

# **A Framework for Understanding FDI Firms' Exit Behavior**

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# **A Framework for Understanding Firms' Foreign Exit Behavior**

## **Abstract**

Although research on foreign market entry and expansion behavior has attracted significant interest in the literature, there is a general lack of research (either conceptual or empirical) on the exit behavior of international companies. To address this issue, the authors develop a conceptual framework to understand firms' foreign exit behavior. The objective is to lay the conceptual foundation for subsequent empirical research in this area. A series of research propositions are advanced that can guide hypothesis generation for future research.

**Keywords:** exit behavior, performance, international company, conceptual framework.

## 1. INTRODUCTION

International trade is an open and dynamic business cycle, as every year numerous firms initiate their business in foreign markets and a large proportion of firms exit their foreign markets, with new firms stepping in. Firms' entry, expansion, and exit are the three basic activities in the cycle (Campbell 1998). Clearly, these behaviors are not independent from each other because firms' entry, dynamic development, and exit activities are in a long-run equilibrium (Hopenhayn 1992). Therefore, firms' exit rate is usually positively related to entry rate within an industry (Alvarez and López 2008). Exit refers to a long-run decision to leave the market (Mankiw 2011), and other terms such as 'divestment', 'divestiture', and 'disinvestment' have also been used interchangeably in previous research on exit (Brauer 2006).

At the micro level, accompanying the rapid economic globalization during the past half century, the increasingly furious worldwide competition frequently pushes many firms to the verge of exiting from the foreign market. Commonly, numerous firms experience tough decisions on exiting from a market. This implies that exit decisions have never become as important as now (McDermott 2010), but despite the paramount role of such decisions, most managers have no idea of how to handle these efficiently and confidently (Burgelman 1996), nor do they conduct detailed analyses before and after these decisions are made (Boddewyn 1983). This may be partly explained by the fact that present research on international exit behavior is scant (McDermott 2010) and, therefore, unable to provide insightful instructions for firms' operations.

In the literature, severe asymmetry exists in the research on entry, expansion, and exit behavior. Specifically, there is a plethora of research on firms' entry and expansion behavior (Griffith, Cavusgil, and Xu 2008), but a general lack of research (either conceptual or empirical) on firms' exit behavior (Fetscherin, Voss, and Gugler 2010). Although research on entry and expansion behavior may help managers to understand the important factors for success, research on exit behavior informs managers about factors that inhibit success. Learning from unsuccessful strategies may be more valuable than learning from success, as managers will become more aware of success inhibitors based on painful lessons, which may increase the probability of subsequent success (Madsen and Desai 2010). Therefore, firms' exit behavior should be as important, if not more so, than their entry and expansion behavior.

The purpose of this study is to address the under-researched topic of firms' foreign exit behavior, by developing a new conceptual framework. Hence, the contributions are the following: Firstly, in the international marketing field we are among the few to expand the extant research on the entry- and expansion-focused behavior to exit behavior, thereby contributing to the understanding of a complete picture of the issues involved in the international business cycle. Secondly, we develop a conceptual framework for understanding firms' foreign exit behavior. We consider unsatisfactory performance of a firms' foreign operation as the most important trigger of an exit decision. In addition, several moderators were also included in our conceptual framework to understand when or under what circumstances this trigger will eventually lead to an exit/non-exit decision. This allows us to better explain/predict firms' exit behavior and, therefore, also helps firms to enhance the quality of their strategic decisions.

In the following section, we develop a literature review on foreign exit research. We then present the theoretical bases for developing our conceptual framework. Next, the conceptual framework for understanding firms' exit behavior and corresponding research proposals is developed. The paper concludes with the theoretical and managerial implications, limitations of the study, and future research directions.

## **2. RESEARCH ON FIRMS' FOREIGN EXIT BEHAVIOR**

Academic research on firms' exit behavior may be traced back to the work on foreign divestment by Boddewyn and Torneden (1973), and Gilmour (1973), among others. Although several pioneer works on foreign divestment were published by Boddewyn and his colleagues between 1973 and 1985, subsequent researchers show inadequate attention to their work (McDermott 2010).

Similar to research on domestic exit behavior, studies on foreign divestment cover antecedents/incentives/drivers, outcomes, and the decision-making process. Previous studies show that firms' exiting from a foreign market may be caused by forced drivers (such as governmental takeover, expropriation, and political risk) and/or voluntary drivers (such as poor financial performance, absence of strategic synergy, different entry strategies and poor relationship between headquarters and subsidiaries) (e.g., Boddewyn 1979; Li 1995). Some researchers also show interest in the decision-making process of foreign divestment (e.g., Gilmour 1973; Nees 1978). In general, interviews and case studies are used to collect data in previous research (e.g., Matthyssens and Pauwels 2000). No generally accepted framework has

been developed to guide subsequent research, and only one theory proposed by Boddewyn (1985) has been specifically developed for foreign divestment.

Among all the antecedents/drivers of a foreign exit, poor/unsatisfactory performance has generally been singled out as the most important antecedent (Berry 2010b). This is understandable considering that the majority of the firms are for-profit organizations and firms initiate strategic changes such as a foreign exit mainly when the performance is unsatisfactory (Shimizu and Hitt 2005). However, among the very few empirical studies which have examined the performance-foreign exit relationship, the relationship is found to be inconsistent (e.g., Berry 2010b; Engel, Procher, and Schmidt 2013). This indicates that we need to go a step further to understand why the empirical performance-exit relationship is inconsistent. In this case, it is necessary to determine the moderators influencing the performance-exit relationship, rather than simply assuming a direct relationship exists (Berry 2013). Therefore, to advance our understanding of firms' exit behavior, we propose to examine the possible impact of several moderators on the performance-exit decision relationship.

### **3. THEORETICAL BASES**

The conceptual framework in this study mainly draws on the notion of the behavioral theory of the firm to explain the performance-exit decision relationship, while the real options theory, resource advantage theory, and agency theory are used to explain the three sets of moderators.

### **3.1. Behavioral Theory of the Firm**

Building on the assumptions of bounded rationality and uncertainty avoidance, the behavioral theory of the firm predicts how firms will change their behaviors given the level of performance compared with managerial aspiration levels (Argote and Greve 2007; Shimizu 2007). The behavioral theory of the firm argues that firms continually adjust their behavior in reaction to how satisfied they are with their performance (Lant and Shapira 2008). Therefore, when performances remain above their aspiration levels, firms are satisfied and tend not to initiate behavioral changes. Only when the performances fall below the aspiration levels, are organizational changes more likely to occur (Argote and Greve 2007; Cyert and March 1963). Based on this notion, exit decisions are contingent upon whether the performance of a foreign market is above or below its threshold performance (i.e., aspiration level) (Gimeno et al. 1997). Foreign operations with satisfactory performance (i.e., performance is above their threshold performance) tend to stay in the foreign market, whereas foreign operations with unsatisfactory performance are more likely to initiate strategic changes such as exiting from the foreign market, regardless of the absolute level of the economic performance. In this case, the behavioral theory of the firm explains the main path of our conceptual model.

### **3.2. Real Options Theory**

The first set of moderators influencing the performance-exit relationship derives from the real options theory. Given unsatisfactory performance in a foreign market, firms are faced with a decision as to whether to remain in or exit from the foreign market, but this is a difficult decision surrounded by great uncertainty (Shimizu 2007). In the context of uncertainty, real options reasoning has gained increasing attention in explaining/predicting decisions (Belderbos and Zou

2009). Challenging the two common assumptions concerning inertia and sunk costs, the real options theory argues that sunk costs and environmental uncertainty are key factors in understanding firms' exit behavior (O'Brien and Folta 2009). Sunk costs refer to costs that have been incurred and cannot be reversed (Sutton 1991), while environmental uncertainty is defined as decision makers' perceived unpredictability of the environment (Buchko 1994). Under the real options theory, when making exit decisions, rational firms should consider the important role of sunk costs and stay in the market for some time, as long as the exit option still exists in the future (O'Brien and Folta 2009). The reason is that if firms exit immediately after a negative benefit arrives, and if conditions dramatically improve in the near future, re-entering the market will incur previously-paid high sunk costs (Berry 2010a).

In addition, the uncertainty about the environment means that managers are unable to predict the foreign markets, government regulation/intervention, actions of competitors and suppliers, and/or general conditions facing the organization (DeSarbo et al. 2005), as well as future performance and the relationship between strategy and performance (Harrison and Kelly 2010). In this case, maintaining the investment position of a foreign operation provides option value. Thus, it is important to examine environmental uncertainty when making strategic decisions such as whether to exit a foreign market (O'Brien and Folta 2009). Consequently, as the key constructs of real options theory, sunk costs and environmental uncertainty are both included as moderators in firms' exit decision-making.



### **3.3. Resource Advantage Theory**

The second set of moderators influencing the performance-exit relationship derives from the resource advantage theory. Similar to the resource-based view, resource advantage theory perceives firms as aggregators of valuable, rare, inimitable and non-substitutable resources and capabilities (Griffith and Yalcinkaya 2010). Instead of competition *per se*, the resource advantage theory highlights the translation from comparative advantage in resources into a position of competitive advantage in the marketplace (Hunt and Morgan 1995). Therefore, all the allocation and exploration of resources and capabilities in a larger societal system should be directed to favorable competitive advantage, which in turn leads to superior performance. In this study, we argue that competitive resources may moderate the relationship between firms' performance in a foreign market and the final exit decision. Two constructs derived from resource advantage theory are included as moderators: slack resources, which indicate the munificence of competitive resources; and their relatedness with other SBUs (Strategic Business Units), which represents the complementarily competitive resources.

### **3.4. Agency Theory**

In addition to the aforementioned two sets of moderators, another important moderator, managerial self-interest, is also at work during the decision-making process. In this model, we use agency theory to explain the rationale behind managers' pursuit of managerial self-interests in making an exit decision.

Agency theory holds that there are goal conflicts between managers and the organization, since managers are always self-interested (Eisenhardt 1989). This reveals that managerial self-interest

plays an important role in organizational thinking (Perrow 1986), and outcome uncertainty offers a platform for managers' self-interest seeking behavior (Eisenhardt 1989). Based on this, our theoretical framework posits that managers tend to be more self-interested when making exit decisions, because the goal conflict and difference in risk preference between managers and firms become intensified and explicit in such a decision context (Amihud and Lev 1981). In this case, the extent to which managers pursue their self-interests will influence their choice between an exit and non-exit decision. Therefore, in this study, managerial self-interest is included in the framework.

In summary, based on the behavioral theory of the firm, real options theory, resource-advantage theory, and agency theory, we propose that unsatisfactory performance is an important antecedent of firms' exit decision, and that its impact is moderated by three sets of factors. Specifically, perceived environmental uncertainty and sunk costs are introduced based on the real options theory, while slack resources and relatedness with other SBUs are also included on the basis of resource advantage theory. Moreover, managerial self-interest is introduced as suggested by agency theory (see Figure 1). These relationships are discussed in more detail in the next section.

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Insert Figure 1 about here  
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## **4. RESEARCH PROPOSITIONS**

Our conceptual framework in Figure 1 aims to explain the link between firms' performance in a foreign market and the exit decision. Specifically, we propose that if the performance of a foreign operation is unsatisfactory, an exit decision is more likely to be made. In addition, the performance-exit relationship is contingent upon three sets of moderators. The following sections discuss the research propositions underlying this framework in more detail.

### **4.1. International Performance and Exit Behavior**

Many researchers postulate that poor or unsatisfactory performance is the most important predictor of the exit decision (Boddewyn 1979; Duhaime and Grant 1984; Sachdev 1976; Shimizu 2007). Performance is usually considered as feedback on firms' previous business operations (Moliterno and Wiersema 2007) and as an indicator of expected future performance (Duhaime and Grant 1984). As such, unsatisfactory performance indicates that the prior strategy choice (including strategy formulation and implementation) of a foreign operation has failed to meet the local demand and/or that the foreign operation competes unfavorably against its counterparts in the target market. More importantly, unsatisfactory performance implies that future performance will also be unsatisfactory or even worse if no changes are made. Therefore, unsatisfactory performance is likely to trigger strategic changes (Day and Wensley 1988). Further, because unsatisfactory performance also signals that the existing strategy has proven to be unsuccessful in the current market (Berry 2013; Hoskisson and Turk 1990), it is very likely that many managers make an exit decision unless they are certain about the success of alternative strategies in improving future performance in a short time. Some empirical research also

suggests that unsatisfactory performance is positively related to the likelihood of foreign exit (e.g., Gimeno et al. 1997; Shimizu and Hitt 2005). Thus, the following proposition is developed:

*Proposition 1: A firm's performance in a foreign market has a negative impact on the firm's decision to exit from the foreign market*

## **4.2. Moderators**

Based on the three theoretical bases aforementioned, three sets of moderators tend to influence the relationship between satisfaction with performance and exit decision. *Environmental uncertainty* refers to the extent to which future states of the environment cannot be precisely predicted (Tushman and Anderson 1986). Environmental uncertainty usually prevents managers from precisely analyzing present causal links between past strategies and present performances, and predicting the possible cause-effect relationships between certain strategies and their future performances (O'Brien and Folta 2009). Therefore, when the performance of a foreign operation is unsatisfactory and the environment is very uncertain, managers tend not to make big strategic decisions such as to exit from a foreign market (Berry 2010a). Instead, they prefer to wait for more information which allows them to better predict the relative chances of a business turnaround to that of a business failure (Bragger et al. 1998), in the belief that the additional information will enable a better exit/non-exit decision to be made. Therefore, in the case of poor performance, the more uncertain the environment is, the more likely managers will choose to stay in the market. Empirical studies also suggest that the greater the environmental uncertainty of a foreign operation, the more likely firms will keep switching options open, and the less likely it is that an exit decision will be made (Berry 2013; Bragger et al. 1998; Downey, Don, and Slocum 1975).

*Proposition 2: The negative relationship between a firm's performance in a foreign market and the firm's exit decision becomes less negative as the environmental uncertainty increases.*

*Sunk costs* refer to costs that have been incurred and cannot be reversed (O'Brien and Folta 2009). In international markets, sunk costs include costs of information about demand conditions and competitive structures overseas, establishing networks with distributors, and costs to break down entry barriers, and emotional attachment, among others (Chi and Liu 2001; Day 1997). The sunk cost effect means that sunk costs tend to influence managers' decisions in such a way that they are more risk-seeking than they would be had no sunk costs been incurred (Zeelenberg and van Dijk 1997). Specifically, when facing a foreign exit/non-exit decision, due to the large sunk costs, managers tend to choose to remain in the market. The reason is that if a firm were to re-enter the same market in the future, a similar amount of sunken costs would be re-incurred. Therefore, when firms experience poor performance, the large sunk costs associated with foreign establishment create a high exit barrier which delays or prevents managers' exit decisions (Harrigan 1985; Porter 1976). In this case, the larger the sunk costs are, the less likely it is that an exit decision will be made. Therefore,

*Proposition 3: The negative relationship between a firm's performance in a foreign market and the firm's exit decision becomes less negative as the sunk costs increase.*

*Slack resources* refer to potentially utilizable resources that can be diverted or redeployed to achieve organizational goals (George 2005). They have a positive relationship with managers'

risk-taking when making decisions (Singh 1986). Accordingly, the availability of slack resources encourages firms to be more risk-taking. Namely, they will continue to invest in unsatisfactory business ventures expecting an upturn (Shimizu 2007). In addition, the presence of slack resources indicates that the competition for resources among all the business operations of international firms is not intensive (Cheng and Kesner 1997). Firms can afford to, and are more willing, to continue to invest in the unsatisfactory foreign operations, because the slack resources will not create any value for firms without being put in the market. In this case, managers tend to protect the unsatisfactory operations from exiting from the foreign market when slack resources are available.

*Proposition 4: The negative relationship between a firm's performance in a foreign market and the firm's exit decision becomes less negative as the firm's slack resources increase.*

*Relatedness with other SBUs* refers to the extent to which a certain strategic business unit supports or complements other units' activities (Davis et al. 1992). If a firm's foreign operations is highly related with other SBUs of the international firm (regarding the marketing, production, distribution network, etc.), even in the presence of unsatisfactory performance, it will be less likely to exit from a foreign market considering the potential joint losses from other related SBUs (Bergh 1995; Berry 2010a). Empirical studies also indicate that if a foreign operation is highly related with other SBUs, it will be less likely to exit from the foreign market (Cheng and Kesner 1997; Shaver and Flyer 2000).

*Proposition 5: The negative relationship between a firm's performance in a foreign market and the firm's exit decision becomes less negative as the relatedness with other SBUs increases.*

*Self-interest* can be defined as the extent to which individuals devote their attention to the pursuit of personal benefits (Cropanzano, Goldman, and Folger 2005). People usually pay insufficient attention to the conditions under which self-interested behavior occurs (Perrow 1986). Managers are self-interested if their behavior is intended to achieve their own benefits instead of organizational benefits. When facing a decision on whether to exit an unsatisfactory foreign operation, the more self-interested managers are, the less likely they will choose to exit the foreign market. The main reason is that, in this decision context, the divergence between managerial self-interests and organizational interests becomes explicit and intensified, and priorities are usually given to managers' own self-interests (Eisenhardt 1989; Guth and MacMillan 1986). To managers, exiting an unsatisfactory foreign operation may signal their own inability and personal failure, which will harm their personal benefits such as promotion, reputation, self-esteem, and/or self-justification (Staw 1976). As a result, to protect their self-interests, managers are more likely to filter information about negative feedback (Duhaime and Schwenk 1985), commit more resources to keep the foreign operation, and prevent the top management team from reaching a quick agreement on exit during the discussion (Staw and Ross 1987), with the hope of an upturn. Thus, we postulate:

*Proposition 6: The negative relationship between a firm's performance in a foreign market and the firm's exit decision becomes less negative as managerial self-interests increase.*

## **5. CONCLUSIONS AND IMPLICATIONS**

Firms' foreign exit behavior is an increasingly important research topic and more attention should be paid to exploring the moderators of the performance-exit relationship. The conceptual framework in this study uses different theories to enrich our understanding of firms' exit behavior. Specifically, drawing from notions of the behavioral theory of the firm, real options theory, resource advantage theory, and agency theory, this study examines the most important trigger of exit behavior and the potential moderators during the course of exit decisions.

### **5.1. Theoretical Implications**

Several theoretical implications can be drawn from our conceptual framework. Firms' exit behavior cannot be explained by a single theoretical basis, because the exit phenomenon *per se* is so pervasive and comprehensive in practice that it goes beyond disciplinary boundaries. Therefore, it is essential to link different theoretical perspectives together, because each theory offers a plausible, but only a partial, explanation of the whole phenomenon. Using the behavioral theory of the firm, we explain the link between unsatisfactory performance and exit decision. In addition, based on three different theories, we propose three different sets of moderators for the performance-exit relationship. Specifically, drawing on the notions from the real options theory, resource advantage theory, and agency theory, we highlight the factors that are likely to influence a firm's foreign exit decision in the presence of unsatisfactory performance. In this way, we capture a clearer picture of firms' exit behavior, including the most important determinant/trigger, and the moderators which influence the relationship between the trigger and



the final exit/non-exit decision, thereby providing a better understanding for researchers and managers.

## **5.2. Limitations and Further Research**

The conceptual framework developed in this study focuses on the three sets of moderators which influence the relationship between a firm's performance in a foreign market and an exit/non-exit decision. It may be criticized for neglecting other possible moderators which may also be important. However, our intention is to emphasize the importance of some key moderators which could influence managers' exit decisions, and not to exhaust all possible moderators. Therefore, other variables than those proposed in this study can be considered in future research.

This framework tries to contribute to a better understanding of exit behavior. It does not aim to include exhaustive theoretical bases. Therefore, there might be other perspectives (e.g., viewpoints from prospect theory) that are not included in our framework and warrant future investigation. Additionally, our choice to treat unsatisfactory performance as the most important trigger of firms' exit behavior is mainly based on normative research and early empirical studies, either on domestic or foreign exit behavior; but it is likely that nowadays some other triggers are as important as performance, because the worldwide competitive environments are constantly changing. Furthermore, it is also possible that the relative importance of potential triggers will vary in different contexts/cases.

In addition, for future research, empirical study is urgently needed because the majority of previous studies on foreign exit behavior have been normative, while statistical analysis based on

empirical cases (especially a large scale of cases) is scarce. Particularly, the empirical research on foreign exit behavior has largely fallen behind the development of normative research.

Finally, future research may be interested in separately considering some cases of exit decisions as exogenously-triggered issues (e.g., triggered by an attractive purchase offer). Although there may be some cases in which exogenous factors initiate the consideration of a firm's exit, we believe that some endogenous determinants must simultaneously lie behind the exit behavior. However, it is still meaningful to consider these special cases for a better understanding of the entirety of exit decisions.

Given the great relevance and importance of exit behavior in mutually informing firms' entry and expansion behavior in international marketing practices, it is regretful that research on exit behavior has been largely ignored. Therefore, we hope our study contributes to attempt to close this void in the literature and stimulate others to pursue this research stream.

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**Figure 1. A Framework for Understanding Firms' Foreign Exit Behavior**

