INTERNATIONALISATION IN GERMANY'S SME SECTOR – STEP BY STEP TO GLOBAL PRESENCE

Strong SME presence in international markets confirms Germany's position as a leading global competitor

[1] Germany continues to hold a leading position at a global level among exporting nations. In 2011 the value of goods and services exported reached EUR 1.2 billion. At present, only China has higher export sales. The 3.8 million companies in the SME sector ('*Mittelstand*') contribute a significant portion here. It is not just medium-sized and larger industrial enterprises that are taking the lead in the global market place – an increasing number of smaller SMEs are venturing abroad. In 2011, half of total export sales (EUR 597 billion) were achieved by SME companies.

[2] A new survey of KfW and Verband der Vereine Creditreform e. V. highlights the strong ties with external economies – in particular among larger sized companies in Germany's SME sector: 65 % of the companies polled were already exporting. This export trade brought them a quarter of their preceding year's turnover. One in five of the companies surveyed is currently represented abroad via foreign direct investments (FDI). Companies making FDIs place around 18 % of their total investments abroad.

[3] The size of a company is an important determinant of its involvement abroad. Larger SMEs are much more active in exporting and in foreign direct investments. It is not only the frequency of operating in a given export market that increases with the size of the company: the number of different export markets in which a company is active at the same time also increases with firm size. This can be explained by advantages in terms of fixed costs, levels of efficiency and the degree of specialisation. Larger companies are almost twice as likely to export as smaller businesses. In the area of foreign direct investment, this difference is even more pronounced: The probability of making a FDI is thus over twelve times higher for the largest enterprises than it is for those in the smallest size category. Companies in the manufacturing sector and firms that engage extensively in R&D are particularly active abroad.

[4] The most common form of foreign direct investment (78 %) is setting up a foreign subsidiary. 37 % of companies have a representative office or a sales office abroad. Cross-border joint ventures were reported by 24 % of companies. Whereas the prevalence of joint ventures remains roughly equal across the various company size classifications, having a subsidiary and/or representative office is clearly size-dependent. Both these forms of direct investment come with considerable management and capital requirements which smaller companies are often unable to muster.

[5] Accessing new markets is the main motive for foreign direct investment (78 %). Cost-driven FDIs play a somewhat secondary role (42 %). Since expanding sales markets tends to generate additional demand, and hence additional need for labour input, foreign direct investments are likely to have a positive effect on the employment situation in Germany.

Advancing one step at a time makes a retreat less likely

[6] For Germany's SME sector, the road abroad leads through Western Europe. Among those firms surveyed, Western Europe was the main target for both exports *and* investments: 92 % of exporting SMEs are present in at least one Western European country. Within Western Europe, the market in Austria and Switzerland is the top export region (77 %). This is followed by the Benelux countries (64 %) and then by France (57 %). Of those companies which have made foreign direct investments, 56 % have invested in one or more Western European countries. Factors which contribute to Western Europe's significance here include geographic proximity, similarities in customer preferences, language and business processes, close ties in both factor and product markets and the existence of a common currency.

[7] Experience in exporting to Western Europe encourages exports to more distant regions. Companies with at least two years of export experience are more likely to operate in more geographically remote markets than exporters who have yet to gain this experience. This suggests that accumulating experience and having robust business relationships with foreign partners, together with increasing knowledge of export activities and export markets, leads to an expansion in export activity, spreading out from markets which are geographically close (most notably Austria and Switzerland) to markets which are more distant in both cultural and geographic terms (especially China). At the time of the survey, only 5 % of exporting SMEs that were operating in North America, Latin America or Asia were not also present in Western Europe. Access to Western Europe is therefore key to the ongoing process of internationalisation within the SME sector.

[8] Companies which shy away from exporting are unlikely to make foreign direct investments later. Through exporting, SMEs gain experience and accumulate knowledge about operating abroad. The likelihood of making a direct investment abroad grows substantially as export involvement increases. The probability of a company with a 5 % export ratio becoming a foreign direct investor is just under 9 %; but for companies which are heavily engaged in exporting (an export ratio of 40 %) this probability doubles to 19 %. Furthermore, direct investments are made far more frequently in those regions where export connections have already been established. This has been clearly shown in regression analyses. To take just one example: the probability of a company making a foreign direct investment in China is 1.5 times greater if that company has an existing export relationship with China.

[9] Foreign direct investments carry greater risks than exports. International business activities in terms of foreign direct investments are four times more likely to be discontinued than international business activities in terms of exports: 12 % of direct investors pull out, whereas only 3 % of exporters withdraw from foreign markets. What is more, export experience forms the cornerstone of long-term engagement for FDIs. If a company lacks export experience, the probability of withdrawing from a foreign direct investment climbs to 36 %. Hence the strategy chosen by most German SMEs – which is to expand abroad one step at a time – represents a sensible business strategy to long term success.

SMEs ignore the crisis of confidence: exporters and investors are keen to expand business abroad

[10] Despite a crisis of confidence in the Eurozone and the uncertain economic development, exporters are looking to the future optimistically at the time of the survey. 64 % wanted to expand their exports by 2015. 38 % want to maintain their current level of exports. The intention to expand exports increases in line with company size and export intensity. Companies which focus more on the domestic German market (e. g. retailers) tend to be more cautious. 7 % of those who took part in the survey were planning to start exporting, but had not yet ventured abroad. Overall, exporting among the German SME sector is expected to continue to grow in the future.

[11] SME companies are expected to increase their involvement in foreign direct investments, if circumstances permit. However, direct investors are more cautious in their assessments. This can be attributed to the greater level of risk associated with investing abroad compared to exporting: 46 % of foreign direct investors plan to extend their involvement by 2015 and a further 42 % intend to maintain their present level. There is a similar pattern here to that seen among exporters: those planning to increase their investment activity mostly operate in segments which already have an above-average proportion of investors and an above-average investment ratio. In addition, 15 % of those companies which are not yet represented abroad in terms of FDIs are planning to make this step.

[12] The present focus on Western European export markets in will remain strong in the future. For most SMEs, the significance of North America and the high-growth markets in Asia (especially China) – both as export regions (25 to 28 %) and as regions for foreign direct investments (between 17 and 28 %) – is still relatively low, but this will increase over the

medium term. Particularly among foreign direct investors, investment preferences tend to favour these regions.

[13] It is expected that companies from those segments which have been less active in foreign markets to date will venture into exports increasingly in the future, especially smaller companies. Compared to a company which is already exporting, the average company which is planning to move into exports is smaller and has a lower level of R&D activity, and is likely to come from the service sector or the construction industry. Smaller companies in particular are also expected to engage in foreign direct investments in the future. Overall – contrary to the trend in exports – there are good reasons to expect that those segments which are already strongly represented will, on average, expand their involvement. However, actually implementing these plans for exports and direct investment should not be taken for granted. It will only be possible to mobilise this dormant potential if existing obstacles are removed.

Uncertainties over jurisdiction – a major brake on the expansion of internationalisation

[14] Non-tariff barriers are the main type of export obstacles. Principally, these are barriers which are applied in a rather covert fashion. They apply within parts of the internal European market just as much as it does in China or in South American markets. These obstacles hinder both initial ventures into exporting and the expansion of established export structures alike. Particular factors which present major hurdles to companies wanting to expand their export activities include foreign legal jurisdiction (39 %), the administrative effort required for export business (34 %), and customer payment practices (36 %). Smaller SMEs are the ones most seriously affected by these obstacles.

[15] For initial FDIs and subsequent FDIs alike, the obstacles most frequently reported are uncertainty over foreign legal jurisdiction (43 %), the lack of suitable business partners (36 %), and problems regarding bureaucracy (34 %). Along with these “hard” factors certain “soft” factors also emerge, which frequently cause direct investors to pull out of foreign markets after some time. These include language shortcomings and a lack of international experience.

Financial constraints hamper internationalisation – especially for small companies

[16] For one business in four, difficulties in financing are a key obstacle to their plans to go abroad or to expand their existing internationalisation activities. This applies equally to exporting and to direct foreign investments, and it affects SMEs of all sizes.

[17] The probability of problems in export financing or foreign direct investment is higher for small companies than it is for larger enterprises. The difference between companies in the smallest size category (having a turnover below EUR 5 million) and companies in the largest size category (having a turnover above EUR 50 million) amounts to 9 percentage points in the case of exports and 21 percentage points for direct investments. Smaller companies face inherent structural problems in financing foreign projects. Export experience tends to reduce these difficulties – which is due to the fact that external lenders are more prepared to foreign finance direct investments made by companies with export experience.

[18] Half of direct investors (48 %) who applied for external funding for projects abroad reported difficulties (to some extent) in raising external capital. Small companies within the SME sector are particularly hard hit by financial constraints.

[19] The situation regarding the financing of projects in foreign countries is deemed to have changed very little over the last five years. Assessments of what the financing situation will look like in the future are cautiously optimistic, but they are also characterised by uncertainty: one in three exporters (34 %) and one in five direct investors (20 %) do not dare to make a prediction regarding the medium term outlook.

Conclusion

For Germany's SME sector, the challenges on the road abroad are substantial and diverse. Examples range from a general uncertainty over the processes involved in internationalisation and the differences in law and jurisdiction, through to covert protectionism, cultural and linguistic barriers, the increased risk to the business, and the obstacles posed by financing constraints. All are reasons which explain why a significant part of Germany's SME sector has yet to embark on a process of internationalisation.

In order to mobilise this sleeping potential for internationalisation, the obstacles which have been identified must be addressed. Given the incremental nature of the internationalisation process, adopting one approach in particular – at an early stage –can prove fruitful. Particularly for those SMEs where this potential is still laying dormant, suitable financial products and consultancy services can simplify both starting and expanding business activities abroad.

Study design

This study was conducted by KfW Bankengruppe in cooperation with Verband der Vereine Creditreform e. V. It aims to provide a differentiated picture of both the current and anticipated future activities of the German SME sector in foreign markets. The study is based on the results of a postal survey among all companies who are members of Creditreform, the largest commercial credit agency in Germany. The platform on which the survey was conducted therefore represents the largest database of German companies in existence.

The survey was conducted in the second quarter of 2012. Over 28,000 companies were included and a total of 3,594 questionnaires were returned (response rate: 12.7 %). From other studies it is already known that smaller SMEs are less frequently involved in business activities abroad. For that reason, the survey was restricted to SMEs with at least 30 employees.