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International High-Tech SMEs Amid Geopolitical Pressures

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In the wake of increased geopolitical tensions, we investigate the impact of geopolitical risk on the investments of international high-tech small and medium-sized enterprises (SMEs). Prior research on SME internationalization has primarily emphasized the importance of home and host-country institutions and political risk, with limited attention given to geopolitical risk as a distinct contextual factor. Drawing on international relations literature, we posit that geopolitical risk, captured by diplomatic relations between home and host countries, creates political legitimacy concerns for international high-tech SMEs, discouraging their international investments. This effect is contingent on SME innovation (through patents) and the scope of international diversification. Analysing data from international high-tech SMEs and their subsidiaries for the period 2009–2022, we find consistent evidence for our hypotheses.

Introduction

The past decade has seen an increase in geopolitical risk – the risk associated with wars, terrorist acts and any tensions among states and political actors that affect the peaceful course of international relations (IR) (Caldara and Iacoviello, 2022). A rise in populism, fragmentation and violence in both developed and developing countries (Devinney and Hartwell, 2020; Luo, 2022) has created an environment of heightened political and economic uncertainty for firms (Ciravegna and Michailova, 2022). While recent international business and management research has explored the impact of geopolitical risk on multinational enterprises (MNEs) (Adarkwah *et al.*, 2024; Bertrand, Betschinger and Settles, 2016; Hasija, Liou and Ellstrand, 2020; Li *et al.*, 2018), it offers limited insight in understanding its impact on the internationalization of small and medium-sized enterprises (SMEs).

Prior research on SME internationalization has focused on the importance of home and host-country institutions (Adomako, 2020; Catanzaro, Messeghem and Sammut, 2019; Torkkeli *et al.*, 2018) and political risk (Buckley and Munjal, 2017; Chen *et al.*, 2024; Li *et al.*, 2024; Thanos, Dimitratos and Sapouna, 2017), with limited attention on geopolitical risk as a distinct contextual factor (Jafari-Sadeghi *et al.*, 2023). Unlike politi-

cal risk, which represents instability within a country, geopolitical risk is specific to the relations between home and host countries and can arise even in countries with high institutional quality. It often involves direct conflicts between the political elites of home and host countries (Meyer *et al.*, 2023), leading to negative sentiments towards foreign firms from countries with unfavourable relations (Arikan and Shenkar, 2013; Li, Makino and Jiang, 2019). Given the unique nature of geopolitical risk, many firm-level strategies that help mitigate political risk (e.g. political connections) have a more ambiguous, if not detrimental, role for managing geopolitical risk (Hartwell and Zadorozhna, 2024). Consequently, this study investigates how geopolitical risk, as captured by diplomatic relations between home and host countries, affects the foreign investments of international high-tech SMEs and identifies the firm-specific conditions that enable these SMEs to cope with such risks.

This is particularly important in light of the recent surge in techno-nationalism that perceives high-tech firms as national security threats (Dachs *et al.*, 2024; Godinho and Simões, 2023). Consequently, high-tech SMEs are considered more vulnerable and unable to navigate political conflicts and foreign diplomatic pressures due to limited resources, inadequate knowledge of foreign markets (Child, Karmowska and Shenkar, 2022;

Delios and Henisz, 2003) and inability to wield political influence (Child, Karmowska and Shenkar, 2022; Sun *et al.*, 2021; Vendrell-Herrero, Bustinza and Vailant, 2021). However, a recent UNDP report (UNDP, 2022) on the impact of the war in Ukraine found that SMEs adapted quickly, with only 22% remaining closed in mid-April 2022 compared to 75% in early March. Thus, identifying firm-specific factors that affect the impact of geopolitical risk on high-tech SME investments can help these firms develop targeted strategies to mitigate such risks.

We argue that unfavourable diplomatic relations between home and host countries create political legitimacy issues for international high-tech SMEs, thus discouraging investments. However, not all international high-tech SMEs are equally affected by them. Indeed, innovative SMEs are able to enhance their perceived legitimacy by contributing positively to economic growth and local innovation in the host country (Keizer, Dijkstra and Halman, 2002). Meanwhile, SMEs with a high scope of international diversification face legitimacy challenges due to resource limitations and difficulties in understanding and adhering to diverse regulatory frameworks.

We capture diplomatic relations between home and host countries, with the affinity of voting patterns in global affairs, in the United Nations General Assembly (UNGA) (Adarkwah *et al.*, 2024; Bertrand, Betschinger and Settles, 2016; Buchner *et al.*, 2024; Gartzke, 1998; Hasija, Liou and Ellstrand, 2020). To empirically test our hypotheses, we use a comprehensive panel dataset of international high-tech SMEs from 31 home countries and their subsidiaries in 55 host countries, covering the period from 2009 to 2022. Our findings provide strong support for our theoretical arguments.

This study makes three important contributions to the international business (IB) and management literature. First, we contribute to the literature on geopolitical risk and investment (Adarkwah *et al.*, 2024; Bertrand, Betschinger and Settles, 2016; Hasija, Liou and Ellstrand, 2020; Yoon, Peillex and Buckley, 2021) by providing new evidence on the importance of geopolitical risk for the investment decisions of international high-tech SMEs, especially given the SMEs' limited resources and capacity to exert political influence. Second, we contribute to the literature on SMEs and institutional and political context (Adomako, 2020; Chen *et al.*, 2024; Child, Karmowska and Shenkar, 2022; Thanos, Dimitratos and Sapouna, 2017) by drawing on the IR literature to conceptually incorporate geopolitical risk into the international high-tech SMEs' investment. We show that SMEs' innovation and the extent of international diversification are two key factors that explain why some high-tech SMEs are differently impacted by unfavourable diplomatic relations. As such, we provide IB and management scholars with a bet-

ter understanding of the conditions that help SMEs to better cope with geopolitical risk. Third, we also make an important empirical contribution to the literature on SMEs and geopolitical risk by moving beyond qualitative assessments (Ferreira de Araújo Lima, Crema and Verbano, 2020) and empirically testing the impact of unfavourable diplomatic relations on high-tech SMEs across various home and host countries, enhancing the generalizability of our findings compared to previous research that focused on specific contexts (Jafari-Sadeghi *et al.*, 2023).

The rest of the paper is organized as follows. We first outline the main theoretical frameworks for understanding geopolitical risk and develop three hypotheses on its effects on high-tech SME investments and boundary conditions. Next, we detail our data and methods, empirically test the hypotheses and conclude with a discussion of our findings.

Theory and hypothesis development

SME internationalization

The internationalization of SMEs is profoundly influenced by the institutional environment in which they operate. A favourable institutional environment supports the internationalization of SMEs through the provision of resources, information and network connections (Catanzaro, Messeghem and Sammut, 2019; Georgiadou, Hughes and Viala, 2023; Torkkeli *et al.*, 2018). In contrast, a high political risk environment or institutional voids inhibit internationalization. Political risk can negatively impact SMEs through regulatory changes, profit remittance restrictions or threats of renege contracts (Adomako, 2020; Chen *et al.*, 2024). Similarly, institutional voids also pose challenges due to inadequate infrastructure, such as poor communication systems or unreliable electricity (de Lange, 2016). To overcome these challenges, SMEs can connect with local entrepreneurs and form non-market partnerships with governments and foreign firms (de Lange, 2016; Georgiadou, Hughes and Viala, 2023; Torkkeli *et al.*, 2018; Zhu, Hitt and Tihanyi, 2006).

Studies on political risk and institutional voids provide a strong foundation for understanding geopolitical risk, yet more research is needed in understanding its impact and implications for SMEs (Ferreira de Araújo Lima, Crema and Verbano, 2020; Meyer *et al.*, 2023). This is important because geopolitical risk differs from political risk in key ways. Geopolitical risk is a subset of political risk that arises from 'the threat, realization, and escalation of adverse events associated with wars, terrorism, and any tensions among states and political actors that affect the peaceful course of international relations' (Caldara and Iacoviello, 2022, p. 1197). Meanwhile, political risk can be defined as the unpredictability

and instability of legal, political and regulatory conditions within a country (Kobrin, 1979).

Geopolitical risk leads to conflicts and tensions in IRs between a home and a host country and can result in unexpected regulatory changes or arbitrary rule enforcement for foreign firms from hostile countries (Bussy and Zheng, 2023; Stevens, Xie and Peng, 2016). It often involves direct conflicts between political elites, leading to negative consumer sentiments and boycotts (Arikan and Shenkar, 2013; Li, Makino and Jiang, 2019). Hence, geopolitical risk is home to host-country specific and can occur in countries with high institutional quality (low political risk and no institutional voids). For instance, Chinese firms like Huawei or TikTok face high geopolitical risks in the United States, despite its strong institutions. Conversely, political risk affects all foreign firms within a country, is common in countries with weak institutions and does not inherently involve negative sentiments (Feinberg and Gupta, 2009). In this case, foreign firms often use non-market strategies to navigate regulatory environments (Sun *et al.*, 2021), typically without facing discrimination based on their country of origin. In fact, many Western firms, with political support from host-country governments, have successfully gained first-mover advantages in high political risk countries like Nigeria (Frynas, Mellahi and Pigman, 2006).

Research on geopolitical risk (captured through the affinity of voting patterns in global affairs, in the UNGA) shows that favourable diplomatic relations between home and host countries (i.e. lower geopolitical risk): increase MNEs' cross-border alliances (Arikan, Arikan and Shenkar, 2020); lower cross-border acquisition premium (Bertrand, Betschinger and Settles, 2016); increase subsidiary investments (Duanmu, 2014; Li *et al.*, 2018, 2024) and post-acquisition performance (Hasija, Liou and Ellstrand, 2020). Meanwhile unfavourable diplomatic relations lower MNEs' investments (Adarkwah *et al.*, 2024), the likelihood of full acquisition (Yoon, Peillex and Buckley, 2021) and research collaborations between firms in home and host countries (Charpin, London and Vincent, 2024). At the same time, strategies that firms use to manage political risks do not necessarily apply in the case of geopolitical risk. For instance, at the country level, geopolitical risk turns political connections into a liability (Hartwell and Zadorozhna, 2024) and lowers crowdfunding performance (Alsagr *et al.*, 2023), despite the positive impact of political connections in overcoming political risk (Albino-Pimentel, Anand and Dussauge, 2018; Duanmu, 2014; Frynas, Mellahi and Pigman, 2006).

In summary, research on geopolitical risk has primarily focused on its impact on MNEs, leaving a gap in understanding its effects on the activities of high-tech SMEs. Only one study currently addresses this topic. Jafari-Sadeghi *et al.* (2023) used mathematical mod-

elling to show that geopolitical risk negatively impacts Iranian SMEs' investments due to increased tariffs and subsidies to domestic firms, making foreign SMEs less competitive. This study is qualitative and focused on a country where firms experience severe forms of geopolitical risk, raising questions about its generalizability. Additionally, SME firm-specific factors that help or hinder a firm's ability to cope with geopolitical risk remain largely unexplored in the literature.

Political realism and legitimacy

The rise of geopolitical pressures calls for integrating political science into international business and management theory (Buckley, 2023). At the core of IR theory, the political realism approach helps us understand a country's political stance in an anarchical and conflict-driven world (Luo, 2022, 2024; Snyder, 2004; Witt, 2019). Under this approach, nations are concerned with their own national security (Wight, 2006) and survival (Witt, 2019). This survival depends, among other elements, on the state's economic, military and political power (Witt, 2019). As such, the political realism approach highlights the importance of national security for a country's balance of power in the world, and it views self-interested states as being continually engaged in competition for power and security (Lobell, 2017). Thus, realist policies aim at increasing a country's own power and influence at the expense of rival states, creating international tensions and conflicts, especially when home and host countries clash over international foreign-policy issues (Gartzke, 1998). For instance, Voeten (2000) shows that rising powers, such as China, continually challenge the existing hegemon – the United States – as demonstrated by their voting behaviour in the UNGA, which consistently differs from that of the United States. Consequently, the pursuit of realist policies can give rise to geopolitical risk, creating legitimacy challenges for firms from countries with hostile relations to their country of investment, affecting their ability to conduct business in such countries.

Legitimacy, defined as 'a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions' (Suchman, 1995, p. 547), is seen through a lens of alignment between the firm's actions and the host government's long-term economic, political and social goals (Stevens, Xie and Peng, 2016). This alignment signals to the government and other stakeholders that the firm is a beneficial and accepted part of the community, thereby securing a 'social license to operate' (Stevens, Xie and Peng, 2016). This is consistent with the legitimacy-based view (LBV) (Stevens, Xie and Peng, 2016), which proposes that host-country governments and society form judgements about firms' legitimacy based on their

attributes and actions in the host country. For instance, Luo (2001) shows that MNEs can enhance their legitimacy with host governments by demonstrating trustworthy behaviour, building social capital and investing in valuable and rare resources within the host economy.

When firms are deemed legitimate, unfavourable and abrupt policy changes are less likely to occur (Stevens, Xie and Peng, 2016). This signals to other firms from the same home country that their investments will likely be treated similarly, thereby increasing their expectations of political legitimacy from local stakeholders, which offers them a shield from opportunistic actions by the host government (Chen *et al.*, 2024; Darendeli and Hill, 2016). In contrast, the host government is more inclined to view foreign firms from home countries with unfavourable and uncooperative diplomatic relations as less legitimate. These firms are more likely to experience increased scrutiny, intervention and added rules and regulation (Adarkwah *et al.*, 2024; Stevens, Xie and Peng, 2016).

Diplomatic relations and investments of international high-tech SMEs

Unfavourable diplomatic relations between the home and host countries can negatively impact the legitimacy of high-tech SMEs. First, when diplomatic ties are strained, host-country governments may impose stricter regulatory barriers and increase scrutiny on foreign high-tech firms (Luo and Van Assche, 2023). This heightened scrutiny can create significant challenges for high-tech SMEs, which often lack the resources to navigate complex compliance requirements (Child, Karmowska and Shenkar, 2022). Second, the host government and local stakeholders may perceive foreign high-tech SMEs as threats to national security or economic stability (Luo, 2022; Luo and Van Assche, 2023; Stevens, Xie and Peng, 2016). This perception can result in a social and political environment that is hostile to the SMEs, undermining their legitimacy and making it difficult for them to gain the necessary 'social' or outright legal licence to operate (Stevens, Xie and Peng, 2016). For instance, the US government forced the Chinese high-tech firm Beijing Kunlun Tech (founded in 2008 and of a size that fits the definition of an SME in China)¹ to sell its controlling stake in Grindr (a dating app for people who identify as gay, bisexual or transgender) to limit the possibility of the information gained from the app being used by the Chinese government to blackmail US officials (Wells and O'Keeffe, 2019). Third, strained diplomatic relations can lead to political and economic retaliation, where the host-country government may impose

¹In 2023, Beijing Kunlun Tech had 1771 employees; in China, an SME can have up to 2000 employees.

tariffs, sanctions or other trade barriers specifically targeting firms from the home country (Meyer *et al.*, 2023; Panibratov *et al.*, 2023). SMEs, which often lack the financial and operational flexibility of larger firms (Child, Karmowska and Shenkar, 2022), cannot survive retaliatory measures and are forced to reduce their investment (Cheratian *et al.*, 2024). Fourth, diplomatic tensions can fuel negative public sentiment towards businesses from the home country, resulting in boycotts, protests or negative media coverage, which erode their legitimacy and market position in the host country (Arikan and Shenkar, 2013; Li, Makino and Jiang, 2019). For instance, Israeli high-tech startups are facing significant challenges due to outright bans and silent boycotts amid the Hamas–Israel war. These startups find it harder to raise foreign capital, and companies and consumers are choosing not to buy from Israeli firms, even opting for inferior technology instead (Hoffman, 2024). Non-governmental organizations have also called for boycotts of Israeli high-tech firms like Monday.com, a Tel-Aviv-based tech startup specialized in work management software (Boycott Israel – A Simple Boycott List, n.d.), particularly in the Middle East and South Asia, where diplomatic relations with Israel are strained (Siyech, 2024).

High-tech SMEs will struggle to manage legitimacy issues due to unfavourable diplomatic relations for several reasons: they lack the experience of large firms in high-risk countries (Delios and Henisz, 2003), do not have the same level of non-market capabilities (Sun *et al.*, 2021), cannot access institutional tools such as insurance and guarantees (Adarkwah and Benito, 2023) and lack the leverage of MNEs in value creation during negotiations with host-country governments (Fagre and Wells, 1982). Consequently, high-tech SME investments are highly sensitive to unfavourable diplomatic relations between home and host countries. Therefore, we hypothesize:

H1: Unfavourable diplomatic relations are negatively related to the investments of international high-tech SMEs.

Diplomatic relations, legitimacy and innovation

Firms differ in how they are impacted by geopolitical risk based on their innovativeness – the extent to which a firm can use its resources and capabilities to successfully drive innovation (Zhou, Gao and Zhao, 2017). According to the techno-nationalism perspective, governments view the world as a zero-sum game centred around technological rivalry as a prime driver of economic growth (Luo, 2022; Luo and Van Assche, 2023). In a techno-nationalist world, more innovative firms would experience increased legitimacy issues in the host countries due to (i) host country's heightened

concerns over national security and economic stability and (ii) policies aimed at prioritizing national technological independence and reducing technological interdependence from foreign firms. Consequently, more innovative firms might be perceived as less legitimate and subject to more government intervention, resulting in decreased investment in the host country.

On the other hand, innovation can serve as a strategy to signal a firm's value to the host-country stakeholders, even in challenging institutional environments, thereby increasing legitimacy (Wang, Zhang and Shou, 2021; Zhou, Li and Wang, 2024). Therefore, SMEs' innovativeness can play a significant role in mitigating geopolitical risk. For instance, in adversarial host countries, SMEs can implement 'local for local' strategies, which grant more autonomy to their subsidiaries to tailor innovation to local market needs (Dachs *et al.*, 2024). This strategy often involves engaging in local R&D activities and patenting (Zhou, Li and Wang, 2024), which create jobs and contribute to the host country's economy, showcasing the firm's long-term commitment to the local market. When high-tech SMEs contribute to the host economy through technology, new products and job creation (Ayyagari, Demirgüç-Kunt and Maksimovic, 2011; Li and Rama, 2015), they are perceived as proactive contributors to economic growth (Keizer, Dijkstra and Halman, 2002). As a result, host-country governments may be less inclined to impose restrictive measures and are less likely to penalize firms that actively contribute to local innovation and growth (Stevens, Xie and Peng, 2016; Zimmerman and Zeitz, 2002). The greater the extent to which stakeholders perceive a firm's actions to be 'desirable, proper, or appropriate' (Suchman, 1995, p. 574), the higher the firm's legitimacy in the host country (Marquis and Qian, 2014). Therefore, more innovative firms encounter fewer legitimacy issues.

Thus, although techno-nationalism poses significant challenges to high-tech SMEs, those that are more innovative are likely to contribute to local technological advancement and growth in the host country, reducing legitimacy concerns and mitigating geopolitical risks. Therefore, we hypothesize:

H2: The negative effect of diplomatic relations on the investment decisions of international high-tech SMEs is less pronounced the higher the level of SME innovation.

Diplomatic relations, legitimacy and international diversification

We further argue that the investments of high-tech SMEs are impacted by unfavourable diplomatic relations between the home and host country based on

the geographical scope of their international diversification.² International diversification with a low geographical scope can reduce high-tech SME risk by allowing them to focus on geographically and culturally similar countries and regions, effectively managing their limited resources (Cieřlik, Kaciak and Welsh, 2012; Patel, Criaco and Naldi, 2018). Conversely, a higher geographical scope increases risks due to the complexities of operating in diverse cultural, economic and regulatory environments, leading to higher costs of doing business and the potential for resource over-extension, which elevates the risk of failure (Chu, Deng and Xia, 2020; Mammen, Alessandri and Weiss, 2021; Patel, Criaco and Naldi, 2018).

We propose that an increased geographical scope of international diversification has a negative moderating effect on the relation between unfavourable diplomatic relations and high-tech SMEs investment. First, as the geographical scope of international diversification increases, it compounds the legitimacy issues that SMEs face in foreign host countries, making it harder to establish legitimacy and thus making SMEs more vulnerable to geopolitical risk in each host country. As SMEs operating in multiple host countries encounter different formal (e.g. economic and political systems) and informal (e.g. consumer preferences, culture) institutions (Bell, Filatotchev and Rasheed, 2012; Zaheer, 2002), they are more likely to face frequent changes in regulatory landscapes and stakeholder demands, leading to legitimacy issues if they inadvertently violate regulations or fail to meet new compliance standards. Second, international diversification increases overall complexity and operational costs of SMEs. Managing a geographically diverse portfolio requires substantial information processing and strategic foresight. SMEs often have limited managerial expertise and resources (Hitt, Hoskisson and Kim, 1997; Zahra, Ireland and Hitt, 2000) to effectively gather and process information across multiple markets and ensure reliable commitments from local partners and stakeholders (Fariborzi, Osiyevskyy and DaSilva, 2022). Third, international diversification requires substantial financial and human resource commitments (Goerzen and Beamish, 2003), leaving SMEs even more resource constrained to deal with geopolitical risk. Thus, the more extensive the diversification strategy of an SME, the harder it is to manage legitimacy issues, given the SME's scarce resources.

As such, we argue that high-tech SMEs with a higher geographical scope of international diversification are more likely to reduce their investment in the host

²International diversification is a strategy through which firms expand their operations across countries into different geographic locations (Hitt, Hoskisson and Kim, 1997; Lu and Beamish, 2001).

Table 1. The distribution of data by home and host countries

Home country	#	Host country	#	Host country	#
Australia	7	Argentina	14	Netherlands	272
Austria	9	Australia	122	New Zealand	20
Belgium	843	Austria	87	Norway	216
Bulgaria	38	Belgium	156	Peru	6
China	6	Brazil	147	Philippines	3
Czech Republic	52	Bulgaria	51	Poland	120
Denmark	123	Canada	103	Portugal	93
Estonia	55	Chile	17	Romania	200
Finland	383	China	143	Russian Federation	61
France	313	Colombia	39	Singapore	61
Germany	54	Croatia	19	Slovak Republic	75
Hungary	97	Czech Republic	135	Slovakia	11
Ireland	155	Denmark	214	Slovenia	1
Italy	891	Estonia	129	South Africa	347
Japan	36	Finland	44	Spain	298
Latvia	228	France	448	Sweden	168
Lithuania	55	Germany	414	Switzerland	141
Luxembourg	602	Greece	10	Thailand	9
Netherlands	165	Hungary	46	Republic of Korea	2
Norway	146	India	68	Turkey	17
Poland	28	Indonesia	8	Ukraine	16
Portugal	307	Ireland	161	United Kingdom	815
Republic of Korea	2	Israel	18	United States	804
Romania	48	Italy	239	Venezuela	2
Russian Federation	9	Japan	86	Total	7178
Slovakia	81	Republic of Korea	4		
Slovenia	16	Latvia	74		
Spain	917	Lithuania	50		
Sweden	236	Luxembourg	256		
United Kingdom	936	Malaysia	44		
United States	340	Mexico	74		

country amidst high geopolitical tensions. Formally, we hypothesize:

H3: The negative effect of diplomatic relations on the investment decisions of international high-tech SMEs is more pronounced in SMEs with a higher scope of international diversification.

Methods

Data and sample

The database consists of a sample of high-tech SMEs for the period 2009–2022. The data are downloaded from Orbis, which provides financial, ownership and subsidiary information for both private and public companies. To identify SMEs operating in the high-tech sector, we follow Eurostat's 2008 high-tech industry and knowledge-intensive services classifications. Among the high-tech industries included are pharmaceuticals, chemicals and chemical products, scientific R&D, biotechnology, computer software, information services and telecommunication, aerospace, test measurements, medical and surgical equipment, and semi-conductors.

The definition of an SME is based on the number of employees and levels of revenue. The number of employees is the most commonly applied criterion, although the maximum thresholds vary between countries. For instance, in the European Union and the United Kingdom, the maximum threshold is 250 employees (European Commission, 2020), while in the United States, the upper limit is 500 employees and in China, it can be as high as 2000.³ As most SMEs in our dataset are from European countries, we apply the EU definition of SMEs with a threshold of 250 employees and an annual revenue not exceeding €50 million (European Commission, 2020).

We identify international SMEs as those with at least one foreign subsidiary. We employ 1-year lags of all parent firm-level characteristics in our analysis, resulting in a sample of 7178 host-country subsidiary year observations. The distribution of the data by home and subsidiary host country is shown in Table 1.

³For a comprehensive summary of definitions and classifications of SMEs, see Zahoor *et al.* (2020).

Variables

Dependent variable. *Investments* is measured as the annual number of foreign subsidiaries per host country, for each SME. This measure builds on extant research which posits that the annual number of subsidiaries captures substantial changes (increases or decreases) in a firm's investment commitment in a given host country (Adarkwah *et al.*, 2024; Oh and Oetzel, 2017). A higher number of subsidiaries is associated with higher levels of investment commitment to a particular host country.

Independent and moderating variables. *Diplomatic relations* reflects the (dis)similarity of national interests in global affairs between home and host countries, as evidenced by their respective voting patterns in the UNGA (Adarkwah *et al.*, 2024; Bertrand, Betschinger and Settles, 2016; Gartzke, 1998; Hasijsa, Liou and Ellstrand, 2020; Yoon, Peillex and Buckley, 2021). Nations that cast similar votes on global affairs (i.e. on economic, political or social issues) are likely to form robust relationships and engage in cooperative initiatives due to their alignment on global issues (Gartzke, 1998). Conversely, countries that vote differently do not share the same views and understanding of world issues and are more susceptible to conflicts (Gartzke, 1998). Consequently, these votes act as markers of the extent to which countries agree or disagree on international matters. Diplomatic relations are an index score that ranges from -1 (dyadic countries have completely opposing views; thus, they fully disagree on world affairs) to $+1$ (dyadic countries have voted identically in a given year; thus, they fully agree on world affairs). We invert this index so that higher values capture disagreements in voting (i.e. unfavourable diplomatic relations), while lower values capture agreements.⁴

Patents captures the innovation of SMEs and is measured as the annual number of patents granted to an SME (Doh and Kim, 2014; Pertuze *et al.*, 2019). We use the normal logarithm of this count variable to reduce skewness and take the 1-year lag in the analysis.

International diversification is measured as the number of host countries in which an SME has international activity (i.e. foreign subsidiaries) in a given year (Fariborzi, Osiyevskyy and DaSilva, 2022; Lu and Beamish, 2001; Zilja *et al.*, 2023). We take the 1-year lag of this variable in the analysis.

Control variables. We control for firm-level, country-level (home and host) and dyadic-level variables that have previously been associated with a firm's subsidiary investment decisions in foreign markets (Lu and Beamish, 2001; Oh and Oetzel, 2017). *Firm size* is measured using the logarithm of firm assets. *Solvency ratio*

is calculated as the debt-to-equity ratio, which captures a firm's ability to meet its long-term obligations and reflects its financial health. *Firm age* is measured as the logarithm of the number of years since firm inception. *Firm performance* is captured by returns on assets. We take 1-year lags of the above firm-level controls in the analysis. We also control for whether a firm operates in the host country through a full-ownership or partial-ownership entry mode with the wholly owned subsidiary (*WO dummy*). *WO dummy* = 1 when the firm owns more than 95% of the foreign subsidiary in the host country.

At the home- and host-country level, we control for distinct economic, political and institutional factors that influence the investment decisions of international SMEs. As such, we account for the economic factors (home or host) with *GDP per capita growth*, *inward FDI*s, *trade openness* and *natural resources*. *GDP per capita growth* is measured as the annual percentage growth of GDP per capita and accounts for the market size. *Inward FDI*s are measured as the yearly ratio of inward foreign direct investment (FDI) to a country's GDP. *Natural resources* are measured as the total rents from oil, natural gas, coal, minerals and forest, as a percentage of the country's GDP. While *trade openness* is measured as the yearly share of exports plus imports to the country's GDP. These variables are expected to capture a country's capability to attract investments as well as its competitiveness (Buckley *et al.*, 2018).

With regard to political factors, we control for a country's political regime, which is captured with the *polity V* index that ranges from -10 (fully autocratic) to $+10$ (fully democratic) (Marshall *et al.*, 2002) as firms' decisions to invest in a given location depend, to a certain extent, on the political regime of the home and host countries. In addition, we control for *country risk* and *intellectual property rights (IPR)*. *Country risk* consists of risk scores provided by the International Country Risk Guide (ICRG) that rates countries from the riskiest to the least risky in terms of economic, financial and political changes. The ICRG scores range from 0, for the highest-risk countries, to 100, for the lowest-risk countries. We use the 3-year volatility in ICRG scores to capture the dynamic nature of country risk. The *IPR* index ranges from 0 to 10 and rates countries in terms of whether IPR is adequately enforced. The higher the index, the more effective the enforcement of IPR.

At the home- and host-country dyad level, we control for institutional differences (and similarities) with *cultural distance*, *colonial ties* and whether the two countries share a *common border*. *Cultural distance* is constructed following Kogut and Singh (1988), employing Hofstede's (1984) four original dimensions. The *colonial ties dummy* = 1 if the home and host country were in a colonial relationship, and 0 otherwise. The *contiguous dummy* = 1 if the home and host countries share a common border. A list of all variables and data sources is

⁴The inverted measure has the same mean with the affinity in voting data and also ranges between -1 and 1 .

available in Appendix A (in the supporting information file).

Estimation strategy

Our dependent variable (*Investments*) is a count variable of the number of subsidiaries in a given year and host country. Due to the count nature of the data, either the Poisson or the negative binomial model is appropriate. To determine which model to use, we perform a chi-squared test to assess whether the dependent variable exhibits overdispersion ($\chi^2 = 5262.9$, $p = 0.000$). This test is significant, indicating the presence of overdispersion. Therefore, we estimate negative binomial models to ensure that overdispersion does not deflate the standard errors (Albino-Pimentel *et al.*, 2021; Marano, Tashman and Kostova, 2017). Furthermore, to control for non-time-varying differences between industries and locations, we include industry and region fixed effects; to control for unobservable firm host-country characteristics that are the same for all firms within a given year, we include year fixed effects (deHaan, 2021). Given the nested nature of the data (i.e. several parent-firm subsidiaries in a host country), we use heteroscedasticity-robust and autocorrelation-consistent standard errors by clustering the errors at the parent- and host-country level (Oh, Shin and Oetzel, 2021).

Prior research shows that firms' decisions to invest in foreign markets are not random (Getachew and Beamish, 2021) but a function of firm and home/host-country characteristics (Adarkwah *et al.*, 2024; Oh and Oetzel, 2017; Oh, Shin and Oetzel, 2021). Therefore, we implement Heckman's two-step selection model to control for this self-selection bias (Heckman, 1979; Shaver, 1998). In the first step, we estimate the likelihood that a parent SME could invest in any potential host country (from the list of all host countries in our database) as a function of firm and home/host-country characteristics, including the diplomatic relations between the home and host country. To this end, we create all potential combinations of SME parent firms and host countries for which we have data during the period of analysis. As an instrument in the first stage, we use the logarithm of the exchange rate between the home and host countries. Previous research suggests that the likelihood of expansion increases when the host country's currency depreciates, making assets more affordable, and decreases when the currency appreciates, making assets more expensive (Clegg, Voss and Tardios, 2018). Accordingly, the instrument is negative and significant ($\beta = -0.063$, $p < 0.001$). The inverse Mills ratio from the first step is included as a regressor in the main (second-step) regressions. The results of the first-step selection model are provided in Appendix B.

Table 2 reports the correlation matrix and summary statistics of the main variables used in the regression

analysis, showing no high correlations. In addition, we calculate the variance inflation factor (VIF) to test for multicollinearity. The average VIF value is 1.86. While VIF alone is not sufficient to exclude multicollinearity (Kalnins and Praitis Hill, 2023), jointly with the results of the correlation matrix we conclude that multicollinearity is not a concern.

Results

Table 3 reports the regression results for host-country market *investments* of high-tech SMEs, based on negative binomial model estimations. Model 1 tests the direct impact of *diplomatic relations*. Model 2 tests the interaction effect between *diplomatic relations* and *patents*. Model 3 examines the interaction between *diplomatic relations* and *international diversification*, while model 4 represents the full model and tests for all three hypotheses simultaneously.

H1 predicts that unfavourable diplomatic relations negatively impact the investments of high-tech SMEs. Consistent with previous research on MNEs (Bertrand, Betschinger and Settles, 2016; Duanmu, 2014), we also find that, in the case of SMEs, on average, unfavourable diplomatic relations have a negative impact on investment in a given host country (model 1, $\beta = -0.629$, $p < 0.001$). In terms of economic significance, when diplomatic relations deteriorate by one standard deviation (1 SD), the investment of SMEs is reduced by 6.28% ($(e^{-0.629} - 1) \times 1 \times 0.32$). This effect is somewhat more pronounced for SMEs compared to larger firms. For instance, Bertrand, Betschinger and Settles (2016) find that a 1 SD reduction in political affinity increases the acquisition bid premium by 5.2%, while Adarkwah *et al.* (2024) find that a 1 SD reduction in political affinity decreases subsidiary investments by 4.3%.

H2 predicts that the higher the level of firm innovation (as captured by patents), the lower the negative impact of diplomatic relations on the investments of high-tech SMEs. In model 2, the coefficient estimate for the interaction between diplomatic relations and patents is statistically significant and positive ($\beta = 0.632$, $p < 0.001$), providing confirmation of H2. Figure 1 shows that as diplomatic relations become unfavourable (i.e. an increase in diplomatic relations by 1 SD above the mean), the negative effect on high-tech SME investment is reduced for firms with a very high level of patenting (i.e. mean + 2 SD), as evidenced by the upward-sloping graph, compared to firms with high (mean + 1 SD) and average (i.e. mean) levels of patenting. Thus, we find support for H2.

H3 predicts that the negative effect of diplomatic relations on the investment decisions of international high-tech SMEs is more pronounced in SMEs with high

Table 2. The correlation matrix

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25									
1 No. sub	14.15	35.08	1																																	
2 Diplomatic relations	-0.65	0.32	-0.1	1																																
3 Patents	0.54	1.44	-0.02	0.22	1																															
4 Int'l diversification	8.52	8.47	0.32	0.13	0.12	1																														
5 Firm age	2.20	0.26	0.04	0.06	0.07	0	1																													
6 Firm size	11.79	3.49	0.46	0.25	0.25	0.5	0.14	1																												
7 Solvency ratio	46.03	32.86	-0.19	-0.1	-0.08	0.06	-0.1	-0.23	1																											
8 Firm performance	2.71	22.14	0.04	-0.18	-0.14	0.19	0	-0.02	0.28	1																										
9 WO dummy	0.32	0.47	-0.14	0.15	0.14	-0.07	0.04	0.08	0	-0.05	1																									
10 Colonial ties	0.15	0.36	-0.08	0.23	0.03	-0.11	0.04	-0.01	-0.06	-0.07	0.02	1																								
11 Cultural distance	1.43	1.19	0.23	0.07	0.01	0.04	0.03	0.02	-0.1	-0.04	-0.05	-0.22	1																							
12 Contiguous	0.21	0.41	-0.14	-0.34	-0.09	-0.22	-0.03	-0.23	0.04	0.04	-0.02	-0.01	-0.23	1																						
13 GDP capita growth home	1.42	3.49	-0.05	0.02	0.07	-0.07	-0.03	-0.03	0.04	0.05	0.04	0.04	0.04	0.04	1																					
14 GDP capita growth host	1.57	3.37	-0.03	0.05	0.05	-0.05	-0.04	-0.04	0.02	0.02	0.01	0	0.11	-0.03	0.62	1																				
15 Inward FDI - home	2.21	18.71	-0.01	-0.06	-0.02	-0.07	0	0	-0.03	-0.01	0.02	0.02	0.03	0.03	0.1	0.02	1																			
16 Inward FDI - host	1.98	33.60	0	0.02	-0.02	-0.01	-0.09	-0.02	-0.02	0	-0.01	0.02	0.04	0.05	-0.01	0.07	0.01	1																		
17 Trade openness - home	97.51	73.96	-0.06	-0.22	-0.17	0.38	-0.08	-0.19	0.36	0.27	-0.17	-0.13	-0.05	0.14	0.06	0.01	-0.08	0	1																	
18 Trade openness - host	89.11	70.59	-0.12	-0.28	-0.01	-0.1	0.03	-0.11	0.06	0.06	-0.02	-0.14	0.05	0.25	0.04	0.09	0.03	0.08	0	1																
19 Natural resources - home	1.43	2.38	-0.1	0.28	-0.02	0.1	0	0.09	-0.05	0.01	0.06	0.04	0.04	-0.02	-0.11	0.03	-0.04	0	-0.05	1																
20 Natural resources - host	0.51	1.32	-0.11	-0.01	-0.01	-0.2	-0.04	-0.23	0.09	-0.08	-0.03	-0.02	-0.11	0.01	0.03	0.07	0	0.02	0.1	-0.11	1															
21 Polity - home	9.40	1.17	0.15	-0.13	-0.14	0.16	-0.04	0.05	0	0.07	-0.06	-0.09	0.04	-0.07	-0.05	-0.04	0.02	0.02	0.1	-0.16	0.08	1														
22 Polity - host	8.58	3.09	0.07	-0.4	-0.07	0.03	-0.06	0	0.04	0.05	-0.1	-0.01	-0.31	0.13	0	-0.16	0.01	-0.03	0.09	0.05	-0.16	0	1													
23 IPRS - home	7.30	1.03	-0.3	0.06	0.08	-0.11	-0.03	-0.16	0.21	-0.1	0.08	0.11	-0.14	0.05	-0.03	0.01	0	0	0.13	0.09	-0.05	0	0	1												
24 IPRS - host	7.33	1.25	0.2	-0.14	0.02	0.05	-0.03	0.13	0.05	0	-0.06	0.04	-0.17	0.08	-0.02	-0.12	0.01	0	0.03	0.12	-0.38	0	0	0	1											
25 Country risk - home	0.01	0.01	-0.09	0.12	0.15	-0.11	0.09	-0.02	-0.06	-0.09	0.13	0.04	-0.03	0.02	0.13	0.06	0.03	0.01	-0.25	0.03	-0.04	0.05	-0.17	0	0	1										
26 Country risk - host	0.01	0.01	0.01	0.19	-0.03	-0.01	0.14	0.05	-0.04	-0.02	0.05	0.12	-0.01	-0.08	0.03	0.05	0.05	0.03	-0.04	-0.26	0.14	-0.02	0.05	-0.1	-0.1	-0.01	1									

Table 3. Main results for the impact of diplomatic relations and moderating variables on the investment decisions of international high-tech SMEs

Variables	(1)	(2)	(3)	(4)
Diplomatic relations (H1)	-0.629 (0.114) [0.000]	-0.785 (0.117) [0.000]	-0.160 (0.122) [0.189]	-0.303 (0.125) [0.015]
Diplomatic relations × Patents (H2)		0.632 (0.088) [0.000]		0.542 (0.090) [0.000]
Diplomatic relations × Int'l diversification (H3)			-0.072 (0.007) [0.000]	-0.069 (0.007) [0.000]
Patents	-0.121 (0.042) [0.004]	0.106 (0.055) [0.055]	-0.136 (0.039) [0.001]	0.057 (0.053) [0.289]
Int'l diversification	0.021 (0.007) [0.002]	0.020 (0.007) [0.004]	-0.038 (0.008) [0.000]	-0.037 (0.008) [0.000]
Firm age	0.054 (0.107) [0.614]	0.060 (0.107) [0.578]	0.031 (0.106) [0.772]	0.036 (0.106) [0.732]
Firm size	0.159 (0.012) [0.000]	0.160 (0.012) [0.000]	0.153 (0.012) [0.000]	0.154 (0.012) [0.000]
Solvency ratio	-0.001 (0.001) [0.122]	-0.001 (0.001) [0.139]	-0.001 (0.001) [0.029]	-0.001 (0.001) [0.034]
Firm performance	0.003 (0.001) [0.000]	0.003 (0.001) [0.000]	0.003 (0.001) [0.000]	0.003 (0.001) [0.000]
WO dummy	0.123 (0.047) [0.008]	0.115 (0.046) [0.013]	0.107 (0.047) [0.023]	0.100 (0.047) [0.032]
Colonial ties	-0.248 (0.061) [0.000]	-0.241 (0.061) [0.000]	-0.330 (0.060) [0.000]	-0.322 (0.060) [0.000]
Cultural distance	-0.016 (0.019) [0.386]	-0.015 (0.019) [0.417]	-0.024 (0.019) [0.209]	-0.023 (0.019) [0.227]
Contiguous	-0.029 (0.078) [0.714]	-0.042 (0.078) [0.589]	-0.014 (0.082) [0.868]	-0.025 (0.081) [0.756]
GDP capita growth – home	-0.007 (0.008) [0.408]	-0.005 (0.008) [0.517]	-0.016 (0.008) [0.054]	-0.014 (0.008) [0.084]
GDP capita growth – host	-0.028 (0.012) [0.016]	-0.030 (0.011) [0.008]	-0.025 (0.012) [0.033]	-0.027 (0.011) [0.020]
Inward FDI – home	0.002 (0.001) [0.117]	0.002 (0.001) [0.157]	0.001 (0.001) [0.328]	0.001 (0.001) [0.381]
Inward FDI – host	0.005 (0.001) [0.000]	0.005 (0.001) [0.000]	0.005 (0.001) [0.000]	0.005 (0.001) [0.000]
Trade openness – home	-0.000 (0.000) [0.607]	-0.000 (0.000) [0.557]	-0.000 (0.000) [0.757]	-0.000 (0.000) [0.706]
Trade openness – host	-0.002 (0.000) [0.000]	-0.002 (0.000) [0.000]	-0.001 (0.000) [0.000]	-0.001 (0.000) [0.000]
Natural resources – home	0.097 (0.012) [0.000]	0.097 (0.011) [0.000]	0.092 (0.012) [0.000]	0.093 (0.011) [0.000]
Natural resources – host	0.009 (0.016) [0.572]	0.012 (0.016) [0.446]	0.017 (0.016) [0.282]	0.020 (0.016) [0.216]

Table 3. (Continued)

Variables	(1)	(2)	(3)	(4)
Polity – home	0.053 (0.021) [0.011]	0.054 (0.022) [0.013]	0.058 (0.019) [0.002]	0.059 (0.019) [0.002]
Polity – host	–0.012 (0.009) [0.148]	–0.015 (0.009) [0.076]	–0.005 (0.008) [0.544]	–0.007 (0.008) [0.357]
IPRs – home	–0.027 (0.023) [0.247]	–0.029 (0.023) [0.219]	–0.032 (0.023) [0.170]	–0.033 (0.023) [0.153]
IPRs – host	0.078 (0.021) [0.000]	0.083 (0.021) [0.000]	0.059 (0.020) [0.004]	0.064 (0.020) [0.002]
Country risk – home	–12.631 (2.189) [0.000]	–12.126 (2.174) [0.000]	–12.511 (2.155) [0.000]	–12.067 (2.144) [0.000]
Country risk – host	9.309 (1.739) [0.000]	9.113 (1.730) [0.000]	11.601 (1.763) [0.000]	11.349 (1.750) [0.000]
Inverse Mills ratio	–0.353 (0.107) [0.001]	–0.367 (0.106) [0.001]	–0.405 (0.111) [0.000]	–0.416 (0.110) [0.000]
Constant	–2.145 (0.560) [0.000]	–1.569 (0.563) [0.005]	–1.492 (0.554) [0.007]	–1.005 (0.560) [0.073]
Observations	7178	7178	7178	7178
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Region fixed effects	Yes	Yes	Yes	Yes
Log likelihood	–21,254	–21,254	–21,254	–21,254
Pseudo R ²	0.239	0.240	0.245	0.246

Note: Negative binomial regressions with industry, region and year fixed effects and with errors clustered at the firm and host-country level. All time-varying firm-level variables are lagged by 1 year. The second stage of the Heckman selection model. Standard errors in parentheses, p-values in square brackets.

levels of international diversification. In model 3, the coefficient estimate for the interaction between diplomatic relations and international diversification is statistically significant and negative ($\beta = -0.072$, $p < 0.001$). Figure 2 shows that as diplomatic relations become unfavourable, the reduction in the number of investments is larger for SMEs with very high levels of international diversification (mean + 2 SD) compared to those with high (mean + 1 SD) and average levels. Thus, we find support for H3.

Model 4 shows the coefficient estimates for the full model, namely, for diplomatic relations ($\beta = -0.303$, $p = 0.015$) and its interaction with patents ($\beta = 0.542$, $p < 0.001$) and international diversification ($\beta = -0.069$, $p < 0.001$) simultaneously. All coefficient estimates remain significant. While the size of the effect of the interaction with patents and international diversification remains roughly the same, the size of the impact of unfavourable diplomatic relations is almost halved, providing further evidence of the effect's boundary conditions. Overall, the data largely supports our hypotheses.

Robustness checks

We conduct several supplementary analyses to assess the robustness of our findings against different estimation techniques. For instance, we control for host-country fixed effects, winsorized values of main variables, trade agreements, using different time lags of diplomatic relations, as well as considering alternative measures of diplomatic relations (unpredictable diplomatic relations and economic sanctions imposed on the host country). The rationale for the supplementary analysis is explained in detail below, and the results are presented in Tables 4 and 5.

First, in our analysis, we control for various country-level variables that capture economic, political and institutional differences across the host countries. However, it could still be argued that there are additional differences (e.g. in industry norms or corruption levels) that may lead high-tech SMEs to invest more in some host countries than others. To control for such time-invariant factors, we include host-country fixed effects. The results (Table 4, model 1) show that our findings for the three hypotheses remain consistent.

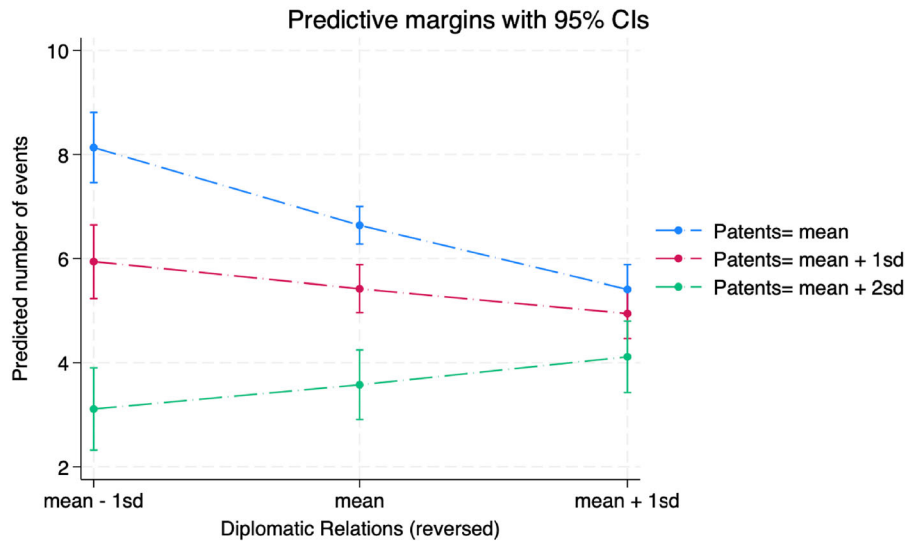


Figure 1. The moderating effect of patents on the relationship between diplomatic relations and the investment decisions of international high-tech small and medium-sized enterprises (SMEs).

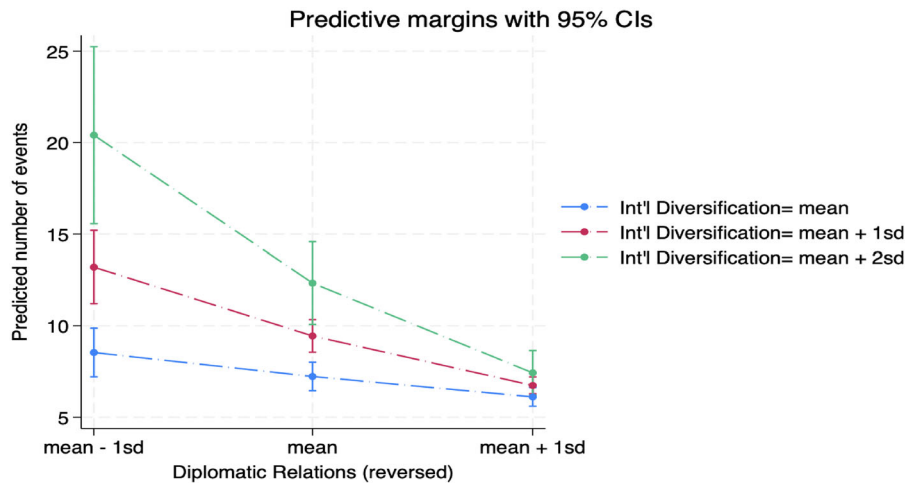


Figure 2. The moderating effect of international diversification on the relationship between diplomatic relations and the investment decisions of international high-tech small and medium-sized enterprises (SMEs).

Second, it may be claimed that the negative effect of diplomatic relations on high-tech SME investments is the result of a few very hostile diplomatic relations between home and host countries. To this end, we winsorize the diplomatic relations, patents and geographic diversification at 5% and 95% levels to ensure that our moderating results are not driven by extreme values. The results for all hypotheses remain robust to winsorization (Table 4, model 2).

Third, it could be argued that we find a negative effect of diplomatic relations on high-tech SME investment decisions because we do not account for whether the home and host countries have an official agreement, such as a regional trade agreement. In such a case, the effect of diplomatic relations could be weaker, or insignificant. However, when accounting for regional

trade agreements (with a dummy equal to 1 if the home and host country are part of a regional trade agreement (source: CEPII database)), the results remain consistent with our main results (Table 4, model 3).

Fourth, it could be contended that SMEs do not directly respond with a large, irreversible commitment (e.g. establishing new subsidiaries or closing existing ones) to friendly or unfriendly diplomatic relations observed in a single year, and that it takes time for diplomatic relations between home and host countries to be incorporated into firms' actions or decisions. Hence, we use two measures of diplomatic relations, namely, its 2-year lag and the 3-year moving average, to account for its long-term impact (Table 4, models 4 and 5). The results, in models 4 and 5, show that all three coefficients remain consistent with our main findings.

Table 4. Robustness checks on various model specifications

Variables	(1) Host-country fixed effects	(2) Winsorize (5%, 95%)	(3) Regional trade agreements control	(4) 2-year lag of diplomatic relations	(5) 3-year moving average of diplomatic relations	(6) Unpredictable diplomatic relations
Diplomatic relations (H1)	-0.505 (0.141) [0.000]	-0.491 (0.134) [0.000]	-0.623 (0.139) [0.000]	-0.462 (0.130) [0.000]	-0.469 (0.145) [0.001]	
Diplomatic relations × Patents (H2)	0.645 (0.087) [0.000]	1.303 (0.174) [0.000]	0.561 (0.087) [0.000]	0.566 (0.080) [0.000]	0.609 (0.091) [0.000]	
Diplomatic relations × Int'l diversification (H3)	-0.055 (0.008) [0.000]	-0.078 (0.009) [0.000]	-0.069 (0.007) [0.000]	-0.045 (0.007) [0.000]	-0.056 (0.007) [0.000]	
Diplomatic relations – residual (H1)						-0.262 (0.128) [0.040]
Diplomatic relations – residual × Patents (H2)						0.388 (0.114) [0.001]
Diplomatic relations – residual × Int'l diversification (H3)						-0.069 (0.009) [0.000]
Regional trade agreements			-0.450 (0.079) [0.000]			
Observations	7178	7178	7178	6310	6286	7178
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Region fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Host-country fixed effects	Yes	No	No	No	No	No
Log likelihood	-21,254	-21,254	-20,613	-18,927	-18,873	-21,254
Pseudo R ²	0.277	0.245	0.248	0.260	0.258	0.242

Note: Negative binomial regressions with industry, region and year fixed effects and with errors clustered at the firm and host-country level. The second stage of the Heckman selection model. Standard errors in parentheses, p-values in square brackets. All regressions include the same controls as in Table 3 and the time-varying firm-level variables are lagged by 1 year.

For an easier interpretation we do not show the coefficients for the control variables. Nevertheless, in Appendix C in the online supplementary material we provide the long version of Table 4, reporting on all control variables.

Fifth, we follow Gartzke (1998) and Bertrand, Betschinger and Settles (2016) to distinguish between predictable diplomatic relations – codetermined by related country-dyadic constructs – and unpredictable diplomatic relations. To do so, we estimate a two-stage model. The first stage is a fixed-effects ordinary least squares (OLS) regression of country-dyadic variables, which captures the extent to which similarities in the bilateral political environment predict diplomatic relations between countries (Appendix D). We use the residuals of this regression as a proxy for the proportion of diplomatic relations that is unexpected and not explained by the bilateral factors in the first stage to replace the main independent variable in the second-stage regression (Table 4, model 6). Our results remain robust when using this measurement.

Next, we look at alternative measures of geopolitical risk. Rising geopolitical tensions have led to an increased use of sanctions (Panibratov *et al.*, 2023); ‘as

nonmilitary coercive measure, they have the potential to disrupt the international business environment, often on short notice, and change the rules of the game’ (Meyer *et al.*, 2023, p. 1). Hence, we use economic sanctions as an alternative proxy for geopolitical risk (Felbermayr *et al.*, 2020). The results (Table 5, models 1–4) show full support for H2 and H3. Meanwhile H1 is significant in model 1 ($\beta = -0.299$, $p = 0.036$) but not in model 4 ($\beta = -0.163$, $p = 0.322$), suggesting only partial support for this hypothesis. Overall, the robustness analyses increase the confidence in our results.

Discussion and conclusions

The SME internationalization literature has analysed the importance of institutions not only as a relevant source of information and resources for internation-

Table 5. Robustness checks with economic sanctions between home and host country as an alternative measure of geopolitical risk

Variables	(1)	(2)	(3)	(4)
Economic sanctions (H1)	-0.299 (0.143) [0.036]	-0.416 (0.148) [0.005]	-0.035 (0.158) [0.824]	-0.163 (0.164) [0.322]
Economic sanctions × Patents (H2)		0.292 (0.139) [0.035]		0.265 (0.134) [0.047]
Economic sanctions × Int'l diversification (H3)			-0.062 (0.013) [0.000]	-0.057 (0.013) [0.000]
Observations	7178	7178	7178	7178
Year fixed effects	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Region fixed effects	Yes	Yes	Yes	Yes
Log likelihood	-21,254	-21,254	-21,254	-21,254
Pseudo R ²	0.237	0.238	0.238	0.238

Note: Negative binomial regressions with industry, region and year fixed effects and with errors clustered at the firm and host-country level. The second stage of the Heckman selection model. Standard errors in parentheses, p-values in square brackets. All regressions include the same controls as in Table 3 and the time-varying firm-level variables are lagged by 1 year. For an easier interpretation we do not show the coefficients for the control variables. Nevertheless, in Appendix E in the online supplementary material we provide the long version of Table 5, reporting on all control variables.

alization (Catanzaro, Messeghem and Sammut, 2019; Torkkeli *et al.*, 2018) but also as a factor influencing the political risk in the internationalization decisions of SMEs (Adomako, 2020; Chen *et al.*, 2024; Thanos, Dimitratos and Sapouna, 2017; Wu and Deng, 2020). While these studies provide a strong foundation for understanding geopolitical risk, more research is needed in understanding its impact and implications for SMEs (Ferreira de Araújo Lima, Crema and Verbano, 2020; Meyer *et al.*, 2023). This is important because geopolitical risk differs from political risk in key ways and does not impact foreign firms similarly.

Thus, the aim of this paper is to contribute to the understanding of how geopolitical risk affects the investment decisions of international, high-tech SMEs. In line with prior research on the impact of geopolitical risk on MNEs' activities (Adarkwah *et al.*, 2024; Charpin, London and Vincent, 2024; Yoon, Peillex and Buckley, 2021), we find that adversarial diplomatic relations have a negative effect on high-tech SME investments. However, compared to the studies by Adarkwah *et al.* (2024) and Bertrand, Betschinger and Settles (2016) on MNEs, we find that the magnitude of the effect is larger for SMEs. This finding suggests that, due to limited resources, high-tech SMEs are less equipped to absorb such shocks compared to MNEs.

We further argue and empirically show that firm-level innovation (through patents) positively moderates the negative effect of unfavourable diplomatic relations on the investments of SMEs. This finding is in line with the argument that patents function as a signalling mechanism of a firm's commitment to the host country that improves firms' legitimacy in the presence of adversarial

diplomatic relations (Wang, Zhang and Shou, 2021; Zhou, Li and Wang, 2024). While previous studies find that firms are more likely to patent when the home and host country experience tense bilateral relations (Zhou, Li and Wang, 2024), we expand on this to show that patenting plays a positive role in mitigating the negative effect of tense bilateral relations.

We also show that the negative effect of diplomatic relations is stronger for SMEs with a high level of international diversification. This is consistent with recent literature, which finds that geographic diversification is associated with increased risk (Fariborzi, Osiyevskyy and DaSilva, 2022) due to the increased complexity across many dimensions, such as regulations, norms and consumer preferences (Chu, Deng and Xia, 2020; Mammen, Alessandri and Weiss, 2021). This finding suggests that the ability to manage institutional idiosyncrasies and to conform to the local legal requirements of various host countries is diminished for these SMEs as they may struggle to allocate sufficient resources to manage the complexities of operating in multiple countries or regions.

This study makes several important contributions to the IB and management literature. First, we expand the discussion on the role of institutions and diplomatic relations for MNEs (Adarkwah *et al.*, 2024; Bertrand, Betschinger and Settles, 2016; Duanmu, 2014; Yoon, Peillex and Buckley, 2021) by introducing new evidence on the role of diplomatic relations for SMEs. The changing political context of international business and the rising interest in techno-nationalism, as demonstrated by the recent new rules set by the United States (for national security reasons) on high-tech investments in

China (Freifeld, Shalal and Shepardson, 2023), are challenging the international activities of businesses, including high-tech SMEs. To the extent that this represents a new normal, it is imperative to understand the implications of this trend for high-tech SMEs given their limited capacity to wield political and institutional influence. This study shows that geopolitical risk does, indeed, affect the investment decisions of international high-tech SMEs. Thus, theorizing about the geopolitical environment of SMEs should be of particular interest to IB and management scholars. As such, this study makes an important contribution by taking the first step in this direction.

Second, we contribute to the literature on geopolitics and SMEs by improving the understanding of strategies firms can use to better manage geopolitical risk (Hartwell and Zadorozhna, 2024; Jafari-Sadeghi *et al.*, 2023; Meyer *et al.*, 2023). Specifically, we show that not all SMEs are equally deterred by the negative effect of diplomatic relations. SMEs with a focus on innovation can better manage unfavourable diplomatic relations, while those with a broader international scope are more likely to reduce their investments under such conditions. As such, we contribute to the literature by demonstrating that the capability of SMEs to innovate and the scope of their international investment should play an important role when theorizing on the political or institutional context of SME internationalization.

Third, our paper makes a significant empirical contribution to the literature on SME internationalization and geopolitical risk by moving beyond qualitative assessments (Ferreira de Araújo Lima, Crema and Verbano, 2020) and empirically testing the impact of unfavourable diplomatic relations on SMEs' investments and boundary conditions. Additionally, our study examines high-tech SMEs across a wide range of home and host countries, enhancing the generalizability of our findings compared to previous research that focused on specific contexts (Jafari-Sadeghi *et al.*, 2023).

Managerial implications

This study provides important managerial implications. Geopolitical risk has emerged as a key concern for managers, with 67% citing it as their top issue according to a recent McKinsey report (Smit, Condon and Kwiatkowski, 2024). However, only 15% of organizations feel prepared to manage these risks (Hatami and Segel, 2023). Our results show that, despite their constraints compared to MNEs, high-tech SMEs that innovate are able to better manage geopolitical risk while still pursuing their investment strategies. Thus, managers of high-tech SMEs should continually assess the geopolitical landscape and promote local innovation to show their commitment to the host country as a strat-

egy to protect their firms and seize opportunities in a rapidly changing world. In addition, SME managers should balance the costs and benefits of pursuing international diversification strategies. A higher geographical scope of international diversification exposes firms to different institutional environments that compound legitimacy concerns. Thus, given the resource constraints of high-tech SMEs, managers should strive to strike a balance between navigating the complexities of investment decisions in a narrower set of countries.

Limitations and future research

Our study has limitations, which reveal avenues for further research. First, we test our hypothesis on a sample of high-tech SMEs. However, future research could consider a larger sample of SMEs from other industries. For instance, given the growing interest in the international trade services industry, a study of this sector may provide complementary findings to our own. Indeed, previous studies show substantial differences across industries in terms of internationalization patterns (Grøgaard, Gioia and Benito, 2013). In addition, the level of governmental scrutiny and interference can differ even among high-tech firms. For instance, the Trump administration specifically targeted Chinese semiconductor and chip companies (Luo, 2022), whereas Chinese cleantech firms faced less opposition and have even expanded their operations in the United States (Groom, 2024; Reuters, 2024). Hence, a cross-industry study would better discern the role of diplomatic relations for different industries and help understand the differential impact of these relations between high-tech and non-high-tech SMEs, and within high-tech SMEs.

Second, we capture geopolitical risk through the use of voting patterns that reflect how countries vote in the UNGA. However, the UNGA voting patterns often reduce complex geopolitical issues to simple yes-or-no votes and may not provide sufficient context to understand the reasons behind a country's vote. While this variable is used extensively in the literature (Adarkwah and Benito, 2023; Bertrand, Betschinger and Settles, 2016; Hasija, Liou and Ellstrand, 2020; Yoon, Peillex and Buckley, 2021), future research would benefit from adopting multiple measures of geopolitical risk. For instance, the newly developed geopolitical risk index (Caldara and Iacoviello, 2022), currently available only for the United States as a home country, could capture its distinct impact more effectively. Finally, while our study is limited to the investment decisions of SMEs, future research could explore the extent to which SME performance is affected by varying degrees of diplomatic relations.

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Supporting Information

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