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The happy few: German SMEs investing abroad

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Global foreign investment has increased significantly in the past decades. Large corporations are the main players driving this development, and Germany is no exception. Cross-border investments by small and medium-sized enterprises (SMEs), however, remain rare. Fewer than 4 % of SMEs in Germany invested abroad between 2012 and 2015. Noticeable differences exist across sectors and company sizes. Large SMEs in the manufacturing sector are particularly active outside Germany.

The main target region for foreign investment by German SMEs is Europe. Half of all SMEs that invested abroad did so in western or northern Europe, one in four in eastern Europe, and one in five in southern Europe. The main target region for foreign investment by German SMEs outside Europe is China.

The vast majority of SMEs use their own resources to fund their foreign investment. Only around 12 % of SMEs use bank loans. A major reason for this is probably the relatively high risk of foreign investment. Investing abroad pays off nevertheless – not only from a macroeconomic point of view, but also for the SMEs themselves, as it potentially allows their international turnover to grow at above-average rates.

Foreign investment has grown more than sixfold since 1990

Time and again, takeover plans of large corporations make business news headlines. Most recently, Bayer, the German chemicals and pharmaceuticals corporation with more than 115,000 employees and annual turnover of some EUR 47 billion, announced its intention to take over US seed manufacturer Monsanto for around EUR 56 billion. If the competition authorities approve the merger and the deal is completed, it would be the biggest takeover of a foreign enterprise by a German corporation in history.

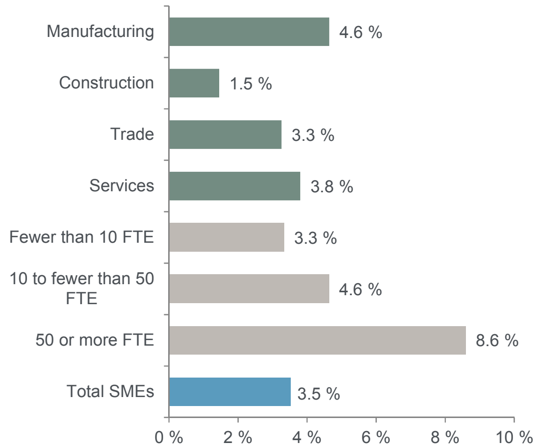
Foreign direct investment – the acquisition of or participation in an existing enterprise or the establishment or expansion of a production or distribution location abroad – is an important factor of growing internationalisation. It promotes enduring links between economies, facilitates the transfer of technology between countries, and promotes economic growth in the countries of origin and destination.[1] In 2016, aggregate global foreign direct investment was USD 1.6 trillion. In 1990 it was only around USD 244 billion.[2]

Large corporations are driving foreign investment in Germany

Germany is among the top ten source countries of foreign direct investment. In 2016 foreign direct investment by German enterprises amounted to nearly EUR 70 billion.[3] Large corporations are the main drivers. Thus, some 52 % of the 1,700 German enterprises with an annual turnover of more than EUR 500 million invested abroad in 2014.[4]

SMEs, on the other hand, are rather less likely to invest abroad. During the period 2012–2015, only 3.5 % of German enterprises with less than EUR 500 million annual turnover invested in a production or distribution facility outside Germany or acquired an interest of more than 10 % in a foreign enterprise (Figure 1). It is true that this represents almost 130,000 of the approximately 3.6 million SMEs. But in most cases, the amounts invested are relatively small. German SMEs' foreign investment can be estimated at EUR 10 to 15 billion for the years 2012–2015. These figures are low not just in comparison with overall economic output. At EUR 782 billion, SMEs invested more than fifty times more at home during the same period.

Figure 1: Fewer than 4 % of SMEs invest abroad



Note: Share of SMEs that invested abroad during the period 2012–2015. Foreign investment includes, for example, the establishment, expansion or modernisation of an own production or distribution facility outside Germany. It also includes acquiring an interest of at least 10 % in an enterprise abroad.

Source: KfW SME Panel 2016

German SMEs' degree of internationalisation is largely steady

These figures also do not point to a growing trend towards internationalisation in the SME sector. During the period 2003–2007 as well, the proportion of SMEs that invested abroad was a good 3 %. The same applies to SMEs' export activity. The share of SMEs that achieve turnover abroad is much higher than the share of SMEs investing abroad, but it has remained largely steady in the past years. In 2016, some 21 % of SMEs achieved turnover abroad, roughly the same share as the average over the past ten years.[5]

Manufacturers and large SMEs are traditionally more active outside Germany

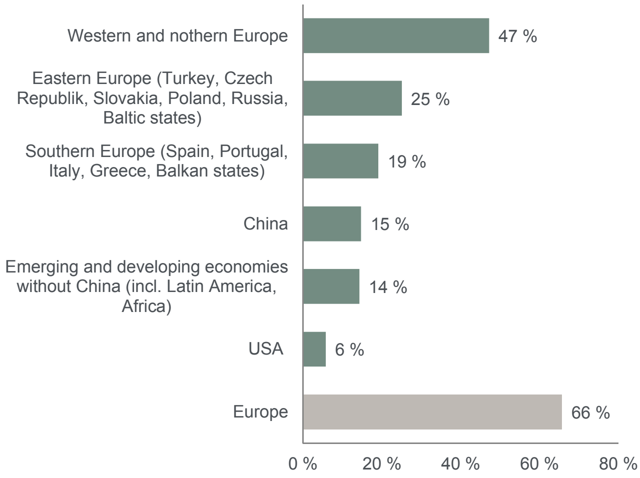
The manufacturing sector – which includes the automotive industry, engineering, chemicals and pharmaceuticals – is traditionally more international than other sectors. This applies equally to foreign investment and exports.[6] In the manufacturing sector, the share of SMEs that invested outside Germany in the years 2012–2015 is a good one percentage point above the average, at 4.6 %.

At the same time, the motivation to invest in other countries increases with the size of the enterprise. Between 2012 and 2015, only around 3 % of SMEs with fewer than ten employees invested outside Germany, but nearly 9 % of SMEs with 50 and more employees. A major reason for this was that foreign investment requires a high level of human and financial resources. For small enterprises with low output volumes, spreading production across several locations at home and abroad is often not worthwhile.[7]

Europe is the preferred place to invest

The free movement of capital and payments within the EU generally enables German enterprises to invest in other member states without restrictions. Besides, most European countries have a high degree of economic and political stability as well as legal certainty. At the same time, they are geographically and culturally closer to German SMEs than countries outside Europe. All these factors probably contribute to the fact that SMEs' foreign investment is heavily focused on Europe. Half of all SMEs in Germany that invested abroad between 2012 and 2015 did so in western or northern Europe, one in four in eastern Europe, and one in five in southern Europe. Overall, two thirds of SMEs that invested abroad were active in at least one European country. The motives for investing in the various target regions vary considerably. By investing in the EU-15 countries, businesses hope first and foremost to gain better access to their foreign markets. Investing in the new EU member states, on the other hand, is associated with the desire to lower their production costs.[8]

Figure 2: China is main investment destination outside Europe



Note: SMEs that invested in the respective target region as a percentage of all SMEs that invested abroad in the period from 2012 to 2015. Multiple responses were possible. Europe comprises the target regions of western and northern Europe, eastern Europe and southern Europe.

Source: KfW SME Panel 2016

German SMEs invest more in China than in the USA

Between 2012 and 2015, around 15 % of SMEs investing abroad did so in China. Sales motives are probably becoming increasingly important. After all, the labour cost advantages that made China the 'world's workshop' in the past are dwindling noticeably. Between 2005 and 2016, the hourly wages of Chinese workers rose from USD 1.20 to USD 3.60 on an inflation-adjusted basis. The purchasing power and quality awareness of the Chinese population increased at the same time.[9]

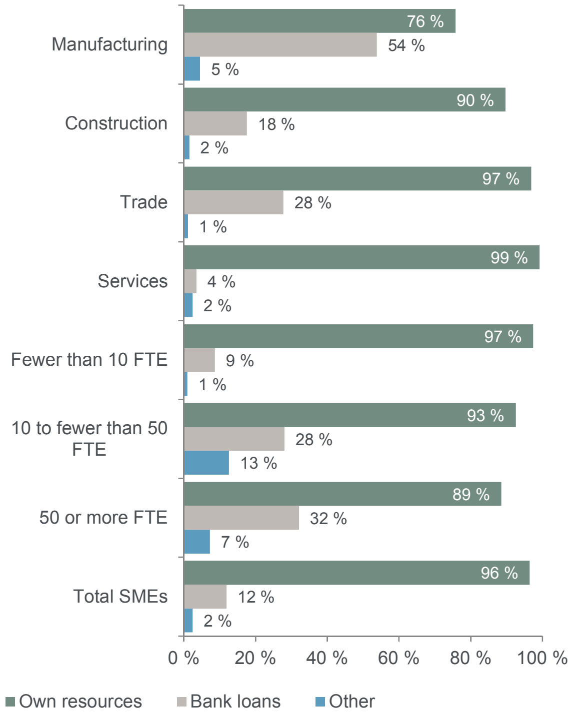
In contrast, only 6 % of all German SMEs invested in the USA. Thus, the fact that the USA is nevertheless the most important target country of German direct foreign investment is mostly due to significant investments made there by large German corporations – nearly EUR 12 billion or 18 % of total German foreign direct investment in 2016.

Internal resources are the main source of funding

The Federal Republic of Germany has entered into investment protection agreements with more than 130 countries to protect investors from political risks such as arbitrary administrative action or expropriation.[10] Enterprises can also apply for state and private investment guarantees to secure their foreign investment. But foreign investment remains a relatively high risk for SMEs in particular – not least due to the limited regional diversification of their activities.

At the same time, it is challenging for debt capital providers to assess the likelihood of success of international investments, especially when they themselves are not present in the respective target markets. This often discourages credit institutions from financing international projects. SMEs therefore consider accessing credit relatively challenging, especially for international projects.[11]

Figure 3: Almost all SMEs use own resources to fund their foreign investment



Note: Share of SMEs investing abroad during the period 2012–2015 that used the respective funding source for their foreign investment.

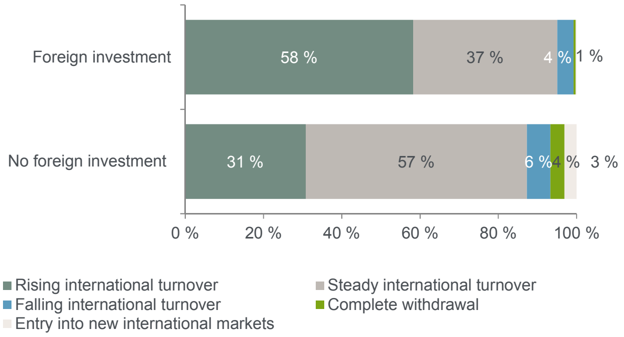
Source: KfW SME Panel 2016

As a result, hardly an SME funded its foreign investment without employing own resources during the period 2012–2015 (Figure 3). Around 96 % of SMEs resorted to own funds for their foreign investment and a mere 12 % used bank loans. Other forms of funding such as private equity hardly play a role. What is interesting is that manufacturers and large SMEs are more likely to employ external capital to finance foreign investments. Not least, this is probably because the amounts they invest and finance are higher and therefore also more attractive for potential lenders.[12]

Tapping into new sales markets in anticipation of higher international turnover

A key motive for investing abroad is to open up new sales markets. Accordingly, SMEs that invested abroad expect their international turnover to develop positively. About 58 % of enterprises that invested outside Germany between 2012 and 2015 expect their international turnover to grow in the years 2017 to 2019. By contrast, only 31 % of enterprises that have exported but not invested abroad expect their international turnover to increase (Figure 4).

Figure 4: Foreign investment bolsters growth expectations



Note: Share of SMEs with international turnover in 2015 that expect rising, steady or falling international turnover for the years 2017–2019, are planning to withdraw completely from international business, or are planning to enter new international markets for the first time, depending on whether they have invested abroad in 2012–2015.

Source: KfW SME Panel 2016.

Foreign investment can thus make an important contribution to turnover growth in the SME sector as well. However, there is very little to support the concern that foreign investment leads to job losses in Germany. Rather, econometric analyses have demonstrated for Germany, too, that investment abroad has no adverse effect on employment or average wage levels in the country.[13]

Conclusion

Cross-border capital investment is playing a growing role at global level. It is being driven primarily by large corporations. Only a small percentage of German SMEs invest abroad and the sums they invest are usually small. A major reason for this is that foreign investment requires significant human and financial resources. The relatively high risk of foreign investment for both SMEs and financial institutions, however, is likely to play an important role as well. As a result, most SMEs primarily employ own resources to fund foreign investment.

The number of SMEs that establish production or distribution facilities outside Germany or participate in foreign enterprises is not set to increase strongly in the future either. Around 6.5 % of all SMEs in Germany are planning to invest abroad in the next three years. But not all will put these plans into effect. So in the future as well, foreign investment will likely remain an activity that only few SMEs will venture into – and which will benefit only a small number of enterprises. ■

[1] OECD (2016): OECD Factbook 2015–2016: Economic, Environmental and Social Statistics, OECD Publishing, Paris.

[2] UNCTAD (2017): World Investment Report 2017. The definition of foreign direct investment adopted by both UNCTAD and the Deutsche Bundesbank is aligned with the 'Balance of Payments Manual' of the International Monetary Fund and the 'Detailed Benchmark Definition of Foreign Direct Investment' of the OECD. The guidelines contained therein ensure international comparability of national balances of payments. Accordingly, foreign direct investment means investment in long-term participation in an enterprise outside the country of the investor. An important criterion for foreign direct investment is that the investor is entitled to exercise control or at least significant influence over this enterprise. This is assumed when the investor acquires at least 10% of the voting rights. When an investor acquires a total of less than 10% of the voting rights, this is referred to as a foreign portfolio investment.

[3] Cf. Deutsche Bundesbank (2017): Direct investment in accordance with the balance of payments statistics for the reporting period of 2013 to 2016.

[4] Cf. Borger, K. (2016): Large German firms invest roughly the same amounts at home and abroad, Focus on Economics no. 136, KfW Research.

[5] Detailed time series on the export activities of SMEs can be found in Schwartz (2017): KfW SME Panel 2017 and corresponding volume of tables, forthcoming, KfW Research.

[6] For more on SMEs' export activities see Abel-Koch, J. (2017): The world is not a village – geographic proximity to export markets is crucial to SMEs, Focus on Economics no. 182, KfW Research.

[7] Cf. Abel-Koch, J. (2016): SMEs' value chains are becoming more international – Europe remains key, Focus on Economics no. 137, KfW Research.

[8] See IW Consult (2016): Mittelständische Unternehmen in europäischen Wertschöpfungsketten (*'SMEs in European value chains'* - in German) and Abel-Koch, J. (2016): SMEs' value chains are becoming more international – Europe remains key, Focus on Economics no. 137, KfW Research.

[9] Cf. Germany Trade and Invest (2017): Lohn- und Lohnnebenkosten - VR China (*'Wage and non-wage labour costs - PR China'*) and Germany Trade and Invest (2017): Investitionsklima und -risiken - VR China (*'Investment climate and risks – PR China'*); in German.

[10] For more information see also the webpages of the German Federal Ministry for Economic Affairs and Energy on investment protection, https://www.bmwi.de/Redaktion/DE/Artikel/Aussenwirtschaft/investitionsschutz.html (in german). The United Nations offers the International Investment Agreements (IIA) Navigator, a comprehensive database that lists bilateral investment protection treaties and agreements with provisions on investment protection, http://investmentpolicyhub.unctad.org/IIA.

[11] Cf. Zimmermann, V. (2016): Business Survey 2016 – Financing climate better than ever – financing purpose is major determinant of credit access, KfW Research.

[12] See also Wocher (2017): Kein Geld für Exporteure ('*No money for exporters'* – in German), Handelsblatt edition of 25 August 2017, p. 20–21.

[13] Cf. Temouri, Y. and N. L. Driffield (2009): Does German Foreign Direct Investment Lead to Job Losses at Home? Applied Economics Quarterly 55(3), p. 1–21.