The Impacts of Internal and External Environments on Subsidiary’s Capabilities

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Abstract

Based on knowledge-based viewpoint, dynamic capabilities have advanced to the prime determinant of the corporation’s profits. Under the MNC setting, more literature advocate that foreign subsidiaries could be seen as means to generate new capabilities from their local, external network and integrate these capabilities into the multinational corporation. It is argued that the development of dynamic capabilities of subsidiaries is driven not only by intra-firm network, but also by inter-firm network. This study tries to explore the role of intra-firm and inter-firm network for dynamic capabilities development varies according to different climate of relationships they face. In addition, the impact of subsidiary’s dynamic capabilities on subsidiaries initiative is also studied.

Keyword: MNC subsidiary, exploration, exploitation, subsidiary initiative, dynamic capability.
1. Introduction

Knowledge is an important resource for firms to develop and retain competitive advantages (Grant, 1996). The ability of Multinational corporations (MNCs) to leverage their knowledge across dispersed foreign subsidiaries has become more essential than before (Gupta & Govindarajan, 1991). Evidently, these perspectives and related empirical efforts have offered rich insights into the importance of capability building for subsidiaries. However, one gap still remains: Most previous studies have investigated knowledge transfer between parent and subsidiary, but have not yet systematically explored the importance of how the acquired shared resources and capabilities are further exploited in subsidiary (capability exploitation) and how new resources and capabilities are upgraded and built (capability exploration). From the dynamic capability perspective, capability exploitation and exploration is essential not only for survive of subsidiaries but also for MNCs’ competitive advantage. Through learning and generating dynamic capabilities, subsidiaries could continuously renew their competitive advantage to ensure sustained financial performance, and could be centers of excellence to disseminate their capabilities to other subsidiaries to enhance MNC’s competitive positions (Zhan & Luo, 2008).

A number of studies have examined such new phenomenon as center of excellence (Moore & Birkinshaw, 1998), subsidiary-specific advantages (Moore, 2001), and subsidiary entrepreneurship (Birkinshaw et al., 1998). Following this stream of literature, this study tries to address the importance of capability exploitation and exploration in subsidiaries. We attempt to examine how capability exploitation and exploration are associated with the subsidiaries’ initiative.

In addition, based on traditional view, headquarters is an important source of new knowledge for subsidiaries. Acting as a conduit, subsidiaries can exploit the knowledge transferred from parent MNC to prosper in local markets (Blanc & Sierra, 1999). The more recent literature on MNCs, influenced by the “market-as-networks” perspective, however, has argued that external partners can constitute a very powerful resource. External partners can be very important for capability development in subsidiaries (Birkinshaw & Hood, 1998). In fact, since the early 1980s, MNCs have increasingly undertaken R&D in multiple subsidiaries. Given the importance of dynamic capabilities for the subsidiaries, the aim of this study is to focus on the question of how foreign subsidiaries actually develop dynamic capabilities that can be seen as critical for the entire MNC. Specifically, this study tries to identify the different impacts of internal and external network partners influencing the development of dynamic capabilities of subsidiaries.
2. Literature Review

Dynamic capability can be defined as the firm’s ability to integrate, build, and reconfigure internal and external competences to address rapidly changing environment (Teece, Pisano, and Shuen, 1997). It requires the capability to extract economic benefits from current resources and to develop new capabilities. Focusing on the international setting, Luo (2002) and Tallman and Fladmoe-Lindquist (2002) conceptualize dynamic capability as consisting of two dimensions: Capability exploitation and capability upgrading. Capability exploitation concerns the extent to which a firm exploits rent-generating resources that are firm-specific, difficult to imitate, and able to generate abnormal returns which capability upgrading involves the extent to which a firm commits to building new capabilities through learning from organizations, creating new skills, or revitalizing existing skills in new situations. Capability exploitation is critical for gaining competitive advantages and determining strategies for exploiting such advantages while capability upgrading ensures the growth of sustainable competitive advantage and generates new bundles of resources (Zhan & Luo, 2008).

Similarly, Yang et al. (2008) distinguish two subsidiary roles in terms of the subsidiary mandates: competence creation versus competence exploitation. Competence-exploiting subsidiaries are expected to transfer and adapt knowledge from their parent to local markets. These subsidiaries are engaged in implementing established home-based knowledge effectively in local environments (Cantwell & Piscitello, 2000). These processes require continual knowledge transfers from parent firms (Cantwell & Mudambi, 2005). On the other hand, competence-creating subsidiaries are expected to develop knowledge assets that are new to the MNC network, like new products, technologies, practices, and skills (McDonal et al., 2005). Competence-creating subsidiaries are expected to diffuse knowledge to other units to the MNC network. A greater volume of distinctive and valuable knowledge is likely to be available in competence-creating subsidiaries than in competence-exploiting subsidiaries, simply by virtue of their organizational role.

Thus, according to Yang et al. (2008), it is expected that competence-exploiting subsidiaries are associated with significantly higher conventional knowledge transfers. Conversely, competence-creating subsidiaries are expected to be associated with significantly higher levels of reverse knowledge transfers.
3. Hypotheses Development

3.1 The Impact of Local Cooperative Environment on Subsidiary Dynamic Capabilities

The literature on multinational corporations frequently emphasizes the point that a subsidiary unit faces competing pressures: for responsiveness to host country demands, and for conformity to corporate norms (Bartlett & Ghoshal, 1989; Prahalad & Doz, 1987). This means that subsidiary dynamic capabilities are shaped by the local environmental context as well as by elements of the organizational context.

In their everyday work, subsidiary employees will typically interact for more with customers and other firms in their local market than with corporate managers, so it seems likely that such interactions will be the stimuli for their dynamic capabilities building. According to the recent studies of economic geography, subsidiaries innovation, capability upgrading, and competitiveness can be related to the presence of industry clusters (Porter, 1990; Solvell & Zander, 1995). Based on these studies, it is argued that subsidiary’s exploration capability will be promoted by the local cooperative environment. Thus,

Hypothesis 1: A high level of local cooperative environment will promote subsidiary’s exploration capability.

3.2 The Impact of Local Competitive Environment on Subsidiary Dynamic Capabilities

It is argued the exploration capability is essential for subsidiary’s survival especially under dynamic environment. Because an increasingly competitive environment makes building and sustaining firm owned competitive advantage increasingly difficult. Building new resources and capabilities could facilitate the responsiveness to meet the local needs.

Thus, it is expected that changing business environment, dynamic competitive forces and institutions, and unique and changing customer needs all imply that subsidiary should pay more efforts on building exploration capabilities to create new subsidiary-specific advantage to replace subsidiaries’ ownership advantage which may erode over time.

However, according to Birkinshaw (1999), the initiative was promoted in cases where there was weak local market competition. It seems that in very competitive local markets, many subsidiaries found themselves crowded out, they have no opportunities to build relationships with important local customers and suppliers. Thus,
Hypothesis 2: An appropriate level of local competitive environment will promote subsidiary’s exploration capability.

3.3 The Impact of Intra-firm Cooperative Environment on Subsidiary Dynamic Capabilities

In the setting of a subsidiary, capability exploitation focuses on combining, integrating and reconfiguring parents’ and local partners’ resources so that these resources are best blended and utilized to create value-adding products and/or services. Since resources of subsidiaries are originally derived from parent company and other subsidiaries, it is critical for subsidiaries to cooperate closely with parent and other subsidiaries to ensure resources acquisition and integrating. In addition, since subsidiaries involve repeated inter-organizational exchange that become socially embedded over time, cooperation is an important safeguard that can mitigate both external and internal hazards and a comprehensive and efficient form of governance for subsidiaries learning from parent company and other subsidiaries. Since cooperation plays an important role in tacit knowledge transferring, it is expected that cooperation with parent and other subsidiaries will enhance subsidiaries’ exploitation capabilities.

Hypothesis 3: A high level of intra-firm cooperative environment will promote subsidiary’s exploitation capability.

3.4 The Impact of Intra-firm Competitive Environment on Subsidiary Dynamic Capabilities

Though the MNCs have more integration pressure today to coordinate their dispersed subsidiaries, it seems that there is increasing internal competition between subsidiary units. According to Birkinshaw and Lingbland (2005), two major types of internal competition can be identified. The first one is internal competition for a charter, or the responsibility to perform certain activities for the corporation as a whole. Another one is internal competition for a customer in the next stage of the value chain. Under the coopetition scheme, Luo (2005) indicates that subunits compete for parent resources and support, system position, and market expansion. First, they compete for parent resources to reduce their dependence on indigenous resources and to strengthen their competitive strengths in a local market. Second, subunits generally compete for four interrelated types of position: (a) the value-chain position, (b) the knowledge flow position, (c) the competence excellence position, and (d) the influencing power position. Finally, competition arises when subunits are interested or active in some common markets and offer the same category of products or services to shared consumers.
Regarding the impact of intra-firm competition on firm performance, it is possible that a negative effect may occur. First, competitive rent-seeking behavior may encourage firms either to erect barriers around their distinctive competencies or to behave opportunistically toward others. Second, competitive rent-seeking behavior may fail to take into account the dense web of social relations in which firms are deeply embedded (Lado et al., 1997). Thus, it is expected that this intra-firm rivalry will decreases the level of trust in information sharing and knowledge transferring. It will hurdle internal efficiencies and sharing of best practice for successful deployment and exploitation of knowledge. However, many previous researches assert that a combination of cross-functional cooperative ability and competition may nurture productive interactions (Tsai, 2002; Luo et al., 2006) that can facilitate internal efficiencies and sharing of best practice for successful deployment and exploitation of knowledge. In particular, cooperation among competitors can foster greater knowledge seeking and result in syncretic rents. Thus,

Hypothesis 4: An appropriate level of intra-firm competitive environment will promote subsidiary’s exploitation capability.

3.5 The Impact of Subsidiary capabilities on Subsidiary Initiative

According to Birkinshaw (1999), an initiative is seen as a discrete, proactive undertaking that advances a new way for the corporation to use or expand its resources. Under the setting of subsidiaries, an initiative begins with the identification of a product or market opportunity by a subsidiary employee, and ends with corporation’s commitment for resources to that opportunity. Since subsidiaries are often low in influence and power, and that therefore have to work much harder to achieve these initiatives. Facing the difficulties of fulfillment, it is expected that both inertia and outright resistance from certain aspects of the corporate-level context will suppress initiates, while there will also be strong forces, primarily within the subsidiary, to overcome these challenges and bring the initiatives to come true. Among these positive forces, it is expected that the existence of distinctive capabilities at the subsidiary as the most important driver of subsidiary initiative. As distinctive capabilities refers to the extent to which the subsidiary has value-adding capabilities that they believe to be superior to those in sister units around the world, these capabilities can provide the technical and market-based expertise on which the initiatives are built, thus offset the resistance to subsidiary initiative in the head office. Previous research has identified a link between distinctive capabilities and subsidiary’s value-adding role (Roth & Morrison, 1992; Birkinshaw et al., 1995). Since a high level of distinctive capabilities in the subsidiary will depend on continuous renew of resources and capabilities, the higher
level of distinctive capabilities they own, so as subsidiaries’ initiatives.

In addition, because superior capability exploitation could allow the subsidiaries to make better use of current resources, accordingly, it can generate superior financial and competitive outcomes. In contrast, inability to integrate and reconfigure resources from parent and local partners may lead to value erosion and might not derive maximum gains in financial and competitive terms. Possessing exploitation capabilities means good proof of performance. Subsidiaries could easily get credit and attentions from parent companies. Thus, subsidiary’s superior exploitation capability will enhance initiatives fulfillment.

Hypothesis 5: A subsidiary’s initiative will improve as its exploitation capability improves.

Further, according to Luo (2007), for MNCs in a foreign emergent market, the dominant strategy is shifted from competence transfer to competence building, particular to build such competences as brand, innovation, distribution, human capital and social capital. Successful subsidiaries need to possess the ability to deeply understand and closely integrate with the local environment. Such efforts improve proximity and responsiveness to local customers and increase speed to market. This in turn promote subsidiaries’ initiatives fulfillment. According to the above, we hypotheses:

Hypothesis 6: A subsidiary’s initiative will improve as its exploration capability improves.

4. Conclusion and Discussion

This study has shifted the focus from the knowledge transfer to the exploitation and exploration capability of subsidiaries. Theoretically, this study may contribute to research on subsidiaries’ dynamic capabilities. It is argued that for subsidiaries’ evolution and success, possessing resources transferred from parent is not enough. How to effectively exploit parent-contributed resources and continuously explore new capabilities in local market may be more important. Especially, this study explains what type of contingencies in terms of internal environment (cooperate vs. competitive) and external environment (cooperate vs. competitive) may shape exploitation capabilities and exploration capabilities. It is expected that when subsidiaries operate in a more local embedded business environment, subsidiaries will more depend on exploration capability to offset the severer competitive condition. In addition, while subsidiaries face a more intra-firm embedded environment, subsidiaries will more depend on exploitation capability to fully utilize the current resources contributed by parent.
Moreover, it is suggested subsidiaries tend to perform better in initiatives fulfillment when they possess the exploitation capabilities and exploration capabilities. The proposed framework is shown in Fig. 1 for further justification in future research.

![Fig. 1 The Framework of Proposed Research Model](image)

Managerially, this study suggests that merely possessing valuable resources is a necessary but insufficient condition for superior performance of subsidiaries. Not only do subsidiaries need to effectively exploit the current resources, they also need to dynamically build up new resources and capabilities to sustain competitive advantage. On the one hand, from the perspective of subsidiaries, what kind of capabilities should be set on first priority could be subject to their internal and external environments they face. The subsidiaries’ managers should decide how to leverage resources both from local network and intra-firm network they are embedded in to gain subsidiaries’ sustained advantage. On the other hand, from the perspective of MNCs, they should give subsidiaries enough autonomy to embed into local network to increase the exploration possibility. In addition, how to encourage an appropriate competitive climate in the intra-firm network is also a challenge to raise subsidiaries’ exploitation capability.

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