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## Impact of Sequence of International Entries on Country Exits

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## **Impact of sequence of international entries on country exits**

### **Abstract**

A classic model of international entries - the Uppsala model - postulated that firms enter foreign countries in increasing order of psychic distance between the home and the host country to minimize the risk of failure. A question that was left unanswered was whether this sequence of entry results in any performance benefits. Literature on the impact of psychic distance, or its components like culture distance, on the performance of foreign operations abounds but the order of entry that is critical to the Uppsala model remains conspicuously absent. This paper presents an analysis of foreign country entries and exits by American multinationals in the manufacturing and services sectors since 1965. Companies that enter foreign countries in increasing order of culture distance do gain a significant performance advantage over those who do not. Changes over time and across industry sectors are discussed.

**Keywords:** International entry; international exit; cultural distance; psychic distance; Uppsala model

## **INTRODUCTION**

Based on observations of internationalizing firms, the Uppsala model (Johanson & Wiedersheim-Paul, 1975; Johanson & Vahlne, 1977) postulated that lack of direct, experiential knowledge (Levitt & March, 1988) about foreign countries and the uncertainty arising thereof is the reason why risk averse firms enter foreign countries in increasing order of host country's psychic distance from the home country. All the factors that may contribute to such lack of knowledge e. g. differences in culture, language, education levels, industrial development etc. were collectively termed as psychic distance.

What the model didn't say was whether followers of the psychic distance based sequence of entry performed better in foreign countries than those who do otherwise. Being a descriptive model, the Uppsala model left the performance question unanswered. Furthermore, later empirical studies that did analyze company performance overseas did not specifically consider the performance implications of following or not following the psychic distance based sequence of entry. To address these issues, this paper presents an analysis of foreign country entries and exits by American multinationals in the manufacturing and services sectors since 1965.

The structure of the paper is as follows. First, a review of the literature is presented highlighting major shortcomings of the relevant literature. Second, hypotheses are delineated, based upon the background presented in the introduction and the literature review. Third, a section on methodology describes the sample and the statistical technique used to analyze the data. Fourth, results of the analysis are explicated. Finally, conclusions are drawn.

## **REVIEW OF THE LITERATURE**

The Uppsala model was originally meant to be a descriptive model (Johanson & Vahlne, 2009), i.e. it only described how and why firms choose foreign countries for their international

operations. The Uppsala model and other similar process models of internationalization (Bilkey & Tesar, 1977; Johanson & Vahlne, 1977; Cavusgil, 1980; Reid 1981) were, in fact, seen as deviations from the prescriptive model (Stobaugh, 1969; Ehrman & Hamburg, 1986), according to which firms should choose the best location after careful evaluation of the profit potential of all possible locations. The process models emphasized that internationalization is a gradual path dependent learning process in which subjective behavioral factors play a much more important role than objective rational calculations. Bilkey & Tesar (1977: 94) wrote that the exploratory phase of export development process ‘seems to be much more nearly a function of managements’ general images of exporting and of foreign lands than of immediate economic considerations! [sic]’. Johanson & Vahlne (1977: 26) described the internationalization process in a similar vein, ‘We do not believe that it is the result of a strategy for optimum allocation of resources to different countries where alternative ways of exploiting foreign markets are compared and evaluated’.

The Uppsala model left the question of performance in foreign countries unanswered but many studies since then have shown that greater psychic distance (or its components like culture distance) has a negative influence on performance, prompting Johanson & Vahlne (2009: 1413) to claim that the Uppsala model can therefore be considered ‘a model of rational internationalization, and can be used for prescriptive purposes’. However, contradictory evidence also exists. O’Grady & Lane (1996) termed it a ‘psychic distance paradox’ when they found that out of the 32 Canadian retail firms that entered United States, a low psychic distance country, almost 80 per cent failed. Evans & Mavondo (2002) studied firms from various countries and also found support for the psychic distance paradox i. e. improvement in firm performance with increasing psychic distance. Apart from the conflicting evidence regarding the impact of psychic

distance on performance in foreign countries, a glaring shortcoming of previous studies on the topic is that those do not incorporate the order of entry and therefore suffer from endogeneity problem (Shaver, 1998). The order of entry is not merely an empirical issue. It is also important theoretically because by taking small rather than big steps (Barkema & Drogendijk, 2007), in terms of psychic distance, firms may be able to learn how to handle the challenges associated with high psychic distance and consequently may be able to prevent the adverse impact of high psychic distance on performance (Sousa and Tan, 2015).

Moreover, an inherent paradox lies at the heart of the Uppsala model. The model emphasized that country specific experiential knowledge is critical and cannot be acquired without having operations in a particular host country. In other words, firms do not really know about a foreign country without actually entering it but if that's true, how can such firms be sure that low psychic distance countries are less risky than high psychic distance countries?

## **HYPOTHESES**

The Uppsala model of internationalization emphasized that lack of knowledge about foreign markets creates uncertainty and therefore risk-averse firms enter low psychic distance countries before entering high psychic distance countries. As mentioned earlier, the model was intended to describe the process of internationalization and therefore it did not offer any guidance on the impact of psychic distance on the performance in foreign countries. Nevertheless, several studies have since linked psychic distance to performance in foreign countries. Notwithstanding few studies with contradictory evidence, the general consensus is that firms need to go through a difficult process of acculturation when they enter foreign countries and are therefore 'more likely to fail whenever the acculturation involved is more demanding' (Barkema, Bell & Pennings, 1996: 154; Hutzschenreuter, Kleindienst and Lange, 2014). In a study of the business failures of

foreign-controlled firms in the United States, Li & Guisinger (1991) found support for the hypothesis that foreign affiliates of parents from culturally dissimilar countries are more likely to fail than those from culturally similar countries. Psychic distance represents the difficulty of knowing a particular foreign market and therefore high psychic distance countries should present greater difficulties as compared to low psychic distance countries by definition. However, this will be true only if countries are chosen at random. The Uppsala model, in contrast, describes a non-random process in which firms choose low psychic distance for initial entries and only later move into high psychic countries. By following this sequence of entry, firms act deliberately to avoid the problems that they might face in high psychic distance countries. A gradual step-by-step movement ensures that at no time during the internationalization process a sudden jump into vastly different locations is made. Taking a step at a time enables learning and experience building, thereby reducing the likelihood of fatal mistakes (Hutzschenreuter, Kleindienst and Lange, 2014). Unfortunately, studies that use Uppsala model as their theoretical anchor have not incorporated the order of entry aspect of the model in their empirical analyses. The impact of the psychic distance based order of entry on overseas performance can only be established if we differentiate between firms that follow the Uppsala model versus those who do not, as follows:

Hypothesis 1: Firms that follow the Uppsala model's order of entry i. e. enter foreign countries in increasing order of the psychic distance between the home and the host country perform better than those who do otherwise.

The Uppsala model was first proposed in late 1970s. Since then, the world has undergone significant changes due to globalization. The KOF index of globalization (Dreher, Gaston, & Martens, 2008), for example, has increased from around 35 in 1970 to about 57 in 2012. It rose only about 17 per cent between 1970 and 1990 but rapidly increased by approximately 43 per

cent between 1990 and 2012, indicating the heightened pace at which the world has globalized in the last two decades. The KOF index measures economic, social and political globalization and all three dimensions have seen similar increases, highlighting the fact that the integration between countries is not only at the level of trade flows and foreign direct investments but also at a social and political level.

Several authors have argued that rapid globalization of the world has made psychic distance increasingly irrelevant. Two different rationales have been put forth in support of this argument. First is the convergence hypothesis (Williamson, 1996; Guillen, 2001), according to which differences across countries are disappearing and consequently countries are increasingly becoming similar to each other. Levitt (1983), for example, claimed that technology is driving the world towards 'a converging commonality' (p. 92) and that 'different culture preferences, national tastes and standards, and business institutions are vestiges of the past' (p. 96). Using this rationale, Melin (1992: 104) hypothesized, 'as the world becomes more homogenous, the explanatory value of psychic distance tends to decrease'. However, the convergence hypothesis is a highly debated issue and empirical evidence supporting convergence across countries is mixed at best (see Guillen, 2001 for a review). Second rationale is that forces of globalization have made it easy to overcome barriers posed by differences across countries, so much so that a new breed of firms - born globals or international new ventures - have emerged that are successful despite defying the Uppsala model (Rennie 1993; Oviatt & McDougall, 1995). Factors like availability of internationally experienced personnel, easy availability and access to information about foreign markets and reduction in transportation and communication costs (Rennie, 1986; Oviatt & McDougall 1994; Rialp et. al. 2005) have been cited as reasons why barriers like psychic distance are easier to overcome now than they were in the past. Unlike the

convergence hypothesis, this second rationale is relatively under explored and large scale longitudinal studies are especially rare. Irrespective of the causal mechanism, if psychic distance is losing its relevance and is not as significant a barrier to understanding foreign markets, then its impact on performance should also decline over time.

Hypothesis 2: The impact of following or not following the Uppsala model on the performance in foreign countries has weakened over time.

The Uppsala model is a generic model i. e. it is supposed to apply to all firms irrespective of industry. However, the authors of the model had acknowledged that factors such as ‘firms size, technology, product line, home country etc.’ (Johanson & Vahlne, 1977: 31) may affect the internationalization process in different ways. The model was based on observations of manufacturing firms and it is unclear if it applies to firms in the services sector too. In this paper, the primary concern is not the internationalization process per se but rather the impact of the propensity to follow the Uppsala model on the performance of firms in foreign countries. However, it is reasonable to expect that this may also be affected by the industry sector.

Several major features that distinguish service sector firms from manufacturing sector firms have been identified in the literature. These are intangibility, inseparability of production and consumption, perishability and heterogeneity (Boddewyn, Halbrich, & Perry, 1986; Knight, 1999). Services are produced and consumed at the same time and therefore cannot be readily exported. The opportunity to learn about a foreign market through exports is therefore not always available to services sector firms. Unlike manufacturing products, services cannot be easily standardized because every customer interaction is different and therefore service sector firms need lot more localization and customization to individual markets. As a result, the knowledge barriers represented by psychic distance should be much more important for service sector firms.



Therefore, disregarding the Uppsala model's psychic distance based sequence of entry should be more detrimental for the international operations of service firms compared to manufacturing firms.

Hypothesis 3: The impact of following or not following the Uppsala model's psychic distance based foreign country entry sequence on the performance of firms in foreign countries shall be greater in services as compared to manufacturing.

### **DATA AND METHODOLOGY**

The sample consists of publicly listed US manufacturing and services firms that established foreign subsidiaries during 1965 and 2002 and either continued presence or exited foreign countries during 1966 and 2012. The ten year difference in the latest year between entries and exits (2002 vs. 2012) was kept to allow sufficient time for observations of country exits. The standard industrial classification (SIC), devised by the United States Census Bureau, was used to identify the industry sector for each firm. An year wise list of all firms in each industry sector was obtained from the Standard & Poor's Compustat database. Multinationals in this list and foreign countries where these firms had operations were identified using Uniworld's Directory of American Firms Operating in Foreign Countries. The directory provides addresses of foreign subsidiaries in which US firms have substantial foreign direct investment, excluding franchises, representatives and non-commercial entities. History of each firm that began foreign operations after 1965 was tracked through various editions of the directory, to obtain the year of entry into a foreign country and exit, if any. This data was then verified against company histories gleaned from multiple sources such as the company web sites, other internet sources and various editions of the International Directory of Company Histories published by St. James Press, Michigan, USA.

## **Variables**

The dependent variable is the likelihood of exit from a foreign country. Psychic distance is the main independent variable. It is a multi-faceted construct that captures geographical, cultural, economic and institutional differences among countries. Ghemmawat (2001) also included these four dimensions while proposing the CAGE (cultural, administrative, geographic, economic) framework as a tool to understand country differences that are important for firms having operations abroad. Different variables were used to measure each of these dimensions.

To measure differences in culture between US and the host country, a composite measure of three items was used. The first item was calculated by applying Kogut & Singh's (1988) formula separately to country scores from Hofstede's studies (1980, 2001) and societal value scores for each country from Global Leadership and Organizational Behavior Effectiveness (GLOBE) research project (House, Javidan, Hanges, & Dorfman, 2002). Second and third items were religious and language differences. Religions and languages of countries were obtained from the World Factbook (Central Intelligence Agency, US), as done earlier by Flores and Aguilera (2007) and Dow & Karunaratna (2006). Christianity was identified as the major religion and English as the major language in the US. Religious difference was given a value of zero if Christianity was the major religion in the host country, one if Christianity was one of the major religions and two if religions other than Christianity were the major religions. Language difference was based on the language classification from Ethnologue: Languages of the World which classifies English into the Indo-European family. Language difference was given a value of zero if the major language in the host country was English, one if English was one of the major languages, two if a language belonging to the Indo-European family was one of the major languages and three if languages not belonging to the Indo-European family were the major

languages. These values for religious and language differences were added to Hofstede and GLOBE based cultural difference measures to obtain the composite culture distance.

Country rank based on the absolute value of the difference between host country per capita nominal gross domestic product (GDP) and US per capita nominal GDP in the same year was used to measure the economic distance. This variable also captures host country characteristics like infrastructure, education and wage levels etc. that need to be included to control for the alternative explanation that macroeconomic characteristics of the host country determine likelihood of survival in a foreign country. Per capita GDP has been found to be highly correlated with measures of infrastructure, education level etc. (Dow & Kumaratna, 2006) and was, therefore, used as a common proxy for all these variables. Administrative or institutional distance was measured using the 'polity2' variable of the POLITY IV database (Marshall & Jaggers, 2002). It is a composite measure of the degree of democracy and autocracy in a country, ranging from 10 (highly democratic) to -10 (highly autocratic) political system. Administrative distance was calculated as the absolute value of the difference between polity2 value for the host country and the polity2 value for US in the same year. Geographic distance was calculated as the great circle distance in nautical miles using Google Maps' distance measurement tool.

Other independent variables were economic size of the host country, firm size, time period and industry sector. Economic size was measured as country rank based on nominal GDP (higher the rank, larger the host economy). Country ranks were used instead of raw figures for nominal GDP and per capita nominal GDP because the descriptive models of internationalization suggest that foreign country selection is not based on actual data but on a rough mental ranking of foreign countries by the decision makers in the internationalizing firm. Moreover, unlike

nominal GDP that generally increases over time, ranks are consistently comparable across time periods. GDP data was obtained from the World Bank's World Development Indicators database. Firm size was measured as the log of firm assets using Compustat data. The sample was divided into two time periods using the sample median year of foreign entry.

## **Methodology**

Survival analysis using Cox proportional hazard model with time variant covariates (Cox, 1972; Andersen & Gill, 1982; Therneau & Grambsch, 2000) was used to obtain the results. Exits from foreign countries may happen not only because of host country issues but also because of factors that are not related to the host country e. g. when a firm faces a setback in its home country and decides to divest foreign operations to generate resources or in the extreme case when a firm dies and consequently all foreign operations, healthy or otherwise, cease to exist (Hennart, Roehl, & Zeng, 2002). To separate such cases from exits that are purely related to host country factors, all observations were treated as censored if there was no record for the firm in the future.

Observations were deemed an exit only when affiliates ceased to exist in a particular foreign country but the firm was still present in other countries. All entries at the end of the sample period were also considered as censored. Diagnostic test for the proportional hazards assumption (Grambsch & Therneau, 1994) did not reveal any major concerns.

The order of entry aspect of the Uppsala model was incorporated by introducing indicators of the propensity to follow the Uppsala model. These indicators were measured as correlations between the rank of each foreign country entered by a particular firm (first country entered = 1, second country entered = 2 and so on) and measures of cultural, administrative, geographic and economic distance of those countries from United States respectively. These variables were called 'increasing culture distance', 'increasing administrative distance' and so

on. Firms that followed the Uppsala model more closely had higher positive correlations and vice versa. The descriptive statistics is presented in Table 1.

‘insert Table 1 about here’

Interaction of time period and industry variables with the propensity to follow Uppsala model were included to determine changes in the impact of the psychic distance based order of entry on the likelihood of exit from foreign countries, over time and across sectors.

## **RESULTS**

The results of the survival analysis are presented in Table 2. The first model uses culture distance based on Hofstede national culture values and the second model uses GLOBE based culture distance.

‘insert Table 2 about here’

Culture distance, economic distance, size of the host economy and firm size were significant in both the models. Greater cultural and economic differences between the home and the host country increased the likelihood of exit from foreign countries. On the other hand, bigger size of the host economy reduced the likelihood of exit from foreign countries. Similarly, bigger companies faced significantly less risk of exit abroad compared to smaller companies. Time period was also significant throughout. The likelihood of exit from foreign countries reduced significantly over time. In contrast, industry sector did not play any significant role i.e. firms in both manufacturing and services sectors faced similar probabilities of exit from foreign countries.

Culture distance and economic distance based sequence of entry significantly reduced the likelihood of exit. In other words, companies that entered foreign countries with gradually increasing cultural and economic differences relative to the home country faced significantly less

risk of exits from foreign countries. Administrative distance and geographical distance based sequence of entry, in contrast, did not have any significant influence on the likelihood of exit from foreign countries. The cultural and economic dimensions of Uppsala model, therefore, does help reduce likelihood of exit from foreign countries.

Interactions of time period with geographical distance, cultural distance and administrative distance based sequence of entry were all significant. In the more recent time period, entry into foreign countries with gradually increasing geographical, culture and administrative differences between the home and the host countries increased the likelihood of exit. This result shows that the impact of Uppsala model based sequence of entry has reduced over time.

Interactions of industry sector with increasing geographical and culture distance were both significant but with opposite signs. Entry into foreign countries with gradually increasing geographical distance reduced while that with gradually increasing culture distance increased the likelihood of exit for service firms as compared to manufacturing firms. Therefore, the impact of following culture distance based sequence of entry was weaker in services as compared to manufacturing.

## CONCLUSIONS

The main conclusion from the results is that cultural and economic differences between countries increase the likelihood of exit from foreign countries but this effect can be mitigated by entering foreign countries in increasing order of cultural and economic differences relative to the home country. Administrative and geographical distances, on the other hand, do not have any significant impact. Therefore, the answer to the primary research question of this paper is that the Uppsala model can be used as a prescriptive model, despite its origins as a descriptive model, provided culture distance replaces psychic distance as its main construct. However, the impact of the Uppsala model has weakened over time.

Industry sector, on its own, does not influence the likelihood of exit from foreign countries. However, it influences the relationship between geographical distance and culture distance based sequence of entry and the likelihood of exit from foreign countries. Specifically, service firms faced reduced likelihood of exit when they entered foreign countries in increasing order of geographic distance but the reverse was true in case of increasing culture distance. Therefore, cultural differences matter more for manufacturing companies rather than service companies, as far as the order of entry into foreign countries is concerned.

Entry into larger foreign economies is much safer than entering smaller economies. The risk of failure abroad has also reduced over time. However, smaller firms should exercise greater caution while venturing abroad as they face higher likelihood of failure compared to larger firms.

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## Tables and Figures

Table 1 Summary statistics

	Variable	Minimum	First Quartile	Median	Mean	Third Quartile	Maximum
1	Culture distance (Hofstede)	0.03	1.28	1.79	2.08	3.04	7.31
2	Culture distance (GLOBE)	0.10	0.69	1.32	1.33	1.76	3.48
3	Administrative distance	-10	7	10	Not applicable	10	10
4	Geographic distance	891	4028	4379	4781	6220	9078
5	Economic distance	1	23	71	Not applicable	164	191
6	Host economy size	17	129	156	Not applicable	176	190
7	Firm size	2.49	5.97	7.14	7.13	8.24	12.34
8	Increasing culture distance (Hofstede)	-0.26	0.16	0.25	0.24	0.32	0.56
9	Increasing culture distance (GLOBE)	-0.31	0.11	0.21	0.20	0.30	0.60
10	Increasing administrative distance	-0.62	-0.35	-0.25	-0.25	-0.15	0.19
11	Increasing geographic distance	-0.20	0.10	0.16	0.16	0.22	0.50
12	Increasing economic distance	-0.51	-0.13	0.18	0.12	0.36	0.64

Table 2 Survival analysis of country exits

	Model 1			Model 2		
	Coefficient	Std. Error	Significance	Coefficient	Std. Error	Significance
Cultural distance (Hofstede)	3.09	1.34	*			
Cultural distance (GLOBE)				6.36	1.81	***
Administrative distance	6.41	5.72		18.74	6.74	**
Geographical distance	1.98	14.67		0.23	16.42	
Economic distance	10.05	5.04	*	11.65	5.79	*
Size of host economy	-13.19	1.18	***	-14.50	1.56	***
Firm size	-6.71	1.88	***	-9.02	2.13	***
Time period	-55.58	14.51	***	-33.44	16.06	*
Industry sector	-4.26	17.79		-19.67	20.62	
Increasing culture distance (Hofstede)	-12.28	3.99	**			
Increasing culture distance (GLOBE)				-8.17	3.58	*
Increasing administrative distance	3.93	3.27		4.90	3.59	
Increasing geographical distance	-3.95	4.77		-4.01	5.39	
Increasing economic distance	-6.70	2.00	***	-5.25	2.26	*
Time period:Increasing geographical distance	42.63	8.12	***	39.83	9.18	***
Time period:Increasing culture distance (Hofstede)	22.16	6.64	***			
Time period:Increasing culture distance (GLOBE)				28.42	5.46	***
Time period:Increasing economic distance	3.35	3.52		1.86	3.91	
Time period:Increasing administrative distance	25.97	6.51	***	33.14	6.72	***
Sector:Increasing geographical distance	-32.25	9.52	***	-31.01	10.95	**
Sector:Increasing culture distance (Hofstede)	29.00	9.42	**			
Sector:Increasing culture distance (GLOBE)				16.26	7.97	*
Sector:Increasing economic distance	-2.95	2.88		0.23	3.11	
Sector:Increasing administrative distance	13.54	9.27		-1.85	8.91	
Number of events		1515			1199	
Number of observations		11437			9818	
Degree of freedom		20			20	
Likelihood ratio test		270.1	***		224.9	***
Wald test		283.5	***		233.8	***
Logrank test		286.2	***		235.6	***

Significance levels: \* 5%, \*\* 1%, \*\*\* 0.1%