WHEN DO FOREIGN FIRMS INVEST IN LOCAL SUPPLIERS?
A COMPARISON BETWEEN MNCS AND LOCAL COMPANIES IN VIETNAM

Soonkyoo Choe
Ph.D., School of Business,
Yonsei University, Seoul, Korea

Abstract: This study investigates the effect of ownerships on local supplier investment and how this effect varies across different configurations of local market orientation and investment incentives. The findings indicate that foreign firms invest in local suppliers less than domestic firms and that foreign firms increase their local supplier investment if they focus on the Vietnamese market.

Key words: flexibility, commitment, ownership, local supplier investment, emerging economy, Vietnam

I. INTRODUCTION
This study attempts to advance the understanding of multinational corporations’ (MNCs) local supplier strategy by investigating the impact of ownership structure on their investment in suppliers in Vietnam. In this study, we posit that MNCs invest in their suppliers less than domestic firms, since the former, compared to the latter, has a strong desire to maintain managerial flexibility in the foreign market (Belderbos and Zou, 2009). In additionally, we suggest that such a tendency will diminish when MNCs have local joint venture (JV) partners, as well as that the relationship between ownerships and local supplier investment will be moderated by certain firm and country-specific factors, such as local market orientation and investment incentives.

II. THEORY AND HYPOTHESES
Flexibility and commitment are the main drivers of a firm’s investment and are considered opposite extremes of the spectrum (Pacheco-De-Almeida, et al., 2008). Flexibility refers to the ability of a firm to respond to uncertain and fast-occurring environmental changes, whereas commitment implies the desire to cultivate long lasting exchange relationships with business partners (Rylander et. al., 1997).

A comparison between foreign and domestic firms, in terms of local supplier investment, offers a finergrained illustration for the flexibility versus commitment trade-off. Compared to intra-firm relationships, the supplier relationships are argued to be more risky, especially when the suppliers come from emerging economies (Liu et. al., 2009). Thus, a foreign firm will avoid being embedded in the relationship with an unknown supplier to maintain its managerial flexibility. However, its local supplier investment decision can change in consideration of other contingencies (Ganesan, 1994). For the reason,
this study examines three factors that may affect MNCs’ local supplier investment decision: the buying firm’s ownership structure (e.g. foreign or domestic firm), the buying firm’s local market orientation, and the government’s investment incentives.

A. Foreign vs. Domestic Buyers
An important advantage of MNCs over domestic companies resides in their ability to switch the location of their operations from one country to another in response to the changing conditions in the foreign markets (Belderbos and Zou, 2009). Thus, MNCs will have a strong desire to retain their flexibility in their foreign operations. Further, a commitment strategy creates “barriers to exit” (Porter, 1976). Especially, since local supplier investment usually involves a large capital expenditure, as well as a time-consuming endeavor, foreign firms may suffer significant losses if market conditions turn adverse. Hence, a high level of commitment to suppliers will limit managerial flexibility in dealing with a hostile environment (Li and Li, 2010). On the other hand, the commitment strategy with local suppliers are likely to be more valuable to domestic firms since their businesses are mostly based on the home country (Ganesan, 1994).

Hypothesis 1: Foreign firms invest in their local suppliers less than domestic firms

B. Wholly-Owned Subsidiary vs. Joint Venture
Contrary to wholly-owned subsidiaries (WOSs), joint ventures (JVs) are characterized by a shared ownership with local JV partners. As insiders in the host country, local JV partners understand local suppliers better than foreigners. With less information asymmetry and psychic distance, local JV partners can support the JV’s attempt to assess an investment more precisely (Blodgett, 1991). Also, the recoverability of JVs, when firms decide to divest, will be probably higher than WOSs, since local JV partners can help the foreign partners better deal with economic and legal issues in liquidating the assets in the host country. Therefore, the likelihood of a JV using the commitment strategy with local suppliers is higher. In addition, Javorcik and Spatareanu (2008) reason that WOSs tend to more often choose flexibility when compared to JVs, because WOSs usually hold more sophisticated technologies. The concern of technology leakage may cause WOSs to hesitate to invest in local suppliers.

Hypothesis 2: The negative relationship of the relationship between foreign ownership and local supplier investment are weaker in JVs than in WOSs.

C. Local Market Orientation
MNCs can garner more benefits from supplier investment, if their business goal in the host country is to penetrate the local market. A close cooperation with local partners is conducive for accessing the resources and knowledge of the local market which are helpful for foreign firms to reduce the liabilities of foreignness and to adapt to unique market preferences in the host country (Andersson et. al., 2005). By investing in suppliers, for instance, MNCs can secure the supply of key parts and components. Also foreign firms can gain new opportunities via their local supplier networks, since suppliers can play a bridging role between the foreign firm and domestic customers or other service suppliers (Chetty and Holm, 2000).

Hypothesis 3: High local market orientation weakens the negative relationship between foreign ownership and supplier investment.
D. Investment Incentives

The expectation that foreign investment is beneficial to the development of local suppliers motivates governments in emerging economies to offer favorable incentives to foreign investors (Meyer, 2004). Such government incentives reduce MNCs’ perceived risks and uncertainties involved in their investment, since the incentives will increase the estimated return on investment. MNCs may also perceive such government investment incentives as a credible signal that the host country government is willing to improve the local business environment in favor of foreign investors. This can further reduce MNCs’ perceived risks. Domestic firms are often the recipient of incentives from the government, too. However, these incentives are often oriented toward firms with high export intensity, rather than firms which are embedded in the domestic market. Further, domestic companies can have intrinsic motivations to invest in suppliers to maintain or enhance their competitive position in the home market. Consequently, domestic companies would be less sensitive to government incentives in undertaking investment in suppliers.

Hypothesis 4: The presence of investment incentives weakens the negative relationship between foreign ownership and supplier investment.

III. METHODOLOGY

Data: Firm-level data is obtained from the “Vietnam Industry Investor Survey 2010”, undertaken by the United Nations Industrial Development Organization, in collaboration with the Foreign Investment Agency under the Ministry of Planning and Investment, the Vietnam Chamber of Commerce and Industry, and the General Statistics Office. This survey is an output of the Project “Platform for Investment Monitoring and Supplier Development Phase I” in Vietnam from between 2009 and June 2012. The initial data set includes 1,493 industrial firms (57.2% are of foreign ownership) in the manufacturing, construction, and utilities industries. Since the study solely focuses on manufacturing firms, the sample size is reduced to 1,409 firms, comprised of 578 domestic firms, 99 JVs, and 732 WOSs. Dependent Variable: In the survey, respondents were asked to provide “yes” or “no” answers to the question, “Does this enterprise interact with local suppliers to help them improve their operations in any of the following ways?”: (1) upgrade the efficiency of their production processes, (2) upgrade the quality of their products, (3) improve their access to working capital/finance/equity, (4) improve the quality of their workforce through provision of training, (5) transfer of technology or know-how through supplying designs or process know-how, and (6) conduct joint product design and/or development work with suppliers. To measure the dependent variable (local supplier investment), we counted the number of “yes” on those six items (mean=1.3, s.d.=1.49).

Independent variables: The ownership structure of a sample firm was measured in two ways. First, a dummy variable takes the value “1” if the firm is a foreign firm, and “0” if it is a domestic firm (mean=0.59, s.d.=0.49). Second, we created two additional dummy variables. One takes the value “1” if the firm is a JV, and “0” otherwise (mean=0.07, s.d.=0.26). Another takes the value of “1” if the firm is a WOS, and “0” otherwise (mean=0.52, s.d.=0.50). Local market orientation is assessed by the portion of domestic sales in the total sales (mean=48.49, s.d.=43.50). In addition, to measure if a sample firm received government investment incentives, we coded a dummy variable which takes the value of “1” if the respondent indicated in the survey that his/her
company received any investment incentives (e.g. capital grants, tax exemptions and other fiscal incentives, grants for hiring and/or training employees, dedicated physical infrastructure), and “0” otherwise (mean=0.44, s.d.=0.50). Control variable: We included three control variable in our model. The first is firm size which is measured by a log of a number of permanent full-time employees (mean=5.74, s.d.= 1.03). The second is firm age which is proxied by a log of the number of years the firm had operated in Vietnam (mean=2.37, s.d. = 0.65). The last is profitability which is represented by the ratio of gross profit over total assets (mean=1.47, s.d. = 2.30).

IV. Results
Table 1 presents means, standard deviations and correlations of the variables used for this study. Hypotheses are tested by using a multiple regression analysis. Table 2 provides the results of the regression.

Table 1 Descriptive Statistics and Correlation Coefficients

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>SD</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
</tr>
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<tbody>
<tr>
<td>1</td>
<td>Supplier investment</td>
<td>1.31</td>
<td>1.40</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<td>2</td>
<td>Foreign</td>
<td>0.59</td>
<td>0.40</td>
<td>0.10</td>
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<td></td>
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<td>3</td>
<td>JV</td>
<td>0.37</td>
<td>0.26</td>
<td>0.11</td>
<td>0.22</td>
<td>1</td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>WOS</td>
<td>0.32</td>
<td>0.30</td>
<td>0.09</td>
<td>0.80</td>
<td>0.35</td>
<td>1</td>
<td></td>
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<td>5</td>
<td>Local market orientation</td>
<td>0.38</td>
<td>0.58</td>
<td>0.07</td>
<td>0.49</td>
<td>0.20</td>
<td>0.40</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Investment</td>
<td>0.44</td>
<td>0.30</td>
<td>0.05</td>
<td>0.10</td>
<td>0.01</td>
<td>0.15</td>
<td>0.04</td>
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<td>7</td>
<td>Size</td>
<td>0.74</td>
<td>0.05</td>
<td>0.00</td>
<td>0.00</td>
<td>0.64</td>
<td>0.14</td>
<td>0.25</td>
<td>0.13</td>
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<tr>
<td>8</td>
<td>Age</td>
<td>0.37</td>
<td>0.65</td>
<td>0.03</td>
<td>0.25</td>
<td>0.01</td>
<td>0.03</td>
<td>0.05</td>
<td>0.03</td>
<td>0.00</td>
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<tr>
<td>9</td>
<td>ROA</td>
<td>0.47</td>
<td>2.30</td>
<td>0.63</td>
<td>0.40</td>
<td>0.01</td>
<td>0.09</td>
<td>0.07</td>
<td>0.00</td>
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</tr>
</tbody>
</table>

Table 2 Multiple Regression Results

N = 1409. Standard errors are in parentheses. + p<0.1; * p<0.05; ** p<0.01; *** p<0.001

In Table 2, Model 1 examines the impact of foreign ownership on local supplier investment. In the model, the coefficient for foreign ownership is negatively significant at the 0.001% level, providing strong support for Hypothesis 1. Hence, foreign firms tend to invest in local supplier less than domestic firms.

Model 2 divides the ownership into JVs and WOSs and tests their influence to local supplier investment level. As expected, it shows a negative and significant coefficient for both JVs and WOSs with a larger negative effect being associated with WOSs, in line with our prediction in Hypothesis 2. Hence, the level of JVs’ local supplier investment is higher than the level of WOSs’ but still lower than the level of domestic firms’.

The results of Model 3 show that the coefficient for the interaction term of ownership and local market orientation is positive and significant (β=0.0059, p<0.01), implying that local market orientation weakens the negative relationship between ownership and supplier investment. On the other hand, in Model 4, the coefficient for the interaction term of
ownership and investment incentives is positive but not statistically significant ($\beta=0.1334$, n.s.). Hence, Hypothesis 4 is not supported by our analysis. Finally, the full model, Model 6, shows the consistent results with the other models.

V. Discussion
Our analysis shows that MNCs are less active in investing in local suppliers than domestic companies. This difference suggests that MNCS tend to avoid investing in suppliers in an emerging economy, since the investment can create exit barriers which limit MNC’s ability to respond to changing market conditions. However, our results reveal that MNCs’ reluctance to invest in suppliers can be tempered if they set up their subsidiary as a JV with a local partner.

The reason may be that the managerial and technical assistance from the local partners can reduce MNCs’ perceived risks in working with local suppliers in the host country.

At the same time, our analysis provides evidence that MNCs tend to invest more in local suppliers if the main purpose of their business in the host country is to penetrate into the local market. MNCs with such a purpose may place higher value on the development of competent suppliers who can produce high quality parts and components. On the other hand, our results do not find evidence that the local government’s investment incentives induce MNCs to invest in local suppliers.

VI. Conclusion
The results of our analysis suggest that MNCs have a strong desire to maintain managerial flexibility in an emerging economy, in order to deal with the high risks and uncertainties in the changing business environment. Our evidence shows that their preference for flexibility does hold even if they receive investment incentives from the host country government. These findings highlight managerial flexibility as an important advantage MNCs can have over domestic companies. At the same time, our analysis suggests that if MNCs focus on the local market, they are willing to forgo some benefits of flexibility and make a significant commitment to the local market. By investing in local suppliers, they can build a competitive supplier network in the host country, and this may give them more benefits in the long-run.

Our analysis also suggests that foreign investors do not much contribute to the development of competent suppliers in emerging economies. To nurture competitive parts and materials industries, therefore, policy makers in emerging economies may focus more on supporting domestic companies which invest in their suppliers. Also, to promote MNCs to invest in local suppliers, policy makers need to take a more fundamental approach such as liberalizing the market, rather than resorting to ad hoc measures such as investment incentives.

VII. Reference
