

# How Do Smaller Firms Select Foreign Markets?

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## Abstract

The purpose of this paper was to analyze the internationalization of small and medium-sized enterprises (SMEs) in relation to the international market selection (IMS). To accomplish this, an investigation of the primary factors influencing SMEs' choice when selecting international markets with a systematic approach way was conducted. In addition we sought to understand whether there was a relationship between the systematic approach in IMS and the characteristics of SMEs. Results revealed that the majority of SMEs adopt a non-systematic IMS. However, in the case of SMEs following a systematic approach to IMS, the study pointed out that SMEs are influenced by firm-specific and host country factors, but not by entry barriers like geographic and cultural distance. In addition, results illustrated the existence of a relationship between systematic IMS and firm size.

**Keywords:** international market selection, small and medium-sized enterprises, international strategy, systematic and non-systematic approach

## 1. Introduction

The internationalization process of firms has been one of the most frequently researched topics in international marketing over the past forty years (Fletcher, 2001).

At the same time, during the last decade, small and medium-sized enterprises (SMEs) have been the object of increasing interest. Furthermore, with improved communication systems, and as a consequence of transportation cost reduction and the lowering of barriers to international trade, SMEs have been pushed towards international markets (Nummela, Loane & Bell, 2006). Finally, in most countries SMEs represent the majority of firms and play an important role in the economic growth of these countries (Musso & Francioni, 2012). For instance, in Italy 99.9% of all firms have less than 250 employees (ISTAT, 2011).

As a result, the internationalization process of SMEs has become a subject of academic attention over the last thirty years (Crick & Jones, 2000; Nakos & Brouthers, 2002).

One of the most important SME decisions regarding the internationalization process pertains to which foreign market to enter and expand into (Ellis 2000; Agndal & Chetty, 2007; Sakarya, Eckman & Hyllegard, 2007; He & Wei, 2011). However, although the importance of this decision and the growing attention to SMEs, most of research related to International Market Selection (IMS) has been tailored to large firms (Douglas & Craig, 1992; Cavusgil & Zou, 1994; Makino, Lau & Yeh, 2002) and few studies were focused on smaller ones (Brouthers & Nakos, 2005; Francioni, 2010).

The paper aimed to examine the degree of diffusion of a systematic approach to IMS among SMEs and, in case of use of a systematic approach, the primary influencing factors in firms' decisions. In addition, the study sought to understand if there was a relationship between a systematic approach to IMS and the characteristics of SMEs.

The organization of this paper is as follows. After the introduction, the second section approaches to the concept of IMS. Next, the methodology, analysis, and results will be presented. Finally, implications for future research are explored.

## 2. International Market Selection

IMS is considered the most important decision in internationalization strategy (Root 1998; Papadopoulos; Chen & Thomas, 2002; Francioni, 2012). According to Papadopoulos and Denis (1988), there are two traditional approaches to the IMS: a systematic approach and a non-systematic approach (Andersen & Buvik, 2002).

A systematic approach requires a structured and formalized decision making process, in which firms carry out several analysis before selecting international markets. The importance and need for selecting foreign markets in a systematic way has been emphasized by several researchers, and many models for selecting foreign countries have been created (Douglas, Craig & Keegan, 1982; Johansson, 1997; Root, 1998; Mühlbacher, Leih & Dahringer, 1999; Rahman, 2003). These models have differed on the basis of the number and type of stages in which the market selection process is composed (Koch, 2001).

Two of the most well-known models (Figure 1) were developed by Root (1998) and Johansson (1997). Root (1998) described IMS as a process composed of three steps: preliminary screening, estimating industry market potential (IMP) and estimating company sales potential (CSP). The first step is carried out using basic quantitative variables to rapidly and cheaply reduce the number of markets to be screened in step 2. The second step aims to determine the total market potential in the remaining markets and the final step aims to estimate company sales potential together with other variables such as financial investments and marketing efforts required to determine the forecasted sales level.

Johansson's model is based on four steps. Its primary differences to Root's model are the two preliminary screening steps made through country identification and the preliminary screening stage. The in-depth screening stage resembles Root's second step, while the final stage could be compared to Root's final step. Johansson's model is significant, because it permits observation of variables like the geographic distance that introduces the effects of the psychic/cultural distance in the decision-making process.

Psychic distance was defined as "the sum of factors preventing or disturbing the flows of information between firm and markets" (Johanson & Wiedersheim-Paul, 1975). Examples could be found in differences between countries in language, culture, political system, level of education, and level of industrial development.

Although some authors have distinguished the concepts of 'cultural distance' and 'psychic distance' (Sousa & Bradley, 2006), they have more often been used interchangeably (Chapman, Mattos, Clegg & Buckley, 2008). Psychic/cultural distance has been widely cited in the international business literature as one of the most important predictors for IMS (Johanson & Vahlne, 1977; Brewer, 2007; Ojala, 2008).

In analyzing Root and Johansson's models, It has been found that firms adopting a systematic approach tend to analyze and examine several factors before selecting international markets. These factors may be divided into three primary categories: firm-specific factors, host country factors and entry barriers.

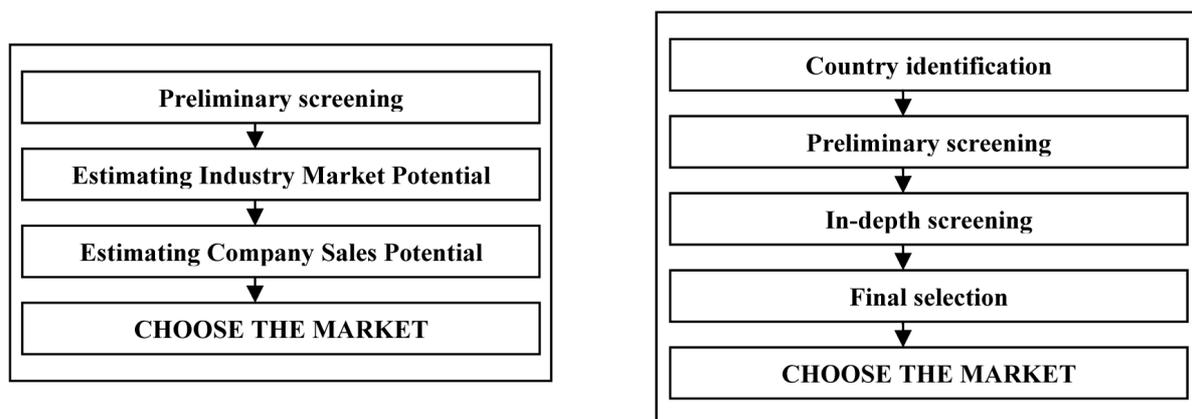


Figure 1. Root's model compared to Johansson's model for selecting foreign markets

Source: Root (1987); Johansson (1997)

A framework to illustrate the most significant factors influencing IMS was created (Table 1) on the basis of several IMS prescriptive models (Douglas *et al.*, 1982; Johansson, 1997; Root, 1998; Mühlbacher *et al.*, 1999), research books (Bradley, 1995) and journal articles examining the influence of specific factors on IMS (Reid, 1983; Czinkota, 1985; Papadopoulos & Denis, 1988; Gomes-Casseres 1989; Calof 1993; Barkema, Bell & Pennings, 1996; O'Grady & Lane, 1996; Yadong, 1999; Andersen & Buvik, 2002; Gaba, Pan & Ungson, 2002; Ito & Rose, 2002; Chetty & Campbell-Hunt, 2003).

Table 1. Primary factors influencing IMS

CATEGORIES	FACTORS INFLUENCING IMS
FIRM-SPECIFIC FACTORS	a) Type of product b) Management characteristics c) Firm size d) International experience
HOST COUNTRY FACTORS	a) Market attractiveness b) Country attractiveness c) Marketing infrastructures d) Competition
ENTRY BARRIERS	a) Country risk b) Tariff and non- tariff barriers c) Psychic distance d) Geographic distance

However, Papadopoulos et al. (2002) stated that IMS models have several problems, because they are not industry specific, generalizable, strategic, and able to reflect the total demand available to the firm, they have not been tested sufficiently, and/or they are too complex to apply in practice.

Indeed, different empirical studies have indicated that firms, and in particular SMEs, usually do not adopt a systematic market approach, because entry decisions are often made by 'nonrational' reasons that apparently defy the optimizing logic of the market (Lee & Brasch, 1978; Ellis, 1995, 2000). For example, Van Hoorn (1979) found that when compared with multinational enterprises (MNEs) SMEs usually have not developed successful administrative policies and procedures, and have an inclination toward adopting opportunistic rather than systematic strategic decisions. In the same way, Karagozoglu and Lindell (1998) discovered that lack of important resources like international managerial experience and know-how, necessary for obtaining relevant information about potential international markets, were common in their sample of smaller firms.

Despite some studies (e.g. Brothurs & Nakos, 2005) focusing on the reason why an SME may not be so systematic in its strategic decision making process, there is a lack of evidence that attempts to illustrate whether a relationship exists between the systematic IMS and characteristics of SMEs.

As a result, the following hypotheses can be formulated:

H1: The bigger the size of the firm, the greater is the SME's probability of adopting a systematic approach.

H2: The greater the firm's international business experience, the greater is the SME's probability of adopting a systematic approach.

H3: The bigger the export intensity of the firm, the greater is the SME's probability of adopting a systematic approach.

H4: The greater the number of foreign country markets served, the greater is the SME's probability of adopting a systematic approach.

### 3. Data and Methodology

To test our hypotheses, direct interviews were conducted over a six-month period and the unit of analysis was the firm. Potential respondents (owners, chief executives and managers responsible for decisions on international processes of their firm) were identified from lists obtained by industry and enterprises associations.

The survey targeted firms located in Marche, an Italian region characterized by a wide range of sectors and industrial districts. Firms have been contacted (by telephone) asking for a direct interview and 355 declared their availability. Before fixing the appointment for the interview, they were asked to indicate the number of employees, industry and international experience. The sample was then reduced to 221 firms on the basis of: dimension (small and medium enterprises with at least 6 employees), industry (manufacturing sectors), and international markets experience (exporters).

Smaller firms (1 to 5 employees) were excluded in order to select only those firms with a real possibility of having choice in foreign country decisions: an inadequate organizational and financial capability could generally hinder any choice that differed from a non-systematic approach to IMS.

Table 2 summarizes the primary characteristics of the sample.

Table 2. Main characteristics of the sample (N=221)

		Frequency	Percent
<b>FIRM SIZE</b>	Less than 10	31	14.0
	10-20	50	22.6
	21-50	69	31.2
	51-100	44	19.9
	101-250	27	12.2
<b>EXPORT WEIGHT ON TURNOVER</b>	Below 20%	43	14.0
	21-40%	87	22.6
	41-60%	48	31.2
	61-80%	24	19.9
<b>YEARS INTERNATIONAL EXPERIENCE</b>	More than 80%	19	12.2
	Less than 5	15	6.8
	OF 5-10	65	29.4
	11-20	78	35.3
<b>NUMBERS INTERNATIONAL MARKETS</b>	21-30	41	18.6
	Above 30	22	10.0
	OF Under 2	52	23.5
	3-5	63	28.5
	6-10	57	25.8
<b>TOTAL TURNOVER</b>	11-20	25	11.3
	More than 20	24	10.9
	Under 5 (millions of euros)	110	49.8
	5-10	44	19.9
	11-20	34	15.4
	21-50	23	10.4
	Above 50	10	4.5

Although the whole sample was used to achieve the objectives of the research, to analyze the primary influencing factors during international market selection, it was necessary to eliminate those firms that selected the market in a non-systematic way, because they did not typically carry out a systematic analysis of the factors prior to making the decision of which foreign country to enter. Therefore, the sample was markedly reduced for data elaboration, since only 55 firms adopted a systematic approach. However, the fact that 75.1 per cent of the firms were not adopting a systematic approach to international market selection can be considered a first relevant result of the research.

The main objective of the study was to investigate the influence of firm-specific, host country and barrier factors in SME's international markets selection. To achieve this objective, the study examined each factor using a five-point Likert scale. In the questionnaire, 13 sentences were formulated (Table 4). Respondents were asked to provide a score ranging from 1 (= no influence) to 5 (= great influence). The means of the Likert scale responses was then compared to a midpoint of 2.5 to determine their significance.

Logistic regression analysis was used to test H1-H4. This method has been previously used in other studies related to the systematic international market selection of SMEs (Brouthers & Nakos, 2005). Logistic regressions are recommended when 1) the dependent variable is dichotomous and 2) there is a combination of continuous or categorically independent variables (Pallant, 2007).

The operationalization of their measures is illustrated in Table 3.

Table 3. Operationalization of the dependent and independent variables

Variable	Measurement
<b>Y1 Systematic IMS</b>	The value of 0 represents an unsystematic IMS and 1 represents a systematic IMS
<b>X1 Firm size</b>	Number of people employed in the business (1 = less than 10; 2 = from 10 to 20, 3 = from 21 to 50, 4 = from 51 to 100, 5 = from 100 to 250).
<b>X2 International business experience</b>	Years of international business experience of the firm (1 = less than 5; 2 = from 5 to 10, 3 = from 11 to 20, 4 = from 21 to 30, 5 = over 30).
<b>X3 Export intensity</b>	Percentage of turnover originating as a result of international sales (1 = less than 20 percent; 2 = from 21 to 40 percent, 3 = from 41 to 60 percent, 4 = from 61 to 80 percent, 5 = more than 80 percent).
<b>X4 Numbers of international markets served</b>	Number of international markets served (1 = less than 2; 2 = from 3 to 5, 3 = from 6 to 10, 4 = from 11 to 20, 5 = more than 20).

## 4. Results and Discussion

### 4.1 Factors Influencing IMS

Table 4 displays the 13 factors considered, the mean response for each statement, and their corresponding t-statistic (assuming a theoretical midpoint of 2.5).

Table 4. Factors influencing IMS

		Mean <sup>a</sup>	Std. Deviation	Std. Error Mean	t	df	Sig. (2-tailed)
<b>FIRM-SPECIFIC FACTORS</b>	Type of product	3.85	1.420	.195	19.739	52	.000
	Management characteristics	3.40	1.317	.183	18.631	51	.000
	Firm size	3.38	1.304	.179	18.852	52	.000
	International experience	2.74	1.546	.212	12.882	52	.000
<b>HOST COUNTRY FACTORS</b>	Market attractiveness	4.15	1.099	.151	27.500	52	.000
	Country attractiveness	3.79	1.405	.193	19.644	52	.000
	Marketing infrastructures	3.28	1.406	.193	17.002	52	.000
	Competition	3.21	1.362	.189	16.998	51	.000
<b>ENTRY BARRIERS</b>	Country risk	2.53	1.527	.210	12.056	52	.000
	Tariff barriers	2.25	1.329	.183	12.302	52	.000
	Psychic distance	2.02	1.336	.185	10.902	51	.000
	Non-tariff barriers	1.98	1.204	.170	11.633	49	.000
	Geographic distance	1.98	1.336	.185	10.694	51	.000

<sup>a</sup>Mid-point on Likert scale= 2.5. Hence, > 2.5: influenced; < 2.5: not influenced

As illustrated, firms were influenced by nine of the considered factors for international market selection. The results clearly demonstrated that SMEs were influenced more by firm-specific and host country factors than by entry barriers.

With regard to firm-specific and host country factors, the research revealed that the primary factor that influenced an SME during the systematic selection of foreign countries was the market attractiveness even if, in general, all factors belonging to these two categories were important.

With reference to entry barriers, results revealed that only country risk was an influential factor. In particular, it is interesting to stress that neither psychic distance nor geographic distance were significant. This result contradicts several studies addressing psychic distance and its influence on international market choice (Davidson, 1980; Phillips, Doole & Lowe, 1995; Barkema *et al.*, 1996; O'Grady & Lane, 1996; Swift, 1999; Yadong 1999; Evans & Mavondo, 2002).

Nevertheless, other studies, particularly those regarding "International New Ventures" and "Born Globals" (Calof, 1993; Oviatt & McDougall, 1994; Knight & Cavusgil, 2004), have found that some SMEs, particularly those operating in high tech sectors, simultaneously develop a large number of foreign markets, independently from their cultural or geographic distance.

It must be considered that a greater openness of international economies exists as a consequence of the reduction of communication and transport costs. This, in turn, tends to reduce the importance of distance as an influencing factor for market choice. A primary reason for unimportance of cultural and geographical distance may be related to the relationship between firm size and entry mode in foreign markets. Most of Italian smaller firms adopt indirect entry modes (Musso & Risso, 2007), so that distance and difficulties related to cultural differences were considered as a kind of "external" problem, for which the international trade partners (importers, trading companies, etc.) were mainly burdened.

#### 4.2 Hypotheses 1 through 4

Before applying the logistic regression, a correlation matrix of the independent variables was created. Coefficient values of 0.6 or higher indicated a multicollinearity problem. In our study, the correlations between the pairs of variables were below 0.6 which provides no indication of the multicollinearity problem. (Table5). Further evidence of the lack of multicollinearity was provided by the variable inflation factors (VIF). In this study VIF score was between 1 and 2, that is very small and eliminating the possibility of multicollinearity (Pallant, 2007).

Table 5 provides information about the contribution, or importance, of each variable. The adopted test was the Wald Test, indicating the significance of each estimated coefficient and providing test for the individual hypotheses.

The interpretation of the regression equation was that a positive coefficient represented a direct relationship, while a negative coefficient represented an inverse relationship between the independent variable and systematic IMS. As illustrated in Table 6, only firm size was significant with the correct sign. No statistical support for the other independent variable hypotheses was found.

Table 5. Correlation matrix

Variable	VIF	H1	H2	H3	H4
<b>H1 Firm size</b>	1.316				
<b>H2 International Business Experience</b>	1.318	0.346**			
<b>H3 Export Intensity</b>	1.221	0.038	0.339**		
<b>H4 Number of Foreign Markets</b>	1.366	0.411**	0.344**	0.305**	

\*\*Correlation is significant at the 0.01 level (2-tailed)

Table 6. Model coefficient

Variable	S.E.	Wald	df	Sig.(p)	Exp(B)	
<b>H1 Firm size</b>	0.358	0.155	5.356	1	0.021	1.430
<b>H2 Intern. Busin Experience</b>	0.165	0.149	1.227	1	0.268	1.180
<b>H3 Export Intensity</b>	-0.241	0.176	1.865	1	0.172	0.786
<b>H4 Number of Foreign Markets</b>	0.105	0.142	0.541	1	0.462	1.110
<b>Constant</b>	-2.185	0.604	13.096	1	0.000	0.112

H1 was supported by our findings ( $B=0.358$ ;  $p<0.05$ ). Accordingly, this result confirms our conjecture that firms with a smaller size were more likely to not adopt a systematic approach to IMS.

As for firm size, a positive-sign was identified in the formulation of H2. However, this influence was not statistically significant. Therefore the role of International Business Experience was not critical in the choice of a foreign country for an SME.

H3 was not confirmed because the results revealed a negative sign for Export Intensity, as well as without statistical significance.

The number of foreign country markets did not serve a significant predictor, so H4 was rejected.

## 5. Conclusions

In this study, using a sample of small and medium-sized firms located in a region of Italy, SME behavior in the international market selection process was tested. Previous studies were mainly focused on larger firms and did not consider a possible different behavior between large and small firms.

Results revealed that 24.9 percent of SMEs in our sample adopted a systematic IMS. These findings are consistent with those of other studies (Lee & Brasch, 1978; Ellis, 1995, 2000; Francioni, 2010) who found that, contrary to multinational firms, the majority of SMEs did not approach IMS in a systematic way.

Such a result provides an indication of a persisting lack of capabilities among SMEs that have difficulties in recognizing the increasing importance of a systematic approach for market selection. Moreover, when the need of a systematic analysis and selection of foreign markets emerges, firms have difficulties in adopting an appropriate methodology.

As a result, studies of SMEs should account for information both at a management level, with the development of specific methodologies that could be suitable for SMEs, and at a public policy level, with the organization of services and training programs for SMEs' management. A strategic approach to international market selection is more relevant as the level of international competition increases. Both marketing strategy effectiveness and efficiency along distribution channels, require a selection of foreign markets whose characteristics need to be compatible with those of firms and sectors.

In the case of SMEs following a systematic approach to IMS, the study pointed out the primary factors which may influence SMEs in the systematic selection of a foreign country. Results found that SMEs were particularly influenced by firm-specific and host country factors. More specifically, the most significant factor influencing IMS was the market attractiveness, which corroborates with several IMS models (Johansson, 1997; Root 1998) emphasizing the importance of this factor for SMEs.

On the contrary, the research revealed some results that were opposite to those found in other studies. In particular, the findings did not confirm previous study results asserting that entry barriers, in particular those defined as natural entry barriers, like geographic and cultural distance, had a significant impact on international market selection. This result may suggest that a more in-depth analysis regarding the influence of these factors on the international strategy is necessary.

Additionally, findings provided support to the existence of a relationship between systematic IMS and firm size, since smaller firms were more likely to choose international markets without systematic analysis. Finally, it is interesting to stress that international business experience, export intensity and numbers of international markets served were not related to systematic IMS.

## 6. Limitations and Suggestions for Future Research

The limitations of this study provide directions for future research. Firstly, the study is focused on SMEs in one region of Italy. Future research could analyze other regions in Italy or other countries. A second limitation was that the study did not take into account other potential factors which may influence the systematic approach to IMS, such as firm's tradition and culture, or the internationalization of the firm's customers. Such a limitation could be overcome by future studies.

We also recommend that future work be conducted on analyzing the relationship between the adoption of a systematic IMS and economic results of firms in terms of export turnover and profitability. Another relevant issue for future studies could be the analysis of the relationships between IMS and entry mode selection. Such analysis should be carried out in a double perspective. On one hand, it would focus on the sequence of the decision processes, that is, if IMS precedes entry mode choice or vice versa. On the other hand, reciprocal influences could be analyzed, as many SMEs are required to follow an approach in entry mode decisions that does not depend on the chosen country.

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