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## Sourcing from China: Connecting Inward and Outward Internationalisation Through Absorptive Capacity

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**Abstract:** The capabilities of small and medium enterprises (SMEs) to partake in the global value chain (GVC) are remarkable. However, the capabilities of SMEs to connect between the sourcing side of GVC to the export side of GVC through learning processes should also be addressed for the SMEs' competitive gains. Therefore, the objective of this study is to investigate firm's absorptive capacity in connecting their inward to outward internationalisation by employing a qualitative case study design using two cases involving Malaysian SMEs' internationalisation as well as semi-structured interviews with the SMEs' Managing Directors for two years, and the data were then triangulated through documentation. Based on the research findings, the absorptive capacity of SMEs should be equipped with inter-firm knowledge sharing and "guanxi" relationship in order to utilize the newly acquired knowledge by means of a reciprocal action and trust involving the focal firm and their suppliers in China. This enables SMEs to benefit from the flows of knowledge in inward and outward internationalisation, thus able to export to China even though they only began from international sourcing.

**Keywords:** Inward Internationalisation, International Sourcing, Outward Internationalisation, Export, SMEs, Inward-Outward Internationalisation Connections; Global Value Chain

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### INTRODUCTION

Due to its size, resources and capabilities, SMEs are confronting many challenges to operate globally and sustain its presence (Arudchelvan and Wignaraja, 2015; Zainuddin et al., 2020). In ASEAN economies, larger firms were the leading players in GVC while SMEs were relatively minor (Arudchelvan and Wignaraja, 2015; Zainuddin et al., 2020). However, the participation of SMEs in GVC is increasing since the late 2000s (Arudchelvan and Wignaraja, 2015). Malaysia is seen as extensively constituted in the global production networks with greater shares of SME exports as opposed to other economies in ASEAN nations (Arudchelvan and Wignaraja, 2015). Their outward internationalisation referring to export in the services and manufacturing industry recorded a 2.6 percent growth in 2019, amounting to RM176.3 billion compared to the previous year of 2018 with only 3.4 percent. Besides, the economic development in Malaysia is highly dependent on foreign markets, and China's demand for inward internationalisation referring to international sourcing offers Malaysia with significant export market (Hong et al., 2020; Nik hashim et al., 2020). In parallel, China is one of the five main sources of Malaysia's intermediate goods imports and the major source of Malaysia's industrial supplies imports. China contributes almost 20% to world's Gross Domestic Product (GDP), with much of the growth coming from foreign investment. Although China highly dominates GVC trade in Asia, Malaysia likewise participates actively in GVC (Arudchelvan and Wignaraja, 2015) that active in export and international sourcing operations. Considering that an open economy lays bare foreign goods and services as well as ameliorating information, technology, and knowledge that may not be extant in their respective nation to its people, Malaysia has relished the benefits from international sourcing, foreign investment, trade agreement as well as trade collaboration (Neumayer, 2002; Hong et al., 2020; Anuar et al., 2020; Abdullah et al., 2020; Mohamad et al., 2020). The participation in GVC and the upstream and downstream partners network partnership enable the focal firm to enhance its flow of information as well as learning opportunities and to utilise advanced technologies and innovative business practices for greater firm's performance (UNCTAD, 2010; Arudchelvan and Wignaraja, 2015; Aziz et al., 2019; Ghoreishi et al., 2020). Arudchelvan and Wignaraja (2015) highlighted that increased inward and outward internationalisation in GVC provides the opportunities for Asia's SMEs in accomplishing not only scale economies, but also developing market shares and enhancing productivity in firms. However, there is a necessity to investigate whether openness in Malaysia could foster export to China (Hong et al., 2020) which fundamentally crucial for the development of learning capability that also develop dynamic capability (Iman and Bititci, 2015). In the context of SMEs, they must develop three sets of dynamic capabilities: cognitive, managerial and organisational in order to manage globally dispersed value chain despite

of their liabilities of newness, smallness, foreignness and outsider ship (Eriksson et al., 2014; Kano et al., 2020). Along the three dimensions of dynamic capabilities, absorptive capacity which constitutes the organisational capabilities is considered as a highly crucial capability (Eriksson et al., 2014). In GVC, the success of SMEs is necessarily presumed to be connected to their absorptive capacity that concerns with knowledge creation and utilization that can enhance a firm's capability of gaining and sustaining competitive gains (Eriksson et al., 2014; Zahra and George, 2002; Hashim et al., 2020). The flows of knowledge and the transfers of assets between the members of GVC allow them to produce valuable output for the end customers (Eriksson et al., 2014). Hence, Karlson et al. (2003) stressed out that the process of knowledge from the relationship of internationalisation, inward and outward, will encourage deeper foreign market intervention. However, the development, use, and dissemination of knowledge by means of the connection between internationalization are not deemed an automatic process, both inward and outward (Karlson et al., 2003). Therefore, within-firm processes which facilitate the creation, transfer, and utilization of knowledge (absorptive capacity) brought forth by the inward and outward internationalization are warranted (Karlson et al., 2003; Mohamad Anuar, 2018). This study primarily aims to explore absorptive capacity development relative to the connection between inward and outward internationalizations in China by SMEs. This constitutes three research questions: 1) How SMEs acquire knowledge? 2) How SMEs assimilate newly acquired knowledge? 3) How SMEs exploit knowledge and establishing connections between inward and outward internationalisations?

## **LITERATURE REVIEW**

### **Knowledge Acquisition**

Acquisition refers to the firm capability for identifying, evaluating and acquiring external knowledge deemed crucial for the operations of firms (Cohen and Levinthal, 1989; 1990; Zahra and George, 2002). As eloquently stated by Cohen and Levinthal (1990) and Kim (1998), firms may not be able to acquire new knowledge without prior knowledge, which is defined as the knowledge unit of individuals in the organization. Further, according to Kim (1998), implicit knowledge is essential to prior knowledge, whereas explicit knowledge including standard operating procedures (SOPs) and blueprints are effective upon the availability of implicit knowledge. While appropriate prior knowledge is vital, the case is otherwise for adequate absorptive capacity (Lane et al., 2006). Zahra and George (2002) demonstrated how new knowledge acquisition tends to be influenced by the intensity (cf. Cohen and Levinthal, 1990), speed and direction of firm's effort to recognize and accumulate new knowledge.

### **Knowledge Assimilation**

Knowledge transfer and comprehension across and within units can be affected by assimilation of knowledge that represent the vital part of the learning process (Fletcher and Prashantham, 2011; Omar et al., 2020). According to Cohen and Levinthal (1990), high degree of prior knowledge and knowledge diversity allows for the assimilation of knowledge by firms. They represented that learning related to existing knowledge provide high level of learning performance and diversity of background increase prospect that received information will relate to existing knowledge and provide basis for learning. They also represented that diversity of knowledge sources enable individual to make novel associations and linkages to strengthen assimilation of knowledge. According to Cohen and Levinthal (1990), Furthermore, the absorptive capacity of firm depends both on the direct association of firms with the outer environment and knowledge transfers in firm. They proposed that technological knowledge that is problematic to be assimilated will requires a gatekeeper for monitoring the environment and translating technological knowledge into understandable form by intended group. They also proposed that gatekeepers are not required when external knowledge is related to ongoing event and ready to be assimilated.

### **Knowledge Exploitation**

Exploitation in foreign entry calls for the application of extant knowledge through the transfer and exploitation of firm-specific gains in foreign operations (Meyer et al., 2009).

## **RESEARCH FRAMEWORK**

According to Lane et al. (2006), the absorptive capacity concept has not been fully utilized by the researchers as high number of studies ignored the detailed dimensions of absorptive capacity and do not specify absorptive capacity as a capability (process) or a resource (knowledge base). They also demonstrated that low level of attention has been given to the influence of knowledge types towards knowledge exploitation as well as exploratory learning as compared to exploitation learning. Additionally, within the framework of R&D firms, absorptive capacity has been largely examined thus limiting the generalizability for other studies (Lane et al., 2006). Previous research focused more on innovation-related performance (Lane et al., 2006) and disregard general commercial application of acquired and assimilated knowledge which proposed by Cohen and Levinthal (1989; 1990), involving the use of commercial outputs such as services, products, and patents, as well as

knowledge outputs such as scientific knowledge, general knowledge, organizational knowledge, and technical knowledge that can modify mental models of firm members and help evolution of firm structures and processes (Cohen and Levinthal, 1989; 1990, Lane et al., 2006). Therefore, absorptive capacity should be explored in non-R&D context, capturing the acquisition, assimilation, and exploitation dimensions (Lane et al., 2006; Flatten et al., 2011).

## **METHODOLOGY**

A case study design was selected in this study owing to the "how" questions on learning process by the internationalizing SMEs. This has been supported by Yin (2003; 2009) who proclaimed that case study can be used as per the need to answer the "how" or "why" questions on a series of present-day situations, which the researcher has slight or no control over. The case study method is also solid for the measurement and recording of organizational behaviour (Chetty, 1996).

## **FINDINGS**

### **Knowledge Acquisition – Firm D and Firm F**

As per the international sourcing activities in China, both Firm D and Firm F succeeded at new market acquisition as well as knowledge internationalization. As Firm D made price-competitive purchases from China for its own competition in the domestic and international markets, Firm D was able to learn the Chinese purchasing market and rendered the development of supplier networking important. Hence, to buy the good quality products from China at a reasonable price, Firm D attempted to penetrate the market by meeting and assigning a Chinese residents who formerly studied in Malaysia as its representative in China. Besides that, the import customs procedure and operations allow for the acquisition of internationalization knowledge with regard to the import rules and regulations, which enables Firm D to manage the import customs codes by constantly applying particular codes in the import customs declaration to prevent any customs-related issues. Besides, internationalization knowledge was further acquired as they learned the import payment methods and procedures in particular. To avoid long delays, a money exchanger was also appointed as the person in charge of making payments to the Chinese suppliers in lieu of payments via Bank of China or the Central Bank of Malaysia, which may require tedious documentation and multiple requirements instead. Additionally, according to Firm D, this type of import payment method is also applicable to another country such as India.

On the other hand, Firm F was able to acquire particular business knowledge of the Chinese purchasing market and export market owing to its product purchases from China. The reason is that while Firm F bought from the suppliers in China, the suppliers, in turn, also bought from Firm F and this allows for business opportunities in terms of product supply every time a purchase is made since most of its Chinese suppliers have contrasting business demands. Firm F, for example, needs specific raw materials, whereas its suppliers require natural rubber; thus, upon negotiating and coming up with certain agreements, the raw materials were bought from the suppliers and natural rubber was then exported as per the suppliers' demand. This process of negotiation, on the basis of "guanxi" relationship, enables Firm F to understand the required adjustments to simultaneously buy from and sell to the suppliers in China. In addition, they also acquired new technological knowledge owing to its machinery purchases from China. In this regard, the machine supplier is in charge of installing and maintaining the machinery; hence, the Firm F parties made their visits to the factory by which they received advices and recommendations pertaining to the latest technology for improving the manufacturing of rubber balls for them to learn, in addition to the latest technology for developing the rubber balls by imitating the key foreign suppliers.

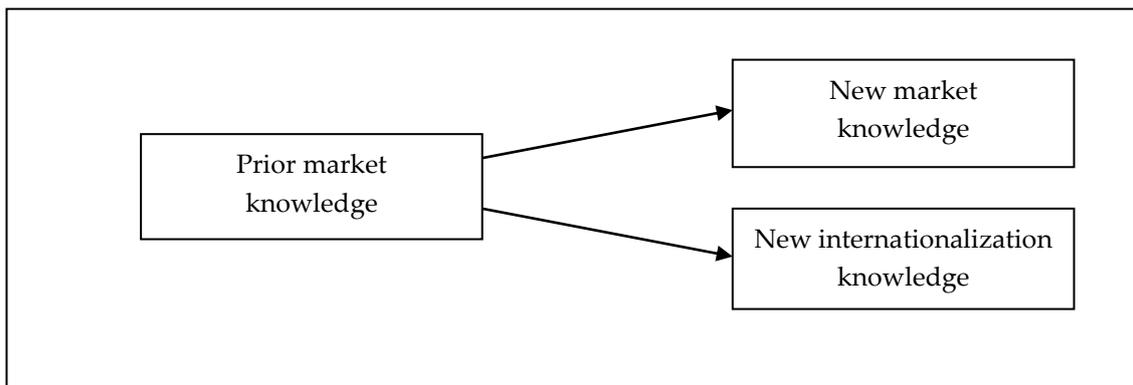
### **Knowledge assimilation and exploitation**

New knowledge was exploited by all case firms as they learn from the foreign buyers by discussing with the foreign suppliers during the firms' visits to their companies. As asserted by Zahra and George (2002), the case firms could leverage any extant capability whilst creating a new capability owing to such routines. For instance, Firm D was able to acquire and exploit new knowledge of the market that helps strengthen its relationships with the Chinese key suppliers, besides acquiring and exploiting new internationalization knowledge and technological knowledge, simultaneously. Initially, they could focus on a new business direction (trading business) whilst identifying new windows to enhance their technical capabilities so as to provide new services within the domestic market. Meanwhile, Firm F focused on the acquisition and exploitation of new market knowledge, which allows it to establish a close cross-border relationship between the buyers and suppliers as well as gaining benefits from this relationship. As a result, they succeeded at expanding their sales in China and this further corroborates the importance of acquiring and exploiting new technological knowledge that concerns with the exterior design of rubber ball.

## DISCUSSIONS

### Market knowledge possession for market acquisition and internationalization knowledge

Firm D and Firm F have prior knowledge of the Chinese supplier market as well as the Chinese purchasing market; hence, this allows for new knowledge acquisition of the market in relation to international sourcing in China. Besides, Firm F also succeeded at new knowledge acquisition of the Chinese export market by turning some foreign suppliers into foreign buyers. In fact, international sourcing allows firms to extend their knowledge scope of the market as they have resources to prior knowledge including prior knowledge of the market (Naldi and Zahra, 2007). Since Firm D and Firm F have made large purchases of physical goods from China, the Chinese purchasing market can, therefore, be penetrated and exploited through the use of prior market knowledge as indicated by Nassimbeni and Sartor (2007). They further evidenced the significance of sufficient knowledge of the market and entry to the Chinese local relational system, which allows firms to handle the culture in China as well as relational networks called “guanxi” upon dealing with the suppliers in China. According to Nassimbeni and Sartor (2007), “guanxi” is referred to as interpersonal ties in Chinese society marked by exchange of favours and mutual assistance.



**Fig.1: The acquisition of new market and internationalization knowledge**

However, referring to the figure 1.0, rather than prior knowledge of internationalization, prior knowledge of the market also allows for new knowledge of internationalization upon entry to the rising market in China. Evidently, Firm D and Firm F relied on prior knowledge in relation to international sourcing for new market acquisition as well as internationalization knowledge; hence, since the market in China is coming into existence, prior knowledge of internationalization is not as effective compared to prior knowledge of the market, which is mandatory for the entry to the market in China (Meyer and Gelbuda, 2006; Sandberg, 2013). Besides, according to Meyer and Gelbuda (2006) and Sandberg (2013), knowledge of internationalization was gathered from the very beginning at the early entry. Since prior knowledge of the market and new knowledge of internationalization are deemed essential upon the entry to the arising markets as per the outward internationalization setting, this study, therefore, extends prior literature works on this context within the framework of international sourcing. As reported by Firm D, “We knew where we can find the best supplier in China, we attended CANTON Fair... Over time, sourcing in China depicts our learning curve. For the first time, we used Bank of China, Then, we learned about the use of a money exchanger”. As asserted by Firm F, “They only entertained large amount of orders. We must note that. But we already established connections with some suppliers there... During Chinese New Year, they will stop for three months. From that, we will struggle. When we struggle, we learn to plan within three, six months.” Hence, the necessity to conform to a local setting and embark on new approaches to international businesses as asserted by Meyer and Gelbuda (2006) leads to the first proposition:

H1: Focal firm’ prior market knowledge from inward internationalisation in China can be utilized for the acquisition of new internationalisation knowledge for inward internationalisation in China as well as new market knowledge for outward internationalisation in China.

### The utilisation of new knowledge

It was found that the interaction process and trust building allowed Firm D and Firm F to utilize their newly acquired knowledge in GVC. In basis, the process of interactions involving certain counterparts in relation to business activities that are currently happening in the foreign market enables better management of problems, the creation of new ideas, and the acquisition of new knowledge (Johanson and Vahlne, 1990; Holm et al., 1996; Eriksson et al., 2000). According to Sharma and Blomstermo (2003) and Crossan et al. (1999) strong connections demonstrate a close relationship between firms that is expensive to maintain such that systems, structures, and procedures provide a framework for interactions. A greater understanding of each other’s

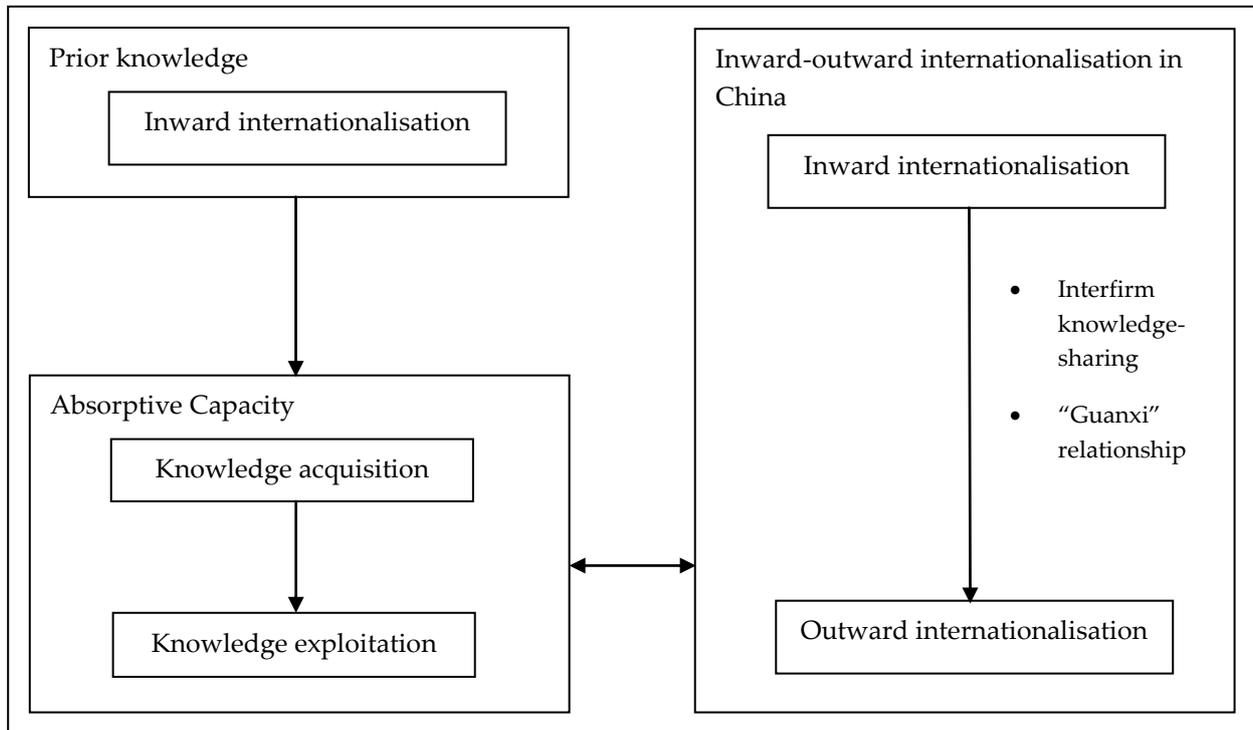
resources can be gained with the increase in the repeated communications appertaining to such context, such as through meetings or any other interactions (Gunawan and Rose, 2014; Hashim et al., 2020). Hence, Firm F was focused on informal interactions by means of informal meetings, which were not confined to discussing personal affairs only but also business opportunities. On the contrary, Firm D was more oriented towards incorporating interactions that are both formal and informal. Normally, informal meeting would be held after conducting formal on-site showroom and factory visits. In fact, firms build their trust along with their commitment to the cross-border relationships buyers and suppliers (Johanson and Vahlne, 2009; Nik Hashim et al., 2019). Trust convinces businesses to engage in information-sharing and encourages shared expectations (Madhok, 1995; Johanson and Vahlne, 2009). Both case firms were keen to create trust with their suppliers in China where According to Firm F, “We treat our supplier as our friend sometimes as a family. This is one of our ways to gain their trust. That is why some of our suppliers become our customers. We learn from them.”

H2: The process of interaction and trust building that involves the focal firm and their suppliers in China should be enriched with the interaction process including trust for the utilization of newly acquired knowledge by the focal firm.

**The connections of inward and outward internationalization**

In order to ensure that the newly acquired inward internationalisation knowledge is applicable to performing outward internationalisation, the interaction process and trust building must be occupied with inter-firm knowledge sharing which empowered by close relationship with the foreign suppliers (refer to Figure 2.0). Based on regular and close contact, Firm D shared the relevant acquired knowledge with the China suppliers through formal discussions. As a result, they were able to strengthen their export market strategies (internationalisation knowledge). However, Firm F was taking one step further by establishing strong personal relationships with the suppliers from China to form “guanxi” relationship, which allows them to sell abroad as they were exposed to the network of China suppliers and buyers. This exemplified the importance of personal upstream and downstream networks in connecting inward to outward internationalisation in China. With prior knowledge of the market in international sourcing for acquiring new knowledge of the market as well as internationalisation, Firm F acquired and exploited technological knowledge from their suppliers in China for the development and export of new product. The routine is that those attending the international sourcing expo as well as visiting the firm and factory of the key foreign suppliers should prepare a paperwork that is further relegated for a meeting (Managing Directors or purchasing personnel), and employees that include the sales and production teams were then given the paperwork results. This leads to the second proposition:

H3: The focal firm can establish the connections from inward to outward internationalisation in China through inter-firm knowledge sharing and “guanxi” relationship to enter the buyer-supplier network.



**Fig.2: The connections of inward-outward internationalisation**

## CONCLUSIONS

This study recognizes the value of prior knowledge for international sourcing as well as foreign export (Oviatt and McDougall, 1994; McDougall et al, 1994) in acquiring new knowledge (Cohen and Levinthal, 1990; Autio et al., 2000; Zahra and George, 2002) in GVC trade. However, it is important that the SMEs measures and use prior knowledge in acquiring and exploiting new knowledge to strategically connect internationalizations in China, both inward and outward. This research also acknowledges the importance of knowledge process, acquisition, and exploitation, which represent the absorptive capacity of the firm and detailed inter-firm knowledge sharing which is essential to enable firms in GVC are connecting to each other through learning processes. The absorptive capacity is projected as crucial for the dynamic capability of the firm in acquiring, assimilating, and exploiting knowledge flow that emerges from the inward and outward internationalisation of the firm (Zahra and George 2002); nevertheless, prior literature was only concerned with the intra-firm knowledge sharing in establishing inward-outward internationalisations (Karlsen et al., 2003; Welch et al., 2002; Mohamad Anuar et al., 2018).

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