ISSN 2029-4581. ORGANIZATIONS AND MARKETS IN EMERGING ECONOMIES, 2015, VOL. 6, No. 2(12)

THE STAGES OF INTERNATIONAL GROWTH OF THE BUSINESS GROUPS FROM EMERGING ECONOMIES

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Abstract. *The previous studies have focused on weak institutional environment in explaining the growth of business groups in emerging economies. The recent events, however, show that business groups continue to grow even when the institutions are getting better. This is evident both in the domestic and international growth stages. This paper addresses this by providing a group and a firm-level analytical framework as an alternative in examining the international growth of business groups. The focus is putting the institutional environment in the background and the business groups in the forefront. The paper builds on the endogenous growth of business groups and proposes that their persistence, regardless of institutions and level of economy, can be explained not only through their environment but also by the internal dynamics of their organizational structure and group-specific advantages. This proposition is based on the theory of the firm through the combined application of transaction cost economics, resource-based and dynamic capabilities views.*

Key words: *business groups, business group advantages, affiliate-level advantages, internationalization, emerging economies, organizational growth*

1. Introduction

The analyses of business groups in different developing economies are well-documented in the literature (Colpan, Hikino, & Lincoln, 2010). A business group (also abbreviated as *BG* or *BGs*) is defined as a hierarchy of independent firms, conceived to collaborate in domestic and international markets under a common administrative control; the affiliate firms are linked by various social and economic exchanges of resources, interpersonal trust, and mutual adjustment (Granovetter, 1995; Leff, 1978). In general, the transaction cost economics (TCE) theory, which argues that business groups will emerge due to the imperfections and incompleteness of the market, applies to the majority of the cases (Chang, 2006). Accordingly, the business groups are able to avoid the market imperfections by internalizing some transactions within the business group network rather than the external market (Leff, 1978). Therefore, the creation of an

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internal market provides the business groups with legitimate powers to exercise control over their operations without heavily relying upon the inefficient open market.

In recent decades, the above application of TCE for understanding the organizational choice of business groups has been enriched by scholars. This is through incorporating the concept of 'institutional voids' in the analyses. Institutional voids refer to the constraints that hamper the smooth functioning of the market. These are the absence of reliable institutions, standards and intermediaries, either soft or hard, which impede the efficiency of the transactions between buyers and sellers (Khanna & Palepu, 1997; Langlois, 2013; North, 1990). This new line of reasoning maintains that because of the existence of institutional voids, some institutional and contextual mechanisms will exist to support the growth of business groups (Carney, 2008). Indeed, some scholars suggest that since the strong competitive position of business groups in developing economies is attributed to institutional voids, the lessening of the voids or strengthening of the institutions can mean deterioration in the growth and expansion of business groups (Gaur & Kumar, 2009; Kock & Guillén, 2001; Strachan, 1976). However, recent research results and the existing growth pattern of business groups show a different picture. Siegel and Choudhury (2012) found that in the two decades after Indian liberalization (1989-2008), when institutions were getting better in India, business group firms on average performed better than non-business group firms due to their recombination of existing economic inputs. The same conclusion was drawn by Colpan and Hikino (2010) for some business groups in the East and Southeast Asian regions. Also, the recurring trend in the list of top performing firms from the developing economies as ranked by the United Nations Conference on Trade and Development (UNCTAD) shows that firms affiliated to a business group continue to be on top of the list despite the many transformations of the institutions of the developing economies (UNCTAD, 2013). Hence, the overarching explanation of the growth and persistence of business groups should by no means restrict the focus on institutional voids but must also include the 'group-specific characteristics'. These group-specific characteristics are likely related to the 'capabilities of recombination' rather than the developing economy environment. Therefore, this paper contends that exogenous explanations, such as the institutional environment, are just types of environmental or institutional conditions which only serve as inputs to the growth of business groups and not the source of persistence themselves.

In view of that, this paper argues that the growth of business groups in the emerging economies does not lie within the institutional conditions but on their innovative response to such conditions, that is, internalization of market imperfections and endogenous capability building among the affiliates (Mahmood, Zhu, & Zajac, 2011). This is consistent with the Penrosian theory of the growth of the firm and the dynamic capabilities view (Penrose, 1959; Teece, Pisano, & Shuen, 1997; Verbeke, 2009). Following this, the paper builds and theorizes on the business group-specific explanations rather than the explanation of institutional voids. Further, the paper proposes that the explanation of the persistence of business groups, regardless of the type, location and level of economy, lies in the group dynamics and the functioning of its resources and capabilities. These group resources and capabilities form an internal market, where the competitiveness is being developed and exploited, and thus serve as the key explanation of their existence and evolution over time.

2. The emergence of business groups

The emergence of business groups in the twentieth century is not a new phenomenon. Jones (2000), corroborating on the work of Chapman (1985), reconfirmed that the British trading merchants in the nineteenth century evolved into (and use the structure of) diversified business groups in order to expand, both in geographic and product operations. These early business groups were understood as entities that intermediate between the 'inter-country' market imperfections and their affiliates (Jones & Khanna, 2006; Jones & Wale, 1998). This pattern was also evident in the transformation of Japanese trading merchants, as part and parcel of the government's policy towards the modernization program during the mid-nineteenth century (Kojima & Ozawa, 1984).

In the developing economy literature the emergence of business groups is associated with the issue on the severity of horizontal and vertical incompleteness of the market (Khanna & Yafeh, 2007). In fact, some actually do not have any credible markets to start with. Thus, the market transactions are deemed costly and the market system needs time to develop. In his notable work Leibenstein (1968) identified two broad types of entrepreneurial activities which he termed routine and "N-entrepreneurship" or "new type entrepreneurship". The former means that the activities involved in carrying and coordinating the parts of the production are well known and operate in well-established or clearly defined markets (at least to some extent in the developed economies). The latter is the opposite, where not all markets exist and the entrepreneurs (or the economic actors of an economy) must fill in for the market deficiencies (ibid., p.67). To address this, entrepreneurial activities will make some portions of the market less impeded through extending markets but may make others more so through the creation of monopolies, or the creation of other barriers to entry where they previously did not exist (ibid., p.77).

The condition where N-entrepreneurship exists utterly mirrors the entrepreneurial activities of firms in the developing economies. The firms emerge to fill a substantially high volume of gaps in the market network. This is basically how the development of firms in the developing economy is different from those in the developed ones. Practically, the developing economy firms choose to innovate their organizational structure, such as networks-like business groups, to respond to the multiple levels of market imperfections in the external market. The seminal work of Nathaniel Leff on the industrial organization and development in the developing countries was the first to analyze this phenomenon. Leff (1978) reasons that the business group pattern of industrial organization is readily understood as a microeconomic response to well-known conditions of market failure in less developed countries. The institution of the group is an intrafirm mechanism for dealing with deficiencies in the markets for primary factors, risks, and intermediate products. It is an institutional innovation for internalizing the returns which accrue from the interactivity operations in the imperfect market conditions of the less developed economies (Leff, 1978, p.666-668).

There are other perspectives in explaining the antecedents of the business groups and their persistence. These perspectives look at a number of conditions which create supply and demand mechanisms for business groups to emerge. It can result from government related policies (Koike, 1993; Krueger, 1974), cultural embeddedness (Granovetter, 1995) and asymmetric foreign trade and investments (Guillén, 2000). Overall, the emergence of the business group structure is almost synonymous to the effects of the conditions in the developing market economies, coupled with the response of the market actors under such an economy.

3. The endogenous growth of business groups

3.1. The influence of internal organizational structure on the growth of business groups

The organizational structure of business groups differs from the typical single firm with regard to treatment and governance of internal organization or coordination costs. In a single firm, coordination costs arise from the interdependencies of internal markets within the single firm; whereas in the business group, these coordination costs are ideally spread among multiple firms (affiliates) within the business group structural setup. This alteration develops due to the limitation of the coordination capabilities of each affiliate to function efficiently in the developing economy environment. Thus, the boundary of the internal organization of economic production is shifted from the single-firm level to the multiple-firm level, hence the (physical) growth of the group. This phenomenon is again attributed to the market imperfections in weak economies. This arrangement can be explained by transaction cost economics (Williamson, 1981). However, the benefits of organizing complex interdependent activities within the group structure, rather than in a single firm, exceed the costs and risks associated with the various market imperfections and institutional voids in the weak economies.

There are three dimensions that constitute the organizational approach to business groups. First, business groups organize interdependencies mainly with firms and not with markets. That is, a firm can be considered as the first-order hierarchy, i.e. U-form and M-form (Chandler, 1990; Williamson, 1981), while the business group is treated as the second-order hierarchy, i.e. hierarchy of hierarchies. With this setup, an intermediate if not full or centralized control is also necessary. The assumption is that when firms face limitations and overwhelming market imperfections, business group level arrangement is chosen. This is because the business group approach recognizes that market imperfections reside at multiple levels of economic coordination, and some are simply beyond the natural immunity of a single firm. This is aggravated if and when the compounding group versus group competitive tendencies dominate the market. Hence, in certain markets firms belonging to a business group are better off than single firms (Khanna & Rivkin, 2001).

Second, the governance mechanism of a business group takes account of core (hierarchy-type collaboration) and non-core integration (market-type collaboration). These core and non-core integration mechanisms are strategic, with the goal to develop, appropriate and control tangible and intangible group-specific advantages. Core integration is the basic organizational structure of a business group by which elite independent firms are pooled and coordinated. Here we see related and unrelated portfolios being *specialized* and entrusted to the core elite affiliate firms (Demsetz, 1988). Hence not all affiliates share the same operations. On the other hand, non-core integration is the structural extension of core firms that comprises the non-core affiliate firms and markets. This is where the core elite firms and the rest of the group engage in joint ventures, strategic alliances, licensing and other extended social and economic exchanges. These transactions can be domestic, regional and even global depending on the characteristic of the affiliate firm, i.e. domestic or multinational. The control in this setup can be intermediate and decentralized, but not totally independent. Here core and non-core affiliate firms are given fair discretion with regard to external mode governance. This is how the boundaries of the affiliate firms are set at the margin where the benefits of further internalization offset the cost (social and economic).

The consideration as to how the two dimensions above are made possible in a business group leads us to the third point, which is *control*. The control in business groups focuses on two binding aspects: (1) ownership (e.g., cross-holding) and (2) intermediation in the internal transactions (e.g., director interlocks). Ownership in BGs belongs to one of the three types of arrangement: family-owned, widely-held, or state-owned (Cuervo-Cazurra, 2006). Family-owned refers to a family or its members directly controlling the business; sometimes without hiring an outsider manager to run the enterprise. This is the most common type of BGs, especially those from ever-developing markets, i.e. South Korean *Chaebols*, Southeast Asian BGs and Indian BGs. In cases where a hired manager is necessary, family members or their kin still make most of the decisions. For widely-held BGs, ownership is widely dispersed among multiple shareholders and mostly publicly listed. Lastly, state-owned BGs are a unique type of organization as they are clearly reliant on the intervention of the state. These BGs are mostly from previously centrally planned economies like China and Russia (Abegaz, 2005). They function as the market arm of the state and occupy a larger chunk of the state's business operations.

On the other hand, the intermediation in internal transaction of BGs follows a loose-coupled system, where there is both distinctiveness and responsiveness (Orton & Weick, 1990). It is a combination of efficiency responses and mere preference. Group affiliates are interdependent in facilitating coordination, control and external intermediation. Yiu et al. (2007) suggest that within-group adaptive attributes of BG interdependencies take into account two dimensions: horizontal and vertical linkages. Horizontal connections consist of an *internal transactions mechanism*, which refers to internalization and allocation of critical resources and information among BG affiliates. On the one hand, the vertical mechanism of a BG functions and echoes the command chain of the group from the dominant owners to the affiliates. Dominant owners are the *Core owner elite*, an individual or an entity (i.e. an affiliate firm), or a collection of individuals/organizations having the dominant share and control over the BG parent company and/or core companies of the business group. Companies in the vertical hierarchy would have the apex firm/headquarters, a holding company, strategic business units and operational affiliates.

3.2. The group-specific advantages as catalysts of business group's growth

In emerging economies the advantages of the firms affiliated to a business group arise from the interaction of and response to specific country characteristics, imperfections in capital, labor and product markets, and the recombination capabilities of the affiliate firms (Chang & Choi, 1988; Chang & Hong, 2000; Leff, 1978). These advantages are supported by the accumulated knowledge that has been captured, owned and controlled by the business group over time (Dierickx & Cool, 1989; Mahmood et al., 2011). This paper calls these advantages the *Business Group Advantages* (here also abbreviated as *BGAs*) as they accrue exclusively to business group-affiliated firms. The BGAs are internalized and found within the business group structure and stored at the group level. Since a business group is composed of independent affiliate firms, BGAs, in theory, can be found within each affiliate firm. Therefore, BGAs have two levels, one is the group as a whole and the other is at the individual affiliate level. Both facilitate the dynamic growth and persistence of the business group.

3.2.1. The impact of group-level advantages

There are three generic components to describe the competitive structure of business group advantages. The first is reduced *transactions costs* through the group internal capital, labor, internal buying and selling, and market information search. This explains the incentive of reducing the risks and costs from searching or developing information and advantages in the external market (Leff, 1978; Williamson, 1981). The business group structure provides an array of internal resources, which an affiliate can exploit. The most common example is the internal group capital that is a very good source of capitalization for affiliates in times of investments, including foreign investments, and expansion (Gonenc, Kan, & Karadagli, 2007). The second component includes transferable *group managerial skills and experience* in product and geographical diversification, contacts and intermediation capabilities, and state relations. These advantages provide a combination of context specific and transferable skills among BG affiliates (Tan & Meyer, 2010). Amsden and Hikino (1994) argue that the repeated industry-entry pattern of business groups was realized because of their "contact capabilities" with the state and foreign multinationals, followed by "project execution capabilities". According to them, these project execution capabilities refer "to the skills required to establish or expand operating and other corporate facilities, including undertaking preinvestment feasibility studies, project management, project engineering, procurement, construction and startup operations". These capabilities are generic to business groups and not industry-specific. In addition, business group experience in management of product and geographic diversification directly aid other affiliates in other potential product areas and locational expansions (Kim, Hoskisson, Tihanyi, & Hong, 2004).

The last component is the *economies of scale and scope* such as allocation and co-development of resources in the area such as in R&D and technology, marketing and distribution, group brand and reputation (Chandler, 1990). A successful processing system that is developed by one affiliate may, at one point or another, be useful to another affiliate for benchmarking. Lead times and costs are reduced through this approach. Another important and unique BGA is group reputation. Group affiliates enjoy the ease of winning contracts or projects only because of their membership in a reputable business group. A business group might have a very long successful history of operations and transactional negotiations that create a positive halo effect on all the affiliates in the group.

3.2.2. The dynamics of affiliate-level resources and capabilities

The business group-level advantage explains what kinds of advantages are found at the group level, but it does not explain all the potential advantages that are found at the individual affiliate level. These affiliate level advantages contribute to the growth of the business group by strengthening the overall resources and advantages of the group. This paper proposes that what individual BG affiliates have are both the subset of the BGAs and *Affiliate-level Advantages* (here also abbreviated as *ALAs*). By building on BGAs, affiliate firms can develop specific advantages independently. These advantages are unique resources, capabilities and strengths specific to an affiliate firm (Barney, 1991). The bundle of these BGAs and ALAs is a function of the recombination capabilities by the individual affiliates (Teece et al., 1997; Verbeke, 2009). It defines the overall advantage of each individual affiliate as well as the heterogeneity of the affiliates within a business group (Rugman & Verbeke, 1992). The variance among ALAs occurs due to the level and extent of BGA recombination by each affiliate, that is, some affiliates operationalize or depend on BGAs more than others. This is because each affiliate has specific objectives, roles, operational scope and, eventually, competitiveness. Hence, the affiliates can use the group structure to complement for the missing and potential advantages (Dyer & Singh, 1998; Lavie, 2006; Mahmood et al., 2011).

4. The growth of emerging economy business groups across borders

4.1. Initial internationalization growth stage

The international growth of business groups from emerging economies has been studied for quite a while. However, the results are inconclusive. Specifically, the issue on the advantages of business groups has been cited as the rationale for both success and failure, but the dimension in which these advantages are based is completely lacking(see, e.g., Hoskisson, Johnson, Tihanyi, & White, 2005; Lall, 1983; Pananond & Zeithaml, 1998). This paper argues that the fundamental approach to understand the nature and extent of the international growth of business groups is through their business group advantages, i.e. the extent to which they share or benefit with the strategic resources and capabilities of the business group while growing across borders. This can be determined by looking at the extent to which affiliates are dependent on BGAs. As such, the greater the reliance on BGAs, the stronger the relationship of an affiliate with the business group; or the more an affiliate firm explores and exploits group resources (the knowledge captured and owned by the group), the more they can benefit from the group structure. The practical way to validate this approach is to illustrate the international development stages of the business groups through time.

The business group affiliates rely on their business group when deciding to enter a new market and even more so in entering an international market. The necessity of having knowledge about new markets is tantamount in their strategic intent or entering into a new venture. As practiced, this knowledge can be acquired at the group level for strategic reasons. The most direct is that some of the BG affiliates of the business groups have already done it before and some are even operating in that same market. Their experiences and familiarity are expected to be channeled back to the group for benchmarking. Another obvious reason why BG affiliates rely upon their business groups is access to capital which is controlled at the group level or their group holding companies. The BG affiliates prefer to secure their capital requirement within the group rather than taking a higher risk of negotiating with an external financial provider. Hence, in the internationalization and initial stage of operations of BG affiliates, reliance on BGAs is very important considering the liability of foreignness (Zaheer, 1995) of the new market or venture. In short, business group affiliates may not possess strong affiliate level advantages at the initial stage of international operations.

Proposition 1: *The initial international expansion growth of business group affiliates from emerging economies is significantly influenced by their reliance on business group advantages. The weaker their ALAs, the higher their reliance on BGAs.*

4.2. International development stage

As the business group affiliates continue to share significant support from their business group, they also advance their own affiliate-level advantages in the development stage. However, the quality of ALAs matters a lot here, beyond BGAs, due to the presence of location and non-location bound assets. These assets are the advantages that can be acquired by the affiliates in the host countries (Rugman & Verbeke, 1992). As a response, BG affiliates start to learn and acquire other capabilities which are very important in their operations. The business group affiliates recognize that they must evolve according to what they foresee as an important arrangement between their internal characteristics and the external system enabling them to achieve independent growth (Penrose, 1959). This is strategic in order to keep its pace with other firms or multinationals. Clearly, the only way for the BG affiliates to survive in the competition with incumbent multinationals is to develop superior or comparative specific advantages through the combination of external and internal resources and capabilities.

Proposition 2: In the development stage as business group affiliate multinationals, the higher the pressure for internalizing and exploiting non-location-bound assets in the host countries, the higher their reliance on BGAs

4.3. Mature stage

A firm's organizational structure is the result of its interaction with its direct environment (Nelson & Winter, 1982; Scott, 2001). The firms have their own ways of blending with their institutional environment for the sake of legitimacy (DiMaggio & Powell, 1983). In the case of the business group affiliates, operating in other countries means more difficulties compared to the traditional organizations in terms of legitimacy and organizational management. The reason is that business groups are embedded in a multilevel inter-organizational structure in their home and host countries more than the typical single firms (Kostova, Roth, & Dacin, 2008). This multilevel structure contains vertical and horizontal ties bonded by formal and informal relationships between individuals and firms. This is also heightened when transactions within the group are becoming far too many to handle. Indeed, the implication of this multilevel business group structure is inherently complicated (Granovetter, 2005). However, if there is a sound and dynamic governance framework in place, the probability that business group advantages remain to complement the BG affiliates exists even in the mature stage of its operations (Jones, Hesterly, & Borgatti, 1997). Nonetheless, the ultimate trajectory lies on the significance of the long-term goal of a BG affiliate as a multinational and the whole business group in general. In the end, the influence of home-host environmental factors determines the BG affiliate's level advantages and defines their competitive position in the global environment (Bartlett & Ghoshal, 1987).

Proposition 3: As business group affiliate multinationals operate in other economies apart from the emerging market environment, they face high institutional pressures. The higher the pressures, the higher their reliance on BGAs and ALAs.

5. Theoretical implications, research limitations and future direction

The analyses of business groups have been predominantly domestic in orientation. Thus far, business groups are well understood as domestic groups of interdependent firms, collaborating as well as competing with multinationals in their home country. They are not seen as international firms or global players despite their international activities in inter-regional markets and even in advanced economies. As a matter of fact, business groups have already evolved along with their home country institutions and developed some internationally transferable resources and capabilities (Ramamurti, 2012). What is lacking, however, is the explanation on how these accumulated advantages become significant if the business groups intend to grow globally or compete with other multinational enterprises in different regional markets. Therefore, this paper contributes towards understanding this gap. It argues that the business group organizational structure and advantages are the fundamental point of departure in explaining the business groups' international expansion and competitiveness. It departs from the existing literature by building on the internal dynamics of business group advantages rather than on the external institutions in the emerging economies. In addition, the explanation of how and why business groups exist in international markets is categorically understudied compared to their domestic trajectories (Delios & Ma, 2010). The paper shows that this can be analyzed in different international growth stages. This is a considerable gap in the literature that, if addressed, brings new insights not only in understanding business group internationalization but also in the debate about how business-affiliated multinationals can differ from conventional multinationals from other economies, especially the advanced ones. It can also open some new arguments on how international entry modes like exports, joint ventures and wholly owned subsidiaries are carried when business groups are the major actors.

Although this paper is robust in theoretical grounding, it has clear limitations on the empirical testing. One of the reasons for this is the limited number of business groups which could provide a generalized result in testing the concepts of this paper. Nevertheless, this study provides a lens on how to foresee the growth of business groups both in their domestic and international dimensions. On the other hand, there is enormous potential to expand this study. Firstly, using the concept of BGAs and ALAs, the business organizations in emerging markets can now be clearly classified into business groups and non-business groups. By this, the growth pattern of the two types of organizations can be differentiated. As a result, the analysis of organizations in emerging markets can also be done at the group level. The analysis can even be conceptualized at the global level where the internal business group dynamics will be measured not only from business group and affiliate levels but also including all the foreign subsidiaries across countries. Secondly, the existing literature of business groups has focused on Asia and Latin America. But, by broadening the scope of emerging economies, which include Africa and the transitioning eastern European economies, a consistent theoretical analysis can be applied. For example, the firms in these economies can be analyzed with regard to how they respond to market imperfections as their economic and political institutions are still developing. The firms are the key drivers of the development of markets which then boosts economic development and catch-up.

In sum, the organizations in the emerging economies, such as the business groups, are evolving faster than ever. This evolution blurs the boundaries of the firms, requiring more in-depth analysis to understand their nature. This research contributes to the conversation by focusing on endogenous growth, which provides a more realistic perspective, as an alternative to the traditional institutional analysis.When incorporating the concepts and propositions of this research into the wider dialogue on emerging market firms, it will result in a more comprehensive picture of the ecology of organizations in the emerging economies.

Acknowledgment

This work was supported by Hankuk University of Foreign Studies Research Fund of 2015.

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