

THE INTERNATIONALIZATION OF PROFESSIONAL SERVICE FIRMS: EFFECTS OF HUMAN CAPITAL AND SOCIAL CAPITAL

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INTRODUCTION

Movement into international markets helps firms gain economies of scale and scope and increase their market power. It helps them achieve faster returns on the new products that are brought to market and to diversify their portfolios thereby spreading their risk (Barkema & Vermeulen, 1998; Hitt Hoskisson & Kim, 1997). The linkage between international expansion and firm performance is complex and the causes and effects have not been effectively determined by prior research (Tallman, 2001). We need to understand the requirements for expanding into international markets and how firms do this successfully. Hymer's (1960, 1976) seminal work suggested that firms must possess some unique advantages to overcome the additional costs of cross-border operations and be competitive in foreign markets. Our focus is on professional service firms in the earlier stages of internationalization. Therefore, we examine the effects of resources on the international strategy and on firm performance. In particular, we identify idiosyncratic, intangible resources of the firm that lead to international diversification, specifically human capital, the degree to which it is leveraged, and social capital We contribute to the understanding of how critical firm resources may affect the implementation of an international expansion strategy. The research provides support for arguments of the resource-based view that firm strategy is based on resources, and independently and jointly, firm strategy and resources influence outcomes (Barney, 1991).

CONCEPTUAL FRAMEWORK

Firms must have the appropriate resources for international expansion and those resources must be bundled and leveraged effectively in order to implement an international strategy (Barney, 1991, 2001; Barney, Ketchen & Wright, 2001). Possessing valuable, rare and inimitable resources is a necessary but insufficient condition to achieve a competitive advantage. Those valuable resources must be managed effectively (bundled and leveraged) to achieve a competitive advantage (Barney & Arkan, 2001; Sirmon & Hitt, 2003). While the extant

research has focused largely on proprietary technology, and scale and scope economies, we examine the contribution of more intangible assets to international expansion and performance. The primary asset for rendering professional service is knowledge (Grosse, 2000; Maister, 1993). Knowledge (especially tacit knowledge) largely resides in a professional firm's human capital (Bartlett & Ghoshal, 2002). As a result, professional service firms create value through their selection, development and use of human capital (Lepak & Snell, 1996; Hitt, Bierman, Shimizu & Kochhar, 2001).

Professionals hired to provide the service to clients gain knowledge through their formal education (articulable/explicit) and through learning on the job (tacit). Those with degrees from the top ranked institutions are assumed to have the best knowledge set and have the opportunity to participate in valuable elite social networks (D'Aveni & Kesner, 1993). After individuals receive their degrees, they are employed and gain experience on the job thereby developing tacit knowledge (Pisano, 1994). Thus, compared to many other resources that depreciate over time, human capital appreciates as knowledge increases with experience (Penrose, 1959). Individuals who have learned the greatest amount of knowledge and have been the most effective in applying that knowledge to provide service to the firm's clients are generally made partners in professional service firms (Galanter & Palay, 1991; Hitt et al, 2001).

In addition to their professional role, partners in professional service firms also perform a managerial role. Thus, managerial competences in such areas as recruiting, leading project teams, retention of personnel and strategic management are required from partners (Løwendahl, 2000). Firms can exploit these managerial skills through expansion into new markets such as international diversification (Mahoney & Pandian, 1992). Experience helps managers to develop knowledge of the opportunities for diversification and the means to enter new markets (Penrose, 1959). Most professional service firms also leverage their human capital by assigning associates to work on projects for clients with a partner as project leader. The associates then gain tacit knowledge by working with the partner (Hitt et al, 2001).

This leveraging process involves the integration of co-specialized complementary resources (associates' skills and partners' tacit knowledge) (Mitchell, 1989; Tripsis, 1997). Professional service firms having the strongest human capital and the capabilities to leverage such capital are the most likely to enter international markets. These firms can gain new clients in the international markets because of their reputations for serving the clients well. Reputation thus generates demand for the firm's services from customers in foreign countries leading firms to expand internationally (Løwendahl, 2000).

Partners with formal education from top ranked institutions and with the most experience are assumed to be the most knowledgeable in the firm. The top ranked institutions that provide the formal education to these partners often have international reputations and educate many people from outside the United States thereby helping to attract clients in the new international markets entered. Furthermore, partners with strong human capital can help recruit high quality human capital to work in the international markets. Additionally, partners in professional service firms have strong loyalty to their profession (Løwendahl, 2000), thus are more likely to exploit their human capital through geographical diversification (e.g., international expansion) than through product diversification. These arguments lead to the following hypothesis.

Hypothesis 1: There is a positive relationship between a firm's human capital and its level of international diversification.

Firms that are effective at leveraging their human capital should also be more efficient in leveraging their other assets as they move into international markets. As a result, firms with

effective leveraging capabilities can better achieve economies of scale and scope from their international expansion. As a result, we expect that firms with more effective capabilities for leveraging their human capital can better enter and sustain operations in international markets. Effective leveraging of the partner's knowledge may provide them more time to manage international expansion. These arguments lead to the following hypothesis.

Hypothesis 2: There is a positive relationship between a firm's leveraging of human capital and its level of international diversification.

A firm's social capital can be useful in developing and implementing its strategy (Nahapiet & Ghoshal, 1998; Hitt, Lee & Yucel, 2002). An effective working relationship with clients and gaining their trust are important assets to professional service firms (Cooper, Rose, Greenwood & Hinings, 2000). Some of a professional service firm's social capital is embedded in its human capital, (i.e., a partner's specific relationship with a client) (Løwendahl, 2000). Professional service firms' relationships with large corporate clients can be especially valuable because they are multinational enterprises with global reputations that can provide legitimacy to their service providers as they enter new international markets (Shan & Hamilton, 1991; Tsang, 1996). This legitimacy can help professional service firms attract new clients in recently entered international markets. This social capital with large corporate clients helps the service provider to form relationships with other important entities in the new markets such as government units (and officials) and suppliers, facilitating international expansion. Thus, we can expect that firms with greater social capital are more likely to enter international markets and to have a broader international scope. These arguments lead to the following hypothesis.

Hypothesis 3: There is a positive relationship between a firm's social capital in relationships with large corporate clients and its level of international diversification.

Research on the relationship between international diversification and firm performance has resulted in some mixed results (for a recent review see Goerzen & Beamish, 2002; Tallman, 2001). However, one reason for the mixed results is that the research largely ignores the implementation of that strategy (c.f., Hoskisson & Hitt, 1990). Furthermore, resources facilitate strategy implementation (Barney, 1991, 2001). Research shows that firm capabilities moderate the relationship between international expansion and strategic outcomes (Kotabe, Srinivasen & Aulakh, 2002; Makino, Lau & Yeh, 2002). Hitt et al (2001) found that the human capital served as a moderator between the firms' strategy and their financial performance. Extending this to the international environment, Fey and Bjorkman (2001) found that investments in human resource practices moderate the relationship between the strategy and the performance of MNC subsidiaries in international markets.

The firms' human capital is important for implementing the international strategy by providing the primary service to clients in international markets. Therefore, while international diversification produces both benefits and costs, firms having the strongest human capital and using it to enter international markets should experience the highest performance. High quality human capital attracts new clients and additional high quality human capital to staff the new offices. Also, the partners' managerial skills help to organize the international expansion and to facilitate coordination between the home and host country offices, thus exploiting internalization advantages.

In addition, professional service firms may enter international markets to learn from more diverse projects (Løwendahl, 2000). Firms with higher human capital can be expected to have

higher absorptive capacity to learn from such diverse projects. Partners with longer experience with multiple different projects have more advanced knowledge sets. As a result, they are more capable of learning from the diverse experiences associated with international expansion. These arguments lead to the following hypothesis.

Hypothesis 4: The interaction of international diversification and human capital has a positive effect on firm performance.

Hitt et al (2002) argued that social capital is a critical resource to firms moving into international markets. The relationships with large corporate clients allow the firm to enter new international markets with greater ease and establish relationships with other important constituents. An international diversification strategy that leverages the social capital to attract new clients also can produce enhanced revenues and profits for the firm. Firms with greater social capital should be able to use it to increase the implementation effectiveness of an international diversification strategy, leading to higher performance. These arguments lead to the following hypothesis.

Hypothesis 5: The interaction between a firm's international diversification and its social capital in relationships with large corporate clients has a positive effect on firm performance.

METHOD

The sample for this study was drawn from the list of the 100 largest law firms in the U.S. between 1992 through 1999 from *The American Lawyer*. Changes in the ranking over the years resulted in data on 72 law firms and 452 firm-year observations. The data are both cross-sectional (firms) and time series (years) in nature, thus a panel data methodology, using the least squares dummy variable model (LSDV) estimated using generalized least squares regression, was utilized (Hsiao, 1986; Sayrs, 1989). The LSDV model serves to minimize problems of heteroscedasticity and autocorrelation. Further, we incorporate a one-year lag between dependent variable and independent variables.

Dependent and Independent Variables

Firm performance. Firm performance was operationalized as the ratio of net income to total firm revenue. These data were derived from the profitability index reported annually by *The American Lawyer*.

International Scope (Diversification). The degree of international scope of each law firm in each year was measured by counting the number of countries and the number of cities in which each law firm had an office outside of U.S. (obtained from the *American Lawyer*) The two measures loaded on one factor (eigenvalue = 2.00). We created a composite measure of the international scope for each firm in each year.

Human Capital. We adopted the measure of human capital used in Hitt et al (2001). The measure of human capital has two dimensions, quality of law school attended by partners (a proxy for articulable knowledge and prestige) and average experience of the partners in the focal firm (proxy for firm-specific tacit knowledge). The first data were obtained from a database that identified all partners in each firm and the law schools from which they obtained their degrees

(*Lawyers Almanac*). We then calculated an average ranking score for each firm. We used the data from 1991 (or the most recent available) for each firm. To obtain the data on firm-specific experience of partners, we used survey data via electronic mail and received 2,701 usable responses (from 12,217 contacted and adjusted the survey data to accommodate the change of average partner tenure in each firm over 1992 through 1999. The two dimensions of human capital were highly correlated ($r = .82$, $p < .001$) and loaded on one factor (eigenvalue = 1.35). Thus, we created a composite measure of human capital.

Leverage. Leverage is defined as the total number of associates in the firm divided by the total number of partners. Data for this measure were obtained from the *American Lawyer*.

Social Capital. We calculated the number of large corporate clients for each law firm in each year of the study as a proxy for the law firm's social capital. These data were obtained from *The National Law Journal's* listing of major law firms used by the 250 largest U.S. corporations.

Control Variables. We included three variables firm size, service diversification, and geographic dispersion within the U.S. Firm size was measured by the number of partners in each firm. The overall sample means for service diversification and geographic dispersion in each year were calculated with a Herfindahl index (Sherer, 1995) and included in the model. Data were obtained from the *Lawyer's Almanac*.

RESULTS

The intercorrelations among the independent variables suggest no problem with multicollinearity. The results show that human capital has a statistically significant positive effect on the scope of the firm's international diversification ($b = .19$, $p < .001$), thus providing support for Hypothesis 1. The results also provide support for Hypothesis 2 as leverage had a statistically significant positive effect on the scope of international diversification ($b = .62$, $p < .001$).

The results, however, show that social capital has no statistically significant relationship with the scope of international diversification ($b = -.07$, N.S.). These results do not support Hypothesis 3. Alternatively, the results show that the interaction effect of international scope and human capital on firm performance is statistically significant and positive ($b = .02$, $p < .001$), supporting Hypothesis 4. When human capital is strong, increasing international diversification leads to higher firm performance.

Finally, the results show that the interaction of social capital and international scope has a statistically significant negative effect on firm performance ($b = -.01$, $p < .01$). These results do not support the hypothesis as the direction of the effect is opposite of that hypothesized. Interestingly, social capital has a statistically significant positive main effect on firm performance ($b = .03$, $p < .001$).

DISCUSSION

The results provide support for the resource-based view of the firm (Barney, 1991, 2001; Penrose, 1959). The firms that had stronger human capital and efficiently leveraged it were also the most diversified into international markets. The resource-based view suggests that firms develop a strategy to leverage and exploit their valuable resources and thereby gain a competitive advantage. In this case, professional service firms use their human capital to enter international

markets and thereby gain an advantage over their competitors. Certainly, greater international scope allows the firm to gain economies of scale and economies of scope providing advantages over their more domestic competitors. Previously, Li and Guisinger (1992) argued that firms often follow major customers into international markets in order to continue providing full service to them, and this argument is supported by work on the globalization of professional service firms (e.g., Aharoni & Nachum, 2000). Our research suggests that professional service firms do not use their large corporate clients as a base for expanding into international markets. Actually, these results are similar to those found by Li and Guisinger (1992) as they found no support for their hypothesis.

We found that human capital had a positive effect on firm performance in support of prior research (i.e., Hitt et al, 2001; Wright, Dunford & Snell, 2001), but we found no main effect of international diversification on firm performance. Hoskisson and Hitt (1990) argued that a primary reason for the mixed results of corporate strategy research was the failure to examine the implementation of that strategy. As expected, we found that human capital had a positive moderating effect on the relationship between international diversification and firm performance. Firms with strong human capital experienced a positive return from entering international markets. However, firms with weaker human capital experienced negative returns from increasing the scope of their international diversification. Social capital also had a positive main effect on firm performance, but it negatively moderated the relationship between international diversification and firm performance, opposite of that hypothesized. Perhaps, firms with major corporate clients overly depend on them for business in the new international markets rather than seeking new and clients in these markets. Alternatively, the large corporate clients may have an expectation of a discount when providing more business to the firms on a global basis. Additionally, learning is likely to be less if firms rely on their existing clients rather than establishing relationships with new customers as they expand into new countries. The lack of such learning may harm firms' ability to adapt to the new market. This research provides a value-added contribution to our knowledge of the resource-based view of the firm and the development and implementation of an international diversification strategy. The results suggest that firm strategy is, indeed, based on important resources in the firm. Additionally, the results suggest that critical firm resources play an important role in the implementation of the strategy. In fact, the performance effects are based on using resources to implement the strategy.

Our research provides support for the general arguments that firms enter international markets partly to use important assets (resources) such as human capital. Our research also provides information that may help us better understand the mixed results of prior research. The results suggest that the international strategy affects firm performance, but only when the manner in which it is implemented is considered. Our research continues to support the efficacy of firm resources and specifically the importance of human capital. In addition, our research suggests that social capital is important for firm performance, in support of prior research on the efficacy of social capital. However, more research is needed to understand why and if social capital has a negative effect on the relationship between firm strategy and performance.

Thus, in conclusion, our research provides important implications for strategic practices and the implementation of international strategies. The implications of this research are important for executives and scholars alike in understanding the management of critical firm resources and the development and implementation of international strategies.

REFERENCES ARE AVAILABLE UPON REQUEST OF THE FIRST AUTHOR