

## RISK FACTORS IN THE INTERNATIONALIZATION PROCESS OF SMES

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### Abstract

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At the present time characterized by globalizing market, increasing competition, accelerating change and the occurrence of many risks it is necessary for businesses, which want to remain competitive, to be able to respond flexibly to the changes in a timely manner and to identify and manage risks. Companies try to diversify business risks, such as the loss of market share in the domestic market, by entering the foreign markets and participating in international trade. Involvement in the internationalization process cannot be understood only as an opportunity to achieve greater profits and a competitive advantage, it is necessary to consider potential risks accompanying this process, because engaging in the internationalization process may bring the companies many different specific risks. It would be useful for companies to identify the factors of failure resulting from internationalization. Identifying the barriers to internationalization, the main risk factors associated with it and designing their possible prevention or elimination could provide SMEs an impetus to enter foreign markets. Although the risk is a frequently discussed issue in the international discussion, only few studies were strictly focused on risk management in the internationalization process. Risk management is a broad discipline that requires a specific knowledge in practice. However, particularly small and medium-sized enterprises are often unable to identify the potential risks of the internationalization process and therefore are not able to manage the risks. This is due to the fact that SMEs usually do not have managers with a deep knowledge of risk management and, moreover, these managers also often lack experience with foreign markets. Unfortunately, the surveys of SMEs conclude that the poorly predicted risks of entering foreign markets are one of the most common causes of failure of SMEs internationalization process.

The main objective of this paper is to identify the risks of the internationalization process of Czech small and medium-sized enterprises. To achieve the main aim, it was necessary to make a survey of current situation in Czech small and medium-sized enterprises with focus on the participation in international trade, compared to the situation of these enterprises in recent years. It was also important to define the risk factors faced by Czech small and medium-sized enterprises in connection with the entry and activities on foreign markets and to identify key risk factors SMEs in the internationalization process are exposed to. It was also necessary to find out the obstacles to the internationalization process affecting the decision of Czech SMEs to penetrate foreign markets. And the last but not least task was to suggest some elementary methods that could be used by Czech small and medium-sized enterprises to eliminate risks in their internationalization process.

internationalization process, SMEs, risk factors, barriers

The increasing competition caused by growing globalization is reflected in the effort of companies to expand into foreign markets. Competition from abroad has been growing and for small and medium-sized enterprises (SMEs), unlike large companies, it is more difficult to remain

competitive at the domestic market and also to succeed in the foreign market. The ability of Czech SMEs to take part in the internationalization is often a discussed problem and the specifics of the internationalization of SMEs are often analyzed not only in the literature but also in practice, because

SMEs are in the internationalization process in a different position compared to large enterprises. In general, the advantage of SMEs is their speed and flexibility to respond to market changes, but as their disadvantage can be considered a lack of capital and a difficult access to external resources.

As all firm's processes, the internationalization process is accompanied by many risks. If a company decides to participate in the internationalization process, it is necessary to realize that the entry into foreign market could mean many specific risks associated with the geographic location of foreign market, the different economic environment and the differences in legislation in the target market. The individual risks should be seen in context, as they may interact. A comprehensive view of risks associated with the internationalization process should be integrated in every key decision regarding this process. The risks will also vary with each form of foreign market entry. For example the risk associated with indirect exports is different than with direct investments in foreign markets. Despite knowing that the key risk factors influencing the internationalization process of SMEs can positively affect small and medium-sized enterprises in their plans of international activities, unfortunately, there has not been published any output of a survey among SMEs yet, which would bring the list of risks in the internationalization process of SMEs from the Czech republic. Therefore, the authors decided to carry out such survey and compare the results valid for Czech SMEs with the output of a survey among SMEs throughout the world conducted by the OECD in 2009.

## METHODS AND RESOURCES

The process of internationalization can be defined as „the process of increasing part in international operations“ (Welch, Luostarinen; 1988), or as a gradual development taking place in distinct stages (Melin, 1992). In general, the internationalization process was described by two major schools: the models initially developed by Johanson and Wiedersheim – Paul, 1975, and Johanson and Vahlne, 1977, referred to as Uppsala models (U-models) and the Innovation-Related internationalization models (Imodels) conceptualized by Cavusgil, 1980. Both the I-models as well as the U-models emphasize firm's involvement in foreign market segments, both models view the internationalization as an incremental process. U-model is a more often mentioned model in international business literature, but a lot of companies do not follow this incremental stage approach and start their international activities immediately from their birth instead (Andersson, 2004). These companies are called as “Born Globals” (e.g. Oviatt, McDougal, 1997). Knight and Cavusgil (1996) define born globals as small technology oriented companies that operate in international markets from the earliest days of their establishment. At this point,

it should be noted that some small and medium-sized enterprises, such as above mentioned “Born Globals”, often begin the activities in several markets simultaneously and their product is developed specifically for international (or global) market.

In connection with the internationalization process definition, also the question why some companies decide for internationalization and others do not should be answered in the introduction. This topic was discussed by Thompson *et al.* (2005), Deresky (2000) and Yip (2003). The determining forces that initiated the need of companies to internationalize were mentioned also by Stremtan, Mihalanche and Pioras (2009). These authors divided determinants of internationalization into 4 main groups – commercial, industrial, environmental and opportunity determinants. According to Harrison (2008), it is possible to include “the overarching factors” and “the firm-specific factors” among the motives that lead firms to engage in the internationalization process.

Although many businesses long for entering foreign markets, the possibility of SMEs involvement in the internationalization process is often limited. The barriers to internationalization can be, according to Fliess, and Busquets (2006), defined as “the restrictions which prevent undertakings in the initiation, development or maintenance of business operations in foreign markets.” Many authors (e.g. Onkelinx and Sleuwaegen, 2008 or Siringoringo *et al.*, 2009) divide the internationalization barriers into two groups: internal barriers (related to corporate resources and capabilities) and external barriers (resulting from the business environment of domestic and foreign markets in which the company operates or intends to operate).

The survey conducted by the OECD in 2009 among SMEs throughout the world reveals that the majority of SMEs perceive the external barriers to the internationalization process as less important and emphasize the internal barriers. The top ten barriers to the internationalization of SMEs, according to the OECD survey, is the lack of working capital to finance exports, the identification of foreign business opportunities, the limited amount of information to discover or analyze markets, the inability to establish contacts with potential foreign customers, the difficulty in obtaining reliable foreign representation, the lack of managerial time to deal with the internationalization, the lack of staff and/or untrained personnel in international trade, the difficulties in comparing prices with foreign competitors, the lack of support from government and the extremely high transport costs.

The internationalization process is, like all processes in the firm, accompanied by risks. SMEs often do not have enough experience with the internationalization process. Therefore, they often deal with the problem of identifying the key risk factors in this process. The idea is that knowing the risk factors makes it possible to propose SMEs

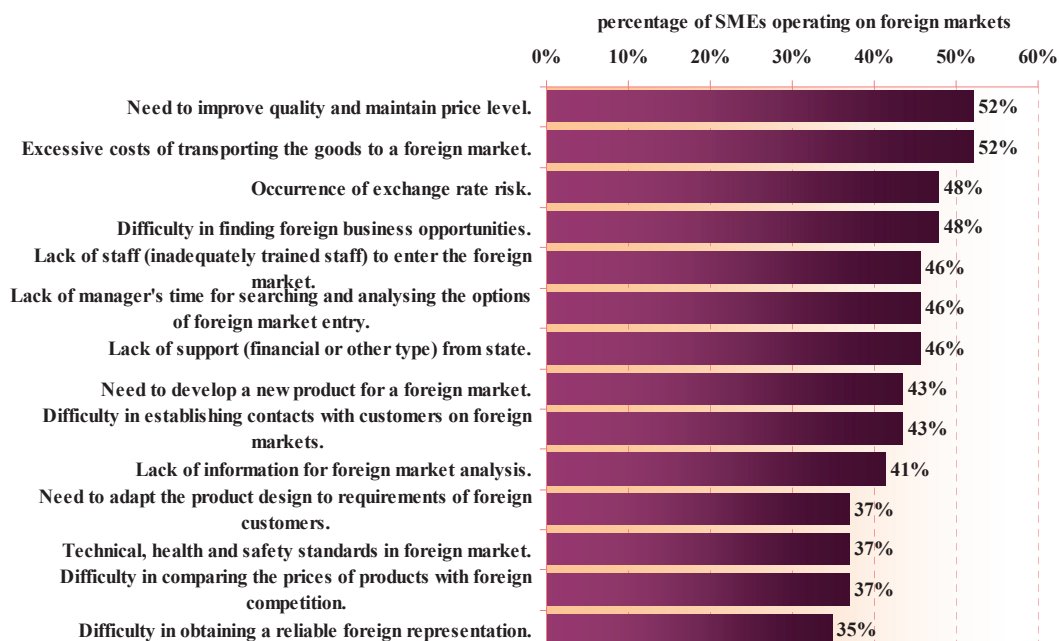
the way how to reduce or eliminate possible risks in their activities on foreign markets. Risks of the internationalization process can be described in various ways. According to Stremtan *et al.* (2009) risks of the internationalization process can be divided into two categories: the risks caused by underestimating the costs and the risks arising from uncontrollable international environment. Another authors, Rodriguez, Barcos and Álvarez (2010) compiled different classification of risks arising from the internationalization of businesses. They divided risks into 9 groups (risks associated with business strategy, with management and corporate culture, with logistical infrastructure, with project management, with socio-economic and political situation of the country, with legal aspects of the country, risks arising from business relationship to environment, market risks and culture risks). Risk management can, according to Rodriguez *et al.* (Rodriguez, Barcos, Álvarez, 2010), allow companies to identify the potential risks of internationalization project, set priorities and propose measures to eliminate these risks. Flanagan and Norman (1993) describe risk management as a process of risk identification and classification, followed by risk analysis and taking into account the approach to risk management, a position which has direct influence on the final stage of the process responsible for the risk. In recent years, the issue of risk management has become a widely discussed topic in the field of internationalization. Among authors, who deal with the risk management context in the interantionalization, can be included Reuer *et al.* (2004), Rivoli and Salorio (1996), Shrader, Oviatt and Mc Dougall (2000), Kwok and Reeb (2000) and others.

Although the risk management in relation to the internationalization of companies is widely discussed issue, there are only few studies available that focus on risks in this process and only few studies dealing with the risks of SMEs internationalization. Therefore, authors of this article decided to focus on the identification of risk factors in the internationalization process of SMEs.

To be able to identify the key risk factors of the internationalization of small and medium-sized enterprises, a survey of 1000 Czech SMEs was conducted in 2012. The primary data were collected through a questionnaire survey focused primarily on risk factors and barriers to the internationalization process of Czech SMEs. The data were collected electronically through the “Umbrella” system, the system of Mendel university in Brno for data collection and processing, 91 responses were obtained, total return rate was 9.1%. In terms of number of employees were obtained responses from 29 micro-sized enterprises (1–9 employees), 42 small-sized companies (10–49 employees) and 20 medium-sized enterprises (50–249 employees).

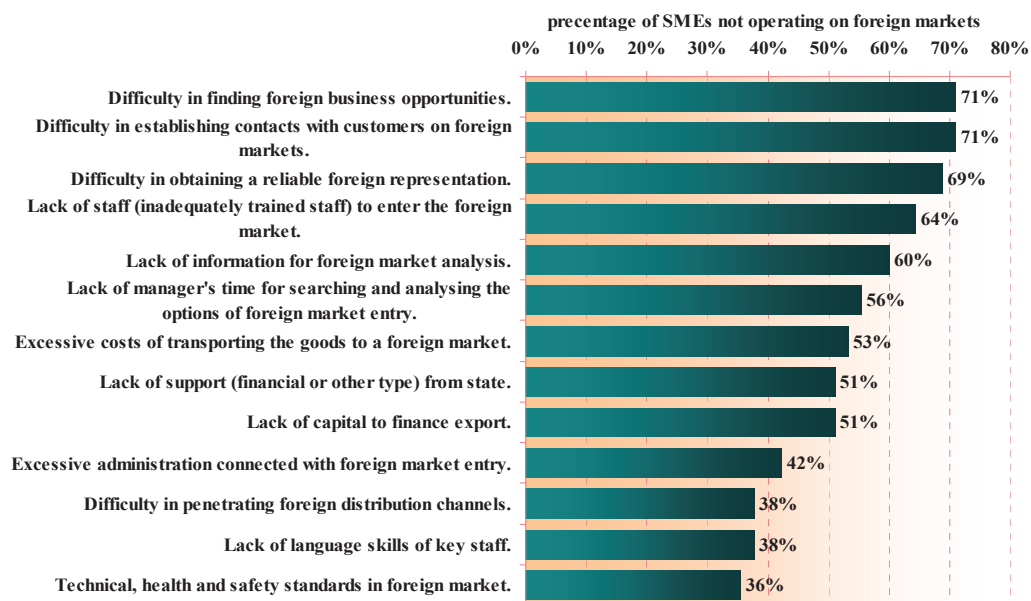
## RESULTS

The survey conducted among Czech SMEs was aimed not only at identification of the key risk factors, but also at finding out the main barriers affecting the decision of Czech SMEs to enter the foreign markets. These barriers were identified separately for SMEs already operating on foreign markets and SMEs not operating abroad yet. Fig. 1 shows the significant barriers to the internationalization process of SMEs operating on foreign markets and Fig. 2 summarizes



1: Key barriers of the internationalization process for SMEs operating on foreign markets

Source: author's research



2: Key barriers of the internationalization process for SMEs not operating on foreign markets  
Source: author's research

1: Key barriers of the internationalization process for all questioned SMEs

	key barrier	responses (%)
1	difficulty in finding foreign business opportunities	59
2	difficulty in establishing contacts with customers on foreign market	57
3	lack of staff (inadequately trained staff) to enter the foreign market	55
4	excessive costs of transporting the goods to a foreign market	53
5	difficulty in obtaining a reliable foreign representation	52
6	lack of information for foreign market analysis	51
7	lack of manager's time for searching and analysing the options for foreign market entry	49
8	lack of support (financial or otherwise) from state	48
9	need to improve product quality while maintaining the current price level	42
10	occurrence of exchange rate risk	37
11	lack of capital to finance exports	37
12	technical, health and safety standards in foreign market	36
13	need to develop new products for the foreign market	34
14	difficulty in comparing the prices of products with foreign competition	34

Source: author's research

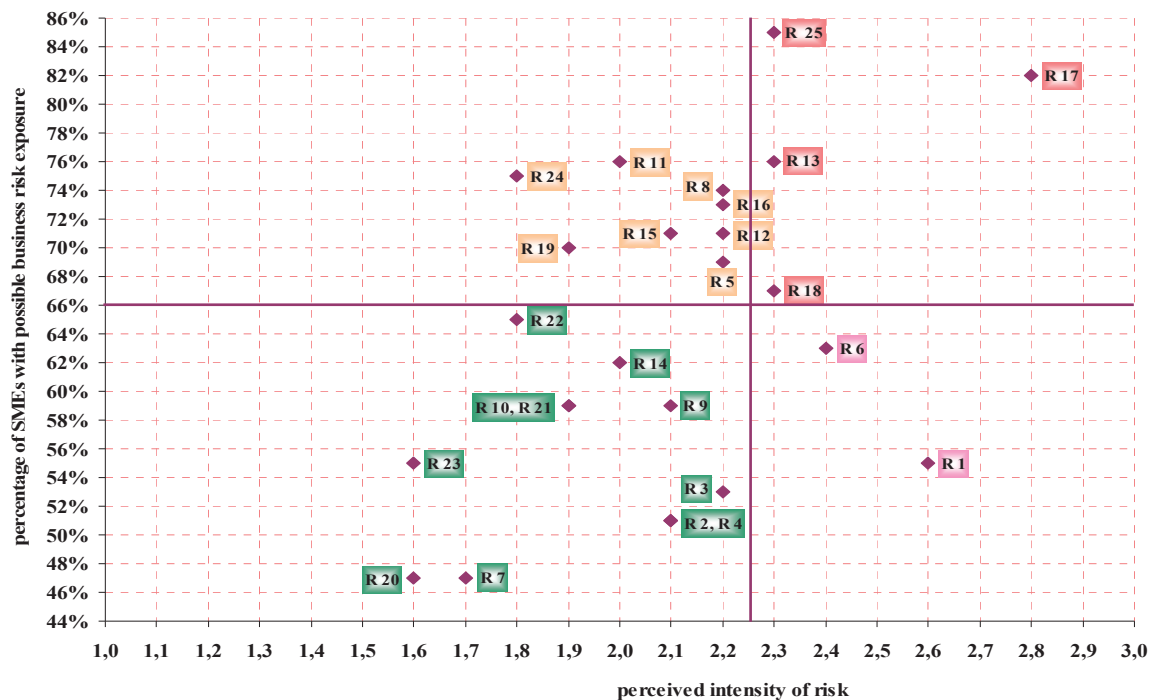
the significant barriers to the internationalization process of SMEs not operating abroad.

After a general assessment of the data collected from all respondents the key barriers for all questioned SMEs were sorted in descending order according to their significance, see Tab. I.

Most of the key barriers in the process of internationalization can be classified as internal constraints related to corporate resources and their own abilities. Although some external barriers arising from the business environment of domestic and foreign markets are listed among the key barriers, the number of these barriers is significantly lower.

In addition to the identification of barriers, it was also necessary to determine the main risk factors in the process of internationalization of Czech SMEs. According to the results of our research, the risk factors were divided into two categories: those perceived by Czech SMEs as significant and those perceived by Czech SMEs as less important. Furthermore, it was possible to evaluate which risk factors are crucial (key) for SMEs when entering and operating on foreign markets. Evaluation of risk factors in the internationalization process of Czech SMEs is shown in Fig. 3.

### Evaluation of risk factors in the internationalization process of Czech SMEs



3: Key risk matrix

Source: author's research

#### Explanatory notes to the chart:

Risk of loss of key foreign customers (R 1), risk of loss of key foreign suppliers (R 2), risk of loss of favorable negotiating position with foreign customers (R 3), risk of loss of favorable negotiating position with foreign suppliers (R 4), risk of changes in the general business environment on the foreign market (R 5), risk of substitutes for the company's product (R 6), risk of natural disasters (R 7), risk of relative prices change between the conclusion of the purchase contract and its fulfillment (R 8), risk of state intervention in sales or pricing (R 9), risk of changes in interest rates on the capital markets (R 10), risk of changes in preferences of foreign customers (R 11), risk of changes in legislative regulations on foreign market (R 12), risk of withdrawal of foreign customers from the contract (R 13), risk of withdrawal of foreign suppliers from the contract (R 14), risk of default of the supplier (R 15), risk of not taking goods by foreign customer (R 16), risk of protracted default or insolvency of a foreign customer (R 17), risk of conclusion of an incorrect purchase contract (R 18), risk of delivery of defective goods (R 19), risk of damage to health or property caused by a product (R 20), risk of deterioration of the product or product damage during transport (R 21), risk of non-delivery due to transport (R 22), risk of loss of product during transport (R 23), risk of loss due to inflation (R 24), risk of foreign exchange losses (R 25)

All risk factors were in matrix arranged on the basis of two criteria: perceived intensity of risk and percentage of questioned SMEs admitting the possibility of exposure to the risk.

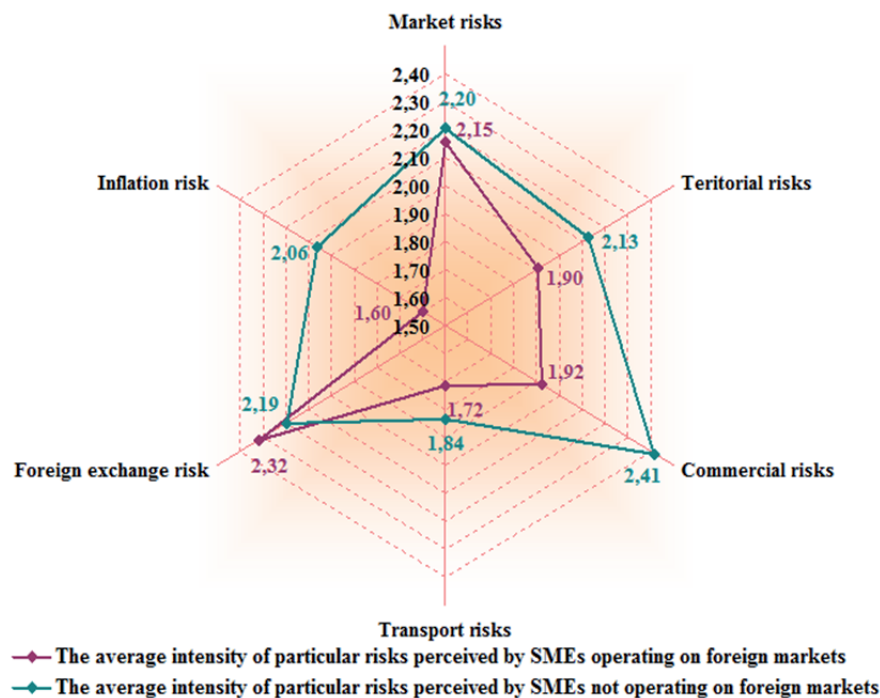
The vertical axis of the graph expresses a percentage of questioned SMEs which admit that their business may be exposed to the risk and therefore the vertical axis can express the probability that SMEs encounter the particular risks. The horizontal axis in the chart reflects the intensity of the perception of each risk or, in a simplified way, how high is the risk for questioned SMEs.

The chart is divided into two lines of four fields. The vertical line divides the chart on area with risks of lower intensity and area with risks of higher intensity. The dividing point was set according to the subjective consideration of various factors influencing the perception of risks and so was determined by the intensity of 2.25. The horizontal line divides the chart to area with risks which may have impact on the higher proportion of surveyed SMEs and area with risks with impact on the lower proportion of surveyed SMEs. As the dividing point was chosen 66% or two thirds of all respondents.

In the top right area, there are placed the key risk factors, to which SMEs should pay particular attention. SMEs should be prepared to possible effects of these risks when entering foreign markets and develop useful measures to reduce the probability of their occurrence or the height of potential impact. As the key risk factors were thus identified:

- the risk of conclusion of an incorrect purchase contract (R 18),





4: The average perceived intensity of particular risk categories

- the risk of withdrawal of foreign customers from the contract (R 13),
- the risk of protracted default or insolvency of foreign customer (R 17),
- the risk of foreign exchange losses (R 25).

Furthermore, there were also identified significant risk factors located in the near field of key risks – the risk of substitutes for the company's product (R 6), the risk of changes in general business environment on the foreign market, the risk of changes in legislative regulations on foreign markets (R 12), the risk of not taking the goods by foreign customer (R 16) and the risk of changes in the relative prices between the conclusion of purchase contract and its fulfillment (R 8). Among the significant risks can be included also the risk of losing key foreign customers (R 1), even though it is not in the direct neighbourhood of the key risk area in the matrix, but still SMEs perceive its intensity as relatively high.

Key risk factors include mainly the commercial risks and the foreign exchange risk. Other important risks can be ranked mainly among the market risks. The following graph (see Fig. 4) shows the average level of SMEs perception of various categories of risk factors occurring in international trade according to results of our research.

Generally, it can be assessed that Czech SMEs not operating on foreign markets perceive the risks more intensely than SMEs that already operate abroad. While market risks are perceived by both categories of SMEs with almost the same intensity, commercial, territorial, and inflation risks are perceived with greater intensity by SMEs not operating on foreign

markets. The only category of risks that is perceived as stronger by SMEs already operating abroad is the category of foreign exchange risks.

In the context of risk perception, two hypotheses are tested. The hypotheses are based on qualitative data concerning the survey results and therefore the independence of qualitative signs with the use of chi-squared test of a contingency table is tested.

Hypothesis A:  $H_0$ : Perceived intensity of risks connected with operating on foreign markets is not dependent on the area of economic activity of the enterprise.  $H_1$ : Perceived intensity of risks connected with operating on foreign markets is dependent on the area of economic activity of the enterprise.

The value of chi-square ( $\chi^2$ ) test statistic with 14 degrees of freedom is 22.51. Compared with the critical value of this statistic ( $\chi^2_{0.05}(14) = 23.69$  and  $\chi^2_{0.10}(14) = 21.06$ ) it is found that the value of test criterion is greater than the critical value of chi-square statistic at 10% significance level. Therefore is the null hypothesis at 10% significance level rejected and the alternative hypothesis accepted. This means that the influence of area of economic activity on the perceived intensity of risks is statistically significant, in other words that there is dependence between both two signs. According to Pearson's contingency coefficient ( $P = 0.46$ ), there is a medium degree of dependence between these two qualitative signs.

Hypothesis B:  $H_0$ : Perceived intensity of risks connected with operating on foreign markets is not dependent on the number of years operating on foreign markets.  $H_1$ : Perceived intensity of risks connected with operating on foreign markets is dependent on the number of years operating on foreign markets.

The value of chi-square ( $\chi^2$ ) test statistic with 14 degrees of freedom is 15.01. Compared with the critical value of this statistic ( $\chi^2_{0.05}(14) = 23.69$  and  $\chi^2_{0.10}(14) = 21.06$ ) it is found that the value of test criterion is lower than the critical value of chi-square statistic at both 5% and 10% significance level. Therefore can not be the null hypothesis rejected.

## CONCLUSION AND DISCUSSION

The main aim of this paper was to identify the key risk factors in the process of internationalization of SMEs, which can significantly affect the competitive ability of the enterprises. Partial objective was to find out what are the most important barriers for Czech SMEs in the foreign market penetration. Key risk factors were determined on the basis of two criteria – the number of SMEs, which admit the possible exposure of their business to particular risk and the average perceived intensity of particular risk factor. Risk factors were divided into four categories. As key risk factors were selected those that were perceived as possible risk for foreign market entry of more than two-thirds of questioned SMEs and at the same time their average perceived intensity was high (reaching values above 2.25 on the scale from 1 expressing low intensity to 4 expressing high intensity). As key risks were identified: the risk of conclusion of an incorrect purchase contract, the risk of withdrawal

of a foreign customer from the contract, the risk of protracted default or insolvency of a foreign customer and the risk of foreign exchange losses. Among the significant risk factors were included the risk of creation of substitutes for company's product, the risk of changes in general business environment on foreign market, the risk of changes in legislative regulations on foreign markets, the risk of not taking the goods by foreign customers and the risk of changes in relative prices between the conclusion of purchase contract and its fulfillment.

Furthermore, it was found that the main barriers to Czech SMEs entering the foreign market are almost the same as the 10 main barriers to the internationalization process of SMEs throughout the world identified in research by the OECD in 2009, but with a different order of importance of each barrier. While for SMEs in the world is the lack of capital to finance exports the primary barrier, for questioned Czech SMEs is the lack of capital to finance exports exceeded by other barriers. The biggest barrier is the difficulty in finding foreign business opportunities and the difficulty in establishing contacts with foreign customers. Furthermore, surveyed Czech SMEs are exposed more than SMEs in the world to the barrier of excessive costs of transporting goods to foreign markets.

## SUMMARY

This paper presents the results from a survey among Czech SMEs. First of all, the main barriers of the internationalization process of Czech SMEs were identified. As the biggest barrier for Czech SMEs when entering foreign markets were identified the difficulty in finding foreign business opportunities and the difficulty in establishing contacts with foreign customers. Interesting is the fact that even though the lack of capital to finance exports counts among the important internationalization barriers, it is not placed at the top position. Then the barriers perceived by SMEs already operating on foreign markets and barriers perceived by SMEs not operating on foreign markets were compared. However, the main aim of the survey was to identify the key risk factors of the internationalization process. These risks are shown in the risk matrix in the top right area. As key risks were identified: the risk of conclusion of an incorrect purchase contract, the risk of withdrawal of foreign customer from the contract, the risk of protracted default or insolvency of a foreign customer and the risk of foreign exchange losses. The key risks were detected on the basis of two criteria: the perceived intensity of risk by surveyed SMEs and the percentage of surveyed SMEs admitting the possibility of exposure to the risk. Moreover, other important risk factors were identified. Those were the risks that were located in the risk matrix near to the top right area. The key and important risks were identified mainly in order to show Czech SMEs the risks which they should pay special attention to when entering foreign markets.

Then the risks were classified according to the categorization of risks in international trade by scientific literature (market, commercial, territorial, transportation, inflation, foreign exchange risks) and the importance of these aggregate categories for Czech SMEs was discussed. The average perceived intensity of particular risk categories was compared among SMEs already operating on foreign markets and SMEs not involved in the internationalization process. It was found out that Czech SMEs not operating on foreign markets perceive the risks of the internationalization more intensely than SMEs that already operate abroad. The only category of risks that is perceived as stronger by SMEs already operating abroad is the category of foreign exchange risks.

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