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ENTRY MODES AND LIABILITY OF FOREIGNNESS EFFECTS: EVIDENCE FROM RUSSIAN FIRMS ON THE GERMAN MARKET[1]

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Abstract. *Foreign subsidiaries are at a disadvantage as compared to domestic enterprises, which is especially the case for emerging market firms in more developed economies. In this paper we apply liability of foreignness (LOF) concept to address the issue of these disadvantages. We consider LOF effects associated with equity vs. non-equity entry modes for Russian firms when penetrating the German market. The paper presents the results of a pilot study of 41 subsidiaries of Russian firms operating in different regions of Germany. Our results show that investors are more concerned about information, customers and partnerships, which can be explained by preeminent reliance on their own resources, while exporters appeared to be driven mostly by image considerations indicating minor interest in other characteristics of the host market. Although both exporters and investors experience significant negative effects from the lack of proper institutional and business knowledge on the host market, these effects vary for equity and non-equity entry modes. We suggest instruments to mitigate these effects, including cooperation with institutional agents, which is especially important for FDI strategy.*

Key words: *liability of foreignness, social costs, entry strategy, German market, Russian firms*

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Introduction

The phenomenon of additional costs which firms face when doing business abroad is one of intensively discussed topics in academic literature (Zaheer, 2002; Nachum, 2010; Kudina, 2012). Since the first widely recognized formulation of this problem in Hymer's dissertation in 1960 and later on in his book (Hymer, 1960, 1976), this phenomenon has received considerable attention from academic community and resulted in a massive array of concepts aimed at its operationalization: "costs of doing business abroad" (Hymer, 1960, 1976); "liability of foreignness" (LOF) (Zaheer, 1995); "liability of emergingness" (Madhok & Keyhani, 2012); and even some imitative concepts departing from the original field and content of the term, such as "liability of origin" (Kolk & Curran, 2016); "liability of privateness" (Bhanji & Oxley, 2013), to name a few. This diversity can be viewed as an indicator of a substantial impact of costs of doing business abroad on overall company's performance, which is reflected in constantly increasing interest in this phenomenon from management scholars (Denk et al., 2012; Jiang et al., 2014; Zhou & Gullien, 2016).

While entering foreign markets, firms traditionally choose between equity vs. non-equity modes, which is associated with different levels of investment, risks, costs, and benefits. Although general preference of firms for FDI over exports was claimed many decades ago (Hymer, 1960; Buckley & Casson, 1976), the alternative reasoning supporting export option over FDI was also significant (Aharoni, 1986; Schleifer & Treisman, 2001).

In this paper, we investigate LOF effects for Russian exporting and investing firms due to a number of reasons. There is a growing number of Russian firms venturing abroad and attempting to expand outside their region encompassing mainly post-communist countries. However, they have little experience, are not always able to predict the problems they might face in host markets, cannot successfully explore their 'Russian' image, and do not have any guidelines on how to overcome challenges related to foreignness. In this respect, Russian firms experience very similar challenges to other emerging market firms penetrating a developed market.

Consideration of LOF effects might bring new insights into the process of decision-making on the choice of a particular entry mode. Entry decisions of Russian firms are often based more on evaluation of firm-specific resources and ownership advantages, and rarely on assessing the role of an entry strategy in mitigating and overcoming of additional LOF costs. In other words, the choice between an FDI and export strategy is largely determined by resources availability rather than by the degree of potential disadvantage on host markets.

This paper aims at addressing the following research question: ***Is there any significant difference in the LOF costs experienced by firms which use equity vs. non-equity entry mode?*** An answer to this question could bring valuable insights and understanding of potential traps for emerging market firms and their competitive advantage on a

developed market, which might help to adopt a more appropriate strategy while diminishing possible negative LOF effects.

The paper is structured as follows: in the beginning, we provide an overview of existing literature on LOF putting an emphasis on the context of emerging markets. After this, we introduce research settings and explain the method chosen. Then, we present the results of empirical analysis of the hypothesised relationships, and, finally, we make conclusion followed by limitations and further research sections.

1. Theory and hypotheses development

The concept of costs of doing business abroad in its original setting was originally supposed to be measured by the disadvantages of national firms in their home markets relative to foreign-owned firms (Hymer, 1976). These costs are perceived as a barrier to overcome by means of firm specific competitive advantage, however, after this first formulation researchers have focused on various firm-specific advantages multinationals exploit to minimize these costs rather than on their disadvantages. The concept of costs of doing business abroad was soon dislodged making more space for research on multinational firms' advantages (Buckley & Casson, 1976; Rugman, 1981). National firms have more opportunities to extract more value from the assets of their home country that are used to develop competitive advantages deprived from foreign firms investing in their country, which leads to the costs of doing business abroad for new entrants (Nachum, 2003). Host governments and domestic firms view powerful multinationals as threats to their countries' technological and industrial development, so the local resistance should exist causing obstacles for new entrants.

In 1995, Zaheer made a sufficient contribution by formulating "liability of foreignness concept". The main research question articulated by Zaheer emphasized the nature of the mechanisms that are used to overcome LOF: "If in fact MNE subunits face a liability of foreignness, does importing firm-specific organizational practices or imitating local organizational practices better help them overcome this liability and compete successfully against purely local firms?" (Zaheer, 1995, p. 342).

This two-fold view was produced from combination of two schools of theoretical thought. On the one hand, multinationals' subunits are likely to meet the requirements of the local, host-country institutional environment, i.e. tend to become isomorphic to the practices of local firms. On the other hand, multinationals also have an opportunity to enjoy the advantages of their firm-specific resources and organizational capabilities to mitigate or even overcome LOF (Zaheer, 1995). This setting integrates two rather diverse theoretical perspectives, namely, the theory of multinational enterprise with theories of international strategy and organization. Moreover, Zaheer (1995) contributed by summarizing four possible sources of LOF on the basis of Hymer's definition of potential costs of doing business abroad (Hymer, 1960, 1976):

(1) costs directly associated with spatial distance, such as the costs of travel, transportation, and coordination over distance and across time zones;

(2) firm-specific costs based on a particular company's unfamiliarity with a local environment;
(3) costs resulting from the host country environment, such as the lack of legitimacy of foreign firms and economic nationalism;
(4) costs from the home country environment, such as restrictions on high-technology sales to certain countries.

Four sources of LOF are traditionally assumed to be the point of departure in the absolute majority of both key empirical and conceptual papers devoted to analyzing LOF phenomenon (Nachum, 2003; Eden & Miller, 2004; Denk et al., 2012; Kudina, 2012; Moeller et al., 2013; Zhou & Gullien, 2016). Among widely used theories to analyze LOF phenomenon are theories of international expansion (Bai et al., 2013; Wei & Clegg, 2015); social network theory (Chen et al., 2016; Tiwari et al., 2016); institutional theory (Bell et al., 2012; Edman, 2016); resource based view (Miller et al., 2008; Cuervo-Cazurra & Un, 2015) including those emphasizing firm-specific advantages (Zaheer & Nachum, 2011; Kolk et al., 2014); population ecology (Li et al., 2008) and others. Theoretical frameworks produced are quite different in terms of combinations of particular types of LOF costs and the underlying criteria for their grouping. The differences in preferred research angle on LOF are partly grounded in theoretical assumptions taken into consideration. For instance, the paper by Miller and Richards (2002) emphasizes long-term and short-term nature of costs associated with LOF, so that even after foreign firms incur costs to learn about host country environment, local customers may continue to have unfavorable perceptions of the outsiders (Miller & Richards, 2002). Calhoun (2002) treats cultural dimension as the central one in LOF structure in terms of interpreting informal processes and norms in the local environment and other tacit and more intangible aspects of LOF. Eden and Miller (2004) distinguish between economic costs (activity based and associated with spatial distance) and social costs (associated with attaining legitimacy in the host country) relying on the notion of distance.

One more LOF stream highlights internal and external legitimacy issues contributing to added costs of being foreign when establishing operations abroad (Newburry et al., 2006; Garg & Delios, 2007; Li et al., 2008; Yildiz & Fey, 2012; Lindorfer et al., 2016). The paper by Li et al. (2008) emphasizes the role of signaling in banking industry and empirically tests the relationship between the number of domestic and foreign entries to evidence that legitimacy issues affect foreign entrants' competitiveness as compared with the local ones. Garg and Delios in their work (2007) examine how business group affiliation and the development stage of the host country jointly influence the survival chances of foreign subsidiaries in terms of mitigation of LOF. The results show that business group affiliation does not have an independent influence on a subsidiary's survival rates, but it does have a contingent effect, where the contingency emerges from the development stage of the host country. Finally, Eden and Miller (2004) attempt to provide an equal emphasis on both firm-specific and institutional factors affecting LOF

effect and categorize additional costs in terms of hazards of different types: unfamiliarity hazards caused by lack of international experience and unawareness of local business environment; relational hazards caused by lack of trust; and discrimination hazards caused by nationalistic tendencies and the host government's, suppliers' or consumers' perception that a foreign firm lacks local legitimacy. This three-fold view may look like a simple restatement of the initial set of LOF sources from Zaheer (1995), however, what makes this restatement valuable is its much better grounded definitions. The main rationale for three hazards is that the process of internationalization of emerging multinationals can be described using the notion of distance split into two types – geographic and institutional (regulatory, normative, cognitive), which can be measured in terms of actual costs companies face and result in a particular ownership strategy (Eden & Miller, 2004). Further research has come a long way linking the original typology of LOF sources with a variety of organizational theories, however, from work to work it is still quite similar to the initial one listed in Zaheer (1995).

Reconsidering this tapestry of approaches to LOF we would like to focus not only on the cost typology side, but also bring in suggestions to mitigate LOF effects on foreign firms articulated by the scholars working on this topic. Papers devoted to analyzing LOF phenomenon pay considerable attention to competitive advantage typology side identifying the ways in which companies can minimize or mitigate LOF costs when expanding abroad (Elango, 2009; Jiang et al., 2014; Maruyama & Wu, 2015). Firms can most effectively mitigate LOF by either using their ownership-specific advantage or by becoming isomorphic to local firms or by doing both. The key findings among studies emphasizing firm-specific factors are their high effectiveness in mitigating LOF effect. For instance, the paper by Petersen and Pedersen (2002) provides evidence that the willingness to adapt to the local environment and the extent to which firms used globally standardized routines in their overseas operations vary across these clusters, so more local adaptation is better for the success of a local subsidiary. Luo, Shenkar and Nyaw (2002) report that foreign firms located in China use a combination of offensive (e.g., networking, legitimacy improvement, etc.) and defensive strategies (contracts, guanxi, parents control, etc.) to mitigate LOF.

However, one of the shortcomings of the LOF literature with regard to entry modes is unequally distributed attention to their types. Papers which analyze entry mode choices empirically take into account equity modes only (Klossek et al., 2012; Denk et al., 2012; Baik et al., 2013; etc.), while non-equity modes are left uncovered. Considering the fact that non-equity modes are growing more rapidly than industries in which they operate, i.e. their value added represents up to 15 per cent of GDP in some economies and their exports account for 70–80 per cent of global exports in several industries (UNCTAD, 2011), in our paper we make an attempt to fill this gap. Moreover, academic works analyze non-equity modes in a variety of contexts (Erramilli et al., 2002; Wang & Nicholas, 2007; Roza, Van den Bosch, Volberda, 2011; Gudergan, 2016;

etc.); however, only few of them deal with LOF concept in these contexts and take FDI alternatives into account.

Having outlined various underlying criteria to systematize LOF costs (i.e. long vs. short-term costs; external vs. internal costs; economic vs. social costs) as well as diverse angles on LOF mitigation (using ownership specific-advantage or becoming isomorphic), we would like to bridge the following two gaps in the literature. Firstly, we focus on the link between possible entry modes and types of social costs of LOF that companies are most likely to face, taking into account non-equity entry modes overlooked so far in the empirical literature. Secondly, we do not attempt to restate the original LOF costs typology from Zaheer (1995), but simply group the specified LOF sources into external vs. internal environment categories to account for interdependencies between establishment modes and country environment.

Following previous scholarly considerations as a theoretical basis for our discussion, we propose a conceptual framework for further analysis (Figure 1).

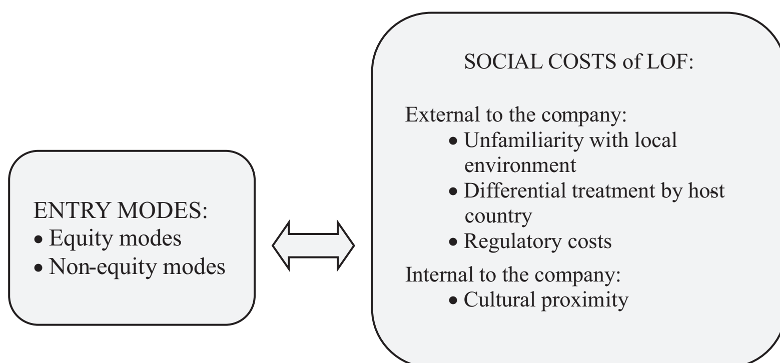

FIGURE 1. **Conceptual framework**

Looking at the business environment on the firm level we categorize social costs of LOF into two groups according to their source being either internal or external to address various types of challenges affecting operations at the firm level. We account for the corresponding dependencies between the types of entry modes (equity vs. non-equity) and social costs of LOF to elucidate interdependencies between internal and external environment producing additional costs.

Relatively recent and quite intensive internationalization of emerging market firms, especially into developed economies, has introduced new investment patterns and strategic challenges for them due to unique nature of conditions they operate in. On the one hand, relative underdevelopment of major industrial sectors and resource orientation of emerging market firms reduce their home country advantages as compared with firms from developed countries (Gammeltoft et al., 2010; Mihailova & Panibratov, 2012) so that it pushes them to engage in FDI.

H1: There is a significant difference between external LOF costs for firms that choose equity entry modes vs. those that choose non-equity entry modes.

On the other hand, institutional specifics of emerging countries affect both their location choices and profitability (Rugman & Nguyen, 2014; Meyer, 2015). As a result, in terms of firm capabilities, emerging market firms appear to be in a contrasting position compared to a more advantageous state of firms from developed countries and try to minimize this pressure.

Eden and Miller (2001) argue that entry mode choices should be made to reduce the effects of LOF. More empirical support for this type of rationale in the context of LOF can be found in a study of the Canadian auto industry by Eden and Molot (2002) illustrating how first movers use firm specific advantages to become "insiders" and create entry barriers for later arrivals. Haiyang, Griffith and Ru (2006) provide an integrated view on the foreign firm entry strategies and firm specific advantages in the Chinese market, and also posit they are influenced by the degree of LOF.

H2: There is a significant difference between internal LOF costs for firms that choose equity entry modes vs. those that choose non-equity entry modes.

Emerging multinationals received a lot of scholarly attention for their substantially different internationalization patterns (Ramamurti & Singh, 2008; Barnard, 2010; Pananoid, 2015). Academic literature generates new theoretical and empirical arguments to contribute to the debate whether emerging multinationals have redefined the specifics of international business (Luo & Tung, 2007; Cuervo-Cazurra & Narula, 2015) or whether their increasing influence is a consequent step in gradual development of systematic relationship between investment trajectory and the inward and outward activities of multinational enterprises (Narula, 2006; Meyer, 2015). Nevertheless, emerging market firms need to find their own trajectory to outperform their more advanced competitors (Narula, 2012; Gammeltoft et al., 2012).

H3: There is a significant difference between market analysis tools for reduction of LOF costs used by firms that choose equity entry modes vs. those that choose non-equity entry modes.

2. Data, variables and methods

The data were collected through a survey conducted in 2015 in different regions of Germany. Our sample of German subsidiaries of Russian firms was formed from the population provided by the German-Russian Chamber of Commerce. The number of Russian firms operating on the German market and registered in the commercial register is a bit more than 1600; they are predominantly small and medium-sized firms. We randomly selected 50 firms and invited their top managers to participate in the survey and fill in a specifically developed questionnaire. The questionnaire included 15 questions addressing various aspects of companies' activities. For instance, respond-

ents were asked about their activities implemented on the German market, instruments of assistance employed to undertake the investment, challenges of various nature they faced when penetrating the German market, as well as their choice of a subsidiary location in Germany and an entry strategy they used. The questionnaire aimed at capturing perceived risks and opportunities which Russian firms experience on the German market. Considering two key disadvantages of using a questionnaire, namely impersonal approach and reaction time, the questionnaire was distributed through interviews. A minor part (about 15% of respondents) was treated with face-to-face interviews; the other part of respondents was interviewed over the telephone. The respondents were provided with a detailed introduction and in-depth explanation of survey questions and asked to fill in the questionnaire.

41 firms accepted the invitation and formed response rate of 80%. Among 41 firms included in the sample 14 firms preferred an export (a non-equity mode) as an entry strategy, and 27 firms used an equity mode (mostly M&A or joint venture). Apart from an entry strategy used to penetrate the German market, respondents were asked about organizational characteristics of their firms, reasons for the choice of a particular region in Germany, external and internal challenges they experienced while entering and operating in Germany, as well as some other aspects.

About 40% of the firms included in the sample operate in trading industry that does not require solid investment and significant adaptation of business processes. Around 20% of the firms are involved in logistics and warehousing, which is not surprising as Germany has traditionally been a European hub for raw materials flows from various locations (European countries, Asian region, Americas) to Russia. About 27% of the firms provide various services, and 15% are engaged in commodities and raw materials.

More than a half of the firms included in the sample (63%) had already been operating on the German market for more than 6 years. During the last decade German authorities made significant efforts to make a process of legal entities registration less restrictive, which stimulated foreign firms to enter the German market. Thus, about 10% of respondents had been functioning for less than 2 years, and the rest 27% – from 2 to 5 years before the survey took place.

Due to the fact that most of the questions have 'yes' or 'no' option as an answer, all of our items were measured on a binary scale. For example, we asked respondents what was their reason for choosing a particular region for market entry and provided them with different answers such as popularity and image, or local benefits and support of entrepreneurs, or strong local demand, etc. Respondents could choose one most relevant rationale. We also asked about their entry mode, such as a green-field, an M&A, a joint venture, or a selling subsidiary. In addition, they were asked about major external and internal challenges they faced on the German market on the first stages of their internationalization there. To properly address our research question we applied contingency tables and cross-tabulation analysis to test the relationship between the type of an entry mode (equity vs. non-equity) and different social LOF costs. The method choice is

determined by the type of the data we had. Most of our variables are measured on a nominal scale, so non-parametric methods are to be applied. Cross-tabulation is usually performed on categorical data as it offers a simple method of grouping variables, which minimizes potential confusion or error by providing clear results (Lauritzen, 2002).

3. Results

Table 1 presents the results of cross-tabulation analysis for the relationships between external challenges a company encountered when expanding to the German market and a type of entry strategy. The UNCTAD World Investment Prospects Survey 2013–2015 classified Germany as the most attractive business location in continental Europe (UNCTAD, 2015). It provides a number of advantages for foreign companies doing business there, such as sophisticated business environment, high-quality infrastructure in conjunction with advanced transportation and logistics services, geographic location offering proximity to main European markets. Furthermore, human capital advancement and workforce qualifications enriched with appropriate social climate also contribute to its attractiveness. German transportation and automotive industries, biotechnology and energy sector, as well as pharmaceuticals are classified as economic growth drivers and the most probable sectors for investment (World Economic Forum, 2015). German investment attraction policy and instruments implemented by the German Federal government and assigned institutions also stimulate investment inflows into the German economy.

Traditionally, Germany provides wide and diverse incentive packages that include cash incentives, public loan programmes, public guarantees, labour-related incentives, and R&D incentives. As for cash incentive, the smaller the size of the enterprise, the more intensive is funding. Loan incentives are provided by several institutions, e.g. by the Credit Institute for Reconstruction – KfW (Kreditanstalt für Wiederaufbau), whereby the entrepreneurial loan is one of the most commonly offered instruments. In general, not only German public banks, but also private banks are encouraged to provide loans, specifically to firms of medium or small size. This is achieved by means of public guarantees issued by the German Federal government, and designed to help businesses to obtain bank financing (NRW Invest, 2014). Labour-related incentives are independent of the firm's size, location and industry. The applications can be submitted to local employment agencies, but the procedure, funding volume and durability varies from municipality to municipality. The classic labour-related incentives are recruitment and training support, as well as wage subsidies and on-the-job-training promotion (GTAI, 2015).

Generally, foreign investors are equalized with domestic ones in Germany in regard to incentive packages. A key aspect in determining the type and volume of the incentive is the firm's size of an applicant. SMEs are often granted higher incentive rates, in particular for R&D intensive applications (Hamburg Chamber of Commerce, 2015).

R&D incentives are available in a form of non-repayable cash grants or R&D loans (NRW Invest, 2014). The decisive selection criteria for incentive approval are estimated degree of innovation, and technical and economic risk assessment (Deloitte, 2014).

About 25% of our respondents highlighted that they faced considerable problems related to political and legal aspects of business activities on the German market. More than 40% distinguished bureaucracy as a major external challenge. Further analysis allowed identifying statistically significant relationships between the type of external challenges and the choice of equity/non-equity entry strategy (chi2 (6)=11.5707, $p<0.05$), which provided support to H1. The higher perceived customer requirements are, the more likely is a company to choose FDI over exporting. Moreover, a need for active interaction with market players pushes companies to invest in the German market. At the same time, inefficient financial support prevents companies from engaging in FDI, and, in contrast, stimulates export activity.

Germany is famous for the strength of its trade unions. Our results show that more than a half of respondents acknowledged conflicts with trade unions as the major internal obstacle when entering the German market. On the other hand, about 25% of respond-

TABLE 1. **Contingency table on relationships between the type of an entry mode and external social costs.**

Types of external social costs	Equity mode	Non-equity mode	Total
Problems of political and legal nature, protectionism	5	5	10
Lack of information support	2	0	2
Insufficient financial support (e.g. subsidies, tax incentives)	0	2	2
Bureaucracy	10	7	17
Market requirements and interactions	7	0	7
Others	3	0	3
Total	27	14	41

Pearson chi2 (6)=11.5707 Pr=0.041

TABLE 2. **Contingency table on relationships between the type of an entry mode and internal social costs.**

Types of internal social costs	Equity mode	Non-equity mode	Total
Conflicts with unions, stringent labor law	13	10	23
Language barriers, different mentality of Germans and Russians, team relationships	2	2	4
Problems with staff recruitment	3	0	3
None	9	2	11
Total	27	14	41

Pearson chi2 (3)=4.1401 Pr=0.247

ents noted that they did not experience any internal challenges at all. The results of contingency analysis of the relationships between internal challenges a company faced when penetrating the German market and a type of entry strategy are presented in Table 2. They do not confirm statistically significant relationships between variables, so that expected activity-based costs and internal challenges such as cultural proximity between countries grounded into communication within the members of staff are not strongly associated with a particular entry mode. Thus, we did not find empirical evidence for H2.

To mitigate the consequences of LOF, companies penetrating the German market could use a wide range of instruments to increase market awareness and get some information support from different institutional agents. However, as we may see most of the respondents (63%) were inclined not to approach any institutions, but to rely on their own expertise and market analysis. Still, 25% of respondents noted the role of the Chamber of Commerce at initial stages of their activity on the German market. Fairs and exhibitions, as well as legal consulting are of interest for companies making investment, while exporting companies prefer not to spend resources on such types of activities. Accordingly, the hypothesis on significant relationships between a choice of equity/non-equity entry strategy and tools of market analysis (H3) was not supported (Table 3).

TABLE 3. **Contingency table on relationships between a type of entry strategy and tools of market analysis used by a company.**

Tools of market analysis	Equity mode	Non-equity mode	Total
Legal consulting	3	0	3
Fairs and exhibitions, Chamber of Commerce	10	2	12
Personal analysis	14	12	26
Total	27	14	41

Pearson chi2 (3)=5.1496 Pr=0.088

4. Discussion and conclusions

Germany as a target market amongst developed economies plays a key role for Russian investments. Statistically, the only two Western European economies obtaining more FDI from Russia than Germany are Cyprus and the Netherlands (UNCTAD, 2015). However, the latter two are considered to be the major offshore hubs within Europe, where the investments rather represent capital fleeing motives.

The industrial spread of Russian investors is mainly represented by the financial service sector (18% of OFDI stock), followed by the energy sector, IT/software and transport/logistics sector (14% each). Furthermore, Russian OFDI actively goes into tourism and sales.

Germany remains a strategically important market for Russian firms, even taking into account re-orientation towards Asia. Predominantly brownfield investments are of

special interest. But also in the context of greenfield-based investment projects, Germany is a favorite location for Russian OFDI. Out of 936 Russian greenfield investment projects registered between 2008–2013 worldwide, 63 projects (7% worldwide or 23% within the EU) went to Germany. USA with 6% of all projects was slightly behind. The Russian OFDI stock in Germany, as reported by the Bundesbank, was above 3.2 EUR bln in 2012, making Russia the leading BRIC-investor (by FDI stocks) in Germany (GTAI, 2012).

Strategically, Russian firms investing in Western economies are interested in efficiency-seeking expansion, mainly realized through acquisitions of technologically intensive enterprises (Dikova et al., 2016). Opening of an own manufacturing site in Germany, as a competitive strategy followed by subsequent market penetration, is still considered as a less attractive mode of entry.

Summarizing the results of the empirical analysis we found that when choosing some particular location in the host country, Russian firms are mostly driven by popularity and image of the region regardless of an entry strategy they prefer. Moreover, companies that choose export as an entry strategy unanimously state this criterion as a determining one. For companies that choose FDI mode, the region's popularity and image are equally important to economic conditions of a region and concentration of key players there. Availability of options for different types of support is of minor relevance, which means that companies rely mostly on their own resources.

Both exporters and companies that used FDI options stated that problems of political and legal nature, including protectionism as well as bureaucracy, are considered as the major external challenges while operating on the German market. Moreover, companies who made FDI also identified a lack of information support, insufficiency of interactions with other market players and high customer requirements as aspects of great concern, while exporters did not experience such challenges.

To mitigate negative social costs of LOF, both exporters and companies involved in FDI used a number of instruments to overcome the lack of information about the market. Legal consulting and personal analysis were identified among the most important ones. Companies that opted for FDI have also highlighted the importance of cooperation with the Chamber of Commerce that not only provides informational support, but also stipulates faster legitimization.

Our results show that whatever entry strategy a company chooses while penetrating the German market, it faces significant challenges in terms of a lack of institutional and business knowledge. Exporting companies experience comparably lower pressure, however, export strategy does not fully safeguard them from negative impact of LOF.

This study contributes to the existing literature on LOF by exemplifying LOF influence on emerging market firms entering foreign market of a developed country. More specifically, our analyses show that firms face considerable external challenges accosted with the host country context.

The results are to some extent contrary to the elaborated stream of research that postulates that developed markets possess more progressive institutional context that favors foreign operations, compared to emerging markets. We suggest explanation based on the idea of Cuervo-Cazurra and Genc (2008), who state that firms from emerging economies being in a disadvantage in the global markets compared to their more developed counterparts transform these disadvantages into advantages while operating in other developing economies. The contrast between business climate in Russia and in Germany is higher than, say, in Russia and in Poland or Hungary due to the more significant institutional distance between Russia and Germany. Since Russian investors and exporters are more familiar with markets such as CEE and CIS, they feel less comfortable in the market of Germany, although consider the latter as a key target in terms of image considerations and political stability. However, departing from the idea of Cuervo-Cazurra and Genc we see the backward effect: having an advantage of operating in other emerging markets, Russian firms feel that they are at a disadvantage in more developed markets. In other words, Russian firms appear at a disadvantage in Germany after having a privilege to operate in the less developed markets where their disadvantages are not as harmful and make them less concerned about the competitiveness abroad.

5. Limitations and further research

We recognize that our study has a number of limitations. First of all, we consider LOF effects experienced by Russian firms on the German market only, which allows limited generalizability of the obtained results. Secondly, the nature of our data and the size of the sample define our commitment to non-parametric methods that have lower explanatory power compared to parametric ones. Moreover, LOF effects associated with internationalization of emerging market firms are more diverse in terms of internal social costs which emerging market firms face. This can be captured using bigger samples.

Considering these limitations further research might take the next step in categorization of internal social LOF costs taking into account time dimension to establish cross-comparisons in their overall impact on business activities using bigger sample. Alternatively, future works can employ in-depth categorization of equity and non-equity modes to capture more interconnections between social and economic LOF costs to produce more detailed recommendations to practitioners.

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