates to the discrimination that foreign firms face in the host country, such as discrimination from government, consumers and suppliers. As a result, national firms tend to benefit from easy access of information and have a more nuanced understanding of the changing environment conferred by these location-specific advantages. This asymmetry is cost-bearing in nature and tends to have an impact on foreign firms’ profitability and survival. While Johanson and Vahlne (1977) see “psychic distance” as a key cause of risks and uncertainties. Zaheer (1995) sees these as related to the liability of foreignness (LOF). The LOF faced by foreign firms in the host country often cause them to perform less well than local competitors and to have a lower chance

of survival (Zaheer, 1995). Institutional hazards are causes of LOF (Eden & Miller, 2004), along with *outsidership*, as LOF of being alienated from the local network (Johanson & Vahlne, 2009).

Similarly, the eclectic paradigm uses ownership, location-specificity and internalization advantages to confer MNEs competitive superiority. As such, MNEs prefer to internalize their ownership and location-specific advantages to reduce the transaction cost (LOF) in an imperfect market (Dunning, 2002; Nachum, 2003). Thus, they can be profitable and have higher rate of survival in a host country.

In Zaheer's (1995) study of LOF of foreign exchange trading firms, she attributes LOF to four sources: "*costs directly associated with spatial distance; firm-specific costs based on a particular company's unfamiliarity with and lack of roots in a local environment; costs resulting from the host country environment; costs from the home country environment.*" (Zaheer: 343). Thus LOF explains why foreign firms in the host country often perform poorer than local competitors and have a lower chance of survival. Zaheer's study suggests that overcoming LOF involves both exploiting organizational capabilities and adopting local isomorphism (following the organizational practices of the market). The study employed a paired sample of 12 foreign exchange trading rooms in New York and 12 foreign exchange trading rooms in Japan respectively. The study revealed that if the competitive advantage of the firms lies in their organizational capabilities, they should export these capabilities abroad to overcome the LOF (Dunning, 2002).

Zaheer's work has encouraged extensive scholarship and debate. Daamen et al. (2007) undertook case-study research of four heterogeneous Korean MNEs operating as subsidiaries in the Netherlands to explore the causes of LOF and whether it could be circumvented through certain strategies. The Dutch subsidiaries were managed autonomously by Korean directors who were the only decision makers. Although Dutch managers were hired, they had little influence on the daily operations and strategy. Costs associated with foreignness included staff relocation costs, high local staff turnover, loss of several business opportunities and litigation fees because of managerial errors.

The findings above resonate with Zaheer's (1995) argument that LOF will be reduced if foreign firms adopt similar organizational practices to local firms in the host country. These findings support the concept of psychic-distance as a hindrance to internationalization, as postulated by the *Uppsala model* (Johanson & Vahlne, 1977). However, certain costs of LOF are predominately related to the incidental costs of doing business, which are non-discriminatory in nature. In other words, initial incidental costs could be defrayed if MNEs are discerning in their choice of organizational mode. Subsequent incidental costs can be minimized as MNEs learn to cope with the idiosyncrasies of the host country (Pedersen & Petersen, 2002; Sethi & Judge, 2009).

In line with the assertions of the OLI eclectic paradigm that competitive advantages compensate for foreign firms' LOF, Nachum's (2003) study found that they were not disadvantaged by their foreignness. In other words, their competitive advantages were more salient against national firms in the same industry, which resulted in better performance. She further asserted the possibility of a non-existent LOF under certain circumstances as opposed to typical assumptions that foreign firms tend to experience higher cost (LOF) as a result of psychic distance, institutional hazards and *outsidership*. Most importantly, the extent of LOF experiences by foreign firms are affected by how they aligned their advantages to achieve optimal competitive edge in a given environment (Sethi & Guisinger, 2002).

In Nachum's (2003) study, firm-specific advantages such as intangible assets and firms' multi-nationality are determinants that eliminate the LOF. She argues that foreign firms have integrated international networks that help to accelerate the gathering of information and resources from multiple geographical locations more efficiently, spread risks in multiple cross-border transactions and benefit from economies of scale and scope in production. Moreover, LOF tends to be reduced in M&A because of easier access to information and resources in the host country. On the other hand, the capabilities of local firms are constrained to the home-based context because they do not own foreign operations and networks that could be exploited to access better resources. However, the study found no evidence that home-based advantages have impact on superior

performance of local over foreign firms. She further argues that the nationality of firms tends to be overshadowed as firms converge into the globalization process.

Jiang, Lu, and Stening's (2014) study took a different approach of assessing the LOF of foreign firms based on how local firms in China view foreign firms' competitiveness. Specific variables of each dimension of firm-specific, multi-nationality, and home-based advantages were selected to determine the degree of LOF on foreign firms. In the context of China, firm-specific advantages comprise R&D, production, marketing, technology, know-how and innovation, branding, financing, information technology and value chain creation. Significant home-based advantages include the protectionist measures imposed by different levels of government in various sectors to allow local firms and SOEs to develop their competitiveness while eliminating foreign competition and the deeply rooted *guanxi* in a high cultural context that foreign firms will tend to face challenges in such an integrated setting. Contrary to Nachum's (2003) findings that home-based advantages of local firms do not increase the LOF of foreign firms, their findings show that local firms enjoy these home-based advantages in China. Although, these home-based advantages increase the LOF of foreign firms, they do not have a significant impact on their performance. It is compensated by their firm-specific and multi-national advantages. They also argued that foreign firms' competitiveness in China will tend to be enhanced over a period of time due to the home-based advantages that they have accumulated, thereby further reducing the LOF as a result of established home-based advantages.

Laudien and Freiling (2015) argued that regional headquarters (RHQ) could serve as an interlocutor between the headquarters (HQ) and local subsidiaries to materialize location-specific advantages and conversely reduce the LOF. The role of the RHQ is to act as a formal governance on behalf of the HQ. On the one hand, local subsidiaries can be coordinated more effectively by the RHQ, preventing opportunistic behaviour due to cross-border transactions on the other. Hence, reducing uncertainty and increasing the predictability of transnational business activities. As such, RHQ are assigned administrative and managerial roles. The close proximity in geography and culture tends to strengthen the RHQ ability to acquire quality information in a cost-effective way.

Furthermore, it also shifts the RHQ position to a higher level with the HQ which compensates for the subordinate hierarchical relationship of the RHQ to the HQ. As a result, this forms RHQ competitive advantage between the two hierarchical structures (HQ to RHG, RHG to local subsidiaries). Due to their comparative advantage, quality information in terms of market assessment of the local subsidiaries pertinent to investment decisions by the parent, can be accurately codified and transmitted to the HQ. In this instance, location-specific advantages can be materialized to offset the emerging LOF through standardization and differentiation of related organizational functions.

Another stream of research suggests that the origins of LOF have their roots in the home country. It is the incompatibility of home country institutions with the norms and practices of the host country which leads to the distance. Contrary to the style of LOF research which is typically an outward view of the costs in the host country, this stream of research has an inward view of the institutional factors from the home country that is exerting its impact on the normative, cognitive and regulative distance in the host country. Stevens and Shenkar (2015) address this phenomenon as liability of home country. They argue that foreign firms are pre-embedded by their home institutions in terms of governance, socially acceptable norms, and shared beliefs. This embeddedness will become an impediment in their international operations that causes the LOF which has its roots at home first and foremost. As such, local isomorphism (localizing marketing materials, manpower), will trigger a negative response from the home country, such as activities deemed legal in the host country might be viewed as human rights violation by the stakeholders or NGOs in the home country. As a result, complying with these groups is an inflicted liability of home (LOH) that would affect the performance of foreign subsidiaries. This is because subsidiaries are disabled from doing “the right thing” to attend to the market and customers’ needs. Furthermore, Stevens and Shenkar (2015) suggest that LOH is a more concrete measure of LOF because it explores the cross-relational friction between the pillars arising from the host country regulative institutions and the home country normative institutions. Differences in ethical views and legal recourse between the home institutions and the normative institutions of host countries are a manifestation of LOF that requires closer examination using the LOH construct.

### **2.5.1 Deconstructing the Sources of LOF**

Several scholars have sought to disaggregate the sources of LOF and the means to address these. Eden and Miller (2004) disaggregated LOF into the unfamiliarity, discrimination and relational hazards of doing business abroad. ‘Unfamiliarity hazard’ is the inability to sense and feel the way of doing business (like the locals do) in a foreign country that hinders an appropriate optimal response to a situation (similar to ‘*outsidership*’ as argued by Johanson and Vahlne, 2009). ‘Discrimination hazards’ are the existing conditions inflicted by the host country’s government, consumers and the general public towards foreign firms. ‘Relational hazards’ are the extra efforts needed as a result of internal and external organizational transactions. Taken together these three hazards are linked to institutional distance. The greater the institutional distance between two countries, the greater the LOF

Zaheer’s (1995) finding that Japanese traders in New York (foreign) performed less well than local (home) firms supports Hymer’s (1976) argument that there are always costs of doing business abroad (CDBA). A cross-sectional mixed-method study of paired financial service firms in London using samples of foreign and local firms in 2000 did not show the same results (Nachum, 2010). The empirical findings showed that foreign firms enjoy competitive advantages derived from the location attribute of being in global cities and these firms do not experience additional costs. As a result, foreign firms did not experience poorer performance. Interestingly, Zaheer’s (1995) study of foreign exchange firms in New York and Tokyo, which are global cities, showed poorer performance. This implies that the effect of LOF on performance is more acute among line-staff than at the firm level as shown in Zaheer’s (1995) study. Nachum (2010) used firm-level data such as Return on Assets (ROA), age and size of firms, growth and productivity, to measure the effect of LOF on firm performance. In this case, despite the value of diversity in global cities, the LOF still varies. Zaheer (1995) used the difference between a foreign room’s profitability and the average profitability of local trading rooms in a specific location to measure the LOF of the foreign firm’s performance.

Sethi and Guisinger’s (2002) study of LOF marked a departure from extant research in emphasising the traditional costs of doing business in the host country considering that

unfamiliarity and discrimination are the only costs incurred in the host country. They contend that in reality, MNEs are operating in a dynamic international business environment (IBE) within a global-meta environment (GME) that are shifting other costs that add to the traditional CDBA. Differences arising from the IBE and the GME are more complex and volatile in nature. They include geographical, political and economic, and social dimensions that the MNEs have to contend with. Differences are becoming more compelling in an integrated global business environment of interdependency and interconnectivity.

Such shift in costs arises from the MNEs inability to “read” the IBE accurately, and their lack of competence in designing and implementing an appropriate strategy to be aligned to the IBE. As a result of such failure, MNEs incur these costs over and above the tangible CDBA. However, they argue that LOF arising from the IBE could become a competitive advantage. To achieve that, MNEs should follow the “sequential steps” of exercising the “reading” function of IBE effectively without errors, formulating strategy that is compatible to the IBE, internalizing the firms’ processes to be adapted to an integrated whole and ensuring successful implementation of that strategy. Any error in the steps will become a liability. Thus, MNEs with superior skills at reading the IBE are capable of transforming the LOF into a competitive advantage.

Sethi and Judge (2009) in their longitudinal case-study on the operations of Ford Motor Company (FMC) in India over the past 80 years developed two further concepts of importance to the present study. Firstly, the IB literature using Hymer’s (1976) CBDA view focuses only on host country’s costs incurred and thus ignores the other costs that are incurred outside the subsidiary. Secondly, IB literature has focused on the costs, without considering the benefits derived from doing business abroad. They develop a concept – the Assets of Foreignness (AOF) - which includes host country pro-foreign investor policy such as preferential subsidies, lower/free rent, tax holidays etc. In addition, branding and quality of foreign firms are often perceived to be better than local firms. These are competitive advantages that could favour the foreign firm.

Nachum (2010) characterizes foreignness as an asset when it becomes a competitive advantage for foreign firms in the host country. In this case, FSAs such as firm size, brand,

technology, and organization capabilities, would be deployed effectively to offset the cost of the LOF. Thus, foreign firms enjoy ownership, location, and internalization advantage (Dunning, 2002). The advantage becomes more salient when compared to local firms and diminishes when compared to other foreign firms (Nachum, 2010).

The relationship between spatial distance and LOF has been studied by researchers. Boeh and Beamish (2012) studied the liability of distance between 1,171 Japanese-US and parent-subsidiary dyads. Dyad travel time of managers between the parent-subsidiary is used to represent the cost of doing business across distance. Their study looked at actual travel time needed to travel between 1171 parent-subsidiary dyads to show that dyad travel time (not geographical distance) has a strong influence on firm governance and location decisions. Their empirical study showed that firms with high dyad travel time tended to favour market entry through joint-venture, in order to reduce monitoring costs. Empirical evidence also showed that firms with more experience in managing across distance would be more likely choose a location that is easier to access.

Institutional distance has also been widely used in studies of LOF. It is defined as the extent of dissimilarity between the regulatory, cognitive and normative institutions of two countries (Kostova, 1996). Eden and Miller (2004) consider institutional distance to be a key cause of LOF and postulate that it affects the entry modes that MNEs will choose. Institutional distance has been found to have a direct impact upon entry-mode strategy and country selection (Xu & Shenkar, 2002). LOF can be reduced or overcome by adopting an appropriate entry mode and carefully selecting the host country. Building on North's (1991) concepts of regulatory, normative and cognitive institutions, Xu and Shenkar (2002) suggest that successful transfer of MNE organizational routines to a host country depends on the normative distance between the two countries. They assert that the normative pillar has a direct impact on organizational practices, as it defines the organizational goals and objectives and the appropriate measures to achieve them. They hold that MNEs which have strong, firm-specific, routine-based competitive advantage should choose to invest in host countries that have a narrower normative distance. Similarly, MNEs with a global strategy orientation should invest in countries where normative and cognitive distance is small, to avoid problems that arise from parent-

subsidiary cooperation. They argue that the regulatory distance has little impact on firms' choice of host country, although it becomes significant if the host country imposes mandatory TT that are not in line with the MNEs' proprietary strategy. In essence, the choice of host country in terms of institutional distance must be matched to firm-level attributes, so that legitimacy in the host country is established.

Ando and Paik (2013) investigated the impact of institutional distance on staffing practices by examining 2,980 foreign subsidiaries of Japanese manufacturers operating in 41 countries. They argued that institutional distance between parent and subsidiary can be bridged by adopting staffing practices that would facilitate the merger of localness and foreignness to achieve organizational legitimacy and reducing the LOF. At the same time, MNEs could use the foreign staff to maintain control which is necessary for the transfer of knowledge and organizational practices. As a result, MNEs' predicament of balancing between gaining legitimacy and maintaining control of foreign subsidiaries could be resolved jointly rather than at the expense of one another. On the one hand, they could achieve legitimacy by retaining its "localness" by hiring local staff to handle the cultural idiosyncrasies, and the foreign staff could transfer knowledge and organizational practices effectively to maintain control of the subsidiaries on the other. In this way, the normative and cognitive distance between the home and host countries is narrowed by the local staff ratio and the controlling aspect of the subsidiary is enforced by the foreign staff ratio. Their empirical findings confirm that foreign staff ratio could be used to gain legitimacy and the number of foreign staff could be used for transferring knowledge and organizational practices to achieve control of the subsidiaries. In cases when the institutional distance is high, firms that have high international experience and availability of competent foreign staff can increase the number of foreign staff more than firms that have less international experience do. In other words, experienced foreign staff could function at the same level as the locals do and simultaneously control the subsidiaries.

Lack of experience and knowledge causes risks and uncertainties in an unfamiliar environment (Johanson & Vahlne, 1977) that become LOF (Zaheer, 1995) manifested by institutional distance between the home and host countries. The study by Hilmersson and Jansson (2012) examined the impact of specific knowledge on reducing uncertainties of

203 South Swedish exporters' entry to three institutionally different markets before 2005: new Eastern EU member-states, Russia, and China. International knowledge gained experientially was found not to have any significant effect in reducing uncertainties although it has been argued by researchers that accumulated experiential knowledge in international operations is not country-specific. Thus, such knowledge could be exploited in another country to reduce LOF. On the contrary, host country's knowledge accumulated has an impact on reducing uncertainties upon entry. Specific knowledge accumulated such as the ability to understand and respond to the host's regulatory environment, possessing social capital in understanding the nuances of the business environment and insider business network knowledge tends to reduce the perceived uncertainties and thus lower the LOF. Hilmersson and Jansson asserted that firms cultivate trust and build relationship to compensate for the uncertainties arising from lack of business network knowledge, which is deemed to be the most important means of reducing uncertainties in market entry.

Puck, Rogers and Mohr, (2013) examined the effects of political strategies on 173 foreign subsidiaries' risk exposure in emerging economies. They suggested that political strategies such as financial incentive strategy, information strategy and reputation building strategy would help foreign firms reduce their risk exposure in emerging markets which tended to be institutionally weak. However, their findings did not lend support to their hypotheses. Their study also examined the effects of host country stakeholders such as consumers and NGOs on foreign firms' visibility (reputation building strategy) to moderate the outcome of political strategies that foreign firms deployed in emerging economies. Their findings showed that the risk exposure of foreign firms increased and not decreased as a result of deploying reputation building strategy to increase firms' visibility to consumers.

Gaur, Kumar, and Sarathy (2011) argue that LOF differs between firms in developed and emerging markets (EM) because of differences in home and host country environments and firm-specific assets. Taken together, the interaction between the macro-level environment encompassing institutions and the firm-level attributes including ownership and organizational capabilities determines the degree of LOF faced by firms operating in differing institutional environments and their capabilities to deploy their FSAs. They suggest that government in EMs tend to support domestic firms in their

internationalization offsetting their LOF faced in foreign countries. However, such domestic support will likely increase the LOF faced by foreign firms operating in EMs.

A comparative study by Curran and Thorpe (2015) on LOF faced by Chinese FDI in the French and Australian wine industries, indicated the specific issues of EMNEs and LOF. The study shows that unfamiliarity and relational hazards were the key causes of LOF experienced by the Chinese MNEs. Discriminatory hazards were less significant even in a highly regulated wine environment in France. However, this was not case when we hold the highly regulated industry constant. European companies operating in the EP sector in China faced tremendous discriminatory hazards that affected their operations to a significant extent (Ng & Curran, 2016). Not being in the wine business at home did not discourage Chinese investors in going abroad to acquire vineyards. However, it was a LOF since the Chinese investors did not have any prior knowledge or experience that could be exploited in the host countries to defeat the LOF faced. Within the local institutional context, it is an AOF because the outward investment was to cater to the high-end wine consumers in the home market. As such, easy access to a large home-market, exploitation of existing home embedded networks and deep understanding of the consumer market are AOF (Caves, 1982) for exporting wines back to China.

On the other hand, LOF tended to be eased by the effects of learning arising from prior experience in the host context as compared to investors who did not have such experience. Tight regulations governing the wine industry from production to the types of factors of production employed created an unfamiliarity hazard to Chinese investors in France who did not understand the legal idiosyncrasies of the French legal framework. The comparative study shows that LOF could be mitigated by trust developed between the Chinese investors and the host country partners in prior joint business venture. In this case, trust was a LOF in France but it helped to reduce LOF in Australia which was partly due to the Chinese diaspora.

A one-case study method using the LOF perspective investigated the reasons behind a failed Greenfield investment of a Chinese MNC in the Australia mining industry (Huang & Huang, 2013). Close examination of the three hazards proposed by Eden and Miller (2004), revealed that the Chinese investor was discriminated in terms of access to foreign

workers, compared to another local mining company. The local mining company could exploit cheap foreign labour that helped to reduce cost in a labour-intensive industry, strengthening its competitive advantage over the Chinese investor. Moreover, the Chinese investor was disadvantaged by the English skills of the skilled Chinese workers as they had to sit an English Proficiency Test prior to acceptance into the project. This caused project delay that led to increased costs. Additional time and costs were incurred in adhering to the compliance measures and control systems established by the Australian authorities.

In addition, lack of international experience of the Chinese managers in managing large-scale mining projects in a developed country contributed to unfamiliarity and relational hazards. The decision to enter Australia as a Greenfield investor was not supported by the company's own internal resources and capabilities (Dunning, 2002) to mitigate the high-risk investment and transaction costs. Rather, it incurred costs as a result of unfamiliarity in conducting pre-feasibility and feasibility studies in the Australian context. Again, lack of experience led the Chinese investor to select an inappropriate Chinese partner to manage the construction project. The partner had experience in China, Brazil, and Iran, but they lacked experience in developed countries in general, and Australia, in particular. As foreign players in Australia, both the Chinese investor and the Chinese partner experienced *outsidership* (Johanson & Vahlne, 2009) because they were not part of the local and global network of mining project construction, including engineering, procurement, and construction. Although the investment was managed by an Australian-led team, supporting isomorphic practice, the top Chinese management doubted their competency and trust was in question. More relational hazards surfaced subsequently in the Chinese-led management team, asserting that the local employees should adapt to their Chinese culture.

Some scholars argue that EMNEs' learning and experience could be inherited by FDI as foreign MNEs sought to include local actors into their integrated network (Klossek et al., 2012). Similarly, as foreign MNEs gain market knowledge and experience when operating abroad (Johanson & Vahlne, 1977), local MNEs also stand to gain such knowledge and experience from foreign MNEs (Johanson & Vahlne, 2009). The knowledge and

experience gained by EMNEs in this way may enable them to reduce their LOF when they invest in developed markets (Klossek et al., 2012; Curran & Thorpe, 2015). Emerging markets MNEs may use different tools to help them mitigate the LOF (Curran & Thorpe, 2015) in the host country, however a key motivator is that the institutional environment is more stable than in the home country (Ramamurti, 2009) However there are few studies looking at LOF in the other direction i.e. MNEs moving into emerging markets. Precisely because of these differences in stability of institutional environments one would expect LOF to differ to that of EMNEs in developed markets (Eden & Miller, 2004).

### **2.5.2 Reducing LOF over time**

The above LOF literature demonstrates that LOF is an inevitable disadvantage arising from the CDBA (Hymer, 1976). In this instance, how do firms mitigate these costs in the context of the host environment? This context has been widely researched by IB scholars as noted in the above literature. Competitive advantages in the form of OLI advantages (Dunning, 2002) developed at home could be internalized in host country's operations, thus reducing transaction costs. Furthermore, these advantages tend to be more salient against local competitors in host countries (Nachum, 2003). Firms develop new advantages such as knowledge and experience gained as the tenure in the host country increases over time (Johansson & Vahlne, 1977, 2006, 2009). The level of LOF mitigation strategies depends on the environmental context (Sethi & Guisinger, 2002), such as institutional factors pertaining to the normative and cognitive pillars, which have a critical impact on the LOF in a foreign country (Eden & Miller, 2004). Individuals and firms in a given society function within a set of acceptable societal norms that are deemed to be coherent with their social beliefs and values. As a result, foreign firms are likely to adjust their strategy to achieve legitimacy, by mimicking other firms (DiMaggio & Powell, 1983).

In terms of the evolution of LOF over time, several scholars have found that LOF can be reduced (Zaheer & Mosakowski, 1997; Pedersen & Petersen, 2002).

Zaheer and Mosakowski (1997) studied the competitive advantages in terms of organizational factors such as size of firms, strength of parents' financial resources, mode

of managerial control, technology adoption and firms' multicultural network affiliation, to determine whether these advantages changed over time and if they impacted firms' survival. The study focused on foreign financial service firms that were operating in a very dynamic environment, inside financial trading rooms. Empirical results show that technology adoption and a less authoritarian management style have a positive impact on foreign firm's survival. On the other hand, the study found that 12 years is the minimum condition for foreign firms' survival in the industry. The foreign firms' survival is measured by the exit rate. Foreign trading firms were likely to experience higher exit rate for a period of up to 9 years. This implies that it takes a considerable length of time for foreign trading firms to be on a level playing field with local trading firms. As a result, foreign firms must have firm-specific advantages which are superior to local firms, in order to compensate for the LOF faced from the start of their operations. LOF tended to decrease as the financial market was deregulated and became globalized.

However, Zaheer and Mosakowski's (1997) study suggest that LOF could be reduced over time as a result of accumulation of knowledge and familiarization with the host country environment as the tenure of foreign firms in the host country increases. Moreover, the host country would become more accepting of foreign firms and recognize their contribution as time elapses. Zaheer and Moskowski suggest that the effect of reducing LOF would also lead foreign firms to expand into other product areas where their competitive advantage is lower. Suggestions by Zaheer and Mosakowski (1997) were a generalization of the host country's positive response (environment) towards foreign firms based on their tenure. They did not take the economic actors and stakeholders into considerations. In real life context, the host environment involves various economic actors and stakeholders which could have an impact on foreign firms' LOF in either direction over a period of time. For example, competition from local economic actors would mean increased difficulties and higher LOF regardless of foreign firms' tenure.

Pedersen and Petersen's (2002) study focuses on the learning aspect of LOF that could be used to reduce unfamiliarity hazard (Eden & Miller, 2004) to understand better the host country's business environment as a result of information and cultural asymmetries. While CDBA (Hymer, 1976) are non-recurring costs that are inherently embedded when firms

go abroad, these costs are beyond the control of foreign firms. They argued that such unfamiliarity of the foreign business environment could be defeated through learning engagement by entrant firms, which reduces the reliance on FSAs to reduce the LOF. The study used a mail survey method and took place in Sweden, Denmark and New Zealand. These countries are small in population size and expanded abroad quickly for the opportunity to enter larger markets. Thus they were highly susceptible to LOF (Zaheer, 1995) due to early entry into foreign markets (Knight & Cavusgil, 2004; Mudambi & Zahra, 2007). Pedersen and Petersen's (2002) study revealed that high learning engagement in the form of pre-entry learning that increased institutional and business knowledge and post-entry learning that increased localization of functions and organization routines, reduced the perceived unfamiliarity of foreign markets. Entrants that were in the foreign markets for over 15 years still faced increased perception of unfamiliarity due to an unwillingness to adapt locally because they adopted a global organizational strategy. In essence, the empirical findings show that learning engagement has an impact on the perceived familiarity of the market, which in turn affects the LOF of firms in a foreign market. Firms that have a high learning engagement, rich in pre-entry institutional and business knowledge and post-entry local adaptation, tend to perceive high market familiarity and thus LOF is seen to decrease over time.

As an alternative to using FSAs to reduce LOF over time, Pedersen and Petersen (2002) argued that learning engagement is a resilient tool to reduce LOF over time. This implies that FSAs are assumed to remain as AOF with the lapse of time. This assumption has not been challenged, although previous studies have shown how AOF could be exploited to overcome LOF (Nachum, 2010; Sethi and Judge, 2009). Studies have shown the reducing effect of LOF (Zaheer & Mosakowski, 1997; Pedersen & Petersen, 2002) but limited research has been found on the diminishing effect of AOF with the lapse of time and the effect of the changing conditions of the host country's context.

### **2.5.3 Summary**

In summary, in the IB context, foreignness can be considered both a liability (LOF) and an asset (AOF). Firms in international ventures are likely to face challenges from host institutions and the marketplace manifested by their foreignness. On the other hand, their

foreignness could be a competitive advantage in the form of AOF. These challenges have appeared in many studies with an array of definitions. Hymer (1976) defined these challenges as CDBA, Zaheer (1995) defined them as LOF, while Eden and Miller (2004) disintegrated the sources of LOF into three types of hazards. Sethi and Judge's (2009) study indicated the need to differentiate between the CDBA and LOF, as well as between LOF and AOF, to evaluate the actual performance of foreign firms in the host countries.

The degree of LOF faced in the form of lack of market knowledge and experience is impacted by psychic-distance as postulated in the *Uppsala Model* (Johanson & Vahlne, 1977, 1990, 2003, 2006, 2009). Furthermore, LOF tends to reduce over time when there is an increase in knowledge and experience whether from accumulated learning or as "insider" from local networks (Johanson & Vahlne, 2009). On the other hand, the OLI eclectic paradigm underscores the importance of the I-advantage to reduce transactions costs as a form of LOF faced in foreign operations (Dunning 2002). While the *Uppsala Model* and the OLI eclectic paradigm treat LOF in the form of psychic-distance and transaction costs respectively, another body of research uses institutional distance (Sethi & Guisinger, 2002; Xu & Shenkar, 2002; Ando & Paik, 2013; Hilmersson & Jansson, 2012) as the causes of LOF (Eden & Miller, 2004) and examines how LOF could be reduced (Zaheer & Mosakowski, 1997; Pedersen & Petersen, 2002; Sethi & Judge, 2009) and how legitimacy could be gained by managing the regulative, normative and cognitive distance between two countries effectively (DiMaggio & Powell, 1983; Ando & Paik, 2013).

The body of literature on LOF is mostly about identifying the sources of LOF and suggesting how LOF can be reduced in various ways, such as selecting the optimal entry-mode in relation to firm-level attributes, selecting countries at similar level of development, exploiting competitive advantages, increasing learning engagement to reduce perceived risks and uncertainties. Few studies have reached out to companies to learn directly about their LOF experiences in a high cultural context. In a high cultural context, rules of laws are less explicit and people and firms rely on private relationships to transact business (Li, 2005). Thus, the ID is high and more challenges would be expected. In such an environment, to what extent are their strategic choices constrained

by their LOF experiences as a result of the institutional dissonance between the home and host country contexts? Studies on EMNEs have used their inward learning from foreign MNEs in their home country as competitive advantage to reduce their LOF in foreign expansion. However, limited studies have examined the impact of inward learning by host country's local companies on foreign MNEs' operations. If so, how has inward learning increased and to what extent have foreign MNEs been affected by it?

Two studies revealed how LOF could be reduced through a combination of firms' competitive advantages or increased learning engagement adopted over a period of time. These quantitative studies gathered the LOF experiences of firms from developed economies and indicated that LOF tended to decrease with the elapse of time. However, there is limited knowledge whether these findings would hold true for firms operating in emerging economies, in quantitative and qualitative research. There is a knowledge gap to address the assumption that "*local firms are more legitimate than foreign firms in most countries*" (Zaheer & Mosakowski, 1997: 461). Does it hold true in real life context? In addition, do firms' AOF diminish over time? This research will seek to address these gaps.

## **2.6 Institutions**

North (1991: 97) has undertaken extensive work on institutions and their interaction with economic actors, defining institutions as "*humanly devised constraints that structure political, economic, and social interactions. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).*" In other words, the complexity of human interactions could be contained within an orderly structure to reduce uncertainty. North (1991) argues that the probability of conflict in an exchange increases as trade becomes more intensified. As such, measurements and enforcements are needed to manage conflicts which inevitably require more resources. North (1991) assesses why some institutions evolved after learning and knowledge are gained. Thus, they are able to adopt innovative methods to reduce transaction costs (risks, uncertainties, unfamiliarity) in order to achieve realizable profits for organizations involved in cross-border trade. He contends that the institutional framework provides opportunities for organizations to evolve because it has the power to institute protection of investments. Protection such as enforcement of

contracts and property rights which may be costly and impractical for organizations to undertake.

The new institutionalism by Scott (1995) deconstructs institutions to regulative, normative and cognitive pillars. The regulative pillar depicts a set of formal rules of governance, controls and enforcement by the government. The normative pillar is a set of societal values, beliefs and actions which are viewed to be acceptable norms within a society. The cognitive pillar is the internalized, taken for granted values and beliefs that guide individual and firm behaviour. Taken together, these three pillars may interact differently with one another depending on the organizational form and processes.

Organizational forms and processes are created by individuals with different normative and cognitive experiences. Hence these experiences would shape organizational routines, and practices to respond to the external environment. Deploying methods such as compromise, defiance, and manipulation to secure resources and legitimacy. As a result of the social interactions among the actors between the pillars, the new institutionalism gives rise to the concept of institutional isomorphism to achieve legitimacy. This can be a combination of legitimate governance recognized through accreditation or certification by the public body or culturally accepted practices endorsed by other professional and trade associations or professional training institutes.

## **2.7 Isomorphism**

Adapting to local institutions is a key challenge for MNEs. Firms with global strategies will face difficulties in transferring their organizational practices to host countries. It is costly to codify practices to achieve clarity and understanding (Kogut & Zander, 2003). As a result, firms choose the alternative to adapt to local practices (local isomorphism). Zaheer (1995) suggested that LOF of trading firms could be reduced by adopting to isomorphic organizational practices. This is linked to the work of DiMaggio and Powell (1983) who posit that firms would be rewarded by following the norms and practices in the same market place. DiMaggio and Powell (1983) argue that firms become more similar over time to avoid uncertainty imposed by the formal and informal institutions. As organizations interact more intensively within the institutional structure, adopting similar

practices creates institutional legitimacy that facilitates social fitness in regulative, normative and cognitive aspects. Although such practices may not be more efficient, the legitimacy of organizations is likely to be threatened, if they do not conform to practices and routines of other firms in the marketplace and this may endanger the firms' survival.

DiMaggio and Powell (1983) suggest that institutional isomorphic changes occur in the form of coercive, mimetic and normative isomorphism: "*coercive isomorphism that stems from political influence and the problem of legitimacy; mimetic isomorphism resulting from standard responses to uncertainty; and normative isomorphism, associated with professionalization.*" (DiMaggio & Powell, 1983: 150). Coercive isomorphism is directly related to complying with standards and rules set by the governing body. Thus, any non-conformity will result in sanctions or penalties. As a result, organizational isomorphism is more likely to occur when organizations have to deal more frequently with state agencies.

Mimetic isomorphism relates to the environment that creates a sense of uncertainty. Thus, organizations resort to observing and following the trend of practices in the industry. Homogeneity tends to breed wider acceptability and self-security in an ambiguous environment. Thus, organizations tend to imitate organizations that are perceived to be more legitimate and successful. Normative isomorphism is inherited from the professionalization of employees. Within the professional or trade associations exchange, individuals are influenced by the social behaviour patterns of other participants. Universities and professional training institutions leading to career path and development are avenues of organizational norms and processes. As a result, they tend to behave and respond to a given situation in a similar way. In this instance, organizations will incur institutional isomorphic change when the professionalization of employees is more extensive.

Hitt (2016) accentuates the significance of institutions that would impact firms' internationalization strategy by decomposing the impact formal and informal institutions (North, 1991; Scott, 1995) have on firms' entry mode choice. Thus, cognizance of institutional distance between home and host countries is important when firms internationalize into new market. Drawing on the argument of Holmes, Miller, Hitt, and Salmador (2013) that changes in informal institutions such as culture would take centuries

to take effect but changes in formal institution such as a political regime could occur overnight, Hitt (2016) suggests that informal institutions (norms and *guanxi*) in China are important tools used to overcome institutional voids due to a weaker institutional environment, concluding that both institutions have impact on firms' strategies and activities.

Departing from the concept of isomorphism that has been discussed above, Archibald (2015) incorporates organizational competencies into the institutional dimension to ascertain how cultural and socio-political legitimacies impact upon firms' survivability. Cultural legitimacy reinforces trust, meaningfulness and predictability. These elements enhance understanding of organizational goals and thus contribute to growth and development. On the other hand, socio-political legitimacy is necessary to stabilize routines and practices to fit external institutions that tend to contribute to survival. Contrary to Zaheer's (1995) suggestion that organizational isomorphism tends to reduce the LOF faced by foreign trading firms by adapting to local practices to gain legitimacy. The findings from Archibald (2015) show that isomorphism does not lead to cultural and socio-political legitimacy, so it does not increase organizational survival. Rather it is market segmentation that tends to lead to legitimacy and eventually development and growth. Archibald (2015) argues that organizations compete for resources and customers in an overcrowded market place. Thus, organizations could target market segment by using core competencies and resources to achieve legitimacy and growth.

Organizational legitimacy is more acute in a transition economy that bears the characteristics of a weak institutional environment (Feng & Wang, 2009). As a result, firms are motivated to establish good relationship with politically connected officials and be highly involved in politically supported projects. Firms tend to structure their organizational practices and routines to fit into the political agendas in exchange for organizational legitimacy (Feng & Wang, 2009). In the case of China, the regulatory framework is weak, making it unpredictable and resulting in increased uncertainties and risks. Feng and Wang (2009) studied Chinese firms in China between 1997 and 2006 and explored how they obtained organizational legitimacy in a weak institutional environment. The study shows the various difficulties faced by local private firms during this period.

The survey showed that the burden of the Three Payouts (additional to normal tax, private firms had to pay extra money to the government either in the form of gifting or entertainment) system is a high cost that took up to half of the companies' profits after tax. Furthermore, local private firms had to compete for financial resources with SOEs and had stricter requirements to fulfil in applying for bank loans, often resorting to borrowing from informal institutions (relatives, friends, illegal loan establishments). Due to the weak institutional environment, private companies faced difficulties in getting problems addressed officially on a level playing field. As such, private firms adopt organizational isomorphism to be closer to the governments' expectations, such as engaging in corporate social responsibility programs initiated by the government to obtain legitimacy. Forming alliances with local government facilitates access to a specific market, as well as helping to overcome resources deficiencies and reduce transaction costs.

### **2.7.1 Summary: Institutions and Isomorphism**

Institutional conflicts are manifested by increased trade that compel institutions to become "effective regulators" through learning and knowledge gained. Notably the three institutional forces that shape the functions of institutions are the regulative, normative, and cognitive forces. The tendency to adopt institutional isomorphism is high to achieve legitimacy and lower the likelihood of failure in foreign markets. This is so to reduce uncertainty that tends to increase risks especially when access to market information is limited.

### **2.8 EU Companies in China**

Most IB studies have focused on comparison of strategies between countries, regions, and industries. Limited literature specifically focuses on EU companies' strategies doing business in China. Existing research focuses on the potential in TT as a collaboration mode between the EU and China (Andreosso-O'Callaghan & Qian, 1999) as well as early research specific to EU Member States' business in China. McGuinness, Campbell, and Leontiades (1991) studied the Chinese buying process towards foreign-made machinery, Li and Yeung (1999) investigated the localization benefits of two European manufacturers

in China, and Kumar and Worm (2002) studied the cultural difficulties faced by the Danish and Chinese partners in the negotiation process.

Andreosso-O'Callaghan and Qian, (1999) argued for the feasibility of EU-China collaboration in technology transfer by demonstrating the positive impact it would have on the transferor (EU) and the receiver (China). Historical data showed that the EU was the major supplier of advanced technology and equipment to China representing almost half of China's total imports in 1999. Andreosso-O'Callaghan and Qian (1999) argued that EU firms possessed specific advantages such as an established reputation and performance in the science-based industries, specifically in the energy, chemicals, motor vehicles, and telecommunications and mechanical engineering sectors.

In addition, Chinese government industrial policy was conducive to providing tax exemptions for technologically-advanced foreign investment, high-technology development zones and upgrading of technical skills. Taken together, the collaboration would benefit both EU and China. Furthermore, Andreosso-O'Callaghan and Qian (1999) suggested that success in TT emerged from the ability of EU's firms to adapt the transferred technology to fulfil the specific needs of China through technical training and supervising. As a result, absorption of such technology would tend to lead to innovation. Joint-ventures with local partners tend to have more effective management of TT. Drawing on the joint-venture success of EU-China in the automotive and chemical industry in China, the authors suggested that EU firms could follow suit by localizing their operations in China.

A study by McGuinness et al. (1991) found that good customer relationships did not have an impact on customers' preferences in their buying process. The study examined Chinese buyers' preferences towards their suppliers from Europe (Germany, Switzerland, France, UK, Italy), and Asia (Japan), selling machinery into the textile, flour milling, machinery and food processing industry. Results showed perceived product quality and promotion to be more important determinants of customers' preferences than relationships. However, pricing was not a barrier in the final buying decision process, probably due to the value the Chinese placed on product quality. In this case, they were more value-sensitive than price-sensitive.

The study found that customer relationships in the context of China were twofold: 1) Chinese adopted a western style approach when interacting with westerners and thus relationships were not deemed to be important in the buying decision, which was rather influenced by the overall value placed on the product, in terms of perceived product quality and promotional efforts; 2) relationships were more critical to westerners who were within the Chinese system, and thus long-term relationships building would benefit the foreign operations. Chinese buyers would interact with the westerners within the Chinese system as if they were locals. In this case, the study implies that westerners are likely to exert more efforts in promotional services (user training in product application) when exporting to China and to focus on relationship building and localization if their business was located in China.

On the other hand, TT, financial help and barter offered by foreign suppliers seemed to be important contributors to building customer relationships. This study suggested that the Chinese valued learning new technology, which created familiarity with the equipment. This behaviour implied that price became secondary in the buying decision. Furthermore, the Italians seemed to have a narrower cultural gap compared with others because they tended to be more flexible. Difference in the perception of flexibility was evident in the respective managerial styles of Danish and Chinese managers in the negotiation process. Danish managers were willing to be flexible up to the time the contract was signed, whereas Chinese managers tended to become more flexible once a relationship was established (Kumar & Worm, 2002). The key findings in the empirical work of McGuinness et al (1991) showed that although relationships are important in the Chinese cultural context, this does not necessary imply that they will facilitate strong competitive advantage as opposed to product quality and utility value. Furthermore, relationships become more significant when foreign actors are within the Chinese system. As a result, localizing marketing strategy and getting into the Chinese networks tend to be mechanisms to secure Chinese preferences.

Li and Yeung (1999) investigated the inter-firm linkages and the regional impact of two European manufacturers that invested in Shanghai, China. The study involved two case studies using in-depth interviews. The FDI pattern was on the one hand a 50/50 joint-

venture and a 40/60 joint-venture on the other. As a result, the joint-venture was localized and had increased the bargaining power of the Chinese corporations when negotiating with local suppliers in parts and components. In the case study of the German car manufacturer, Volkswagen (Shanghai Volkswagen), it was found that the outcome of TT necessary to facilitate local operations extended the joint-venture to grow into other provinces in China, as well as promoting the growth of their local suppliers. Another critical benefit was the suppliers' learning process when their technical knowledge was advanced as a result of their business association with the European-Chinese joint-venture. As a result of the learning, they extended their growth overseas. Furthermore, the joint-venture benefited from the industrial policy introduced by the Chinese government, as well as the Shanghai municipality. The industrial policy entailed a local content requirement in exchange for lower tax per vehicle, which propelled the growth of the car manufacturing industry including the supply chain of parts, components and raw materials such as plastic.

Over and above governmental support, Shanghai municipality had been instrumental in encouraging local suppliers to improve their technological knowledge. Findings from the case study of Shanghai Bell were generally similar to those of Shanghai Volkswagen. Shanghai Bell was localized and thus domestic marketing was effectively controlled, resulting in rapid sales and increased growth to become the leading manufacturer of advanced digital switching systems. The TT from Alcatel Bell had narrowed the gap in communication technology between the Chinese and advanced economies by 30 years. Learning about the foreign technology became imperative and hence overseas training increased the knowledge of Shanghai Bell's suppliers. The outcome of the joint-venture was the establishment of a research and development (R&D) centre in Shanghai in 1996.

The key finding in this study is the multiplier effect of a joint-venture on the local supply-chain, which tends not to be obvious when assessing FDI in China. The study showed other underlying growth that happened within the local supply networks, not only in sales growth and expansion, but an increase in technical knowledge that resulted in reducing production costs and raising efficiency. The study implies the importance of industrial policy implemented by the Chinese government and the Shanghai municipality's support towards technology-embodied output, which can be seen from the effective TT by the two

European firms. The success of the TT in part was also due to the organizational arrangement of the joint-venture particularly in Shanghai Volkswagen. As a 50-50 joint-venture, the Chinese took positions of the President and the Managing Director while the Technical and Commercial Directors remained with the Germans. As a result, comparative advantage from each side was likely to be evidenced in the Chinese ability to bargain more effectively when sourcing for competent local suppliers on one hand, and the Germans' knowledge resource in transferring their technology successfully, on the other.

Research by Kumar and Worm (2002) explored the impact of social capital on the dynamics of Danish and Chinese business negotiations. An exploratory case-study method was used to interview Danish managers living and working for Danish firms in China, and Chinese managers working for Chinese firms in China. The purpose was to unveil and compare the types of interactional difficulties faced by these two groups of managers in their business negotiation process. Social capital as defined in the research (Kumar & Worm, 2002: 262) has three components: "1) *cognitive dimension highlights the level of shared understanding among the actors*; 2) *relational dimension focuses on the affective bonding among the actors*; and 3) *structural dimension highlights the nature of interconnectedness among the actors*." The study showed that Danish managers had a level of understanding with regards to the importance of *mianzi*. *Mianzi* refers to a person's status or prestige derived from personal accomplishment (Kumar & Worm, 2002: 275). Trust was likely to be affected if the Chinese felt that they had lost face (loss of *mianzi*) in front of others. Furthermore, the Danish managers understood that negotiation is a long process (several meetings) with the Chinese, because it takes time to establish trust in the process. It was found that only Danish managers experienced difficulty in understanding the goals and objectives of the Chinese, due to underlying differences in perceptions, learning and reasoning. For example, Chinese are much more holistic in their thinking whereas Europeans are more analytical. However, this difficulty tended to be less evident with the younger generation of Chinese negotiators.

Lack of language skills from both parties prevented confidential information from flowing to the Danish. This was because the Chinese were reluctant to divulge sensitive information through interpreters. Information is critical to enhance knowledge and in its

absence, risk and uncertainty is increased (Johanson & Vahlne, 1977). Persuasion to enable another party to accept a particular view seemed difficult but was most likely to be overcome by gaining access to the right people, as well as dealing with younger generation Chinese. In short, the research implies that European managers have in one way or another understood that showing *mianzi* and trust are critical in communicating with the Chinese. These two factors enhance relationships which would be most likely to facilitate achieving goals and objectives. European managers could learn from the difficulties in Chinese negotiation and apply the learning when interacting with institutional actors, such as government, employees and business partners, to build relationships and possibly enter local networks.

### **2.8.1 Summary**

In summary, the above literature has elucidated that product quality is highly linked to localization of products and services and that support from institutions tends to increase sales and growth. Learning new technology is encouraged by Chinese institutions and valued by the consumers, Chinese tend to be more value-sensitive than price-sensitive; *mianzi* and trust tend to be related; and finally exercising flexibility tend to be important in cooperating with the Chinese.

Chinese responsiveness to developing product substitutes can cause problems for IPR of foreign companies because even though the Chinese industrial policy in 1999 was constructed to ensure IPR would be enforced, the legal framework was still deemed to be underdeveloped (McGuinness et al, 1991). It would be interesting to know if EU firms in the EP sector in China faced the same phenomenon of product substitutes and safeguarding IPR.

### **2.9 EP Sector in China**

Enforcement issues for environmental protection in China remain controversial and difficult (Blanchard & Stanway, 2013). Violators were often recalcitrant in their offences and yet were not sufficiently prosecuted (Yang, 1995). Studies showed that there is a need for a top down Chinese government support to its representing agencies such as the Environmental Protection Bureau by assigning them with more power, staffing, proper

working tools and financial resources to perform their duties in eradicating environmental issues effectively (Jahiel, 1997).

A study by Marquis et al. (2011) found that the gap between law and enforcement in the environmental protection in China was closing, as characterized by changes in “regulatory systems: priorities and incentives, bureaucratic alignment, and transparency” (Marquis et al., 2011: 39). The study, using interviews and archival data of 63 diverse organizations, compared the role of the State during China’s industrialization period and post industrialization that closed the gap between law and enforcement. They suggested that companies should align their strategies with the shift in goals and metrics of the central government. Undermining government authority is seen to be detrimental especially when the government is particularly sensitive to such behaviour by MNEs. Integrating into the local supply chain by getting more local stakeholders involved could be exploited by MNEs as they could help them (environmental specialists) to integrate with global standards.

Lo and Fryxell (2003) studied the effects of external support (government and public) and organizational factors (role clarity, supervisory support and resource adequacy) on the preferences for enforcement styles of environmental officials in Guangzhou, Chengdu and Dalian in China. Enforcement styles described in Lo and Fryxell (2003) were: external influence when pressure is exerted on regulatory agencies from the beginning of the regulatory enforcement; setting priorities on enforcement; formalizing implementation deadlines, environmental standards and level of penalties; reluctance to take into account cost-benefit considerations; and interacting with violators through coercion and education. They argue that the enforcement style of environmental officials is influenced by their own personalities and preferences to local conditions in order to achieve compliance from polluting firms. The enforcement style is also subject to the contextual factors in these regions that might prohibit the effective use of one enforcement style over another (for example, agencies in Guangzhou and Chengdu are successful in using education and prioritization to achieve environmental compliance). The study suggests that effective enforcement of environmental policy depends on the government’s policy priority. The key research finding is that the enforcement style in China cannot be generalized because

local governments have autonomy and are not required to follow a uniform set of regimes. This has important implications for companies seeking to develop the EP market.

Qiu and Li (2009) studied the different stages of environmental protection reforms from the early years of the State Environmental Protection Agency (SEPA) to the current Ministry of Environmental Protection (MEP). The purpose of setting up the MEP was to reduce overlapping governmental responsibilities, increase efficiency and reduce administrative costs. The study criticizes the environmental protection framework after the formation of the MEP. Qiu and Li (2009) assert that the fundamental problems of the framework could have been solved by delegating power to the MEP but these fundamental problems have not been discussed, let alone solved. They suggest that the Chinese government should deepen the institutional reform at the legislative level and enact administrative organization laws, especially an organization law for the environmental protection sector.

The predicament of China's environmental degradation is a response to the open-investment policy in the 1980s that has created an economic miracle in the past three decades. In its march towards creating a "green" China, protecting the Chinese environment has become an institutionalized narrative. Ambitious goals were set in the 12th FYP: to reduce the carbon intensity per unit of GDP by 40-45 % by 2020 compared to 2005 level; to produce 16% of its energy from non-fossil fuel sources by 2020 (Beebe et al, 2013). In pursuit of these goals, the Chinese government developed policies to encourage technological innovation through R&D subsidies, TT, increase in public R&D expenditure to improve local technological knowledge (Groba & Cao, 2015) and foreign knowledge accumulation (Liu & Goldstein, 2013).

Chinese businesses responded to the national goals and the EP sector has evolved as a result of strong governmental support that brought about increased investment in renewable energy (RE), turning China into the leading global investor in RE infrastructure, with increasing overseas investments in solar and wind industries (Tan, Zhao, Polycarp, and Bai, 2013). Large financial stimuli by the Chinese government created an easy access to loans to acquire strategic assets when Chinese investors went abroad. Not surprisingly, mergers and acquisitions (M&A) are more favoured over green-field investment (Kong &

Gallagher, 2016) because of lack of knowledge-based technology at home. This is evidenced by the pattern of China's exports in terms of technology sophistication, China's exports are still predominantly in manufacturing, and its level of technological sophistication lies between low and medium range (Tan et al., 2013).

Two major industries in the EP sector in China stand out because of their rapid expansion at home and abroad. The solar and wind industries are the case in point. In 2009, these industries were targeted as "favoured healthy industries" by the National Development and Reform Commission (NDRC) which accelerated the policy-push for overseas investment (Tan et al., 2013). This was, in part, aimed at eradicating excess domestic capacity and removing redundant industries in the EP sector. In the last decade, there has been an increase in the number of Chinese companies penetrating the solar and wind industries in developed countries using different entry mode strategies such as JV (Platzer, 2015); acquisitions (Quitow, 2015); licensing (Ru, Zhi, Zhang, Zhong, Li, & Su, 2012; Liu & Goldstein, 2013); and greenfield investment (Tan et al., 2013). As seen in the above literature on EMNEs' internationalization processes, Chinese investors in the solar and wind industries springboard their internationalization into developed economies to acquire strategic assets such as access to advanced production technology and FSAs to enhance their competitiveness (Tan et al., 2013).

In the solar PV industry, China did not possess technology to compete with world leaders in the US, Germany and Japan (Campillo & Foster, 2008). Over the years, it made remarkable progress to emerge as the top solar PV market in 2013 (EPIA, 2014) accounting for about 70% of solar module production (Platzer, 2015). China's success was a combination of increasing domestic PV capacity installation, Chinese governmental support and worldwide demand that created an environment for Chinese manufacturers to grow and develop their expertise (Liu & Goldstein, 2013). For example, Suntech became the world's largest solar module manufacturers just one year into its first operation. In 2005, it entered the New York stock market and continued its market expansion strategies through acquisitions and joint ventures (Platzer, 2015). By 2007, it had five production locations in China.

On the other hand, Chinese producers of wind turbines had become technologically competent due to the TT or local content requirement of FDI through joint development projects with local partners during the 2000s (Liu & Goldstein, 2013). Goldwind, a Chinese producer benefited from the scheme. It had the licence from REpower of Germany to produce small turbines before entering into a joint development of larger units with another German partner, which was later acquired by Goldwind (Zhou & Wang, 2009). Government FDI policy to promote the wind industry included stipulating TT and local content requirement, together with subsidies that allowed Chinese actors to build on their capabilities and foreign actors to increase their sales in China (Liu and Goldstein, 2013). China is poised to become the leading global producer as well as the leading consumer market in wind turbine rotor blades with an expected market value to increase from \$2billion in 2012 to \$3.7billion by 2020 (GlobalData, 2014).

It is clear that the role of the Chinese government has evolved over the years from an investor to a ferocious environmental regulator (Zu, He, Yan, & Wang, 2015) as attested by the strengthening of their institutions such as the MEP, authorizing it with executive power to be exercised on polluters that non-environmental compliance is costly. The traditional debate that environmental compliance comes with an economic cost of declining growth due to an erosion of competitiveness arising from increasing costs (Ambec, Cohen, Elgie, and Lanoie, 2013) weakens as argued by Porter and van de Linde (1995) that links environmental regulations as a driving force of environment innovation. In their argument, Porter and van de Linde (1995) presented the substantial cost-savings in environmental innovation when companies changed their processes or raw materials to achieve higher process yields, less downtime, materials saving and better product quality. In this instance, Porter and van de Linde (1995) suggest that companies should view environment as a competitive opportunity that would lead to innovation offsets in terms of product and process innovations.

### **2.9.1 Summary**

The above literature review examined the EP sector from an institutional perspective to provide a deeper understanding of the various bureaucracies that exist between institutional hierarchies and how these barriers could be eliminated. Challenges faced by

governmental EP agencies stemmed from administrative and procedural ambiguities (Lo & Fryxell, 2003); central and local governmental support (Yang, 1995; Lo & Fryxell, 2003); lack of staff and adequate resources to carry out enforcement (Jahiel, 1997); conflict between business community and local government (Jahiel, 1997); absence of legal sanctions on offenders (Yang, 1995); and low pollution fees that did not deter offenders (Jahiel, 1997).

The evolution of the Chinese EP sector, evidenced by the rapid expansion of the Chinese solar and wind industries, stems from the underlying need to absorb overcapacities at home, and at the same time, to capitalize home factors of production (cheap labour and raw materials) and to exploit foreign markets' technological knowledge. The Chinese government has been instrumental in instituting investment policies to ensure that technological knowledge is advanced at home. At the same time, home-grown companies have leapfrogged western solar and wind companies by acquiring them. In this case, competition is less intense, FSAs are retained and unthreatened by the M&A. As a result, the M&A would mean lesser incidence of LOF in the host country.

#### **2.10 Summary of gaps in literature: Internationalization and entry modes**

Firstly, limited studies have examined the pertinence of all the internationalization models to investigate the “why and how” of MNEs internationalization processes. Secondly, there is a lack of knowledge as to the specific reasoning behind the strategic decisions of firms from developed economies entering China and investigating the difficulties arising from the interaction between institutional and economic actors. Thirdly, most studies conducted were quantitative and data were based on the size of the companies from various industries rather than on a particular sector. Fourthly, there is a knowledge gap in understanding practical issues that co-exist at the time when firms decide to deploy their resources abroad and their subsequent development strategies.

#### **2.11 Summary of gaps in literature: LOF**

We know very little about the LOF faced by EU firms in China where the regulatory, cognitive and normative distance is perceived to be high. Given its growing importance as a market, this is a curious omission. In terms of the three institutional contextual factors,

little is known about how they impact on firms' internationalization strategies over time. What are the LOF faced by EU firms in emerging economies in terms of business practices, cultural values, and technological innovations? While business practices and cultural values could be mitigated by hiring of local workforce, is possessing technological innovation an asset or liability? Also do their LOF decreases over time in the same way as firms operating in developed economies? Finally, what kinds of strategies are used to cope with their LOF faced?

In light of the above, this research seeks to address these gaps in the literature by exploring the experience of a number of companies in a specific sector in China. The focus is on the EP sector firstly because each sector has a very specific regulatory framework and institutional context so by holding the sector constant, variations due to regulatory distance between sectors is avoided. Secondly, the EP sector is one where there is clearly emergent demand in China (CEC, 2013a), so there should be pull factors, in terms of local market demand that will create a dynamic where EU companies, which are relatively well placed in this sector, should have FSAs.

## **2.12 Research Questions**

The following research questions seek to address the literature gaps through case study research:

1. What entry and development strategies do EU EP companies deploy when internationalizing into China and why?
2. To what extent are EU EP companies' strategic choices constrained by the LOF faced due to the institutional dissonance between the EU and China?
3. Which strategies cope more effectively to overcome the LOF?

# CHAPTER 3

## METHODOLOGY: RESEARCH APPROACH

### 3.1 Introduction

This chapter covers the methodology used and the research design developed to answer the research questions. First it explains the methodology selected. Second, it addresses the selection criteria for the case study companies and the method of data collection. Third, it highlights the issues explored with the case study companies with focus on organizational strategies, institutional relationships and the extent of LOF faced within their operational context. Finally, it details the list of informants from the case study companies and the gatekeepers.

Three approaches to research design have been advanced quantitative, qualitative and mixed methods (Creswell, 2009). A quantitative research approach aims to test theories by examining the relationship between variables that are measured and analysed using statistical procedures. A qualitative research approach adopts an inductive style that explores individual meaning and the complexity of a given situation. It is best suited when little research exists and a given concept or phenomenon needs to be understood. Strategies of enquiries include narratives, phenomenologies, ethnographies, grounded theory and case studies (Creswell, 2009). Qualitative research can contribute to eliciting data and suggesting conclusions to which other methods would be blind, at the same time illuminating elements of the context (Jick, 1979). Finally, mixed methodology employs a combination of qualitative and quantitative methods.

### 3.2 Research Approach: Methodology Selected

Much work in the area of environmental standards and investment has taken a strongly quantitative, econometric approach (Lv & Spigarelli, 2015, 2016) focused on the macro level. For this study, a qualitative case study methodology was selected to address the micro level of companies and in particular their strategic alternatives and management.

Past empirical research relies heavily upon quantitative evidence about firms' internationalization, decision on entry modes and LOF faced (Zaheer, 1995; Zaheer & Mosakowski, 1997; Nachum, 2003, 2010; Boeh & Beamish, 2012; Hilmersson & Jansson, 2012; Ando & Paik, 2013; Puck et al., 2013; Jiang et al., 2014).

A qualitative case study approach informed by semi-structured face-to-face interviews will help to ascertain the various reasons and context leading to firms' decision to internationalize and why a particular entry mode was adopted over another, their subsequent difficulties faced within the operating environment, and how they developed their coping strategies based on their lessons learned in interacting with the institutional and economic actors. For example, this research explores the impact of unfair treatment when foreign companies are not granted a building licence in China and how they coped with this. A quantitative method using statistical data collection would not lead to an understanding of the coping mechanisms that the companies used to overcome the unfair treatment.

A case study methodology allows more meaningful answers to questions of the how and why of strategic decisions in a real-life context (Yin, 2002). Scholars have used qualitative case studies to explore the practical aspects of the theory of LOF originated from Zaheer's (1995) study. Why did LOF emerge and how could it be overcome by adopting specific strategies relating to the LOF faced in specific organizations (Daamen et al., 2007; Curran & Thorpe 2015; Ng & Curran, 2016)?

The qualitative case study method is also well posited for international business research where data are collected from cross-border and cross-cultural settings (Daniels & Cannice, 2003). The geographical distance between EU and China is conspicuously evident and vast. Inherent cultural differences between the two in terms of economic, political and institutional governance have important implications for the internal functioning of the MNE network (Ghemawat, 2001). A qualitative case study method is of further relevance to this study to capture a more comprehensive, holistic, and contextualized portrayal of EU companies operating in China (Jick, 1979). Furthermore, this research relates to European international business and qualitative case-study approach is most popular in this context (Bjorkman & Forsgren 1997). Research using qualitative case study method

shows that employing the correct techniques to overcoming difficulties in access to elite interviewees, managing of power asymmetry, and allowing a candid flow of information lead to receiving quality data from the elite interviewees (Welch, Marschan-Piekkari, Penttinen, & Tahvanainen, 1999; Drew, 2014; Zhang & Guttormsen, 2016).

### **3.3 Research Design**

A single case or multi-case approach can be used in case study (Yin, 2002). In the absence of an ideal number of cases, the recommended number is between 4 and 10 cases (Eisenhart, 1989). Less than 4 cases, it is difficult to generate theory, and more than 10 cases, the volume of data is difficult to cope with (Eisenhart, 1989). As a result, six EU companies in the environmental protection sector that entered China were identified who agreed to participate in providing details of their strategies and operations relevant to this study. Examples of existing IB research that use six cases and the below are: Johanson and Vahlne (1977) who studied the internationalization pattern of four Swedish firms; Li and Yeung (1999) who conducted in-depth interviews using 2 European companies in China to determine their localization benefits; Daamen et al., (2009) who used four case study companies to investigate the extent of LOF in comparison to local competitors; Curran and Thorpe who (2016) examined and compared the LOF in the wine industry between two regions in France, and Choi and Nailor (2005) who used two cases to examine the dynamics of competition in China. Hence, this legitimizes the case for the selection of six EU companies in this study.

#### **3.3.1 Case Study Companies: Selection Criteria**

The following were the selection criteria of the case study companies which covers the research context of POREEN as well as the theoretical context of this thesis.

- The company originates from the EU and is operating in the environmental protection sector
- The company has internationalized into China
- The company is willing to participate
- The company is well developed in its domestic market

- The company has wide coverage internationally

The above criteria were selected because they satisfy the theoretical framework design illustrated in Figure 4.2 covering the internationalization and institutional theories that encompass this study. Specifically, the theoretical argument of a firm's internationalization is due to excess in human endowment (Penrose, 1959; Dunning, 2002) and FSAs (Hymer, 1976; Caves, 1982) that could be exploited to the firms' advantage abroad. Firms' advantages are built over a period of time in their domestic market through learning and experience gained from local stakeholders such as institutions, shareholders, customers, trade associations and their own established networks (Johansson & Vahlne, 1977, 2006, 2009). This is because firms, like other institutions evolve as a result of learning and experience (North, 1991) from their home origins and cross-border operations (Kogut & Zander, 2003).

### **3.3.2 Method of Data Collection**

Semi-structured face-to-face interviews with key informants of the participating companies were conducted between June 2014 and June 2015 in Beijing, Shanghai, and Wuxi, China. The key informants can *"provide important insights into a situation. They also can provide shortcuts to the prior history of the situation, helping to identify other relevant sources of evidence"* (Yin, 2002: 92).

Attention was paid to avoid culture and status bias in the conduct of interviews (Zhang & Guttormsen, 2016). The author academic standing as an EU scholar and a PhD candidate in Toulouse Business School legitimized her status and the purpose of writing to companies and gatekeepers (Welch et al., 1999; Drew, 2014). This legitimacy was authenticated by providing the link to the EU-China Research Network, POREEN (<http://poreen.eu/>) which funded the field research in China (Welch et al., 1999). The author multicultural background was strategically exploited to overcome cultural bias. She introduced herself this way in anticipation of obtaining face-to-face interviews. In interviews, she presented herself as a Chinese Singaporean, living and studying in France (at the time of interview) with permanent residence in the US, having lived and worked in Asia, Europe, and the US. These attributes enhanced her "favoured ethnicity" and when

needed, she put her “desired passport” forward (Zhang & Guttormsen, 2016). In particular, China and Singapore have strong political and economic ties (the most well-known was China-Singapore Suzhou Industrial Park which was backed by the late Prime Minister Lee Kuan Yew and Deng Xiaoping in 1994) (Xinhua, 2016). It was ranked the top country for expatriates to live and work in a recent report by HSBC Explorer (2016). The informants all had high regard for Singapore.

Informants were European and Australian expatriates and local Chinese. They were the top and middle management and were assets to the companies because of their long service tenure, industry experience, and personal networks. Most of them had regional and international exposure prior to joining the companies. As such, they were considered to be elite interviewees because of their valued positions within the organizational hierarchy (Welch et al., 1999). Research shows that interviewing elites pose four major challenges: gaining access, dealing with power asymmetry during an interview, evaluating their openness, and providing feedback to the elites (Welch et al., 1999). In the light of these challenges, the author used her international industry experience and multicultural background strategically to gain access to the elite interviewees (Drew, 2014) and to create a “*more balance in the power relations*” (Zhang & Guttormsen, 2016: 243). They felt more relaxed and were open in relating their experiences in China to me. The author reiterated in the formal letter that the interview would be non-invasive, rather to seek a deeper understanding of their challenges in China and would not pose any threat to the companies (Welch et al., 1999, Yin, 2002). All the expats interviewed were very supportive of the research and provided access to the Chinese managers who reported to them (Yin, 2002). The author would expect to be socially perceived as a “Westerner” having lived outside of her country for so long. However, this was diffused by the Chinese ethnicity. The author and the informants bonded well because of a common language (Mandarin) used to discuss other social matters in between interviews. Sharing a common language increases the probability of securing an interview and helps in establishing rapport in the interview process (Zhang & Guttormsen, 2016).

Gaining access to Chinese government officials is problematic (section 3.3.5). The author did not receive any response from informant G10 despite numerous emails from

November 2014 to June 2015. Many phone calls were made to the official's office but there was no answer. The author figured out later that the email address was actually a mobile phone number, since in China, an email address is created by registering a mobile number. The author therefore called and made a self-introduced in Mandarin using "favoured ethnicity" to increase rapport." The author representation as a PhD candidate from France stoked curiosity and the respondent agreed to a short interview and the date was fixed on the spot.

Background interviews with gatekeepers (government and industry associations representing various stakeholders) were also conducted during this period. These interviews are presented in greater details in section 3.3.5.

All interviews were conducted in English except with the Chinese government official which was partly conducted in English and Chinese. All interviews were recorded and transcribed. This facilitated "playback" to ensure accuracy and clarification. They were supplemented and informed by reviewing the case study companies' website to validate the accuracy of data collected such as background information and press releases about business expansions. Position papers from the European Chamber of Commerce in China were reviewed to enhance understanding of some underlying issues about unfair treatment that were discussed during the face-to-face interviews.

### **3.3.3 The Case Study Companies**

The face-to-face interviews took place from November 2014 to June 2015. They varied in duration but all interviews lasted for at least an hour. All informants wished to be anonymous. A list of 20 questions (Annex I), was used to guide the interview process. The theoretical framework of internationalization and institutionalization theories was used to develop the questions. The list of questions encompasses company background information, reasons for internationalizing into China, organizational strategies in China, institutional experiences with key actors, and the strategies used to overcome the LOF. Background on the case study companies is provided in Annex II.

### **3.3.4 The Issues Explored and Individuals Interviewed**

Key issues relating to the operating environment in China were explored and discussed with the informants. Each case study company has between 2 and 3 key informants and increasing the data reliability through triangulation. First, how and why did they internationalize into China. Second, what types of organizational strategies did they adopt, and what level of institutional relationships do they have with important institutions? After addressing the key issues, participants were allowed to articulate freely to facilitate a fluid interaction in a friendly and non-threatening way (Yin, 2002). For example, CoB had more relational hazards with governmental agencies to the extent of corrupted behaviour, was given more time to share the experiences. Both informants from CoB had similar experiences validating the evidence collected about relational hazards. Similarly, different informants in the same organization have different views mostly due to their positions held and differences in strategic thinking. However, this is solved by cross-probing of different people in the same organization. For example, interview with the PRM of CoC did not reveal much about the discriminatory practice faced but rather how they coped with these. The input was different from the AD, who explained the negative effects as a barrier to organizational growth such as prohibiting the realization of a “One Stop Service” strategy and impeding Class 1 engineers from obtaining higher certification because technical drawings have to be signed by engineers from local institutions instead of engineers in CoC.

Table 3.1 details the companies and the individuals interviewed. The individuals hold key positions and are to a large extent decision maker. Each individual was well placed to provide strategic and operational data because of their years of service in the company and in China. Knowledge and learning accumulated over a number of years in the company legitimized their viewpoint and enhanced the validity and reliability of answers to the questions (Yeung, 1995). In addition, when two or more informants shared the same view to an emerging phenomenon such as unfair treatment by the Chinese government, this attests the validity of the information.

**Table 3.1 Companies and Individuals Interviewed**

Company	Designation	Nationality	Date of interview	Length of interview (hours)	Years with Company	Years in China
CoA (France)	Business Unit Director, Incinerator (BUD)	European	6-Nov-2014	1.5 hrs	10	10
	Plant Manager (PM)	Chinese	3-Mar-2015	2 hrs	5	N/A
CoB (France)	Managing Director, Energy Recovery (MD)	Australian	5-Feb-2015	2.15 hrs	9	9
	Project Development Manager (PDM)	Chinese	10-Mar-2015	1.30 hrs	6	N/A
	Research & Innovation Manager Asia (RIM)	European	11-Feb-2015	1.15 hrs	7	7
CoC (UK)	Associate Director (AD)	European	21-Jan-2015	1.15 hrs	20	15
	Project Manager, Infrastructure and Sustainability (PRM)	Chinese	5-Nov-2014	2.5 hrs	5	N/A
CoD (UK)	Financial Manager (FM)	Chinese	15-Jun-2015	1.5 hrs	15	N/A
	Director, Regulatory EIA services (DIR)	Chinese	18-Jun-2015	1.5 hrs	8	N/A
CoE (UK)	Chief Operating Officer (COO)	European	13-Jun-2015	1.5 hrs	22	16
	Commercial Regional Director (CRD)	English	13-Jun-2015	2.5 hrs	22	16
	Head of Sustainability and Energy (HOS)	European	15-Jun-2015	1.5 hrs	5	N/A
CoF (Finland)	General Manager (GM)	European	15-May-2015	3 hrs	5	2
	Heat Pump Manager (HPM)	European	15-May-2015	1 hr	15	1
	GM's assistant (GMA)	Chinese	15-May-2015	1 hr	12	N/A

### 3.3.5 Gatekeepers

Interviews with majority of the gatekeepers occurred prior to the interviews with key informants in the case study companies, which at that time had yet to be selected. The interviews took place from July 2014 to February 2015. All informants wished to remain anonymous. The time duration varied from 20 minutes to 2 hours. Gatekeepers are institutions and organizations encompassing the environmental protection sectors. These include both local and foreign institutions and organizations in China. The interviewees held management positions and were actively involved in the developing programs of the environmental issues in China. Full details are provided in Table 3.2.

**Table 3.2. Background Interviews with Gatekeepers**

Name of Organization	Designation	Nationality	Date of interview	Interview Time (hours)
EU- China Environmental Governance Program	Program Team Leader (G1)	European	3-Jul-14	2 hrs
	Communication Expert (G2)	Chinese		
UNDP China	Assistant Country Director (G3)	European	4-Jul-14	2 hrs
	Senior Climate Change Advisor (G4)	European		
Delegation of the European Union in China	Attache, Science, Technology & Environment Section (G5)	European	26-Jun-2014	1.15 hrs
	Counsellor, Environment and Climate Change (G6)	European	23-Oct-14	1.5 hrs
	Policy Officer, Trade and Sustainable Development (G7)	European	20-Oct-14	1.5 hrs
China Beijing Environment Exchange	Senior Manager, Environment (G8)	Chinese	16-Feb-15	2 hrs
	Senior Manager, Environment (G9)	Chinese		
Ministry of Environmental	Policy and Law Department (G10)	Chinese	10-Jun-15	20 mins
European Union Chamber of Commerce, Beijing	Coordinator, Environment (G11)	European	27-Jun-14	1.5 hrs
Energy Foundation	Consultant, China Environmental Management Program (G12)	Chinese	13-Nov-14	1.5 hrs
ICF International	Senior Managing Consultant, Environment (G13)	European	4-Feb-15	1.5 hrs
Econet China	Marketing Manager, Building, Energy & Environment (G14)	Chinese	7-Nov-14	1.5 hrs
Tsinghua University	Researcher (G15)	European	16-Jul-14	1.5 hrs
Legal Firm specializes in EPL in China	International Partner (G15)	Chinese	25-Oct-14	1.5 hrs
A European Country Trade	Trade and Commerce (G16)	European	28-Jan-15	2 hrs
UK Consultancy Firm in	China Manager (G17)	European	14-Jul-14	1.5 hrs

The purpose of conducting background interviews with gatekeepers was to gain a deeper understanding of EP development in China in an attempt to strengthen the data triangulation to heighten the accuracy of secondary data collection from government pronouncements and media reports. The other objective was to obtain industry contacts that would open access to potential case study companies or Chinese officials. It was found out later that the gate keepers did not have appropriate industry contacts relating to this research but were helpful and invited the author to their conferences/seminars to gain access to the industry network.

With regards to access to Chinese officials, it was difficult to gain access to them according to informant G6 and the experience as highlighted in section 3.3.2. This informant explained that: *“as far as the Delegation of the EU in China is concerned, the relationship between us and governmental agencies is stable but we have to work within the boundaries of Chinese sensitivity and caution. (Why do you want to impose your regulations on us?)”* (23 October 2014). This indicates the level of openness of government officials toward “foreign” delegates who do not have the power to influence them for a favour in return. It also reinforces the importance of relationship building which

cultivates trust. In this instance, trust does not exist on a personal level between foreigners and Chinese. The meeting deepened the understanding of the carbon market development in China, which is highly supported by the EU.

On the other hand, informant G13 provided valuable insights of the business side of the carbon market. The business climate is positive for EU companies looking to expand their services in China, especially when China becomes a member of the TiSA. EU companies are already in contact with G13 about the business opportunities: *“providing equipment for power sector, or technology for waste management, if there is an equipment upgrade that triggers by emission trading, the Chinese company has to be competitive in the market they will have to put aside old one and invest new technology. This can open up a new window for TT or state of the art technology from Europe”* (2 April 2015).

The response from informants was unanimous with regards Chinese government relentlessness to battle environmental issues. Governmental discussion has deepened: *“It is clear that environment is a major discussion topic in all government meetings. (G3, 7 April 2014). Public awareness and participation has heightened according to the EU-China Environmental Governance Programme Team. This team was created with a €15 million budget from the EU to start governance programs across all provinces including a contribution to preparing the revision of the EP Law which took effect in January 2015. Invaluable insights were gained. The team revealed to me how the provincial government would take steps to suppress the required real time public pollutant disclosure table on its website for the purpose of reducing public/provincial awareness. For example, provinces that are economically less developed tend to value inward investment regardless of pollution compliance. Thus, the real time pollution disclosure table required a few clicks and the position of the table is at the bottom of the web page. Compared to municipality level governance, the table is conspicuous at the top right hand corner. This reinforces the fact that in the real world context, the degree of compliance is relative to the pace of economic development. Although these provinces are still within compliance, access to the information was made difficult by the local government which considers it to be detrimental to their provincial citizens’ livelihood. This phenomenon was confirmed by the team and UNDP China respectively: “No, it is hard for the central government to*

*impose on these provinces. Livelihood is at stake. The government cannot do it” (G1, 7 March 2014); “Closing a factory in a small village would affect the whole livelihood of the village, even though it means closing down only 1 factory. Such measure although small in number will disrupt social order and create insecurity among the locals. China cannot afford such a catastrophe” (G3, 7 April 2014).*

Interview with informant G7 who is the trade negotiator of the launch of environmental goods deepened understanding of the development of trade in green goods negotiation on a world level: *“Big group of companies are joining the green goods negotiation. There are opportunities for them. The most important for the businesses is sustainability and big companies have sustainability policies’ initiatives. More and more companies interested are interested in sustainable development” (G7, 20 October 2014).*

### **3.4 Method of Analysis**

Pattern matching, explanation building, time-series analysis, logic models, and cross-case synthesis are the five techniques used to analyse case studies (Yin, 2002). This study used cross-case synthesis technique to analyse the case study companies. Evidence collected from the semi-structured interviews was immediately transcribed to avoid *“not knowing what to do with the evidence”* during the analytic stage (Yin, 2002: 110). Key issues were categorized and placed on a working matrix to facilitate comparison and to identify any emerging phenomenon of a similar problem. For example, the LOFs of all the companies were immediately noted and categorized in terms of discriminatory, unfamiliarity, and relational hazards (Eden & Miller, 2004). The emerging pattern was that discriminatory hazards permeated the operational climate of all the EU companies.

The classic approach towards analysing case study is using traditional narrative in the form of written report. Such traditional narrative could be applied to single-case and multiple case studies (Yin, 2002). However, the main disadvantage of traditional narrative is such that investigators tend to underestimate the critical importance of composing the report at an early stage (Yin, 2002). Thus, they experience *“writer’s cramps”* writing report hastily at the ending stage of the case studies. However, investigators could subscribe to questions and answers (based on the case-study questions) method to compose each case so as to

avoid “writer’s cramps” (Yin, 2002). This method is useful to report findings for multi-case studies and it does not use traditional narrative for any single case. Such findings would be spread throughout the report (Yin, 2002) which is applied to this study.

Experiences and challenges faced by the six EU EP companies in internationalizing into China were synthesized and organized around the theoretical/analytical framework (Figure 2.1). This framework was developed and served as a construct of analysis. In this manner, the problem of validity is addressed by the multiple evidence gathered from semi-structured face-to-face interviews through the lens of the theoretical framework. It must be noted *that cases are not “sample readily generalizes to a larger universe”*. *Survey research relies on statistical generalization, whereas case studies (as with experiments) rely on analytical generalization”* (Yin, 2002: 37). Hence this framework will facilitate analytical generalization by *“generalizing a particular set of results to some broader theory”* (Yin, 2002: 37). The problem of reliability and accuracy of information is addressed by selecting the correct person for the interview and cross referencing between informants (Yeung, 1995). This framework also helps to provide explanation as to whether the strategies used by the case study companies in a real-life context are similar to the expected strategy postulation of IB theories. In this way, we are able to identify any emerging phenomenon that has not been rationalized in the theoretical framework.

Finally, one chapter is devoted to answer each research question. The following details the chapter of analysis and discussion of each research question:

- Chapter 4: Analysis and discussion of Research Question One: What entry and development strategies do EU EP companies deploy when internationalizing into China and why?
- Chapter 5: Analysis and discussion of Research Question Two: To what extent are EU EP companies’ strategic choices constrained by the LOF faced due to the institutional dissonance between the EU and China?
- Chapter 6 Analysis and discussion of Research Question Three: Which strategies cope more effectively to overcome the LOF?

# **CHAPTER 4**

## **INTERNATIONALIZATION AND ENTRY STRATEGIES INTO CHINA**

### **4.1 Introduction: Case Study Companies**

The home countries of the six case study companies are France (CoA and CoB) the United Kingdom (UK) (CoC, CoD, and CoE) and Finland (CoF). The number of years of establishment ranges from 43 years to 160 years. They are MNCs and were already well-established in their domestic market before their first internationalization. All are rich in knowledge and experience, have wide coverage of internationalized operations, and exhibit strong embedded organizational routines and practices.

They differ in size in terms of turnover and labour force. Global turnover varied from €800 million to €24 billion. The percentage share of turnover generated outside Europe was between 28% and 80%. The total global labour force of each company was between 350 and 80,000 employees. All considered China to be an important market for future development, although the share of turnover in China varies. The larger the size of the case study company, the lower the share of turnover from China. For example, CoF is the smallest in size but turnover from China represents 25% of its total global. It is significantly higher than the share of turnover from China for the rest of the case study companies, which is between 2% and 8%. The company's entry to China took place between 1984 and 2003. The background of each of the case study companies is detailed as follows:

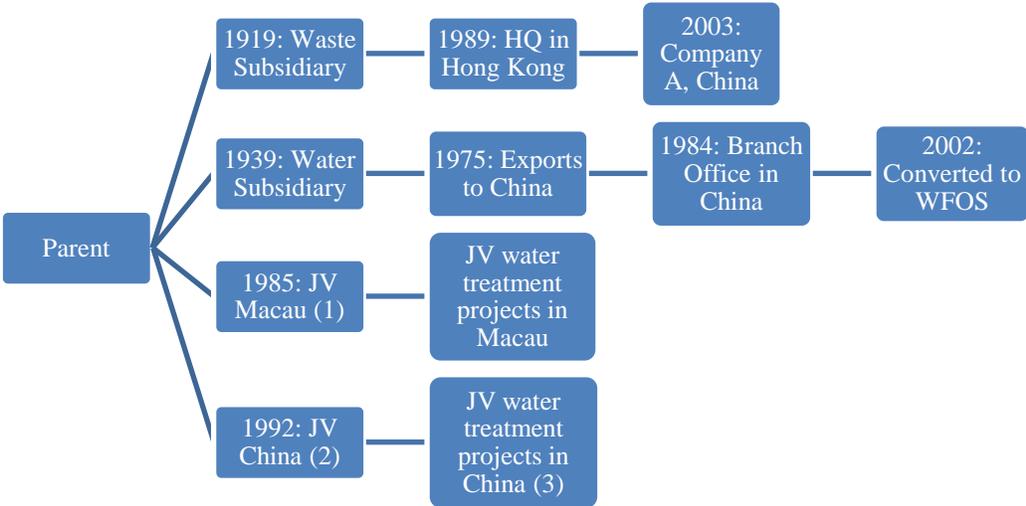
#### **CASE ONE: FRENCH COMPANY A (CoA)**

##### **Background**

The Parent is a result a merger in 1997 between two large corporations that had established business and long presence in Egypt and France in the field of renewable energy and water and waste management services. It has a long heritage dated back to 1880. Today, it is a

world leader in water and waste management services and employs about 80,000 people in over 70 countries covering 5 continents: Europe, Americas, Africa/Middle East, and the Asia Pacific. In 2013, 35% of its global turnover was outside Europe. China’s share of global turnover was 8% and it remains one of its key markets of large growth potential.

The Water and Waste management are segregated into two subsidiaries. The Water Subsidiary internationalized into Saudi Arabia in 1975, while the Waste Subsidiary (WS) entered Germany in 1967. The Water Subsidiary played a key role in the internationalization process of CoA into China. Thus, it is included in the figure below to illustrate the sequence of market entry into China.



***Sequence of Market Entry of the Waste and Water Subsidiaries and the JVs in Macau and China (CoA)***

**Background of Waste Business Models**

The Parent is primarily an operation and maintenance (O&M) company in the field of waste treatment. Clients are categorized into municipality (handling of municipal solid waste (MSW)) and industrial clients (handling hazardous waste).

The business models vary according to the needs of the client. The typical business model is known as build, operate, transfer (BOT) model which PCA enters into a concession agreement with the municipal client for a period of 30 years. In this model, PCA invests in the designing, building, and operating of the treatment plant during the 30 year period.

The plant will be transferred to the client at the end of the concession contract. Currently CoA does not have BOT municipal contracts in China. Other common business models that do not require investment are the design, build, and operate, (DBO) and the O&M models. In the DBO model, the client pays PCA to design, build, and operate the plant. However, in an O&M model, CoA only undertakes to operate and maintain the waste treatment plant of the client. The duration of contract for both models is generally up to 20 years. Currently, the operable contracts in China are DBO and O&M.

The clientele for municipal and industrial clients differs. Unlike a municipal business contract (the municipality would guarantee delivery of “x” ton of waste per day at a contracted price per ton for a duration of 30 years), the industrial business has short-term contract which lasts up to a year for each industrial customer. There is no guarantee of delivery performance. As a result, the risk is greater because of “unfulfilled” capacity. The table below illustrates the differences of these two business segments.

***Differences between Municipal and Industrial Business***

<b>Description</b>	<b>Municipal Business</b>	<b>Industrial Business</b>
Clients	Municipality	Many industrial clients
Delivery of waste	Delivery is guaranteed	Delivery is not guaranteed
Business risks	Low	High

**The Role of the Ministry of Environment Protection**

The two most important institutional actors are the Ministry of Environmental Protection (MEP) and the local government. The MEP has branches known as the Environmental Protection Bureau (EPB) on the provincial, district, and township levels. Each provincial EPB is accountable to its own regional EPB (North, South, East, and West) as well as the highest level which is the MEP. In other words, there is a multi-tier hierarchical that CoA must comply with. First is the provincial EPB, second is the regional EPB, and the third and highest level is the MEP. Daily waste treatment reports are submitted to these authorities which monitor CoA’s emission level very closely to ensure that the toxic is well contained and no sign of explosion is imminent on the report. This is possible through

the continuing environmental monitoring system (CEMS) that is installed to facilitate real-time monitoring of the treatment process by the EPB officials. In other words, the owner of the Industrial Park who is CoA's local partner and EPB are colleagues (government). They are authorized to visit the facility without notice. Each visit could last between 30 and 60 minutes. The relationship with the EPB officials is more clinical than personal. They are easy to deal with. However, this relationship would become more challenging if a precedent of violation is set. As a result, CoA ensures that monitoring devices are functioning effectively to produce results that are in compliance with the EPB's requirements. The table below illustrates the expansion of the Waste Subsidiary

***Timeline of Domestic and International Expansion of WS (CoA)***

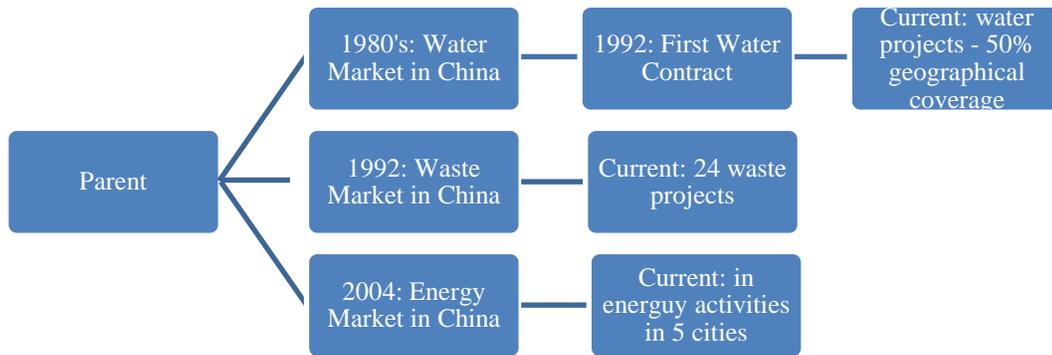
<b>Year of Entry</b>	<b>Country</b>
1919	Waste Subsidiary formed
1960	Domestic business flourished
1967	Germany
1984	Benelux
1989	UK and Hong Kong
1990	Finland and Poland
2000	Australia, Czechoslovakia and Slovenia
2001	Sweden
2003	China

**CASE TWO: FRENCH COMPANY B (CoB)**

**Background**

The parent of CoB is a world leader in water, waste, and energy management services with over 160 years of history. It employs about 180,000 people spreading over 70 countries in 5 continents: Europe; Americas; Africa/Middle East and the Asia Pacific. The parent started as a public service water distribution in its home country. In 2014, over 50% of its global turnover was outside Europe. China remains one of the key markets of growth.

CoB has 2 offices in China; Beijing and Shanghai. It reports to the regional headquarters in HK which also oversees the operations of Korea, and Japan. The headquarters was set up in 2000 which employs about 26,000 people within the Asia region. The figure below shows the timeline of the presence of the 3 core business activities in China namely the water, waste, and the energy markets.



***Sequence of Market Entry of the Waste, Water, and Energy Market in China (CoB)***

The original water business expanded domestically through vertical acquisitions. By the mid-1960s, waste management was added into its business portfolio covering environmental services. In 1980, it combined the two business activities into one single entity. Shortly after, it entered into the energy market through acquisitions. Since then, water, waste, and energy has become the core business activities. The first foreign acquisitions happened around 1980 in the US and Europe. The strategy for market expansion is through acquisitions and subsequent operations are merged into the parent. The table below shows the timeline of domestic and foreign entry through acquisitions in the related core businesses from early 1980 to the mid-2000s. The table first illustrates the different time of entry into China in each of the core business market. The purpose is to show the first presence in China and the lapse in the number of years that led to the final entry into the energy market.

***Timeline of Domestic and International Expansions through Acquisitions and Subsidiaries (CoB)***

<b>Year of Entry</b>	<b>Country/Region</b>
1853-1960	Domestic expansion of water business
Mid 1960s	Entered the environmental services domestic market
1980	Expanded into US and Europe
1980s	Netherlands, Spain, Norway
1980	China Water Market
1985	Chile, Mexico, Peru, Saudi Arabia
1990	United Kingdom
1991	Czech
1992	Portugal
1993	Belgium, Germany, Slovakia
1994	China Waste Market, Poland
1997	Singapore
2000	India
2002	Ireland
2004	China Energy Market
2005	Gulf Countries

CoB is involved in the management of municipal solid waste (MSW) landfills and hazardous waste incinerating plants. In both operations, it cooperates with big local SOEs who have majority shareholding. Together they are operating 3 landfills and 4 hazardous incineration plants in the South of China. However, CoB also operates small landfill gas-to-energy plants which are a wholly owned business, which is the focus of this case. The general managers of the landfill gas business are Chinese.

## **CASE THREE: BRITISH COMPANY C (CoC)**

### **Background**

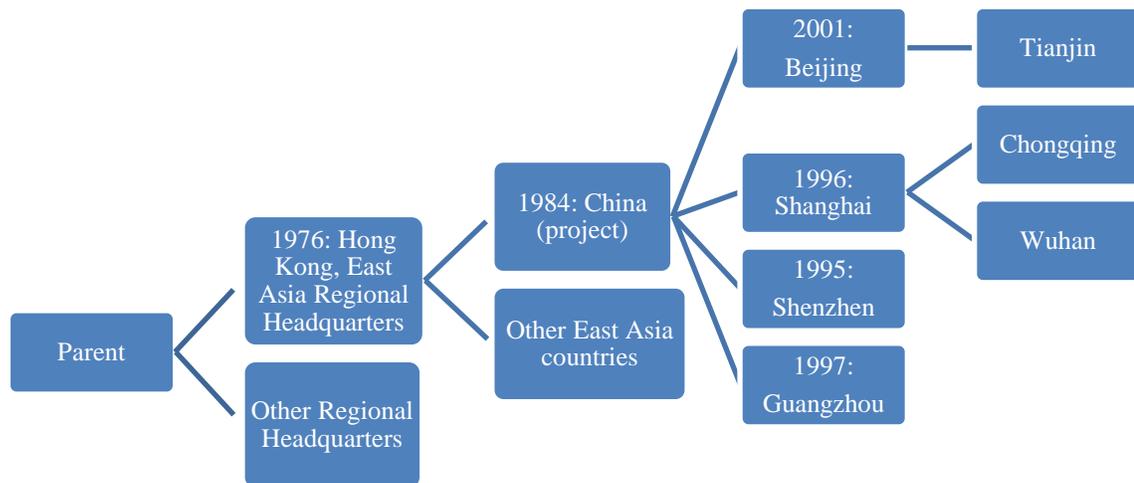
The parent is a world leader in the field of sustainable environmental design consulting and engineering services. The team is made up of designers, planners, engineers and consultants, who are highly specialized in their own field. It is committed to ensuring that environmental protection issues are considered at every stage of project execution. This includes using efficient materials in building design (proposing environmentally friendly equipment, buildings that use fewer and greener resources); incorporating global factors such as climate change in economics and planning; delivering cost-effective, efficient, and sustainable solutions in infrastructure design. The parent was incorporated about 70 years ago and employs over 11,000 people across 35 countries worldwide. In 2013, 39% of global turnover was outside Europe. East Asia's share of that was 46% and China remains one of the key markets of growth potential.

The corporate policy is to remain a European owned company, thus its entry-mode strategy is to enter a foreign market by forming wholly foreign-owned subsidiary (WFOS). The first foreign market entry was in South Africa in 1955. The subsequent international expansion was mostly in the African region. Exceptions were entry into Australia and Malaysia in 1964. From 1963 to 1966, there were at least 2 new foreign countries entered each year. From 1964, international expansion was concentrated in the Asian region. The table below lists the countries of entry from 1955 to 1984. The home market in Europe is the biggest market and Australia is the biggest subsidiary, followed by HK and China. The parent first established a branch office in HK in 1976 when HK was governed by the UK. As a result, starting business in HK was easy because of similar jurisdictions. As the operations expanded abroad, it began to consolidate all foreign subsidiaries into 5 regional clusters. Each cluster is responsible for regional strategy and management.

***Timeline of Domestic and International Expansions (CoC)***

<b>Year of Entry</b>	<b>Country/Region</b>
1946	Parent formed
1955	South Africa
1956	Ghana
1959	Rhodesia
1963	Ireland, Sierra Leone
1964	Australia, Malaysia, Liberia
1965	Nambia
1966	Zambia
1968	Jamaica, Singapore
1971	Saudi Arabia
1974	Iran
1975	France, Papua New Guinea, Mauritius, Qatar
1976	Hong Kong, Libya
1977	Brunei
1980	Bophuthatswana
1981	Iraq, Eygpt
1984	China
1990	Turkey
1991	Germany

Collaborations with international architects and developers have impacted the international expansion of the parent in breadth (increase in geographical coverage) and depth (understanding the complexities and differences in projects execution). The collaborations facilitated entry into the networks of leading international designers and architects and renowned international developers. At the same time, the long-term relationships cultivated have advanced entry into the Chinese market in the 1980s. The first wave of building and industrial boom which started in south China (Guangzhou, Shenzhen, and Shanghai) that has led to an influx of foreign investments. The figure below illustrates the sequence of market entry into HK and China.



*Sequence of Market Entry into Hong Kong and China (CoC)*

**CASE FOUR: BRITISH COMPANY D (CoD)**

**Background**

The parent is a world leader in the field of environmental, health, safety, risk, social consulting services and sustainability related services. The key sectors served include Oil & Gas, Mining, Power, and Manufacturing, Chemicals, and Pharmaceuticals. The parent employed more than 5000 people located in over 150 offices across 40 countries and territories. For year 2014, over 80% of global turnover was outside the home country. The Asia Pacific region remains one of the key markets.

CoD has four offices in China: Shanghai, Beijing, Chengdu, and Guangzhou. The first was in Beijing. The core business includes environmental due diligence (DD), environmental impact assessment (EIA), and assets retirement. Environmental DD is a service required before any construction. Environmental impact assessment relates to a scientific assessment of the affordability of resources in a planned area. It is conducted to avoid pollution and environmental damage before any government or private construction project is launched. It is governed by the EIA Law which was enforced in 2002. A local MD is managing a team of about 80 employees. Employees from different offices get to work on all country-level projects. In other words, a specific provincial project is managed

by employees from different offices. As a result, local knowledge (provincial projects) is transferred and shared through bi-weekly meetings.

The business strategy is to acquire related businesses geographically and merged them into one single operation. The original business was founded in 1971 and spread into the US market in 1977, operating under a different name. In 1987, the US subsidiary was merged with the parent. Taiwan was the first foreign country of entry after the merger. Subsequently the parent entered other parts of Europe in 1989. The next Asian country was Vietnam in 1993, and followed by China in 1994. The table below illustrates the time of entry into different various markets.

***Timeline of Domestic and International Expansions (CoD)***

<b>Year of Entry</b>	<b>Country</b>
1971	UK
1977	US (under different name)
1987	Home country and US merged, Taiwan
1989	Germany, Poland
1991	Mexico, Netherlands
1992	Italy
1993	Brazil, Portugal, Vietnam
1994	China, Australia, France, Ireland
1995	Belgium, India, Spain
1996	Puerto Rico, Malaysia, Thailand
1997	Indonesia
1998	Argentina
1999	Japan, South Korea, Sweden
2000	Sweden, Hong Kong, Peru
2001	South Africa
2002	Canada
2003	Russia, South Africa
2005	UAE, Columbia, Kazakhstan
2006	New Zealand, UAE
2007	Romania
2008	Panama
2014	Kenya, Norway, Switzerland

## **CASE FIVE: BRITISH COMPANY (CoE)**

### **Background**

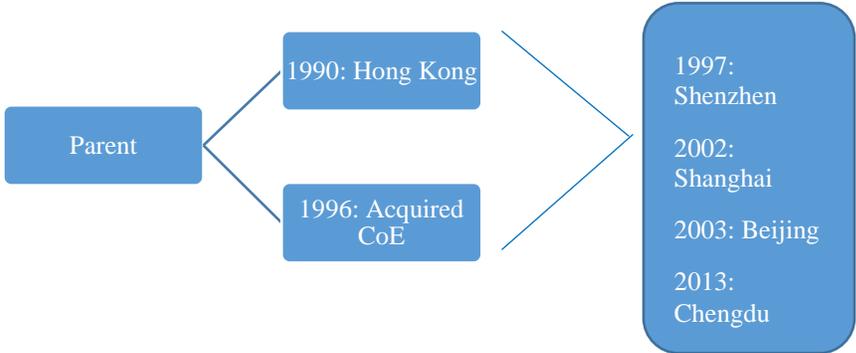
The parent is a multi-disciplinary project management consultancy. It is a world leader in the field of sustainable environmental design consulting and engineering services. The Environmental and Sustainability sectors that the parent has expertise in are; oil and gas, energy, green buildings, power, environment (such as air, water, waste), and eco low-carbon (ELC) urban planning. It was incorporated in 1938 and employs over 17,000 people in more than 20 countries across four continents: Europe; North America; the Middle East, and Asia. In 2014, 43% of estimated global turnover was outside Europe. The Asia Pacific region's share of estimated global turnover was 6% and China's share stood at 37% of this region. Its global share was 2%. Thus China remains a significant market of growth globally as well as regionally.

CoE is a UK company that started in 1947 as a cost management consultancy. In 1996 it was acquired by another UK company (the parent) which needed design support services to strengthen its core business as part of its internationalization strategy in Asia. At that time of the acquisition, CoE was already operating in HK (since 1993). After the acquisition, CoE operations in HK were merged into the parent HK subsidiary. However, the name of Co E remains unchanged so as to remain independent in its core business in cost management consultancy. It is an industry oriented company that has been providing cost control services for global clients in various different industries. During the initial entry into HK, it was involved in an extensive range of infrastructural project management such as airport, commercial, transport networks, and education.

The rapid development in HK had caused an influx of projects into CoE and thus resulting in a need to acquire additional resources. As a result, the parent entered China in 1997, and opened its first office in Shenzhen to exploit the cheap resources (cost is 1/3 of HK) to manage the design support service projects gained in HK. CoE is operating under the parent-subsidiary legal entity in China.

The figure below illustrates the sequence of time of entry into HK and China. The initial difficulties faced by the parent upon entering China, were the differences in building codes

between HK and China. Thus the knowledge and experience in HK became obsolete. Subsequently, the parent started to work for major China’s developers such as Shanghai Greenland and followed its HK developers into China at the same time. As a result, it led to the second registration of the office in Shanghai, followed by the opening of branch offices in Beijing and Chengdu.



***Sequence of Market entry into Hong Kong and China (CoE)***

The entry-mode strategy is to enter a foreign market by forming WFOS or by M&A. The most recent acquisitions were in 2010 and 2013. In some markets the Parent has a presence due to joint developmental projects. The table below illustrates the international presence of the parent as consulting engineers in countries which it has public joint-venture projects. The first Asian office was opened in India in 1961, and followed its first Asian consulting project in New Zealand. North America was the first region of foreign presence that began in 1955. Subsequently, subsidiaries in Norway and Portugal were formed in 1987.

### *Timeline of Domestic and International Expansions (CoE)*

<b>Year of Entry</b>	<b>Country/Region</b>
1938	Parent formed UK
1955	Canada
1961	India
1963	New Zealand,
1972	Algeria
1978	Kuwait
1981	Iraq complete
1987	Norway, Portugal
1990	Hong Kong
1994	Dubai, Ireland
1997	China, Australia
1998	South Korea , Ukraine
2000	Middle East, The Netherlands, Peru
2001	Denmark, Sweden, South Africa, Greece
2003	Russia, South Africa
2005	Spain, UAE
2007	Romania
2008	Panama
2010	France
2014	Kenya (P), Switzerland (P)

### **The Core Business in China**

CoE's business in HK began to slowdown when the infrastructural project management were completed. The Asia financial crisis began in 1999 which affected the future growth in HK. At the same time, China was opening its market to attract FDI in tandem with the accession to the WTO in 2001. As a result, many MNEs that were CoE's global clients began to invest in China that led to CoE following them to China. The core business in cost management control services began to diversify because of the growing needs of its global clients. The diversification was an immediate decision of the COO in response to the needs of the global clients even though CoE did not have the expertise then. As a result of this commitment, Company E began to learn about the business and began to flourish rapidly. It was providing a whole range of services pertinent to the China market only. In

other words, such services are not duplicated in the UK or elsewhere. Between 2005 and 2009, CoE was managing most of the R&D building facilities in Shanghai and Beijing.

### **The Sustainability Business in China**

As a result of the diversification of business to provide complete project management service, CoE has gained knowledge and experience about operational efficiencies in facilities from the industrial clients it works for. As a result of these past learning experiences from industrial clients and the changes in the market, CoE created its sustainability business in China 10 years ago. It is managed by a local, the Head of Sustainability (HOS). It has a team of 40 people who are project managers, engineers, and back office personnel. The foreigners (10%) in the team are in-charge of in-house technical work. They speak very little Mandarin.

### **CASE SIX: FINNISH COMPANY F (CoF)**

#### **Background**

The parent company is a family-owned business founded in 1961 in Lahti, Finland specializes in environmental and energy-efficient technology. It manufactures burners and heat pumps that are widely used in power plants, waste incineration, marine boilers, district heating plants, for heating or cooling large buildings and facilities, and for heating private houses. It employed more than 350 people located in Finland, Russia, China, Brazil, and the US. Two production facilities are located in Finland and China respectively. One assembly line has just been opened in the US. In 2014. It has a global distributorship network that covers Europe, Asia, Russia, North and South America and Africa. About 60% of global turnover is outside the home country. China is the biggest market.

#### **Subsidiary and Production Facility in China**

CoF F's office and production facility are located in the same premises in Wuxi, Jiangsu province. The subsidiary and the production facility were formed in 2002. Due to business development, it moved to a bigger office and production facility in 2011. There are about 35 people working in the office and about 50 people working in the production facility.

Staff turnover is very low. Examples are; only one employee left in 2014 and about 7-8 people have been working with the company for over 10 years. There are altogether eight divisions; administration, human resource, customer service, accounting, heat pump, production, industrial burner and power plant. Each division has a local division manager with the exception of the Finnish Heat Pump Manager (HPM). All of them report to the Finnish General Manager (GM) based in China.

Since its inception, the production facility has been manufacturing gas burners for local distribution only. However, it has started to look into manufacturing heat-pumps recently because of market interest in the new technology that offers huge savings in energy consumption. All the production materials are imported from Europe. As a result, the final output of the burners and the heat-pumps is the same as those produced in Finland. In the event of quality defect issues, it is easily traceable to the origin because each gas burner is produced by one person. Whenever an existing product line is newly added to the China market, Finnish technical engineers will spend two to three weeks training the local engineers and the operators. Thereafter they will manufacture the new product together to ensure that the technical knowledge transfer has taken place effectively.

The advantages of producing locally for local customers are that they will save on the cost of transportation (20% cheaper) and the delivery time will be reduced from 10 weeks to 4 weeks. All products are sold ex-factory. The local facility does not produce all the product lines that the parent offers. Its production criteria are based on the demand of the local market derived from historical sales data and interaction with CoF's distributors.

### **New Heat Pump Business in China**

The parent company has been in the burner business for 50 years and the heat-pump business for 25 years. It owned shares in a leading Finnish heat-pump company specializing in industrial cooling and heat pump solutions for about 9 years, before it was fully acquired in 2011. The acquisition has been a strategic decision to strengthen the cooling business and expansion into new markets of industrial users. The parent company's heat pumps are tailored for domestic heating. According to the GM in China, the heat pump business is more challenging than the burner business. As a result,

marketing of the product by way of education is paramount. The initial investment of a heat pump might be high but at the same time it will save energy cost in the long term. Heat pump technology is suitable in China because of its needs to protect the environment through the use of renewable energy (closed loop ground source heat system). The closed loop ground source heat system is not available in China but the technology is getting popular in the market.

The core business in China has been the gas burner business. CoF is the number one and biggest European provider for burners. After some market research, in 2014, CoF decided to launch the heat pump business in China. It has decided not to focus on small heat pumps since there is an absence of small family houses in China, unlike in Europe. The GM reckons that it will take another 5 years to grow the business. This technology could be used in the dairy and food industry as well as logistics and data centre. CoF has registered with the Dairy Association (DA) in China to introduce its heat pump technology to reach out to the dairy companies. The entire team from the DA has visited the headquarters in Finland to learn about the technology. The biggest dairy company in China has ordered the first heat pump to be delivered to its facility (from Finland as it has not started manufacturing in China yet). Furthermore, CoF is expected to deliver a few more heat pumps (from Finland) to another Chinese company.

The Finnish Manager has been transferred less than a year before the interview) from the headquarters to focus on the development of the business in China. The future vision was to promote district cooling in China and to tie up with building developers and contractors as part of the urban planning process. The heat pump business is in the relationship building phase.

### *Timeline of Domestic and International Expansions (CoF)*

<b>Year of Entry</b>	<b>Country/Region</b>
1961	Parent formed by two Finnish partners
1964	Russia (export)
1974	Parent became wholly family-owned
1993	China (export)
1996	USA (export)
2002	Production facility, China
2004	Russia, Subsidiary
2012	Brazil, Subsidiary
2014	US, Subsidiary

#### **4.2 Internationalization into China**

CoA internationalized into China in 2003 because of prior network connections (Coviello & Munro, 1995) in China. In terms of foreign market entry, its strategy is to use WFOS operation mode so as to maintain control of the foreign operation. However, alliance with local partners is the strategy adopted to invest in public projects. As a rule of thumb, it prefers to maintain majority shareholding in any alliance. The Asia HQ in Hong Kong (HK) was set up in 1989, before HK was returned to Chinese sovereignty 8 years later. Subsequently, the WS entered China in 2003 and set up a subsidiary, CoA. The first hazardous waste incineration (HWI) plant was constructed in Shanghai. The JV partners are a SOE (SOE1) in China and a HK conglomerate. The latter has a long history of experience in regional infrastructural projects in mainland China, and Macau. Moreover, it has been a long-time business partner of the Parent in this region.

In a recent investment of a second hazardous waste incinerator in Nantong Economic and Technology Development Area (NETDA), CoA faced difficulties in finding a respectable and reliable local partner that has good relationship with the local government. Hence, it invited SOE1 to jointly invest in the project. CoA remains the majority shareholder.

CoB's decision to enter the waste market in China in 1994 as a WFOS was purely based on trust and instinct of a senior manager that saw the future business growth was in Asia. Then, the Parent had already been in the waste business in the developed markets for almost 30 years. In 2000, a US-based waste management company decided to relinquish its Asia's business in HK to the ownership of the parent. At that time, there was a pending contract to operate the second largest landfill in China which subsequently came to realization shortly after the acquisition. The RHQ in HK is still operated by the same team of managers.

CoB is involved in the management of municipal solid waste (MSW) landfills and hazardous waste incinerating plants. In both operations, it cooperates with big local SOEs who have majority shareholding. Together they are operating three landfills and four hazardous incineration plants in the South of China. However, the Company also operates small landfill gas-to-energy plants which are a wholly owned business, which is the focus of this case. The general managers of the landfill gas business are Chinese.

In 1976, Parent C followed its international clients to British HK. It was managing projects in the Asia region, before its clients entered China in the 1980s. In 1984, Parent C followed its clients to China. The Chinese projects were managed by the same team in HK which had relocated to China. CoC as a subsidiary was set up in 1996. The corporate policy is to remain a European owned company; thus, its entry-mode strategy is to enter a foreign market by forming wholly foreign-owned subsidiary (WFOS).

CoD has four offices in China: Shanghai; Beijing; Chengdu; and Guangzhou. The first was in Beijing. CoD's entry into China was based on personal relationship. In 1994, a JV was set up with the China Research Institute of Environmental Protection, a powerful institution that had high-level connection with the central government. The partnership was dissolved in 1999 when the Parent's global strategy was to have full control of foreign operations. A buyout occurred and it became a WFOS in 2000.

CoE is an industry oriented company that has been providing cost control services for global clients in various different industries. It followed its HK's clients to China in 2000. In 2005, it started to develop into sustainability business.

CoF's entry into China was sequential. It began with an exploratory visit of the Chinese market in the 1990s. Export activities selling burners to big Chinese boiler companies began in 1993. In 2002, it opened its subsidiary and the first production facility in Asia (located in Wuxi, China), second after Finland, to manufacture burners for the Chinese market. The reasons to be in Wuxi city was because it has the largest industry for boilers and the large Finnish population in neighbouring cities such as Suzhou and Shanghai. In 2008, the production facility expanded in size. It is part of the strategic plan to enter the Chinese heat pump market which would require a bigger production facility. The parent has been in the heat pump business for 25 years but it decided to enter the Chinese market in 2014. Local burners are produced using European parts and local technicians are trained with European skills. The R&D department in Finland is responsible for the technological adaptation of the burners and heat pumps in the Chinese market. For example, recently, CoF has successfully commissioned a new burner (technology was developed in Finland and produced in Finland) that achieves nitrogen oxide (NOx) emission level of 30 mg per cubic meter. This initiative was the result of consultation with MEP and one of its big customers, Beijing District Heating Company (BDHC).

This is then followed by discussions of the internationalization, entry and development strategies into China.

***Table 4.1 Case Study Companies' Internationalization from Europe into China***

Description/Companies	CoA	CoB	CoC	CoD	CoE	CoF
Europe						
Country	France	France	UK	UK	UK	Finland
Location (1)	Paris	Paris	London	London	London	Lahti
Year of establishment	1880	1853	1946	1971	1938	1961
Age of establishment	135	162	69	44	77	54
Global Market Entry Strategy	generic growth	M&A	generic growth	M&A	generic growth	Greenfield
Number of years in domestic market before first internationalization	95	127	9	6	17	3
First year of internationalization	1975	1980	1955	1977	1955	1964

First country of internationalization	Saudi Arabia	US	South Africa	US	North America	Russia
China						
Location (2)	Shanghai	Beijing	Shanghai	Shanghai	Shanghai	Wuxi
Geographical distance (km) between (1) and (2)	9,273	8,226	9,207	8,150	9,207	7,232
Year of entry	2003	1994	1984	1994	2000	1993
Number of years of presence	12	21	31	21	15	22
Year of entry by other sister companies	1975	1980	-	-	1997	-
Aggregate number of years of presence including sister companies	40	35	31	21	18	22
Regional Headquarters in Hong Kong						
Year of entry	1989	2000	1975	-	1993	1990

### 4.3 Discussions

The following discussions follow the trajectory of the internationalization models as detailed in the theoretical framework comprising of the OLI Eclectic Paradigm and the Uppsala Model. The internationalization pattern and the entry mode strategies selected by the six EU companies aligned with the OLI Eclectic Paradigm as well as the Uppsala theories. For instance, the following sections on “global and regional networks managerial experiences and knowledge”, as well as “relationship with an SOE” are characteristics of the OLI Eclectic Paradigm exploiting organizational capabilities in the O-and I-advantage and the L-advantage due to the growth opportunities in China, to internationalize into China. While the last section of “following clients” is a departure from the Uppsala Model of sequential internationalization, instead the speed of internationalization is accelerated by following existing clients to China.

#### 4.3.1 Global and Regional Networks

CoA benefited from the well-established regional networks that started in HK in 1989 and the existence of its sister companies’ Chinese experience since 1970s. The collaboration in HK with a HK business partner developed into formal business connection across the border (China) (Styles & Ambler, 1994; Sapienza et al., 2005). The opportunity to invest in China was a result of this network connection. In 1992, its sister company started a JV

in China. In 2003, CoA was formed as a WFOS. Prior to this JV partnership, CoA's sister's company has had business in China selling Water Technology since 1975.

The sister companies of CoA were the accelerators of CoA's internationalization into China. They had business and institutional knowledge and an existing infrastructure serving the China's market. CoA was able to internalize this knowledge and utilize the existing infrastructure and networks more effectively and efficiently. In China, CoA faced lesser challenges in terms of institutional legitimacy because as a late comer, it benefited from the "legitimized status" of the existing sister companies in China (Wei et al., 2005). It did not have to start its operations from zero from the transaction costs point of view.

It is also evident that the consolidated network connections deepen the loyalty and trust that partners reciprocate and build upon their complementary assets for mutual benefits (Benito et al., 2005). For example, the partnership has over 30 JV projects in China. This partnership strategy with existing local partners is embedded into the organizational routines of CoA. The Business Unit Director of Incinerator (BUDI) stated that *"We are a French company coming to China and we would like to have a local partner in our projects. We believe that our expertise is in the operation, but we do not know about the local conditions, the market so we prefer to work with local company, but we try to be major shareholder to have full control. This is the strategy of the group. Every project here, there is a local partner."* Furthermore, the PM added that *"we always like to have partners to share the risks and benefits."* Local partners are expected to have very good relationship with local governments. Such relationship with local government is paramount to the success of the operation. The BUDI asserted: *"local guanxi" is very important in our industry. Our local partners are our local guanxi."*

In terms of project-investment in China, the development strategy is to exploit existing global and regional networks. All partners are well selected in terms of reputation, financial strengths, relationship with government and share similar corporate ethics. The first project-investment in China is a partnership with an existing HK partner (conglomerate) and a SOE that owns the industrial park where the investment project of an incinerator plant is located. The former has a long history of experience in regional

infrastructural projects in mainland China, and Macau and has been a long time business partner of CoA in the Asia region.

The relationship with the latter deepened and led to a second joint investment of constructing a second incinerator plant in another province in 2013 (Li & Yeung, 1999). Interestingly, this public project investment was ‘given’ (no tender required) by the local government to CoA. It is because the local government is aware of CoA’s brand and reputation in the waste industry, and approached the management to propose the business plan. It needed its expertise to resolve the city’s gamut of hazardous waste problems.

#### **4.3.2 Managerial Experiences and Knowledge**

Experiences and knowledge were found to be salient in CoB and CoF’s internationalization trajectory into China. Along with the postulation of psychic distance that holds that internationalization into distant countries tends to increase risks and uncertainties, in this case, the perceived risks in China would have been seen to be lower because of the international experience of a senior manager in CoB (Eriksson et al., 1997).

The decision to enter the waste market in China in 1994 was purely based on trust and instinct of a senior manager who saw the future business growth was in Asia. Then, the parent had already been in the waste business in the developed markets for almost 30 years. It had “*virtually nothing in the undeveloped markets*” in the words of the MD. It set up a WFOS and built up its business from zero-base. The entry mode strategy is in line with the corporate strategy to take full control of foreign operations.

In a study by Tse, et al., (1997) it was found that countries that with a high power distance tend to choose an equity-based entry mode to exert control especially with lower level governments. This finding resonates with the strategy of CoB. France is a high power distance country and as a public sector service provider, it has to work very closely with all levels of government. Contrary to Brouters (2002) which posited that Western European firms preferred export entry mode over equity mode and preferred to deal with the State, the highest level of government. In this case, the choice of working with different levels of government is irrelevant in public sector projects.

Despite the high institutional distance (ID), CoB chose to form WFOS (Daamen et al., 2007) contrary to the traditional postulation that institutional distance creates uncertainties and risks that results in lower resource investment (Dow & Larimo, 2009). In the case of CoB, the senior manager's experiences and the opportunities in China yielded a net value that propelled the entry into China despite its high ID. Interestingly, although the sister company of CoB started managing projects in China in the 1980s, its initial entry strategy was independent of the existence of the sister's company. The senior manager stated that "*China is about patience. We can't expect wonderful projects in one year. It's easy to get lousy ones, but we're not here for those.*" For three years, there was no contract. CoB exploited the senior manager's experience and knowledge to search for reliable local partners and lucrative projects instead of deploying the services of local agents. Hence, this supports the findings by Wei et al. (2005) that managerial control is positively related to investment value. Firms chose to internalize their organizational resources (senior manager's experience) by forming subsidiary to exert management control.

CoF's expansion into China conformed to the concept of establishment chain explained in the *Uppsala Model*, why firms engage in step-by-step process of internationalization. As a small family-owned business, it tends to be traditionalists in its view of risks and uncertainties, which is characterized as liability of smallness and newness (Zhou et al., 2007). The debate about SMEs smallness and having to align in tandem with their choice of market entry seems to hold for CoF (Erramilli & D'Souza, 1993). CoF adopted the gradual process of internationalization by exporting to China despite having 30 years of exporting experience in Russia. However, it had learned to cope with risks and uncertainties impacted by the liability of smallness and that learning did not deter its decision to export to distant China in 1993 (Johnson & Tellis, 2008). In relation to these expected difficulties, CoF's strategy was to visit China to gain first hand-knowledge about the business climate in China. This indicates the traditional-conservative behaviour as a result of risks and uncertainties as explained by the *Uppsala Model*.

The current CEO of the Parent together with some business developers visited China to explore market opportunities. Door to door enquiries of boilers companies were made in order to understand the market, how and what type of the company's products could be

sold in China. On this basis, market knowledge has been acquired that led to the first export to China in 1993 (three years later after the market visit). Then, Russia was the single foreign country of export for over 30 years before China was selected to be the second potential country of expansion. The over 30-year gap from the Russia to China could be explained in two-fold. Firstly, the exporting activities to Russia were profitable and it did not pose more risks and uncertainties. Hence, it reaped a stable flow of income. Secondly, it has developed skills and gained momentum in how to operate in a new market after 30 years of exporting. It was prepared to enter China after its market research as the country's knowledge is increased that tends to reduced perceived risks upon entry (Hilmersson & Jansson, 2012). Interestingly, it took 3 years before exporting to China began despite the intensive market due diligence conducted on the ground. This is indicative of a risk-averse tendency due to liability of smallness (Erramilli & D'Souza, 1993). As stated by the GM *"little by little when we got customers here we evaluated the situation, market getting bigger and building a factory was quite a big decision."*

Literature on the profitability and survivability of firms after market entry focuses on the balance between firms' competitive advantages (Mudambi & Zahra, 2007) and the impact of the institutional environment (Papyrina, 2007). In the case of CoB, further development in China that impacted its profitability and survivability was accelerated indirectly by the acquisition of a US-owned company based in HK. The standing project-investment in constructing a landfill as a JV partner with the Chinese government materialized into a contractual agreement, shortly after the acquisition. This connected CoB to the local institutional networks and became the milestone for its subsequent development in China. Prior to this, it was operating in China for 3 years without any contracts. The tenacity to remain in China is an indication that the competitive OLI advantages have helped to overcome the LOF.

The critical importance of experiential knowledge in impacting expansion decision as argued by Johanson and Vahlne (1977) is evidenced in the development strategy of CoF. Market knowledge was gathered from the exploratory visit, before export activities took place. As it gained more market knowledge and experience, it increased its investment by setting up a WFOS and a production facility to cater to the local market. The objective

was to expedite delivery and save transportation costs. (Dunning, 2002). It further increased its commitment by expanding its production facility in 2008.

#### **4.3.3 Relationship with an SOE**

Social capital is an important asset to understand the nuances of the business in a foreign country to mitigate risks and uncertainties (Hilmersson & Jansson, 2012). However, limited research has revealed the impact of social capital in a firm's decision to invest in a foreign country. The reason for CoD's internationalization into China was a case in point. It was a consequence of a relationship with the most powerful research institute of environmental protection that has high level connection with the government. The subsequent formation of a JV in 1994 brought seamless projects in EIA and due diligence that also accelerated CoD's experiential learning and entry into the local Chinese network in China. This would otherwise be difficult when entering a foreign market without prior connection. It would have caused CoD to be more vulnerable to *outsidership* (Johanson & Vahlne, 2009). It is evidenced that in China, business cooperation tends to emerge from relationship building, also known as *guanxi* (Su et al, 2009). The Chinese would tend to treat CoD as locals (McGuinness et al, 1991). This reduced CoD's foreignness in China. The benefit of the localized JV would imply an increase in bargaining power when interacting with intermediaries (Li & Yeung, 1999). Organizational legitimacy was further enhanced when the first Premier of China inaugurated the grand opening of the office in Beijing. It indicates that the JV was politically supported by the Premier (Feng & Wang, 2009).

The decision to enter China as JV was largely due to the specific advantages that the local partner had that accelerated its learning experience in China, despite the high ID between the UK and China. Thus a partnership with a strong alliance enhanced its legitimacy and expedited its assimilation into the local culture. The 'diplomatic ties' between these two companies had impacted the entry mode strategy (Tse et. al., 1997). Moreover, the inherent power of the JV partner has substantially reduced the amount of uncertainty and the confidence is naturally embedded into the decision to enter into a partnership (Wei et al., 2005). Having a reliable partner that "guaranteed" inflow of projects, implied that CoD

did not have to compete for business as a new entrant into China. Neither did it have to incur cost of finding a reliable partner (Hymer, 1976).

Subsequently, the change of mode of operation to a WOFS was solely due to the global corporate strategy. A total buyout occurred in all the countries of operations. Thus, the JV in China was diluted in 2000. This indicates that the local knowledge acquired was not the determinant that caused the change of mode of entry (Puck et al., 2009) but rather the global strategy that did this. However, the local team remained and contributed to the success of the transition. Thus, tacit knowledge was retained. On the other hand, CoD was dropped out from the local network and viewed as an “outsider” after the termination of the JV as concurred by the FD “*No more relationship with China Research Institute of Environmental Protection.*” It indicates the vulnerability of relationship especially when it is not cultivated and extended to other people within the organizations. A high dependency on specific individuals would lead to a setback in on-going business. It implies that a change of entry mode entails risk in losing existing network connections and the probability of becoming an “outsider” is much greater. The importance of tacit knowledge as an intangible asset is prevalent in CoD’s responsiveness to the local market development.

The development strategy is to focus on traditional environmental impact assessment (EIA) business because of better financial returns and faced by restricted market access to the local market and the mining industry. It has been leveraging its Class A license to perform environmental impact assessments (EIA) which are technically difficult and complicated in reporting. It cooperates with its multinational customers for such projects. The barrier of entry for such projects for local competitors is high due to lack of technical expertise. Simple EIA report requires little technical skills and best suited for local competitors who charge inexpensively. Thus, it does not make sense for CoB to compete in a crowded place. The new EPL gives rise to new business opportunities as it stipulates that EIA report is mandatory before any construction project can take place. Such report is more complex and the issuance is liable if the client does not comply with the report.

#### 4.3.4 Following Clients

As argued by Fosgren, (2002), firms do not necessarily follow the sequential steps of internationalization for the sake of experiential learning as posited by the *Uppsala Model*. Rather they take short cuts by following their clients. CoC's internationalizing into China supported his argument. Parent C entered British HK in 1976 for the same reason. Despite the vast geographical distance, HK did not pose to be a difficult entry because it belonged to the British administration. This is in support of Coeurdero and Murray (2008) who assert that firms will tend to enter a host country whose regulatory framework is similar to the home country. Using local people diffused the difficulties that could have arisen due to higher psychic distance. Consequently, the experiential knowledge accumulated for 8 years in HK became an advantage that was internalized (Ying et al., 2013) when it entered China in 1984 by following its clients again.

Brouthers (2002) argued that foreign investors would likely use alliances to enter China to reduce the risks and uncertainties due to the formal and informal institutional differences. However, the analyses show that foreign firms that entered British HK had the capabilities to enter China autonomously by exploiting the first mover's advantage that would tend to compensate for the lack of market knowledge (Loane & Bell, 2006). The significance of HK in accelerating CoC's entry into China is apparent. The analyses have shown that the presence in a culturally-related country of proximity tends to accelerate entry into China.

The HK team of CoC came to China to manage the clients' projects in China. The narrow ID between HK and China did not pose excessive cultural challenges as compared to home (UK) and host countries that have higher ID (Johanson & Vahlne, 1977; Chen et al., 2006). Besides the problem of legitimacy was minimized because of an existing HK business community that was already in China (Li et al., 2007). Risks and uncertainties were mitigated because CoC exploited its professional networks of developers and architects to gain learning experience and knowledge as China moved toward market liberation. In 1995, it set up a WFOS to be in line with its corporate strategy. The location of the first office in Shenzhen was due to the first wave of economic growth in the south.

CoE internationalization into China reflects the postulation of Johanson and Vahlne (1977) that the driver of internationalization is the consequence of a process of incremental adjustments to changing conditions of the firm and its environment. The changing conditions were because of a slowdown in HK and the completion of major infrastructural projects at the time when British HK was returning to Chinese sovereignty. At the same time, the multinational clients expanded to China and CoE followed to manage their projects even though it lacked the knowledge and expertise in total project management. The personal relationship that the COO had with the multinational clients was an asset and the impetus for retaining CoE's services in a new market. The COO was responding to the needs of the clients (Knight et al., 2004; Knight & Cavusgil, 2004) originating from a well-connected business relationship (Kuivalainen, 2001; 2003), knowing that he did not have competitive advantage to handle their projects. Accordingly, this action is vulnerable to risks and uncertainties in a new country.

Several factors attributed to this success. The COO exuded entrepreneurial qualities. He was not inhibited by the bureaucracies of an MNE that could have stifled his decision and subsequent action that would have resulted in loss opportunities in China. Based on his instincts and good judgement from years of experience working for the industries' clients in HK, he was able to respond to the market conditions to fulfil a gap. Here, he adjusted the products and services, adding new ones to suit the clients' needs in China. As a consultancy firm, good relationships and effective communications are vital for success. In the light of these factors, lesser difficulties were faced on the strategic level. Furthermore, he had another individual to help him start the business from zero-base. Both of them had similar years of experience and knowledge that were their most valuable assets to succeed in the new products and services pertinent to China.

From the theoretical perspective of internationalization, it indicates the CoE's ability to optimize the necessary conditions posited by each internationalization model to succeed in China. The company's management exploited the O-advantage by tapping informal managerial relationship to gain trust and confidence from the multinational clients. In other words, their strategy was dedicated and focused on the competitive advantage – relationship. It exploited the global networks from the US and the UK (O-advantage) to

advance the business growth in China. It exploited the market information from the multinational clients to learn about the country immediately. Here, it knew how to exploit its presence and optimize the learning about China, while in China.

Although the entry in 2000 by CoE was considered to be rather late as compared to the rest of the companies in this study, the late entry benefited from the institutional change. China was starting to remove some pre-requisites of FDI (Long, 2005). This policy change gave incentives for foreign companies to set up R&D centres in China. As such, CoF's business grew exponentially because it was literally managing all the construction of R&D centres for its clients in Beijing and Shanghai. Contrary to the literature that further deregulation will imply greater competition and less likelihood of success, CoE did financially well as a result of that (Johnson & Tellis, 2008).

In the built-industry, China has been moving towards Green Building Codes. Many major developers started to switch to building projects that incorporates Leadership in Energy & Environment Design (LEED) certification. It is *"a green building certification program that recognizes best-in-class building strategies and practices (GBCI, 2016)*. As a result, CoE has been involved in many LEED projects with major developers such as Vianke, Shanghai Greenland, Tencent, China land and Capitaland. In the past two years, CoE has engaged in energy performance contracts, such as energy retrofit and commissioning that have been gaining popularity in China. It was a remote concept about five to six years ago, as China was not ready to incur more costs in commissioning. The business model had been such that energy efficiency and performance had not been part of building engineering design. Individual contractors were responsible for the technical performance of their own equipment but the overall electricity efficiency of the building project, as such had been neglected. Commissioning means evaluating the design and advising clients on energy efficiency and performance issues of each building project. CoE has this expertise. The future direction of CoE will be on commissioning as it relates to energy reduction to fulfil the needs of China. The HOS said that: *"our advantage is our capabilities, especially in commissioning. We have experienced people and different projects experience."*

CoC exploited its professional networks to gain entry into China. In China, competition is intense due to the rise of the local design institutes (LDI) that have become more technically competent as CoC or other international firms in the industry. Their competency comes having privilege access to CoC's design concept of each project which has to be submitted to them for review. In this mandatory process, they gain inward learning and knowledge. CoC's strategy is to keep improving its innovation technology to be ahead of local competitors. Selecting landmark projects (means government or difficult projects) is the key development strategy to differentiate itself from the competitors and to build upon its reputation. This is possible because employees are not pressurized to undertake big profitable projects at the expense of churning out high quality output in projects undertaking. Based on reputation, it gains projects by "word of mouth." Further expansion in terms of more offices in China is a result of servicing their clients and being close to the local government.

CoE's development strategy has been one that is in response to the market. Entering China was a response to its multi-national clients, and moving into the sustainability business is a response to the business gap found in the old manufacturing sector in South China. As such, it began to develop the business by hiring a local manager. It reached out to existing clients (who built the manufacturing sites) and the local government that is pressurized to ensure environmental compliance in accordance to the new EPL.

The above analyses show that China was a viable country of expansion despite high psychic distance between Europe and China. The distance is mitigated by China's country factors because of the vast market size and, the market was less developed and was in need of the case study companies' goods and services. Studies of WFOS as an entry mode choice in China have examined the impact of China institutional development (Li et al., 2007; Papyrina, 2007) and the level of managerial control (Wei et al., 2005) that led to the entry mode choice.

Accordingly, previous empirical analysis has shown that WFOS had a better chance of survival at this stage because the institutional environment was more predictable and stable (Papyrina, 2007) and information about the market is easily accessible (Puck et al., 2009). However, when such information is not easily accessible, it was found that a small

manufacturing company chose to conduct market due diligence through door-to-door visits of customers in China before making a decision to start its exporting activities. This is due to the liability of newness and smallness (Zhou et al., 2007). While firms from emerging economies entered developed markets to acquire strategic assets because of a stable institutional environment (Luo & Tung, 2007), this study found that the case study companies entered China had a market seeking motive despite a weaker institutional environment as compared to home countries (Chen et al., 2006). The size of China offers huge business potential to the case study companies. Although the significance of the Chinese market varies, all the case study companies regard China as an important market of growth due to its size and its environmental protection priorities.

All case study companies are now operating as WFOS. However, prior to operating as WFOS, some companies had already “entered” China directly or indirectly due to activities in exporting and managing clients’ projects. These activities impacted the initial and the subsequent change of mode of entry. The salient advantage that propelled them to enter China played a key developmental role in their operations in China. As a result of the market opportunities and the companies’ long term view of China, they selected the highest investment value and are operating as WFOS. In the case of firms owning patented technology, WFOS mode of operation facilitates internalization (Williamson, 1981; Dunning, 2002).

Previous research has shown that cultural-specific experience led to selecting WFOS as entry mode (Dow & Larimo, 2009), but this study shows that cultural-specific experience was not the deciding factor for CoB to enter China as WFOS. The initial entry into China was due to the strategy of expanding into less developed markets that had not been tapped.

All case study companies have between 34 and 50 years of international experience with massive geographical coverage prior to entering China. Thus, the risks and uncertainties arising from high psychic distance are greatly reduced by their cumulated knowledge and experience in their international expansion.

The entry and development strategy of the MNEs in China supports existing theories of exploiting OLI advantages. On a firm-level, all companies possessed OLI advantages that

were exploited to enter China. However, the specific reason for entering China between the companies is more related to the possession of O-advantage in the form of intangible assets such as managerial experience, strong global and regional networks that resulted in some following their clients as well as relationship with an SOE. In this study, we built on these salient advantages that impacted their entry and development strategies when internationalizing into China.

Global and regional networks accelerated CoA's entry into China and impacted further expansion. Cumulative knowledge and experience of a senior manager were the impetus for CoB and CoE to enter China directly. The relationship between CoD and a powerful institution was the reason for the JV in China, and subsequent corporate strategy to have full control of foreign operations propelled the change in mode of operation. Following clients as a means of skipping the learning experience in a foreign country as argued by Fosgren (2002) against the *Uppsala Model* is evidenced in the entry strategy of CoC and CoD which followed their clients from HK. However, a small manufacturing company such as CoF chose sequential steps of internationalization conforming with the *Uppsala Model* which posits that "*the more specialized the resources are to the specific market the greater the degree of commitment*" and that the allocated resources are only for that specific market only (Johanson & Vahlne, 1977: 27). On the other hand, it also supports Dunning's (2002) L-advantage that posits that firms exploit location-specific advantage to avoid transportation costs.

#### **4.4 Conclusions**

Emerging from the analyses of how and why do the case study companies internationalize into China, it appears that unique intangible assets (Caves, 1982) drove each company's entry into China. Each case study company entered at a different stage of market reforms in China. Thus the institutional challenges they had faced were varied. The most salient advantages are summarized in Table 4.2

***Table 4.2 Main Drivers of Internationalization into China***

<b>Case Study Company</b>	<b>Salient Advantages</b>	<b>References</b>
CoA	Global and regional networks	Johnson & Vahlne, 2009
CoB & CoF	Managerial experience and knowledge	Penrose, 1956
CoD	Relationship with SOE	Tse et al., 1997
CoC & CoE	Following clients	Fosgren, 2002

With regards to their entry mode choice into a China, the research finding suggest that it is impacted by each company's corporate strategy to own subsidiaries in foreign market. All entered China during the late stage of market reform. However, when we hold the psychic distance between the EU and China as constant, the initial entry mode of the case study companies was not the same. For example, CoB entered as WFOS and CoD entered as JV in 1994. Thus, their entry mode choice was not impacted by psychic distance. Market opportunities, existing relationships in China, and corporate expansion strategy had more impact on the choice of entry mode.

## **CHAPTER 5**

# **LIABILITY OF FOREIGNNESS FACED BY EU COMPANIES IN THE EP SECTOR IN CHINA**

### **5.1 Introduction**

Liability of foreignness arises from the cost of doing business abroad (CDBA) manifested by the host and home countries' environment (Hymer, 1976; Zaheer, 1995). Firms in international ventures are likely to be challenged by restrictions based on foreignness imposed by host institutions and the host marketplace. Certain LOF, such as from host institutions, are regulatory in nature and can be relatively easily understood, because the rules are codified. On the other hand, interpreting the response from the host marketplace (normative and cognitive) is more difficult and complex because it is experiential.

Recent LOF literature has indicated the need to differentiate between the CDBA and LOF, as well as between LOF and AOF, to evaluate the actual performance of foreign firms in the host countries (Sethi & Judge, 2009). This deterministic approach allows for a clearer view of the causes of LOF and enables firms to find appropriate solutions to reduce LOF in the foreign market.

The impact of institutional distance is related to the LOF (Zaheer, 1995) that is often linked to distance (Boeh & Beamish, 2012). On the other hand, LOF experiences vary according to firm-level capabilities to cope with the difficulties arising from the distance (Chen et al., 2006). Some researchers such as Eden and Miller (2004) distinguish the sources of LOF and defined them as discriminatory, unfamiliarity, and relational hazards.

The next section discusses the evolution of the regulatory environment in terms of the laws of FDI and environmental protection. Drawing from the theoretical/analytical framework, the causes of LOF are then analysed and discussed in the context of discriminatory, unfamiliarity and relational hazards (Eden & Miller, 2004).

## 5.2 Evolution of the Regulatory Environment

With regards to the impact of the LOF faced between the home and host country on their strategic choices, it is important to take cognizance of the evolution of the regulatory environment in China's market reforms and the accompanying institutional changes in the environmental protection sector. In this study, the three stages of market reform from Papyrina (2007) are adapted as a basis to assess the changes of the regulatory environment between these stages. The first stage is from 1979 to 1987, the second stage starts from 1988 and up to the time China joined the WTO in 2001, and the final stage is from 2002 onward. Foreign Direct Investment (FDI) and Environmental Protection Laws (EPL) and the institutions governing the EPL are selected to represent the evolving regulatory environment. Table 5.1 illustrates how the EPL and the MEP evolved over time.

**Table 5.1 Evolution of the Regulatory Environment in China**

Stage of market reform	Early	Intermediate	Late
	1979-1987	1988-2001	from 2002
<b>Year of Entry</b>	1975: exporting by sister of CoA 1980: Projects by sister of CoB 1984: Projects by CoC	1990: Market visit by CoF 1993: CoF (exports) 1994: CoB (WFOS) 1994: CoD (JV)	2003: CoA (WFOS)
<b>Legal Framework (FDI and EP Laws)</b>	1979: Equity JV Law (first FDI Law) 1979: Enactment of EP Law 1986: WOFE Law	1980s: Foreign Chairmanship allowed on board of directors - Equity JV Law 1989: EPL became permanent 1995: FDI catalogue	
<b>Evolution of the institution governing the EPL</b>	1980s: Environment Protection Agency (EPA) 1984: State Environment Protection Agency (SEPA)	1998: Strengthening of SEPA 2008: Ministry of Environment Protection (MEP)	2011-2014: Public consultation of amendments to EPL 2015: Effective new EPL (after 4 drafts)
<b>Branches of MEP known as Environmental Protection Bureau (EPB)</b>			Top level: MEP (Central government) 2nd level: Area EPB 3rd level: Provincial EPB 4th level: District EPB 5th level: Town EPB
<b>Anti-corruption Campaign</b>			Since Xi Jinping's administration from 2012

Source: Author's adaptation of Papyrina (2007)

### **5.2.1 Tighter Environmental Governance**

Heightening of environmental protection compliance by rule of law and strengthening the administrative power of the MEP that are the watchdogs of the rule of law have reaffirmed China's government commitment to develop a green economy. This means that all institutional and economic actors are bound by a common order that will determine their entry and development strategies in China. As illustrated from Table 5.1, the EPL has remained unchanged since 1979. Past studies have concluded the weakness in enforcement policy that was manifested by insufficient administrative authorities endowed on the MEP (Jahiel, 1997; Qiu & Li, 2009). Some studies even suggested introducing criminal law to deter irresponsible environmental pollution (Yang, 1975).

The changes finally instituted in January 2015, were the result of four drafts between the efforts of the public and the government over a period of 4 years. This indicates that China's institutions are exercising the rule of law to eradicate environmental problems. The central government is continuously aligning its regulatory framework to meet international standards. According to the RIM of one of the case study companies (CoB), the new EPL is an amalgamation of the best EPL in Europe and the US. However, we have to bear in mind the multi-level government that is in China. They are heterogeneous in relation to economic power, business, and socio-culture, economic and human capacity maturity, industry, distance to central government, and governance in terms of enforcement measures and styles. As a result, the normative and cognitive distance differs between them and foreign companies have to contend and adjust to such nature of distance. The new EPL is seen as a good top down approach tool to punish polluting companies in developed cities but it is seen as an economic threat in developing cities. For example, interview with UNDP China revealed from their ground experience that a closing down a small factory in a small village would affect the livelihood of the whole population.

### **5.2.2 Impact of Tighter Environmental Governance on Case Study Companies**

Most companies agreed that the new EPL had a positive impact on their operations because local companies are weak in compliance and the companies studied have the competitive advantage. These companies originate from a strong formal institutional

environment and belong to the same economic union that advocates environmental protection. Thus have developed expertise in this area. Despite that, the new EPL has a “fear” effect on the case study companies. They are taking measures to ensure that their equipment or procedures adhere to the new EPL. CoD has engaged the services of legal firm to explore the impact of the new EPL on their services and practices. On the one hand, the new EPL brings new opportunities for EIA services but it also has implications on its practices on the other. It may have to adjust its best practices in accordance to the legal implication of the new EPL to mitigate its liabilities. Other examples are:

CoA (PM)	<i>“All these laws in China are becoming stricter and stricter. And local companies have difficulty to comply with such kind of new law. We are more afraid of the EPL now. The waste is more and more complex and our facility is getting older and we have not upgraded it. We have to catch up with the technology. We have to change the back filters more frequently after the new EPL.”</i>
CoB (PDM)	<i>“New EPL will have more pressure and we have to be even more careful to ensure that we comply with the new legislation. Now it is an important time, we cannot be the one to break the law.”</i>

However, there are opportunities too. For example, the RIM of CoB argued that there is a technical advantage. The strict law legitimizes the need to invest in innovative solution that would meet the stricter regulatory standards. As a result, polluting companies would be susceptible to technical solutions designed to lower emissions. In the case of CoF, the new EPL has a special provision which states that *the State promotes the clean production and the recycling of resources*. In this regard, in January 2016, the NOx emission in Beijing for natural gas-fired district heating plants had changed from 100 mg per cubic meters (cbm) to 30 mg per cbm. The BDHC was its first customers to install CoF’s newly developed burners that meet the emission standard. The following table below shows how the new EPL will impact the case study companies’ operations in China.

CoA (BUDI)	<i>“Local companies are already contacting us for technical consultation”</i>
CoB (RIM)	<i>“We need to improve process or creating something local. The law is one of the main drivers in R&amp;D. We can sell our integrated solutions”</i>
CoF (GM)	<i>“All those changes are for our advantage. The stricter the law is the better for us.”</i>

The negative effects of the new EPL are relating to its effectiveness in enforcement; *“sometimes they give the laws but don’t follow quickly”* from the GM of CoF and CRD of CoE stated *“not sure if EPL is well implemented. This is the problem, again it boils down to who you know in a relationship”* and the costs associated to meet compliance standards. The impact of regulatory change affects the operation in terms of budget control because the change were unexpected, and thus there was no budgetary provision. CoB has to invest on improving its current devices to meet the change in emission standard. The engines from Europe that used to meet Chinese standard (and Europe) could no longer be used unless further enhancement is made. Hence, the cost of operation became higher due to the additional modifications but it was still lower than the cost of violation. At the same time, this caused a variance in profitability. In the PRM’s opinion, *“maybe after decade, the environment is getting better maybe the law will go back to be less stringent.”* However, it is very apparent that companies operating in the environmental protection sector in China know that the time has come when the government will criminalize anyone that compromises the environment. Henceforth, all companies have to adopt greener process in their operations to avoid severe consequences.

Background interviews with the gatekeepers supported the positive impact of the new EPL as summarized below:

Legal Firm specializing in environmental	<i>“It will create more opportunities for foreign firms for example, air pollution treatment” new EPL will trigger more stringent environmental assessment issues for start-ups and also for M&amp;As deals. There are going to be more environmental due diligence</i>
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protection laws in China	<i>work and environmental compliance work. These are work relating to law services, we definitely see a lot of opportunities for lawyers and third party consultancy firms</i>
ICF International	<i>“Companies have to be competitive in the market and they will have to put aside old one and invest in new technology. For example, providing equipment for power sector, or technology for waste management, if there is an equipment upgrade that triggers by emission trading...”</i>
UNDP China	<i>“Positive, as provincial government is now responsible of its own environment.”</i>
EU-EP Environmental Governance Programme	<i>“Public awareness is the first step in empowering the citizens the right to know the level of environmental pollution of companies in the industries. The public consultation was encouraged and endorsed by the central government that led to the amendment of the EPL.”</i>

### **5.2.3 Effects of the Anti-Corruption Campaign on Case Study Companies**

In recent years, the Chinese government have been clamping down on corruption on a phenomenal scale. According to international media reports, high level government officials were indicted and serving their sentences. As shown in Chapter Two, (Table 1.2), the EU and China scores on “ethical behaviour of firms” differ drastically. EU companies have to comply with their own corporate ethics. This compliance becomes “operational hiccoughs” because EU companies will not and cannot indulge in corrupted practices. Therefore, all the case study companies viewed anti-corruption campaign to be positive.

CoA and CoB are most positively-impacted by the anti-corruption campaign because they relate with the governmental officials on a daily basis. For example, CoB was asked to pay RMB half a million to get approval for two engines two years ago. Now, *“the anti-corruption campaign has definitely benefited us.”* (MD). The BUDI of CoA stated *“it means that when the local government is opening a tender, there will be less corruption involved since the central government is paying a lot of attention to that.”* However, there

is a general agreement by all the case study companies that the anti-corruption campaign will have a positive impact on their business. It affects CoE indirectly because they work with developers who claimed to have received the greatest impact in operational terms. In the past, they (developers) could get their work approved by the Planning Bureau by gifting. As CoE works mostly with developers, its work process has been slowed down.

**5.3 Discussions**

**5.3.1 Discriminatory Hazards**

The analyses show that regulatory discrimination is the most persistent institutional hazard (Eden & Miller, 2004) that has disadvantaged all companies in terms of growth opportunity due to their LOF (Zaheer, 1995). For several companies, the institutional hazard is exacerbated in an industry that is dominated by SOEs. As by Luo et al. (2011) suggest, they have economic advantage in size, governance advantage in governmental investment subsidies, and shared governmental network and information systems. The following sections discuss the issues that are related to unfair competition, operational barriers, restricted market access, and inward learning and experience of SOEs and local competitors that are manifested in the context of the discriminatory hazards experienced.

**5.3.1.1 Unfair Competition**

CoA is challenged by the low-price strategy of competitors (SOEs) in the municipality market. In other words, it has *“No chance to gain access to municipalities as client”* as stated by the BUDI. State-owned enterprises (SOEs) belong to the same institutionalized network and thus have deeper working relationship with municipalities because of similar cultural background. This is also supported by CoB and CoE:

CoB (PDM)	<p><i>“The level playing field is not and has not been fair. It is highly relationship based and tends to skew in favor of the SOEs during new projects bid. The SOEs have personal networks with the government. As such, their credibility is perceived to be higher than foreign-owned companies.”</i></p>
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CoE (CRD)	<i>“The government and the approval systems are set up so that foreigners cannot get near it”</i>
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As such, CoA adopts a conservative strategy and focuses on the industrial market of fewer SOEs. The low-price strategy deployed by the SOEs in project bidding is not compatible to the home country’s policy as it has to adhere to the interests of the stakeholders in terms of investment profitability. Hence, it is constrained by the liability of home (LOH) that impedes its entry into the municipality market (Stevens & Shenkar, 2015) in comparison to CoB which expanded aggressively into the municipality market. The profit sensitivity is confirmed by the PM who stated that *“I think because at the very beginning when we invested here from 2006 to 2011 we did not earn money for 6 years, then I think that the HQ did not want to take more risk and invest in China to expand too fast.”*

It is obvious that higher financing cost is a significant market barrier for CoA (Karayaka, 2002) but not the SOEs because of the *“different financial systems and unique financial policies in China.”* (Niu et al., 2012: 74). The BUDI stated that *“Local competitors are SOEs that have low finance cost and are not profit orientated. They have advantage in terms of local guanxi. This special national treatment is not going to change.”* The representative from Finnish embassy supported this assertion of pricing challenge of CoA *“Pricing is most challenging for foreign companies because they have high quality products due to better efficiency.”*

In contrast, CoB has a different expansion strategy in China. It expanded aggressively into the municipality (competing with SOEs) and the industrial markets. As such, it does not view relative higher cost of financing as an impediment. However, the MD admitted that the municipality business is declining rapidly, *“In industrial market, I think we have good opportunities. In municipal, I think we have the opposite. In other words, we have declining opportunities for growth.”* A pertinent remark made by the PDM about municipality waste management as to why the SOEs have impacted CoB *negatively “they prefer own Chinese people, cleaning their own waste and not foreigners.”* At the same time, CoB faced chronic relational problems with the institutions as stated by the PDM *“the most important difficulty is we do not have the relationship.”* It lost the operation of

one of the best landfills because it had to be handed over to the government even though there were 13 years to the end of the contract.

When the MD was asked if CoB faces discrimination because it is foreign, the response was: “*Yes oh yes.*” CoB was not offered to participate in a public tender for a second incinerator plant on the same site that CoB has a landfill and an existing incinerator plant. According to the MD, CoB had the capabilities and experience including financial resources. Yet, it was not asked to tender for the project. It was awarded to a local company that was backed by a Japanese firm. This was because the “subsidiary GM was in a relationship with the mayor”. The MD stated that “*it happens all the time that it is not invited to tender.*”

The fact that CoC does not have a building license after 30 years of operation in China is an unfortunate impediment. In the initial years of operation, they felt that it was not a major issue because of their steep learning curve. CoC needed local partners who understood the regulations. After 30 years, the organizational routines have been established and stabilized and has produced a team of qualified people. Yet, it could not utilize their employees’ assets to the fullest potential. This impediment has blocked its ambition to market itself as a one-stop consultancy service. Firstly, concept design will be revealed to competitors (the local design institutes) who stand to benefit from learning and become potential competitors. Secondly, there is a team of Class One engineers that have technical and engineering expertise to sign off their own drawings and submit for governmental approval, yet they are not allowed to because CoC does not own a building license. This impediment is a professional setback for them as long as they remain in the company, because they do not have the status of practiced engineers. Having a “practiced engineer” status increases the chance of hiring by future employers. Thirdly, it means that the company cannot provide a full service package to its customers, which weakens its position compared to local competitors who are able to provide a one-stop service. The unfair competition from the local design institutes (LDI) was because of their relationship with the government. The CRD from CoE stated “*Not a proper process of fairness and equally administrated. Not in China, not transparent at all. Local design institutes have relationships with government bureaus, biggest advantage that the client has or using a*

*LDI is not because they get the design but is the fact that they can talk to Mr. XX to get construction bureau for construction engineering approval. Have dinner, cigarettes and get it approved.”*

CoD’s customers in China are multinational companies. It is difficult to access the local market as it has to compete with 191 local companies that have the same Class A EIA license. The difficulty lies in the fact that these local companies are affiliated to the local environmental protection research and development centres that provided them with projects and end-of project certifications. CoD does not have opportunity to gain into their process because of non-affiliation to any research centres. As a result of this alienation, these local companies ‘competitors have developed excellent technical expertise in the field of EIA and are able to produce high quality work.

### **5. 3.1.2 Operational Barriers**

Both CoA and CoB experienced the discrimination towards foreign firms in trying to bid for public projects. The local government raised the barriers in practice to eliminate them from participation in an indirect way. In a recent experience of CoA, foreign enterprises were prevented from participating in a public tender for a waste incinerator plant in the Eastern part of China. One of the required criteria was that the bidder must have at least two waste incinerator plants already operating in China. The reality is that no international player is operating more than one waste incineration plant in China. For CoA, it has more than 50 plants world-wide. There is no appeal process in such a situation.

Another operational impediment of CoB was during the compliance examination process. According to the PDM, EPB officials would specifically ensure that it complies with all the items on the check sheet but would be less stringent with SOEs or private companies’ compliance. The MD voiced his concern when he was asked about protecting its existing gas-energy business. He said that *“Yes even the existing business is going to be a challenge”* Apparently one of the landfills that is run by a subsidiary of an SOE of a municipality is trying to vilify CoB (it is running the landfill gas on the same site). According to the MD, *“the subsidiary wants us off the site, they want to get rid of us. They want to take over our business themselves... We offered them proposal on how we can use*

*that gas... They turned around and said no, we are on the landfill and the gas belongs to us and we are not going to give it to you... So, our conversation and negotiation stopped.”*

The vilification process started when the subsidiary went to lodge a complaint with the government stating that the landfill is creating odour. Hence CoB feels discriminated because *“from us being a potential solution to a problem, is now vilified as the cause of the problem.”* It did not get support from the government despite showing them the evidence about the proposal and presentation of getting rid of the excess gas. The response according to the MD was, *“The government said that they are not interested in that, we must go back, collect, and treat the gas. So, we went back to the subsidiary, and they said we own the gas and we want 100% of the benefit. Local to local, nothing to do with foreigner.”*

Meanwhile, CoB is collecting all the documentation as there is a dispute as to who owns the gas. However, based on the contractual agreement, CoB has the gas. The MD feels that *“they will install gas engine in their own place and build their own business. Eventually in a year or two years’ time there will not be enough gas to supply their engines and our engines. Our engines will slowly decrease, and we will be back in the corner, and eventually we will all sell and sell the business for a fraction of what is worth. And that is their objective. We have got 13 years in the business left on the contract. We have to pull out of the business as we would be making a loss within two.”* When asked about a recourse to this situation, he said *“Nothing you can do. You take the government to arbitration, you try to take the government to court, and the court is the government. And if you take a municipal government to court, every other municipality in China will know that we took them to court. You will not get any business any way ever.”* When probed if it would be rather difficult to do so, he said that *“finding other innovative solutions is the way to sustain business in China. Leverage is needed, you need something against the government, something against the people, something you can use in the negotiation against them. To be honest I think that these people have made up their mind. They are going to get us out, they will get us out.”*

The MD further points out that the internal combustion engines that are generating electricity has now become an industry standard. It was the IP that benefited CoB in doing

business with the Chinese government. However, SOEs have become CoB's competitors because they have the same IP as they did. They are able to operate just like CoB using locally produced combustion engines which will perform the same task but at a lower efficiency.

The operational barrier of CoC emanates from the building industry which has to comply with a set of approved building design codes. These building design codes consist of a set of rules that must be followed to satisfy the minimum acceptable levels of safety for buildings (for example earthquake resistance) and non-building structures. China has its own set of building design codes that are prescriptive. There is often a narrow leeway for interpretation in China. The development of China's building design codes is slow compared to international design codes. The development of China's building design codes is curbed by the Chinese government's efforts to promote Chinese technologies instead of the best state-of-the-art technology. The AD of CoC asserted that *"For example is air conditioning, most of the time it is hard to get approval for that, as they are trying to push contracts for Chinese."* The rich knowledge of international building design codes that CoC has, could not be applied to China. Hence it could not take advantage of innovations around the world.

Interestingly, foreignness applies to CoD which is managed by local management team and local staff. The government is partial to CoD during inspection routines that are required during environmental impact assessment. CoD does not receive national treatment and has to pass through more stringent inspection routines compared to the local competitors because of "national security interests" according to the FD.

### **5.3.1.3 Prohibited and Restricted Market Access**

Another form of challenge in inward cumulative learning and experience occurred when CoD faced prohibited market access in the mining industry that is not open for tender. Hence, international firms are not allowed to participate and allowing SOEs and local firms to develop their competitiveness (Jiang et al., 2014). Consequently, they became privy to experiential learning and cumulative knowledge. This prohibition enabled local competitors to gain a lot of learning and experience in performing due diligence and

environmental impact assessment reports. This suggests that knowledge and experience gained by local competitors could be manifested from a prohibited industry inaccessible to foreign firms. In other words, foreign firms not only have to protect their own FSAs in the open for tender industries, their overall legitimacy could also be threatened because of the gradual emergence of a pool of very qualified local competitors. As such, this discriminatory hazard is derived from a prohibited but indirectly related industry that has a negative impact on the services provided by foreign firms in the EP sector. This also suggests that firms' services that could be used in multi-industries tend to enjoy greater opportunities for expansion if the industries are open. Besides they are more vulnerable to the changing conditions that could be imposed by the different levels of government. Lost opportunities in restrictive industry such as soil remediation (cannot gain access by CoD) is a consequence of the changing conditions set by the government that it is a national problem that requires national expertise.

Local competition is an impediment to gain access to certain market segments, it is expected that foreign firms would have a fair advantage in participating with foreign ventures that invested in China. We found that the governance relationships between local institutions manifested from a highly regulated sector have created an institutionalized network that prevented CoD from being part of an international venture that entered China. For example, when the US Disney decided to invest in Shanghai as a JV partner with Shanghai municipality, the EIA was awarded to a local institute that is owned by Shanghai municipality. The FD stated that *"we have no chance to get the business. The municipality gave to their own R&D institute because they are cheaper in labour and have strong government support. Competition is not fair. Chinese government promotes local."*

Soil remediation is a huge market in China because soil pollution is a serious problem (MEP 2013). The government has committed to tackle soil pollution in its 12<sup>th</sup> FYP. Although CoD has high-level connection with the top Chinese Think Tank that advises the central government, it is still not able to gain access to the soil remediation market. According to the FM, *"This is not due to barrier. The Chinese government will not let foreign companies benefit from its investment in soil remediation. JV is not possible, unless we cooperate with China institutes"*

### 5.3.1.4 Inward Learning and Experience of SOEs and Local Competitors

Indications that LOF has increased over time due to the inward learning and experience gained by SOEs and local competitors because of industry related regulations imposed by the government are found in this study. The LOF researchers use increased knowledge and experience to illustrate how LOF can be reduced (Johanson & Vahlne, 1975; Pedersen & Petersen, 2002; Klossek et al., 2012), but analyses (below) show that real loss of knowledge and experience has not only increased the LOF but also threatened legitimacy to an impactful extent such as blocking their entry into the local market segment.

CoB (MD)	<i>“These SOEs are now our competitors and they have the same IP that we did and they have the benefit of doing business with the Chinese government in the way that the Chinese government wants”</i>
CoC (AD)	<i>“The local design firms are getting better and better. They are learning from us and benefited out of that”</i>
CoC (PRM)	<i>“Our risk is local competition. Due to Chinese regulation that foreign company must work with local partners, they began to learn how to do high-level projects, and grew very fast quickly. There are many very big local partners.”</i>
CoD (FD)	<i>“Multinationals are our customers. We have always wanted to enter the local market but it is very difficult. Not impossible but very difficult. Their EIA experience far exceeds ours. This is because China has opened so many mines. We cannot compete with them because EIA on local mines are not open for tender to foreigners.”</i>

As discussed above, the prohibited mining industry has created a pool of local EIA expertise that becomes competitors of CoD. It gained learning and experience by performing compulsory EIA in the mining industry. As a result, the EIA experience far exceeded those of CoD. Such inward learning and experience had also impacted CoF. On one occasion, it found out that one of the biggest distributors had copied its burners, manufacturing and selling them to CoF’s customers. The distributor did not choose to stop

the practice as it has invested in its own manufacturing it facility and thus was eliminated from the distributorship. Consequently, they became competitors. The GM stated that *“in China, it is not easy to trust people. Have to trust your instincts. We have been lucky that we have long good relationship.”* Frequent sales visits are the key to maintaining good relationship and build trust. In another occasion, a Chinese manufacturer had produced look-alike products and put them in its exhibition booth. When they were warned of litigation, they responded *“ok we will just copy from someone else.”* According to the GM *“Chinese people are usually very proud of their copy and they make fantastic copy.”* In another incident, CoF has found out that some Chinese manufacturers were creating fake companies and production facilities in Italy and legitimized it during a tender. Fake customs importation labels were reproduced as proof of imports and pictures of production facilities in Italy were distributed. This has impeded the Italian brands in China as they are faced with imitation products sold at a much lower price. It is clear that CoF and other international competitors chose not to litigate because it would be legally tedious to put a stop to copying as it is a “Chinese culture” to do so. Thus, they would stand to lose the case within the Chinese judiciary system. Three employees from CoE were terminated because of corrupted behaviour. They took the company to tribunal, and won the case. According to the CRD *“as an employer if there is a problem or dispute, the tribunal always in favour of employee not the employer.”* Another example from CoB, it did not engage in litigation when the engines were not allowed to run for six weeks because the local government cut down the gas supply causing it to lose substantial revenue. The MD stated that *“you make a loss for those weeks and make a profit when you start again. That’s it, there is no court, there is no court of law that you can go to, and there is no recourse you can take.”*

### **5. 3.2 Unfamiliarity Hazards**

#### **5.3.2.1 Impact of Local Governance**

The LOF faced is related to the unfamiliarity of the governance style by different local governments and the extent of power assertions between them. The MD of CoB said that *“Dozens of regulations have to fulfil but not used. They are the NDRC, Power Bureau, EPB, local government requirements, landfill requirements, tax bureau and all of them*

*are different.*” CoB experienced LOF as a result of institutional dissonance in this case (Huang & Huang, 2013). The MD said that “*we got to have a power generating license, a power generating inspection... and you can have one inspection that is valid for only 2 years, while in most western countries, our power generator license is eternal.*” Some local government exercised authority that was unrelated to them but their actions affected business operations. For example, CoB incurred cost in terms of cash flow planning in not getting value added tax (VAT) refund from the Tax Bureau. CoB was alleged for not rectifying the emission problem from their engines and thus penalized from receiving the VAT in a timely manner.

The other difficulties faced by CoE are inherited from its global clients. In 2010, CoE’s client was keen to produce its own electricity in its own R&D facility using a Combined Heating and Power system. The idea was to put back electricity into the government grid network. However, the government was not interested in letting any foreigner near to their grid network. It was an EP innovation from the client’s point of view but it was viewed as a “foreign project cost” by the government. This is attributed to unfamiliarity hazard inflicted on both sides. The foreign client lacks “local roots” (Zaheer, 1995) to know its way around to legitimize its project. So is the local government who has difficulty in understanding the benefit of the project.

### **5. 3.2.2 Impact of Ambiguity in Governance**

Weak governance in regulating and enforcing business licenses has caused operational anxiety. For example, CoB owns several gas-energy plants in different parts of China is confronted with different standards of adherence in enforcing a power generating license between provinces. Some local government are aware that CoB is operating without a business license but the operation remains unhindered. In one site located in developing city in the west, CoB incurred RMB10 million as relocation expense at the suggestion of the local government so that it could issue the power generating license.

Currently CoE is operating without a “project management” license just like any other international competitors. So far, the Chinese authority has not enforced this requirement even though according to the law, such a license is imperative for project and construction

management firms. It is expected that there would be a lot of costs and constraints when it is finally enforced as currently the procedures for applying for the license are unclear. This experience was reported to be widespread in China that is weak in issuing clear guidelines to economic actors so that they could be in compliance to the law. The parent has been informed about this non-compliance because the consequence will be impactful on the costs of operation.

On the other hand, CoF was disadvantaged by its unfamiliarity with the heat pump market in China when it decided to produce in China in 2014. The application process for the license to manufacture took a longer time than expected because of requests for additional documentation that was not explicitly indicated. This reinforces the argument of Kogut and Zander (2003) that adapting to local institutions is a key challenge for MNEs. Although CoF is a small manufacturing company has high AOF in terms of brand, quality, and technology (Sethi and Judge, 2009), it has to concede to the unwritten demands of the association that grants the license. This implies that LOF has a rebirth nature that is impartial to firm-level attributes, years of local presence and experience, and relationship with local government. Although the market is ready for the new product which is superior and environmentally friendly, the firm-level attributes could not have helped CoF in circumventing the LOF experience.

### **5.3.3 Relational Hazards**

#### **5.3.3.1 Impact of *Guanxi***

The impact of *guanxi* is more pronounced for CoA and CoB whose customers are local governments and governmental departments. Deteriorating relationship is seen in CoB. Its relationship with “their customers” now is not as good as it used to be upon the initial entry. The PDM stated that “*relationship is important in project bidding.*” In the case of SOEs, they have very good relationships with the governments (Zhou et al., 2007). Many of them are childhood friends who graduated from the same school or that they used to work with the governments (Feng & Wang, 2009). The PDM asserted that “*They know and understand each other because of similar cultural background and people trust each other. Why should we give the chance to make money in project bidding to foreigners who think that their technology is better than ours? Project bidding are open to the public and*

*the competition has been assessed in terms of relationship, trust, and technology, equipment parts they would think that foreign enterprises are better. Nowadays people rather trust their friends than foreign companies.*” International players tend to be isolated in the selection process because the trust and relationship that stemmed from early days among the locals tend to favour the SOEs and the local competitors. Foreign players do not have the privilege to be in this network (Huang & Huang, 2013). It is not uncommon that projects are awarded to the SOEs because municipalities prefer to let local companies manage their local waste instead of foreigners using foreign technology. In other words, SOEs have the advantage of nationality.

CoA’s *guanxi* comes from its local partners. As a result, it leverages these networks and did not have to go through the stage of building relationship from scratch. It has good relationship with the local government and the governmental agencies (EPB). The utilities services that are needed to run the facility are interfaced with the local government and the residents. Hence, having a good relationship with the local government creates value to the management of the facility. The legitimization from the local government is very critical: in particular, it provides opportunities to acquire new projects. The local government of the first hazardous waste treatment plant has approached CoA to add a third incinerator line to its current facility. The PM stated that *“the local government wants us to do the 3<sup>rd</sup> line and has supported us very much.”* Such government support is evident throughout the entire construction process. CoA has to engage professionals to conduct environmental impact assessment (EIA). The EIA report would then be reviewed by a panel of professionals and rectified by CoA accordingly. Subsequently, the EIA report is uploaded on the internet for public consultation (opinions and feedback) and approval. The local government would lean towards the public (residents) for project approval. In this case, having strong support from the local government and the residents would tend to impact favourably on project approval outcome. According to the PM, many projects were turned down in 2014 because of negative approval by the residents. Furthermore, the MEP has become very knowledgeable about the best practices. Thus, it will demand companies to follow them. For its 3<sup>rd</sup> line, the EIA was approved within a year (after several trips to the government and many changes) which is deemed to be fast as some

companies have taken more years. There have also been occurrences where companies were forced to shut down because they did not deliver the same practices that they have claimed to be adopting on the EIA report.

As discussed above, CoA has successfully built its relationship with the local government and the related governmental agencies over a long period of time dated back to the prior networks. Thus, it faces lesser challenges compared to CoB. On the other hand, gaining access to the right people to become an *insider* (Johanson & Vahlne, 2009) is very difficult in China. This is affirmed by the PRM in CoC *stated* “*it is difficult to meet the right people in the local governments. There are so many people, you don’t know who to meet and where to meet, and they are all very busy.*”

CoD’s relationship with the MEP and the different levels of governments is mostly a professional relationship. It entails fulfilling the Technical Guidelines stipulated by the MEP in the execution of the scope of duties of CoD. Hence the communication is codified and direct. The DIR asserted that the environmental impact assessment has been implemented for almost 20 years, hence the processes are “*quite natural*” and is “*not expecting to have a lot of uncertainties*” in communicating with the MEP. As asserted by the FD “*we maintain a courtesy distance with the government. Not far and not near.*”

In the analyses on the impact of *guanxi* in relation to the interactions with the EPB located on site (CoA and CoB) and off-site (CoD), findings showed that CoA faced fewer difficulties.

FD of CoD	<i>“Whenever the government come to inspect us, I asked to be treated nationally. Although we are foreign company, we do not need to receive better treatment but...we were not granted”</i>
PRM of CoB	<i>“Usually they pay extra attention to foreign enterprise (as compared to local companies) because they think that you are wealthy because you are a foreign company., They can raise some punishment – raise a sheet and ask you to pay because we are not doing things properly. We have to follow the regulations properly, but for SOEs or private companies they might have their way around”</i>
PM of CoA	<i>“Easy to deal with EPB, if you have done something wrong then very challenging. They do not pay extra attention to us and do not see us differently”</i>
BUDI of CoA	<i>“our local partners are our local guanxi”</i>

### 5.3.3.2 Impact of Networks

The contrasting experience in relating to the government is attributed to the ownership structure between CoA and CoB. CoA’s incinerator plant is jointly owned by a SOE that is also the owner of the industrial park where the plant is located. CoB is operating a small gas-energy plant in the landfill site of the SOE which does not have ownership CoB’s gas-energy plant. The EPB and the SOE are government employees. In this case, CoA has a better relationship with the EPB because of the leverage from SOE’s partner as stated by CoB *“for SOEs or private companies they might have their way around.”* When its gas supply was cut by the local government, CoB could have talked to a higher authority i.e. the mayor but it did not have *guanxi* with the mayor.

For CoD it does not have a local alliance to diffuse its foreignness. It experiences discrimination from the local EPB in a similar context of foreignness as in CoB. However, the underlying factor is its exclusive ownership of an EIA Class A license that no other foreign firms have. The exclusivity of ownership becomes a LOF instead of an AOF. As a result, additional costs are incurred because of higher compliance exerted because of its

foreignness. Analyses from these companies indicate that bureaucratic bias would tend to be affected by the extent of local alliance. Thus, the LOF would tend to be impacted by the extent of this relationship (Sethi & Guisinger, 2002).

For CoF, the Chinese subsidiary was managed by a Chinese partner living in HK and a HK GM was based in China, during the initial four years. The HK GM still remains a board member. The parent company needed the Chinese to help to establish the operations in China. As a result, the Chinese team helped to set up the distributors' network (boilers companies) through careful selection of trust worthy and reputable industrial distributors in China. The same distributors have been with CoF as long as it has started its operations in China. Over the years, they have become sales ambassadors of the company's burners being sold to the industrial users in China. They have a solid technical understanding of CoF's burners. After the departure of the Chinese partner and the HK GM, CoF has always been managed by Finnish GMs.

### **5.3.3.3 Impact of Organizational Learning and Experience**

The CRD has been in China for ten years, he has admitted that his local *guanxi* has not been very good. According to him, it is attributed to cultural difference and a lack of trust, and "language is another barrier." The BUDI (CoA) and AD (CoC) shared the same "*difficulty in getting into the local network*" being new in China. Both have been working in China over 10 years. The experiences of the CoC were that many foreign companies before coming to China, started with short business trips to China to establish connections, meeting the right people and building the trust between clients and government officials. This indicates the extent of relationship building that can take a number of years to materialize before a business contract is established.

In terms of internal organizational impediments, HR management of CoE in China is weak. It is a manifestation of a weak local HR manager as well as the general Chinese labour law that favours the employees. As a result, there have been high staff turnover and other HR related issues in China's operations. Switching jobs within a short period of time is tolerated and is not considered to be negative in China, compared to western countries. This highlights the cultural difference in work ethics and attitudes between the EU and

China. CoE had difficulties managing local staff due to such differences. As a result, they not only have higher staff turnover, a problem several companies underlined, they also have had legal problems with their staff. They recently lost a costly legal case against three local employees accused of agent opportunism.

#### **5.4 Conclusions**

This study has accentuated how the main institutional hazard (discriminatory) had increased costs, impacted expansion opportunities as a result of unfair competition, impacted development strategy to be a “All in One” service provider, increased operational barriers, prohibited and restricted market access, and increased the inward learning and experience of local competitors and SOEs.

The analyses show that these SOEs have gained substantial inward learning and experience manifested by regulatory barriers imposed on foreign companies. Thus, inward learning and experience have caused the LOF of all case study companies to increase and not decrease over time. The SOEs have strengthened their competitive advantages and have advanced their technological and managerial skills to the level of our case study companies. As such, the case study companies’ FSAs have become less salient with the lapse of time that has advanced the SOEs inward learning and increased knowledge. Similarly, previous research has identified how Chinese SOEs and companies in the EP sector have leapfrogged western technologies (Campillo & Foster, 2008; Zhou & Wang, 2009; Liu & Goldstein, 2013; Tan et al., 2013) and overtaking western companies to become global leaders in this sector. On the other hand, home-country stakeholder management strategy does have an impact on the host country developmental strategy. For example, CoA is not in the municipality market but CoB is because of a different stakeholder management style. It was found that a foreign company that has only local employees operating in China, faced LOF in interacting with institutional actors because it is viewed as a foreign firm. The similar culture “local-to-local” interaction does not diminish the foreignness

The case study companies had to cope with unfamiliarity hazards that were unexpected and unreasonably set forth by government officials outside their scope of operation and

authority. Unfortunately, the case study companies had to succumb to their idiosyncrasies in order to get things done. This indicates institutional power asymmetry between foreign firms and government officials. Relational hazards experienced are a result of lack of *guanxi* with local government and governmental agencies. This is exacerbated by a highly regulated environment operated by SOEs that are embedded in the institutionalized networks. However, *guanxi* can be inherited and developed by having strong local partners in gaining access to the institutionalized networks. Institutionalized networks create legitimacy, and provide opportunities for expansion and new investment (Johanson & Vahlne, 2009). Similarly, hiring of locals with experience and training local employees to be technically competent Chinese-English interpreters to develop and enhance local networks help to reduce foreignness.

# **CHAPTER 6**

## **STRATEGIES USED TO OVERCOME LIABILITY OF FOREIGNNESS**

### **6.1 Introduction: Adopting Organizational Isomorphic Practices**

This chapter will begin with a discussion on isomorphism that binds the internationalization and institutional theories together as illustrated in our theoretical/analytical framework. Then, we discuss how the various firm-specific assets (FSAs), the location-specific (L) advantage, and the home and local institutions were exploited to overcome the LOF over time.

Institutional theory posits that the “rules of the game” define the structures, norms, and routines shaped organizational processes to attain social fitness in a constrained environment composing of regulative authorities, customers, competitors, suppliers, public interest groups, and media and so on. As a result of the bureaucratization processes, firms tend to adopt socially acceptable practices to adapt to the conflicting environmental structures for survival (DiMaggio & Powell, 1983; Scott, 1995).

Organizational practices are in the form of setting a local to foreign staff ratio and structuring the number of foreign staff, hiring practices from similar recruitment agencies, universities, or professional training centres, affiliation to certain associations or societies, degree of professionalization of employees, stewardship in R&D collaboration with state owned or recognized institutes and so on. In a context of high institutional distance (EU and China), uncertainty and risk tend to result in firms adapting to coercive and mimetic isomorphism to obtain normative legitimacy (Ando & Paik, 2013). As mentioned earlier, the LOF faced by the six case study companies, is primarily discriminatory in nature due to the highly regulated environment of the EP sector. This section discusses the organizational strategy relating to the normative and cognitive pillars to overcome the challenges imposed by the regulatory environment.

### 6.1.1 Organizational Strategy

Some of the informants did not have any international experience prior to undertaking their roles in China. Literature on international experience of firms and managers have explored its impact towards firm's selection of country and entry mode to reduce LOF (Dow & Larimo, 2007; Sanchez-Peinado et al., 2007; Hilmersson & Jansson, 2012; Wu et al., 2013) but it has omitted to take into consideration the impact of these accumulated experiences on LOF on existing operations. There are mixed findings as to whether the China-specific experience has reduced LOF over time. The BUDI of CoA has very good relationship with the external institutions "*they know I have been here for 10 years and they know I speak Chinese. Somehow I think they like to see foreign face.*" As a result of this familiarity, relational issues are perceived to be lesser (low relational LOF). On the other hand, the MD of CoB feels uncomfortable (high relational LOF) now and that has caused him to be absent from meetings with the local government. He stated that the relationship with the government was stronger when the company first entered China because it had clear competitive advantage that the government needed (integrated processes and equipment engineering). This advantage had diminished over time because the SOEs had copied its processes. It implies that LOF has not reduced but has increased to the extent that local employees are representing the MD in meetings. They are used to mitigate the relational friction as a result of normative and cognitive distance between the MD and the local government.

On the other hand, Chinese companies do not have the expertise to develop state of the art equipment to eradicate the environmental problems, like CoF has. Technology and innovation drew the attention of Beijing District Heating Company (BDHC) that became one of CoF's biggest and most important client. Both are "technology and innovation oriented" and thrive on these factors to build relationship that has now extended to the MEP. Through the BDHC, CoF's became connected with the MEP because of a common vision to use technology and innovation to solve China's environmental problems. It is also through the efforts of the GM by his frequent visits and discussions that have harnessed the partnership. This is because the GM understood and stated that "*In China, relationship is everything.*" Maintaining relationship can be both costly and exhaustive. It

consumes a lot of time and requires frequent monitoring of government's intention of using technology to resolve environmental issues. Only through frequent discussions and increased awareness of China's environmental problems, then can CoF adjust its strategy to be in line with the government expectations and gaining organizational legitimacy (Feng & Wang, 2009). Investing in research and development of new technology is costly, as it may or may not yield a return. Furthermore, the new technology could be exposed to imitation by local competitors or due to any changes in governmental policy.

The theoretical organizational model of benchmarking the number of foreign staff and the ratio of foreign to local staff in the foreign organizational structure to gain both organizational legitimacy and maintaining control to reduce LOF (Ando & Paik, 2013) is mostly supported by the empirical evidence (except for CoD). The organizational strategy adopted by all the case study companies is localization. The Chinese are the majority of each organization's workforce. Chinese culture is seen to be more pervasive social culture. In line with the higher regulatory environment which is China-specific, relational complexities among people of shared cultural background tend to be cushioned and incidental costs could be avoided (Daamen et al., 2007; Sethi & Judge, 2009).

The controlling aspect of the subsidiaries is managed by the home country employees. International experience was found to have an insignificant effect on reducing uncertainties upon firms' entry (Hilmersson & Jansson, 2012), and on firms' performance (Wu et al., 2013). However, it was found to be significant to compensate for the normative distance in international expansion (Andersson, 2011). The management of all the case study companies (except CoD) are from France, the UK, Finland, and Australia. The analyses also show that regional experience resulting from regional responsibilities endowed upon home country employees has an impact on internal cultural legitimacy which tends to reduce cultural distance. For example, the managers from CoA have developed cognitive and normative capabilities as a result of regional responsibilities covering HK, Macau, and Taiwan. As such, they become more culturally aware of the distance. Hence, they would develop programs to reduce the normative distance between the European and the Chinese cultures. The 2-weeks induction program in HK was a case in point. As such, regional experience is non-country specific and is transferrable to

another context to reduce ambiguities that the locals might have and that would obstruct their performance. Another example is that the local Deputy General Manager (DGM) in the Hazardous Waste Treatment Plant is appointed by the JV partner. This implies mutual respect of each for the other's culture and a high regard to ensure an equitable voice arising from cultural differences in the JV. CoA is a majority shareholder of the JV and elected its own foreign GM. At the same time, it allowed the JV partner to elect the DGM. Not only did this enhance the relationship, it also facilitated increased understanding between the European and Chinese cultures to avoid misunderstandings that could affect the performance of the JV (Li & Yeung, 1999). It also indicates that the comparative advantage of each partner can be fully utilized in that the Chinese DGM has an advantage in dealing with the local government and suppliers (Li & Yeung, 1999).

Employees from the home country manage foreign operations to ensure knowledge transfer and organizational practices and norms are effectively implemented through a common monitoring system embedded by the same cognitive and normative framework (Dunning, 2002; Ando & Paik, 2013). On the one hand, the strategy of the companies in foreign operations is to hire locals to gain cultural legitimacy (Archibald, 2015), and on the other hand this ensures that organizational legitimacy is attained through competent employees from the home country (Ando & Paik, 2013). Interestingly it is apparent that the industry norm is to hire French-Chinese managers as in CoA and CoB. It is an indication of industry isomorphism (DiMaggio & Powell, 1983). Their dual cultural background strengthens the communication in the subsidiary, thus reducing LOF. At the strategic reporting level, they are able to observe and decode the information on hand and report accurately to the RHQ (Laudien & Freiling, 2015). The dual cultural background is an AOF as stated by the PDM of CoB that *“we need people like him to play a more senior role, find a way to discuss and resolve problems between Chinese and French.”* The PM of CoA said that *“The GM of the plant deals with board members and we work together in dealing with the government.”*

Normative isomorphism is evidenced in the personnel hiring process of CoA, C, and D. The selection is based on academic achievements from prestigious and renowned universities. Engineers must also have the highest degree of qualified license (DiMaggio

and Powell, 1983). As a result, they tend to share a common goal of excellence and are able to identify their own career path stipulated within the organizations.

CoD does not have any foreign employee in China. This structure defies the literature of achieving legitimacy and maintaining control as highlighted earlier (Ando & Paik, 2013). The internationalization strategy of the Parent is through acquisitions of many small businesses. Thereafter, they are merged into one subsidiary in the specific country. As stated by the FD, *“It was not difficult during the integration process because on a global basis, the parent is consisted of many acquisitions of small companies.”* This implies that the multinational experience of the Parent has created an FSA in terms of organizational routines and practices that could be transferred easily to the subsidiaries without the need to deploy home country employees abroad. In this case, expatriates’ costs (Daamen et al., 2007) become irrelevant. Moreover, the DIR stressed that the communication process with the MEP is *“direct and easy”* which implies that there are lesser relational hazards. However, CoD still faces discrimination from the EPB during routine inspections as previously discussed.

When CoE started its sustainability business, it hired a local manager (HOS) to manage it. The HOS added that the key barrier for foreigners getting into the local network is the *“language.”* He said that *“if cannot speak Chinese with them fluently tell them your ideas and your understanding of their project intention, it is very difficult...even if we talk about international projects in China – the high level and mid-level people are Chinese, you still need to communicate with them. If you are working in consultancy you need to talk to them. Relationship is very important in all industry – more important in China than in HK, Singapore. China is big and complicated, too many people...”*

CoF used local management to develop its local networks and stabilize the local operation when the Chinese subsidiary was opened in 2002. After four years, the transition to the first Finnish GM took place. The Finnish GM and the local sales team travel together extensively around China visiting local distributors. Thus, CoF felt more “secure” in having trained local employees who are travel interpreters to avoid any relational misunderstanding as a result of culture differences. The GM chose not to rely on the local sales team because they lacked cultural sensitivity and discretion compared to the trained

interpreters. CoF chose to rely on its distributors to sell burners instead of direct selling to the end industrial users. This reduces the relational hazards. Thus, it is able to use technology to create unique superior quality products and focus on maximizing customers' value to compete in the global market (Knight & Cavusgil, 2004).

With regards to the China's production facility of CoF, it is entirely operated by the locals. The initial knowledge/technology transfer occurred when a new product line (burner) is introduced in China. Finnish technicians would spend about a month in China to train the technicians. Learning by doing is the key to ensure that locally produced burners are of European standards. Technical documentation of each burner is another success in producing the burners locally. This indicates that knowledge transfer has occurred effectively through training and supervision (Andreosso-O'Callaghan & Qian, 1999). Similarly, when it decided to introduce heat pumps into China, a Finnish manager was relocated to China. A Heat Pump Department was set up with local employees who know the market and the Finnish manager knows the product. The synergy helps to ease its market entry that requires visitations to local customers and explaining to them the application of heat pumps. The future vision was to promote district cooling in China and to tie up with building developers and contractors as part of the urban planning process. According to the HPM, *"We are in the relationship building phase as we just started the heat pump biz in China. We like to think that when we find the right distributor, builders, construction, companies the business will grow in the future..."*

### **6.1.2 Training and Development**

As firms become more experienced in their international activities, they adjust their organizational routines and procedures to the needs of the markets. As such, they develop a pool of competent resources to respond to the changing market conditions of foreign markets (Erikson et al., 1999, Petersen et al., 2008). Experiential knowledge in the form of business and institutional knowledge is found to have an impact on perceived costs of internationalization. In other words, internal knowledge in the form of competent resources is important to realize the business and institutional knowledge to reduce LOF (Zaheer, 1995, Erikson et al., 1999). Specific cost relating to such LOF is the translation

of information collected to meaningful decision making tools affecting the efficiency and functionality of foreign firms (Erikson et al., 1999).

Staff training and development constitutes repetitive organizational routine to demonstrate the critical importance in internalizing objective and experiential knowledge between parent and subsidiary (Penrose, 1956; Erikson et al., 1999). It is acknowledged by most of the companies that tacit knowledge is the most important asset that is critical for survivability (Dunning, 2005). Unlike objective knowledge which is non-country specific and could be copied by firms (Erikson et al., 1999), tacit knowledge is people-specific (Johanson & Vahlne, 1977). Thus, it is more vulnerable upon employees' exit. This is supported by the statement from the DIR of CoD who said that "*The knowledge that our employees have can easily be applied to another company. So, it is important to keep employees with us.*" People are highly valued by all the case study companies and they are regarded as important assets. While local employees are used to reduce LOF, their exodus could be detrimental and challenging that could lead to companies being vulnerable to LOF.

Staff training and development is quite similar in all the case study companies. Mostly driven by the organizational culture that emphasizes heavily in ensuring that local employees have European skills, and are following prescribed set of organizational routines and practices. Moreover, they have training and educational campuses located geographically. CoA's long term plan is to recruit young engineers from the joint-degree programs it has with established universities in Europe and in China. The objective is to provide them with long-term career plans and the opportunity to manage waste treatments plants in China. The BUDI stated that "*I expect that these people will, in 10-15 years' time become potential GM.*" Here, the dual cultural experience that will originate from the universities' programs will help to reduce the LOF over time. CoC integrates its global employees on a digital platform. It is a centre connecting diverse objectives and tacit knowledge within the global subsidiaries network so that employees are aware of the respective country's development in their field of specialization. It also facilitates cross border employees' mobility because they possess prior knowledge. Knowledge gained in China is also transferred back to the home country. According to the AD, "*We do a lot of*

*work on low carbon master planning. The thinking we work on here; we export to UK, South America.”*

Most companies have very low level of staff turnover, which is probably an indication of the effect that training and development has on raising the staff retention rate. One consequence is a lesser threat of losing tacit knowledge to competitors. At the same time, new knowledge could be created as firms internalize this for strategic decision-making purposes (Johanson & Vahlne, 2009). For example, RIM of CoB stated that *“We will find a contract that is pushing to improve in emission efficiency. Will take the technology as it is and validate on existing contract at our own costs. We conduct research internally by gathering experts from the Group to work on such projects. When the test is successful, we can sell the innovation to any markets”* This joint collaboration is feasible only when employees have a considerable amount of firm-specific experience accumulated over time. In this way, the costs of investment would be compensated by new opportunities created from the innovation. Another example from CoC, the PRM said that *“The reason I joined this company is because I can get the best projects. Most of our colleagues share this value.”* Regarding licensed engineers, the license is awarded to them based on the number of projects and the years of experiences. Thus, lower staff turnover implies that such tacit knowledge (FSA) is protected. It is a pre-requisite to undertake difficult projects that differentiate CoA from the local companies who do not have this knowledge.

The project processes of CoD are knowledge-based. Hence the risk of key personnel departing will result in a drain of knowledge. The Class A EIA license regulates that engineers have to have experience in performing environmental impact assessment. As shared by the DID, their experiences can be applied to any other organizations hence it is even more crucial to take care of the welfare of the employees through training and development. It is apparent that it has been doing well in this aspect because majority of the employees have worked for the company for many years. This is supported by the Parent’s Employee Survey that employees feel a strong sense of work direction and they feel proud that there is deep trust between them and the immediate supervisors. In China, team building exercise is conducted annually.

### **6.1.3 Research Collaborations in China**

Research collaborations in China follows a similar pattern in CoA and CoB. The other case study companies have international research collaborations but not specific to China. Research collaborations in China for CoA and CoB have increased progressively in research investment projects. Both started in 2003 (CoA) and 2004 (CoB) offering scholarships and training support to local universities. Today, they have their own Joint Research Centre in environmental engineering and technology with established universities and formalized programs with the MEP. The Chinese government supports and encourage research in universities. Thus, big Chinese universities have environmental research department that connects the government and the industry. Well-established universities have high level connection with the government. As a result, research collaboration helps to accelerate research activities to be compatible to the central government's priorities in environmental protection issues. This phenomenon signifies CoA and CoB's commitment towards achieving institutional legitimacy through public education and research. They have developed cognitive awareness of the environmental degradation in China as a result of their experiential knowledge accumulated over time. Thus, they are able to relate to the societal norms with regards to the citizens' view of environmental pollution.

### **6.1.4 Affiliation to Trade and other Professional Associations**

All companies are affiliated to the home Chamber of Commerce based in China and some are also affiliated to the European Union Chamber of Commerce in China, and are actively involved in working group meetings. Thus, it is expected that this relational network would tend to impact how the acquired information is being processed and used. For example, it could be used as a problem-solving tool to existing challenges that the companies might be facing. CoF exploits such network to discuss the human resource (remuneration, expectations, and challenges) trend with the home country's business community. Hence, the affiliation to trade and other professional associations will tend to result in organizational isomorphism (DiMaggio and Powell, 1983).

### 6.1.5 Operating without Relevant Licenses

The rules and regulations about business licenses are explicitly complex in China. They cause confusion and clarification of these rules and regulations is apparently a very difficult task. As a result of weak enforcement, CoB and CoE have not fulfilled all the required business license applications. In other words, they are technically operating with partial formal licenses (applied and approved) as per below quotations.

<p>MD of CoB</p>	<p><i>“Technically, we are in liability in breach, nothing we can do. No one is prepared to let everyone else knows that their department is not doing its job. This is an example of a way to getting around with regulations. We are waiting for it to happen as we don’t know when this will erupt. If you are in China long enough, people stop planning because they feel that there are so many things that could happen and I cannot plan for this, so I won’t then. Consequences are that you react.”</i></p>
<p>CRD of CoE</p>	<p><i>“As a project management and construction management company, we are supposed to have a license, which we don’t. No one has been fined, all our competitors are in a similar situation. No one is going to stop working. China is an example of: we have been doing this for years and they start to come up with we need license, but they do not say what the requirements are. China is like that most of the time. Nobody has come to our facility and say you can’t do this, we do not know of any of our competitors have done that. Until they start doing that, then we will buy a license.”</i></p>

These actions are isomorphic tendencies where both companies are challenged by obscurity in the rules and regulations. Thus, they have responded based on their experience and information received from their own network. They decided to “wait till something happens.” (DiMaggio & Powell, 1983). However, these isomorphic actions do not imply that the problem is resolved. Should the Chinese authorities exert more supervisory control on foreign companies’ licenses, the case study companies would face LOF since they are

“foreign” and would be susceptible to costly fines *“because they could afford it”* as evidenced by CoB’s experience.

#### **6.1.6 Adaptation of Products and Services**

Literature on the success of born-global firms shows a positive relationship between products adaptation and performance in foreign operations (Knight et al., 2003). Both CoA and CoB are experts in delivering turnkey projects to suit the needs of the market. CoA works with local actors to supply technology and equipment because imports will increase costs. The Chinese government’s policy shifted from manufacturing to technology in the early 2000s provided incentives for high-tech local companies to innovate (Wilson & Segal, 2005). Here, there is a spillover effect of such business development on the local supply chain. For example, CoB cooperated with new startups to integrate their ideas of innovation and technology (local) to the system design of waste treatment plant (foreign). The Chinese government promotes local innovation and technology. According to the RIM, this is not a threat but enhances cooperation between foreign and local firms. By integrating local firms into global standards would tend to enable MNEs’ green growth in China (Marquis, et al., 2011).

The most prominent adaptation of services is found in CoE (Tsai & Eisingerich, 2010). Firstly, it moved from being a cost management service provider to construction project management consultancy upon entering China. The core business in cost management control services began to diversify because of the growing needs of its global clients. According to the COO, *“They required project managers, construction managers, schedulers, and health and safety services for their invested facilities in China.”* The diversification was an immediate decision in response to the needs of the global clients even though CoE did not have the expertise then. The COO said that *“I realized there was a gap in service provision in Shanghai and there was opportunity.”* Secondly, the operation in China led to an accumulation of industry-related knowledge. Thus, the international managers were able to identify a business gap in environmental-related services. As stated by the CRD *“they don’t want inefficient facilities. They want very clean, very high standard of operation at very high efficiency at low operation cost. And that kind of gave us the confidence to talk to developers...”* As such, the Sustainability

Business was created about 10 years ago. According to the HOS, *“It is a business potential. We go back to our existing customers and introduce them this service. We will advise them on overall efficiency to comply with environmental protection requirements. It is slowly developing.”*

CoF’s production facility in China only produces burners that are suitable for the boiler companies i.e. the bigger boilers. As a result of the cross-strategy of matching production to the needs of China, production efficiency increases. Thus, inventory management of the finished products is low. However, customized products for specific customers in China are produced in Finland because the Chinese technicians do not have the expertise. Adaptation of products to the needs of the customers (Andreosso-O’ Callaghan & Qian, 1999) implies CoF’s effective marketing strategy of customers’ satisfaction that leads to opportunity in increasing financial performance. This is evidenced by the steep increase of revenue from the share of product customization since 2011.

## **6.2 Exploit Firm-Specific Assets (FSAs)**

### **6.2.1 Brand, Heritage, and Quality**

All the companies possessed extrinsic qualities that differentiate them from the local competitors when they entered China a few decades ago. These extrinsic qualities were the AOF that compensated for the ID (Sethi & Judge, 2009) upon their initial entry into China.

The experiences of these companies suggest that LOF can be different for companies in similar industry, and LOF is different for different foreigners (Chen et al., 2006). As far as the extrinsic qualities are concerned, they are highly contextual. In the case of CoA, these qualities (brand, heritage, and image) were the LOF that impede its entry into the municipality market. However, the same extrinsic qualities (AOF) got them invited by the local government to directly invest in a waste incinerator plant (second) in its industrial market; 2) it was requested by a local government to expand its existing plant by adding a 3<sup>rd</sup> incinerator line because of the increasing level of hazardous waste within the city.

These two examples highlight the fact that local governments have the power to make autonomous decision that is largely influenced by the way they perceive foreign

companies. In other words, their perception is impacted by the level of intimacy and interaction that they have with the foreign companies. Hence, reducing the normative and cognitive distance by increasing local governments' perception of foreign firms through intimate interactions is a strategy to overcome LOF.

CoA institutes training for ministerial personnel conducted by the local employees in Chinese as a strategy to increase communication flow and build relationship with their institutions. Chinese value training programs because the outcome is increased familiarity with operation of equipment or procedures (McGuinness et al., 1991). This is also evidenced in CoF's strategy in equipping its distributors with extensive knowledge about the technical operation of its burners supported again that the Chinese It has a training centre inside the production facility. It consists of mock-up equipment for training demonstrations. Organizational legitimacy is achieved by establishing relationships with formal (Feng & Wang, 2009) and informal institutions (DiMaggio & Powell, 1983).

Building on a strong brand name would tend to promote visibility to consumers and thus reduce the risk exposure of foreign firms as asserted by Puck et al (2013) but their empirical evidence did not support this. However, it is found that CoA's visibility to consumers (Chinese citizens) impacted positively to enable CoA to obtain its EIA approval necessary to construct the 3<sup>rd</sup> incinerator line to its current plant. The Chinese government advocated public participation in the EIA process. As a result, CoA did not experience difficulties in obtaining the approval because it was granted within reasonable time limit of 1 year. For other companies, the process took longer. As stated by the PM *"Last year, many projects in the municipality could not continue because the public said no and the government stopped. They did not get the EIA approval."* The statement made by the PM suggests that the home-based advantages of the local firms did not increase the LOF of CoA (Nachum 2003). Moreover, the PM stated that *"A lot of people supported us in doing this"* is a conferred legitimacy by powerful authorities (Archibald, 2015) that recognize the significance of CoA's investment has an impact on reducing environmental pollutants. This also indicates that local firms which are weak in EIA compliance, will not have immunity from the newly revised environmental protection law, thereby placing local and foreign companies on a level playing field. As a result, the unique assets of

foreign companies tend to become more salient when compared to local companies that are inexperienced in containing environmental pollutants.

Local governments from remote regions are less open. According to the PRM of CoC, *“they still stay in traditional mind-set, are more difficult to deal with.”* Hence, challenges faced in the communication process are more compelling. However, the overall relationship with the local government remains good. The PRM is confident that the communication barrier can be easily overcome by the FSAs. He said that *“I am confident with our assets and services we have no problems in dealing with them.”* The relationship between the CoC and the central government is slightly distant. The AD said that *“We work behind the scenes most of the time.”* In section 6.9, we discuss the strategies used by the case study companies to reduce this “distance.”

### **6.2.2 Technology**

There is also evidence that owning a technology is a superior advantage (Andreosso-O’Callaghan & Qian, 1999) because China needs technology to fight pollution. CoF’s superior advantage in environmental technology is a competitive advantage that has become more salient over the years of operation in China. The GM said that, *“We really got noticed (everyone knows us here) over the last 6 years. In China nothing happens quickly.”* In other words, it took CoF almost 20 years to be socially recognized as an innovator in environmental technology by the industry and by the local institutions such as local governments and MEP.

Local competitors have not been able to produce substitutes of equal or better quality. As a result, the AOF in terms of a trusted brand and superior technology is a lever to gain greater legitimacy. CoF is officially recognized by the MEP to help in meeting the goal to reduce NOX emission from burning gas to 30mg per cbm (to be enforced in January 2017). It is apparent that the extrinsic qualities of companies tend to go through a cycle of superiority and neutrality vis-a-vis the changing conditions of market demand and the perception it has on foreign products and services. Pollution has become a national problem. Thus, there is a deeper commitment to eradicate it. The commitment is also embedded into China’s FYP. Thus, inaction is not allowed and would be deemed as

“losing face in front of the world” on the part of the Chinese government. CoF is benefiting more than the rest of the companies because its products and services have the greatest (immediate) impact in reducing pollution in China. Thus, it has less competitors at this early stage to compete with. All R&D activities are kept in the parent company in Finland to safeguard its technology (Williamson, 1981; Gatignon & Anderson, 1988; Guillen, 2003) and prevent IPR issue in China as stated by the GM *“All R&D are in Finland. Most Europeans companies do not bring R&D here because of copying.”*

Apart from CoF, the rest of the case study companies do not own any technology. Thus, they do not have many IPR issues. Since they are involved in designing system that integrates process to equipment, they ensure that their creative innovation is always evolving in order to preserve their brand superiority. However, CoB has been involved in an IPR issue that has become a court case. Its system design technology was copied and the case was brought up to the jurisdiction to resolve the patent infringement by the Chinese company. The legal system in China has become “quite developed” as stated by the RIM. However more foreign companies are learning to play the games to get around the legal incompatibilities with their home country. The RIM has further stated that *“usually when we sign an IP agreement we try to take a 3rd party legislation, for example, IP agreement with a company in Korea, but we use a HK legal system. You have to learn how to use the different legal environment. We are getting there.”*

### **6.2.3 Global, Regional and Local Networks**

Companies that have global and regional networks have been exploiting them effectively to “springboard” their entry to China and subsequently impacting the LOF faced. This is evidenced from CoA, which has lesser “discriminated experience” in terms of its interactions with local EPB and the local government because of its local network. Furthermore, being inside the local network (local alliance) has resulted in building a 3<sup>rd</sup> incinerator line on an existing waste treatment plant that is 50% owned by the local partner.

CoB has a different experience. Deducting from the statement from the PRM, *“the most important difficulty is we do not have the relationship”* it reinforces the view of the BUDI

from CoA which exerted that “*local guanxi is very important in our industry.*” It is clear that relationship is paramount and there is a lack of relationship building from CoB’s business process. In this instance, CoB is showing more LOF experiences because it cannot get into the institutionalized network. CoA seems to cope better. Lesser challenges emerged from the interviews with CoA.

When the ex-pat management decided to start the sustainability business in China to service the local business community, a local manager was hired. This was because the British managers had limited relational experience due to language barrier. They did not have *guanxi*. The sustainability business is purely for China and hence it needs a local Chinese to head the business to reduce the LOF. Moreover, the HOS admitted that “*I started my own personal network and also brought in my personal network when I joined this company five years ago. I travel everywhere to all cities to meet existing clients to check on their needs. Sometimes even just to talk to them about their business. If we have new project, I will introduce our retrofit and commissioning services to them. I also meet new clients that we get from our developers’ network.*” According to the HOS, the industry is very small and people remember or heard about each other very quickly. Some people knew each other since college. Having good relationships with local developers is very important, as they are the source of new projects.

CoF uses its local distributor network as a point of contact to the end industrial users. The distributors are a reflection of the same corporate image (ethical, good customers’ technical and follow up service) as CoF. By having good distributors, CoF avoids the costs resulting in the duplication of similar services to the end users. The LOF between the distributors and the end users tends to be lower because of a narrower normative and cognitive distance. As such, the distributors have the capabilities to address their problems better than CoF can.

Contrary to the findings of Kumar and Worm (2002) that negated the value of the interpreters because the Chinese were preventing the flow of critical information through the interpreters, the Chinese-English interpreters help to narrow the normative and cognitive distance between the Finnish managers, the local distributors, and end industrial

users. Moreover, CoF also reaches out to the end industrial uses by visiting them frequently to narrow the distance in relationship.

#### **6.2.4 Learning and Experiences Gained**

Inter-subsidiaries communication network is an effective linkage to understand and share the relational hazards (Eden & Millar, 2004) in communicating with local teams. Thus, it also enables problem solving (Johanson & Vahlne, 2009). In the case of CoA, inter-subsidiaries communication network has deterred its decision to localize the GM of the plant (the Water subsidiary's management had communication problems with the local GM). Thus, it is able to prevent the incidental costs that might arise from localizing the GM too early (Sethi & Judge 2009). On the other hand, the BUDI's decision is also influenced by his own relational experiences with the Chinese external institutions. As such, he is able to absorb and interpret the information received effectively more than anyone else that does not have the same experiences (Pedersen & Petersen, 2002). This could not have happened if CoA had to follow the organizational doctrine from home were it to insist that the GM be localized to save operational costs (Stevens & Shenkar, 2015).

Relational hazards are organizational costs arising from business transactions (Eden & Miller, 2004). It is apparent that CoB's relationship with the institutions is weak as it experiences more LOF compared to CoA. The foreign MD in CoB used local employees to deal with customers, as they are well positioned to "challenge and argue" with them because they are able to understand each other's nuances. This also helps to avoid "losing face" if the foreign MD turns down any request for monetary rewards in exchange for getting work done.

Foreign companies choose survival over legitimacy when the opportunity arises to participate in high-level projects with the government which has a direct impact on the public. CoD chose to protect their expertise in not participating in PM2.5 measurement due to severe consequences as stated by the FD *"firstly, if our figure shows 300, but government reports 50, who is right and who is wrong? Such a discrepancy, why would the companies believe in our measurement? Secondly, I cannot control how our figure is used by the companies. If they argue, we are finished."* Apparently, no other international

companies participated in the project, added by the FD, *“foreign companies have become smarter now as they have local managers who know the local market very well and could offer good advice on local projects undertaking”*

Learning and experiences gained are not necessarily tools that would lead to internalization. For the case of CoF, it has gained rich experiences in China after 25 years of presence. However, it prefers to continue exploiting the distributors’ network to reach out to its end industrial users to distance itself from their operational problems that could be better solved via its distributors. It chooses to harness stronger relationship with these actors and stay committed to them using a win/win strategy. The GM stated that *“We want to have our distributors and it will not change. In China, not all the business is honest. No foreign company wants to be in dishonest business. For us the best way is the distributor will order from us and handle the sales. Everybody knows about the corruption stories, we don’t want to know about it and get involved in it. I think 90% of the companies doing biz with the boiler companies, they deal with their problems we give them technical support but business part we don’t want to get involved in their business.”* Similarly for CoA, it chooses to use local partners in projects even though it is not mandated by the Chinese government.

Although most companies agreed that the anti-corruption campaign is welcoming to their business, corruption still exists in the private sector and at lower levels of government. CoB has to deal with corrupted behavior in their interactions with different local government. Thus, it has learned to adapt to indirect practices accordingly (so as to get things done) as long as it does not violate the corporate policy and the EU policy on corruption. CoF chose to avoid the experience by working directly with the distributors. CoE is aware of “corrupted practice” in the HR system, but prefers to “let it be” as long as it is not severe. It also chose not to be involved in “fitting out” projects because corruption is rampant involving well-connected Chinese companies.

### 6.2.5 Good References

All case study companies mentioned unanimously about having good references in their project executions as a competitive advantage. They are the opportunities for future growth and expansion. The respective examples are:

PM of CoA	<i>You can have people that call us because they know that we have a referenced plant in Shanghai, and say ok we have a need, we want the same for our city.”</i>
RIM of CoB	<i>“Our references abroad help us to defend our brand and expertise.”</i>
PRM of CoC	<i>“Landmark projects that we won from international competitions differentiate us from competitors.”</i>
FD of CoD	<i>“PM2.5 is a hot topic at the high-level but we do not want to get involved. It is our expertise but we said sorry, we do not have the expertise.”</i>
COO of CoE	<i>“If we can demonstrate that your expertise on 1 or 2 case studies and roll it out to other sectors or ceramic tiles providers, there are quite a few in Guangdong, efficiency will go up. Our future is to look at the share of the service.”</i>
GM of CoF	<i>“We have achieved the number 1 brand in China and get quite good references that we can use on new customers, a start for them to think about us a little bit.”</i>

### 6.3 Exploit location-specific advantage

Proximity to local government and governmental agencies is a strategy used to diffuse the distance and increase the presence of foreign companies. Hiring local people in the respective province is the key to reduce unfamiliarity as they are culturally-closer to the

local government. From the LOF perspective, it tends to reduce the perceived distance that the local authorities might have on foreign firms. Similarly, CoF chose to locate in Wuxi to be in the biggest market for industrial boilers. Furthermore, being near to the biggest Finnish community in China enhances the flow of industry and HR information. This is similar to the concept of psychic distance. It also creates entry legitimacy (DiMaggio & Powell, 1983) for firms from the same country but in different industries to operate as WFOS (Li et al., 2007).

CoD moved from Beijing to Shanghai in 2002. The FD stated that *“we saw the opportunities in Shanghai and thus moved our operations there. A lot of FDI came to China and we benefited from it because of due diligence (our services) was required before setting up manufacturing plants in China. There was a big market for our services. In 2000, we had 5 people and our maximum staff strength was 80.”*

Local offices (CoC and CoD) in different locations in China have their own networks with local government. Projects awarded are mostly by “word of mouth” recommendation within business networks. The extent of LOF tends to reduce as the experience and knowledge gained are integrated into the operational process. Local employees are encouraged to visit other regional cities to work and build closer ties with people within the networks. Personal networks were harder to establish especially for non-locals starting to work in China.

#### **6.4 Exploit local and home institutions**

CoA invested in designing local training programs to educate the MEP officials about hazardous waste treatment is a strategy to build relationship. As stated by the BUDI, *“By far MEP is the most important institution for us. It is a regulator.”* CoB’s CEO of China is a French of Chinese descent. His bilingual skills and experience in the local industry narrow the normative and cognitive distance between the local institutions and the subsidiary. A high-level case relating to corruption, CoB had to seek intervention from the French Chamber of Commerce. Two engines were not allowed to operate because they have to be reviewed by the government for approval of operation. In this case, a review had been denied unless CoB acceded to pay a substantial financial sum to one of the

government officials. The case was resolved quickly by the Chinese so as to be removed from the agenda of the imminent visit of the French Environment Minister (FEM) to China. The MD stated that *“he held it up for 2 years and in 6 hours I got approval, a day before the visit of the FEM without incurring a sum of RMB 500 million as he previously demanded.”*

High-level connection between home and local institutions is also evidenced in CoC and CoF. The former uses it to gain socio-political legitimacy (Feng & Wang, 2009) to let local institutions be aware of its presence because of lesser incidence of interactions with them. The home country institutions in Finland have various authorities that promote Finnish Clean Tech companies. They have formalized agreements with the local institutions to promote R&D and innovation cooperation in protecting China’s environment. Thus, CoF exploited diplomatic ties to promote heat-pump technology in China. Again, “good reference is mentioned by the GM, *“this is our first reference here in China, after that we are planning to expand the ground source heat system in China...”*

Although the MEP is not part of CoC’s direct customers (unlike CoA, CoB, and CoD), it is important to be recognized and be accepted as a trusted foreign company by powerful institutions such as the MEP. Establishing such contact is done indirectly. Firstly via projects on environmental sustainability financed by the international institutions such as the World Bank (WB). Secondly, it works via projects which have been assigned to Chinese Research Institutes by the MEP. The most powerful institution is the National Development and Reform Commission (NDRC) that has administrative and planning control over China. Interacting with NDRC is relatively more difficult as compared to other Chinese ministries, according to the PRM. This is supported by the Counsellor from the Delegation of the EU in China, basing on the diplomatic level experience between the EU-China. However, CoC believes that it can circumvent this obstacle because of its established reputation in the Chinese environmental protection market.

CoE has good connection with an investment funding organization that is government-owned. This connection is important to its sustainability business. There are a lot of behind the scene investment bodies owned by the government which are not publicly known. Yet, they are the key driver to grow the sustainability business in China. Hence, CoE has been

diligently building its local network to gain access to these “secret” government owned investment bodies.

The development of the new business in the area of improving processes in old manufacturing facilities in the South of China, is a result of business intuition. CoE’s business grew along with its industrial clients, and they knew that there were many HK investors who had invested in a lot of manufacturing facilities. They also knew that the processes are too outdated and no longer sustainable as China has been moving towards sustainable growth.

As the COO put it, *“we knew in Guangdong there is huge manufacturing and somewhere there is a funder or investor who is prepared to give money for energy efficiency initiatives. We contacted State Grid of Guangdong and starting talking to them.”* From their discussion, CoE found out that Beijing had come up with a noble initiative of funding projects that can reduce Guangdong’s energy consumption by 10% annually. It is a challenge to Guangdong’s State Grid because its energy consumption has actually increased by 10% per year. CoE performed an investment grade audit and the feasibility results were presented to one case company. If this project is accepted by Beijing, the case company will receive funds from the Guangdong State Grid for project execution and implementation. Finally there will be a roll out to the rest of the manufacturing facilities in Guangdong. This means that CoE would be getting a good reference because it has pioneered this initiative.

As far as the relationship with MEP is concerned, the operation of CoF does not fall within the tight scrutiny of the MEP as much as the waste management companies. For example, the local EBP is located inside the compound of the waste treatment plant. For CoF, the MEP officials will inspect the production facility once a year. It does not face discriminatory treatment during the inspection or in daily operations. However, it is very important to build relationship with the MEP in Beijing for strategic reasons.

The BDHC has direct cooperation with Beijing EPB, has been a client of CoF for over five years. As a result of this 3<sup>rd</sup> party relationship, it had led to a discussion with CoF to find a gas combustion solution to help Beijing to reduce its Nitrogen Oxides (NOx)

emission for gas-fired heating plant from 100 mg per cubic meter (cbm) to 30 mg per cbm. CoF has been supplying high quality burners that emit 100 mg per cbm to the BDHC. As a result of the new objective set by Beijing, CoF has undertaken a hefty financial commitment to invest in a product and development project for the BDHC. It has ordered three burners. The first boiler in the production facility has been commissioned successfully. Commissioning is the process of installing the burner into the boiler, pulling the automation together and then running the boiler. An external inspection company validates the testing of the equipment and its emission before approving that everything is order. No other burner manufacturer has the same level of technology as CoF. This is because it is not only difficult to achieve a 30 mg per cbm, it also requires huge financial resources. There are not many burner companies in the world that have burners that combust gas with NO<sub>x</sub> emission level of 60 mg per cbm.

CoF has very good relationship with the landlord of the premises which is owned by the local government. The same landlord has helped CoF in relocating its office and production facility to the newer and bigger premises. Furthermore, it is already building a new production facility back to back with the existing facility. This is to facilitate expansion of the future heat pump business. It has utilized the resources provided by the home country institutions to promote its business in China. For example, the Team Finland network connects Finnish companies operating abroad with the respective actors in the host country. CoF has cooperated with Tekes, the Finnish Funding Agency for Innovation, the Chinese Ministry of Science and Technology (CMOST), and another Finnish company specializing in indoor climate system. The objective of the joint cooperation is to find the optimal technology for ground source heating system in China. It is CoF's first high level reference project in China. The success will help to legitimize its ambition and goal to develop its heat pump business in China. It will enhance credibility of CoF's technology that will help finding good distributors who are willing to promote its heat pumps.

## **6.5 Conclusions**

From the above analyses, exploitation of FSAs and adopting to isomorphic practices were found to be effective strategies to cope with the LOF faced by most case study companies that are operating in a highly regulated sector. Most companies emphasized their superior

knowledge and networks. These could be considered to be an asset of foreignness (AOF) (Sethi & Judge, 2009). The companies studied were more experienced in EP compliance than local actors and were recognized as such. The local companies/government responded to this expertise of foreign companies favourably and this undoubtedly reduced their LOF. Although all firms were aware that local competitors were emerging and they needed to constantly upgrade their capacities to retain their advantage.

Most companies adopted isomorphic practices to confront unfamiliarity and relational hazards. Most of them internalized local knowledge by recruiting and integrating a large proportion of local staff and training them in Western management and technical practice. Companies that lacked *guanxi* with institutional actors relied on local employees to resolve problems and they faced more LOF during inspection routines conducted by the EPB. Most companies learned that setting a record of “good reference” in the delivery of their products and services is an important link to future growth in China.

In defeating the discriminatory hazards, companies chose to focus on the market segments that would increase their competitive advantage and decrease their LOF. In theory, several companies could have requested their home states to pursue a case against China in the WTO, as there were clear cases of institutionalized discrimination against foreign operators, in defiance of WTO commitments. However, none had chosen this route. All considered that a less combative approach, based on local networking and proof of competence through experience, would lead to greater openness over time.

In overcoming relational hazards, all case study companies adopted organizational isomorphism with majority local employees and foreigners are mostly in managerial positions. Seeking the help of home based institutions to overcome LOF is a strategy to enforce cooperation by stubborn local government that tried to inhibit the operation in China. For case study companies that are distant from the most important institution (MEP), they gained access to them by using home based connection as well as leveraging the power of their customers.

The evolution of the EPL also indicates more opportunities for foreign companies’ goods and services to help eradicate China’s environmental problems. Several informants felt

that their patience was being rewarded and that the evolving institutional context was becoming more open. The new EPL aims to level the playing field and hence it is expected to reduce the LOF faced by foreigners in the EP sector. The recent anti-corruption campaign targeting governmental officials, also indicated that the Chinese government was serious about increasing governmental transparency. From the institutional perspective, the improved transparency implied that China was seeking to ensure that the rule of law prevails, thus moving closer to the context to which EU companies are more accustomed.

However, it must be noted that there are continuing problems, in spite of all the efforts to reduce the LOF faced. The mitigating strategies used are contextual in nature. This means that LOF is a recurring issue regardless of the tenure of the case study companies and the extent of their localization. Evidence from CoF's process of applying for a license to manufacture heat pumps in China is a case in point. While the case study companies have adapted to local organizational standards and practices, they are still vulnerable to LOF should there be an exodus of key personnel. As such, there must be concerted effort to balance employees' job satisfaction and social happiness. Again, effort and cost go together.

# CHAPTER 7

## CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

### 7.1 Conclusions

The table below summarizes the strategies that the case study companies chose in entering and operating in China based on the analytical/theoretical framework developed as illustrated in the methodology chapter.

*Table 7.1 Summary of the Strategies Used by Case Study Companies*

<b>The strategies used to enter China based on specific advantages</b>		
Global and regional networks Managerial experience and knowledge Relationship with an SOE Following clients		
<b>Causes of LOF</b>		
<i>Discriminatory Hazards</i>	<i>Unfamiliarity Hazards</i>	<i>Relational Hazards</i>
Unfair advantage	Impact of local governance	Impact of <i>guanxi</i>
Operational barriers	Impact of ambiguity in governance	Impact of networks
Prohibited and restricted market access		Impact of organizational learning and experience
Inward learning and experience of SOEs and local competitors		
<b>Strategies used to overcome the causes of LOF</b>		
Adopt organizational isomorphic practices Exploit firm specific assets (FSAs) Exploit location-specific advantage Exploit local and home institutions		

This study explored firms' strategies in internationalizing into China and their subsequent evolution in seeking to overcome their LOF in a context of high institutional distance using six comprehensive case studies. It has captured meaningfully the impact of industry-level relationships in the EP sector, the case study companies' decision to enter China and their subsequent expansions (Ghauri & Holstius, 1996). The case study companies are from developed economies with high LOF that sought to enter China for market seeking motives, despite a more unpredictable institutional environment in the light of China's transition to a market-based economy (Chen et al., 2006). The internationalization into China was a gradual learning process in relation to their organizational capabilities and meeting the needs of China (Petersen et al., 2008).

We found that all the case study companies deployed their OLI advantages effectively upon their initial entry, the specific O-advantage that influenced their decision to enter China was highlighted in the case studies. They are broadly in line with existing research such as prior network connections (Johanson & Vahlne 2009), managerial experience (Penrose, 1956), relationship with a SOE (Luo et al., 2011), and following clients (Fosgren, 2002). The exploitation of these resources impacted their entry strategies to gain the first mover advantage when China began to restore its economy through FDI to develop its infrastructure and technology. At the time of their market entry, two thirds of the case study companies had connections with HK partners. Half of the case study companies leveraged their accumulated experiential learning in HK, which influenced the speed of internationalization into China (Casillas & Moreno-Menendez, 2014) by following their clients (Fosgren, 2002). The rest formed alliances and exploited their business knowledge in entering China. In support of the postulation of the *Uppsala Model* that limited resources in terms of knowledge and experience are the drivers to the sequential process of internationalization (Johanson & Vahlne, 1977, 1990, 2003, 2009), it is found that this strategy is effectively used by a small case study manufacturing company (CoE) to strategically target China. It deployed sequential strategies (Johanson & Vahlne, 1977) to enter China amid the earlier presence of other bigger international competitors (Johnson & Tellis, 2008) and finally setting up a WFOS and a production facility as a result of acquiring knowledge and developing capabilities (Johanson &

Wiedersheim-Paul, 1975; Puck et.al, 2009). We found that the basic underlying assumption of loyalty and trust deepens as companies consistently engage their existing partners in mutual business development leading to sharing of risks and uncertainties in business expansion.

While Puck et al. (2009) highlighted how local knowledge impacted the change in entry mode, this study rather highlighted the importance of changes in China's institutions. As they became more developed, the case study companies changed their mode of operations in alignment to their corporate strategy to operate as WFOS in foreign countries where possible. However, strong relationship with institutional actors and possessing global and regional integrated networks were found to be an impetus to adjust corporate strategy to form local alliance upon initial entry to accelerate the learning experience in China. Such alliance had impacted developmental strategies in China as well. It is clear that all the case study companies have a long-term view of their business in China evidenced from their tenure and the anticipated positive outcome of the NEPL which is perceived by the case study companies as well as the foreign business community to increase their competitiveness in China (Porter & van der Linde, 1995).

Work on EMNEs had revealed that they developed important skills and capacities as a result of interacting with foreign companies in China, before going abroad (Luo et al., 2011). It has found that technology and knowledge transfer from foreign partners impacts, not only on Chinese companies who subsequently develop international operations, but also on their competitiveness on the local market, eroding the long-term advantages of foreign companies in that environment. This study has shown how developed local competitiveness became a daunting challenge and impacting negatively on the case study companies because of tighter competition causing an erosion of their competitive advantage. In addition, this study has captured the vulnerability of the case study companies' competitiveness as a result of the central government interventions through policies that favoured the local operators that increased their learning and experience, and the local government ambition to localise its partners and making foreign partner redundant.

In the context of LOF, all case study companies experienced to a varying degree, the three types of hazards highlighted by Eden and Miller (2004). Although institutional distance is the same (from EU to China), the LOF experiences were not (Gaur et al., 2011). They are inconsistent between companies. We see from CoF's experience that LOF has the capacity to resurface despite years of local presence, experience and relations with government. As a result, the LOF was context-specific rather than firm-specific. Based on the LOF theory that LOF should be on a diminishing scale overcome by firm's tenure as it becomes familiarized with local operations and thus, is more established and accepted by local institutions. The local institution issuing the manufacturing license for CoF's new product viewed CoF as a "new" foreign company. In the context of China that is relation-based, this could have been minimized if CoF has tried to negotiate and thus "soothing things out" rather than taking the additional demands at face value.

It is clear that inconsistent perception and enforcement of operating licenses persists across local government creating operating anxiety for the case study companies. This is reflected in the degree of asymmetry in uncertainty avoidance between the case study companies and China. The rules and regulations to acquire the proper licenses were not explicit in terms of implementation that created the ambiguity leading to difficulties in compliance. In addition, the local government had insufficient knowledge to see through the process. Due to the power asymmetry between the local government and the case study companies, on the one hand is the governing body and the complying body on the other, it implies that the latter has to be prepared that "things may change", thus taking the necessary steps to ensure that they would not be impacted drastically by the "change". It is interesting to note that knowing that other foreign companies are in the same fate moderates the level of operational anxiety parallel to the concept of *mimetic isomorphism resulting from standard responses to uncertainty; and normative isomorphism, associated with professionalization.*" (DiMaggio & Powell, 1983: 150).

However, discriminatory hazard is the most persistent institutional hazard faced that impacted growth opportunities. This hazard that is consistently faced by the case study companies attest to the extent of institutional weaknesses and voids that exist in China. This forms an institutional gap between the EU and China. Many observers consider this

gap to have been a key motivation for EMNEs' expansion to developed economies, in order to benefit from their stable institutional environment (Luo & Tung, 2007). Despite the institutional gap, the case study companies were able to target specific market segments to sustain their operations and remain optimistic towards China, especially there are many opportunities arising from the development in the western region of China. It was also apparent that practical hazards arising from an institutionalized network that favours the Chinese are difficult to predict. They are not stated explicitly. In addition, as prior literature suggests, discriminatory hazards were often the most difficult to overcome, involving a complex combination of local networking, well-chosen local partnerships and leveraging superior knowledge/experience.

The case study companies consciously chose not to adopt a confrontational, legalistic approach by challenging the discriminatory laws or practices (Marquis, 2011). There was a general feeling that a constructive strategy, based on increasing local embeddedness through partnerships and networking, together with leveraging superior performance and knowledge, would overcome discrimination in time. Hazards like delays in licensing and excessive vigour in inspections were irritants, but did not undermine the business case for developing the Chinese market.

The recurring issue of “no recourse” to legal redress had emerged from majority of the case study companies. In an interview with a Legal Firm they highlighted that their advice to foreign firms has been to take collective (rather than individual) action and address such discrimination to higher levels of authority and/or the Chamber of Commerce, which have greater leverage to deal with the government than business. They agreed that addressing such issues alone “*will not work*” because companies “*do not want to damage relationship with the government and don't want to affect relationship with the Chinese partner.*” This reflects the “fear” that the case study companies had if they were to pursue “recourse” strategies.

The extent of interactional challenges varies in accordance to the economic development and the inter-cultural experiences of the provinces. Thus, it is unrealistic to generalize that institutional hazards are homogenous in China. This study has shown the challenges faced

in interacting with multilevel government (EPB officials) and the strategies used by CoB to resolve ambiguous regulations in a western province.

This study shows the importance of *guanxi* that has a significant impact on easing operational difficulties caused by institutional weaknesses (Hitt, 2016), expanding operations, and reducing LOF over time. All case study companies adopted organizational isomorphic practices to establish legitimacy to overcome the LOF. *Guanxi* is the driving force to develop the sustainability business for CoE. It hired a Chinese to establish networks with the business community as the European managers do not have the advantage of cultural-proximity. A good strategy by engaging in international projects committed by home and local institutions yields good outcome in recognition and acknowledgement by local institutions especially when foreign companies do not have direct contact with these institutions making it difficult to establish *guanxi* as in the case of CoC. Indeed, home institutional support is instrumental to business development in China. CoF could not have accelerated their heat pump launch without the active participation between Tekes and CMOST. Most importantly, macro level participation increases firms' legitimacy especially in launching new products. Furthermore, external collaborations in R&D with the government universities (CoA and CoB) provided a window to learn about the government priorities in environmental issues and aligning subsequent R&D projects as such. In a way, it helps to develop *guanxi* with the government as well as strengthening the political connections with government representatives.

Although the management team in case study included many foreigners, the general culture was felt to be Chinese. This indicates that managerial influence had not weakened the Chinese culture in their subsidiaries. It was necessary to retain the Chinese culture to secure legitimacy when interacting with local institutional and economic actors. This was especially critical for companies that did not have institutional relationships, as we have seen in CoB. However, we see another importance in higher level intervention at a macro-level when CoB experienced an impasse from the local government about its engines. It goes to show that having a good macro-level relationship would not only yield dividends

on a macro-level, it also has good firm-level outcome. In this instance, the impasse was dissolved immediately.

All case study companies shared the same general sentiment that the local competition was becoming more intense. To circumvent the situation, all agreed that they were constantly upgrading their capacities to retain their competitive advantage. In addition, new competitive advantage can be developed through experiential learning, evidenced in CoE's expansion into the sustainability business. The COO was able to connect the industrial gap between their clients and the funding from the local institution. It was developing its new competitive advantage of sustainable processes that can be used to serve their existing clients to reduce their energy consumption imposed by the local institution. On the other hand, CoF's *guanxi* with a big client in Beijing connected it to the MEP to develop further technology to ease NOx emission, thus creating a new competitive advantage. We expect this to be a sustainable competitive advantage as no other foreign or local competitor is able to meet the NOx emission standard set forth by Beijing. This new business development indicates a narrower institutional gap because both parties shared common values of urgency to resolving the severe pollution in Beijing in the long term.

In terms of the current business climate, all case study companies viewed China as a growing market and are reaching out to 2<sup>nd</sup> tier cities and beyond. Possessing technology and innovation capacity is a clear advantage (Knight & Cavusgil, 2004) in China as the central government has shifted to green growth (Marquis et al., 2011), a shift that will eventually be rolled out to all cities in China. China needs technology and innovation to eradicate its environmental problems. However, it is apparent from our findings that it is getting more difficult for new entrants, in particular smaller foreign companies, to enter the Chinese market. According to the GM of CoF, such difficulty can be eased by home country's government. Their LOF will be greater because of insufficient funds to collect market information. They need home country institutions to reduce costs in acquiring market knowledge. The CRD of CoF's experience was that during China's industrialization period, there was less "policing" because FDI was seen to benefit economic development. For example, equipment used in manufacturing plants then were

less environmentally friendly. It did not matter then. Now, EIA is compulsory before any construction can take place and processes and equipment must satisfy emission standards. The MD of CoB felt that owning IPR is important to survivability in China. His experience was such that the government was more ‘friendly’ to him because it had the competitive advantage that the government needed.

The new EPL and the aggressive on-going anti-corruption campaign undoubtedly reflect China’s commitment to combat pollution and aligning its home business code of practices to be ethically compatible to international standards. These changes have been viewed as positive and welcomed by the case study companies which have more experience in environmental protection compliance than local actors and were recognized as such. It indicates that institutional hazards could be reduced over time as China’s modus vivendi and modus operandi become more attuned to the international community.

The case study companies have between 12 and 21 years of experience in China which means that their strategies have evolved in tandem with China’s industrialization stages that have spanned 30 years. Although, it indicates their resilience in the wake of the uncontrollable challenges faced in a highly regulated and protected sector, it does not mean that their LOF has been reduced in accordance to their tenure. We have elucidated how their FSAs have become less salient as a result of unfair business practices that alienated foreigners or making their existing operation redundant, inward learning and experience gained by the local operators such as in the mining industry that prohibits foreign participation, discriminatory practices that restrict foreign participation in the soil remediation and owning a building license.

## **7.2 Contribution to Theory and Practice**

This study has shown that, contrary to existing theory, LOF does not always decrease with learning (Pedersen & Petersen, 2002) and experience (Zaheer & Mosakowski, 1997). The case study companies’ AOF that was vital to entering China and overcoming initial LOF has become less salient over time resulting in increased LOF as the AOF became weaker. Based on the evidences of the LOF experienced by the case study companies and their unanimous acknowledgement of the Chinese government’s efforts in protecting the EP

sector as well as the local actors, it is apparent that the case study companies were operating within a strong institutional entrepreneurship context, regulating the EP sector to prevent foreign competition on the one hand, and nurturing local actors' capabilities on the other. Thus, developing the local actors' FSADs (Marinova et al., 2011) in this case, to the equivalent of the case study companies.

The trajectory of the internationalization process of firms from developed economies to emerging markets (EM) leans on the assumption that these firms possess distinctive FSAs and have the ability to exploit them to enter EM. However, these FSAs were also assumed to overcome the LOF manifested by weaker regulatory environment and higher normative and cognitive challenges. In this study, the normative and cognitive challenges in the Chinese environment were moderated by adopting organizational strategies such as using local workforce, or entry and developmental strategies such as exploiting international networks. However, the magnitude of the regulatory challenges in the EP context was evidently difficult to codify in practice. The increased normative and cognitive learning and experience gained were expected to reduce the LOF over time. The salient host country-specific advantages i.e. the role of the Chinese government as a regulator, had undermined their learning and experience somewhat and we see evidence that LOF has increased over time as a result.

On the other hand, there is distinctive evidence to support the vulnerability of the case study companies' AOF caused by inward learning and experience of local firms in the case of CoB, CoC, and CoD. CoB had to handover the operational management of its best landfills to the government 13 years ahead of contract expiry. CoC's technological design was threatened and exposed to misappropriation by the local design institutes which become the compulsory "middlemen" needed to complete CoC's projects. The knowledge that CoD had is now learned and even advanced by local competitors. As such, the competitive disadvantage of local competitors at home and abroad has reduced (Marinova et al., 2011). This observation is supported by studies of the rapid expansion of the Chinese companies in the EP sector in China and abroad (Campillo & Foster, 2008; Zhou & Wang, 2009; Gaur, et al., 2011; Marinova et al., 2011; Ru et al., 2012; Liu & Goldstein, 2013; Tan et al., 2013; Platzer, 2015; Quitzow, 2015). These studies find that, in China, the

technological expertise of local companies has grown rapidly as a result of a combination of factors, including licensing by original equipment manufacturers (OEM), R&D subsidies, FDI, TT and local content requirements, as well as a growing worldwide demand for solar and wind installations in the sub sector of green energy. Cheap financing at home has created home grown EMNEs that increasingly invest abroad to acquire strategic assets through JVs, acquisitions, licensing and green-field investments. All of these evolutions have strengthened the local EP sector's competitiveness.

The tenure of foreign firms should increase the case study companies' legitimacy, because the host country tends to become familiar with their products and services that generate recognition and tend to lead to acceptability (Zaheer & Mosakowski, 1997). This is not the case for the case study companies. Moreover, the argument that such legitimacy would tend to lead foreign firms to expand into products in which they have lesser competitive advantage (Zaheer & Mosakowski, 1997), does not always hold either. For example, CoF experienced LOF when it applied for a manufacturing license of another product for which it has competitive advantage in China. The company has been in China for over 20 years and was just about to introduce a competitive product, yet it faced difficulties due to its "foreignness" in the application process. This implies that the superiority of the new product carries little weight to overcome the LOF. However, if CoF had had local networks that connect it to relevant institutions, such difficulties could be reduced. This evidence reiterates the above assertion that networks and relationships are sustainable competitive advantages, leading to a reducing effect on LOF over time.

This study has elucidated that in practice, LOF does not always decrease over time when the pervasive environmentally-derived LOF of foreign firms accelerates the transformation of the FSDs into FSADs of the local competitors supported by a strong local institutional environment. In this context, the environmentally-derived LOF has an impact on firm-based LOF derives from firm-characteristics including ownership, FSAs, learning and network based linkages such as affiliation to a business group (Marinova et al., 2011). The AOF relating to the FSAs of this particular group of companies in a particular (relatively skill and technology intensive) sector. This study shows that this AOF is vulnerable in the Chinese institutional context. Evidence from the case study

companies confirms that concerted efforts must be made and indeed have been put into place to protect and constantly develop their AOF during their tenure in China. Despite a reasonable tenure in China, the LOF has not decreased but increased over time. This runs contrary to existing theory.

This study has illuminated several factors that led to the varying degree of challenges the case study companies faced in protecting their FSAs in a strong institutional environment and thus, creating CSAs for local actors causing the case study companies to be vulnerable to LOF. Their capabilities were developed by the Chinese government paternalistic governance leading to the metamorphosis of the locally weak competitors into “globalized” competitors. In this instance, if all else remains constant, in a level playing field of minimum governmental intervention, we would expect the case study companies’ AOFs to remain competitive in reducing their LOF over time. However, existing processes were easily codified and highly susceptible to copying by local partners because learning had taken place leading to opportunistic behaviour resulting in duplicating the same processes from one of the case study companies for the benefit of local companies. Local competitiveness is strengthened by government policies requiring local institutional actors to be part of foreign entrants’ value chains, as well as prohibiting the participation of foreign investors in certain sectors. The policies remained unchanged from the time the case study companies entered China creating an environment for local actors to acquire foreign knowledge that slowly eroded the FSA of the EU companies over time. Although possessing technology and innovation is considered to be a superior advantage (Knight & Cavusgil, 2004), they are also subject to copying albeit at a smaller scale and slower speed as they require more costly resources.

On the positive side, FSAs such as international networks and relationships have proven to be sustainable competitive advantage that ease market entry and overcome operational difficulties, reducing LOF over time. Such FSAs are gained experientially requiring time to develop and nurture them making it more difficult to codify and imitate. In sum, foreign companies tend to lose their FSAs in an environment that is framed by government policies that promote local actors. At the same time, foreign companies have learned to be vigilant, upgrading technological know-how and improving processes.

In conclusion, existing research focuses on learning and experience as the means contributing to the diminishing effect of LOF over time. This study has advanced our knowledge on how the firm-based AOFs were impacted by the driving force of the Host Institutional Environment in a specific sector. Empirical evidence confirming AOFs to be instrumental in reducing LOF, but there is a lack of longitudinal analysis of sustainability of the initial AOFs used to enter foreign markets, over time. This study notes that AOFs became less salient over time and addresses the questions of both the reasons for this evolution and whether there were any mitigating strategies available. It highlights the metamorphosis of the Chinese FSDs into threatening competitors competing ferociously against the case study companies because of favourable institutional entrepreneurship (Gaur et al., 2011; Marinova et al., 2011). Existing research tends to imply that while learning and experience are important tools that firms may develop, to defeat LOF, it is critical to be aware of the vulnerability of AOFs that could make reducing LOF a daunting task especially when increased LOF is related to the Host Institutional Environment. As such, a critical contribution of this study has been that it has advanced our knowledge that LOF has increased over time as a result of the Host Institutional Environment. It highlights that the initial AOFs used to enter China were eroded, leading to an increase in LOF over time. Moreover, it would be wrong to expect that a company's success and high recognition in foreign markets would reduce LOF. Within the LOF theoretical context, further research is needed to assess the dynamics of a company's AOF within its operating and contextual environment. It is clear from this study that the contribution of AOFs to a company's competitive position evolves in concert with its environment.

### **7.3 Limitations**

This study is based on only six cases and the shortcomings of studies based on relatively few cases are self-evident. All case studies are European companies that have internationalized into China which may be a limitation as this may be biased towards those who have already managed to (or managed to learn how to) overcome LOF. The author believes that such work can nonetheless complement the many existing quantitative studies, to provide an overview of the longitudinal process of firms' international expansion, based on a theoretical framework comprising internationalization and

institutional theories. Through face to face interviews, a deeper understanding of entry and development strategies has been gained, the types of LOF faced due to institutional dissonance between the home and host country contexts have been illustrated, and the coping strategies used to overcome the LOF illuminated. In addition, all the companies are rather important actors and have been in China for many years. Thus, they bring extensive knowledge of the context and difficulties to this research. Finally, in spite of operating in rather different sub-sectors, there was a lot of commonality in both the LOF experienced by our case study companies and the strategies they used to cope. This coherence helps to validate the legitimacy of our findings.

#### **7.4 Future Research**

A wider range and depth of case studies would certainly help to confirm and extend these findings, as would more in-depth research on the firm-level and institutional contexts within which these firms interact. Investigating the parent companies of the actors in this research would also add a new dimension in understanding their strategies and implications in similar markets. The LOF faced by the companies could not be explored further with the relevant local institutions, due to difficulty in gaining access. This underlines the importance of having *guanxi* in the Chinese institutional context, even for academics. Joint research with government institutions would facilitate better understanding of these relationships.

In addition, it is possible that the LOF identified in this study is specific to the EP sector, which is both highly regulated and highly dependent on the public sector as a key customer. Comparative studies of LOF faced by companies in other industries could provide useful insights into which issues are more generic and therefore cross-sectoral and which are more likely to emerge in certain kinds of sectors. Further research could also explore other companies (from different home countries) operating in these two industries in China. This would help ascertain whether companies from countries with greater or lesser institutional distance from China experience different types of LOF. If so, to what extent and how do their mitigating strategies differ?

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# **ANNEX I: INTERVIEW QUESTIONNAIRE FOR PARTICIPATING CASE STUDY COMPANIES**

- 1. What is your personal and business background? (years of industry and international experience before joining the company)*
- 2. Please tell me about your company? (Background, structure, nature of business, internationalization process, reasons for entering China)*
- 3. What are the strategic considerations that were the impetus for decision to enter China? (why was China attractive, existing networks in China prior to entry, follow other EU competitors or customers)*
- 4. How did your company enter China (ownership structure, faced difficulty in entry)? Is it still the same now? If not the same, when and why did it change? (control, problems with partners)*
- 5. How long has your company been operating in China? (what other foreign markets and their ownership structure before entering China, years in the domestic market before internationalization)*
- 6. Does your company have a management team in China? (LOF: localized or globalized team, reporting structure to region or parent company, national requirement of management)*
- 7. How important is the China market to your company's business? (percentage of share of China in global turnover)*

8. *How do you perceive the level of business risks and opportunities in doing business in China now as compared to before? Any example?*
9. *What is your company's competitive advantage? (brand, quality, technology, people, network)*
10. *Who are your competitors (local and international, SOEs a big threat, superior or inferior to your company,)? How do you compete with them?*
11. *Who are your customers? Are your products and services the same globally? (Localization of products and services to suit customers by organizing training/seminars). Is there any technical barrier? (conformity with WTO/EU/China standard, local content in China)*
12. *Is international staff training and knowledge exchange part of your company's corporate strategy in human resource development? How is the cultural distance between corporate and China office? (reducing LOF overtime)*
13. *Does your company need or have special licenses to operate in China? How did you get the license (difficult/easy, subject to foreign quota - LOF )*
14. *What are the major Chinese institutions your company has to deal with to run your operations in China (e.g. government, MEP, NDRC, SAIC, MOC, difficult or easy to interact with them)?*
15. *How does your company maintain the relationship with each of these institutions? (interaction between company and institutions through workshops – legitimacy, study tours by Chamber of commerce)*
16. *Is your company in collaboration with any research institutes or Universities on environmental protection R & D in China? If yes, who are they? (legitimacy)*

17. *How do you describe your network connections in China? (LOF: relationship with formal/informal networks, well-known in the local networks, solving problems when in need, receiving advance information before it is released to the industry)*
18. *Could you please tell me about unequal national treatment, market, and financial access? Do you have examples of discrimination when trying to get projects before and now? (LOF)*
19. *Does your company own any technology? Is it patented? (easy/difficult to get it patented) Is it easy to use (need help from HQ). Is IPR protection a key issue in your company's China evolution?*
20. *How has the new EPL impacted your company? Is your company affected by anti-corruption campaign?*

