Economist Intelligence Unit

The Economist

New horizons:
Europe's small and medium-sized companies look to emerging markets for growth

A report from the Economist Intelligence Unit
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About this report

New horizons: Europe’s small and medium-sized companies look to emerging markets for growth is an Economist Intelligence Unit report, sponsored by FedEx Express Europe, Middle East, Indian Subcontinent and Africa. It examines the degree to which Europe’s small and medium-sized enterprises (SMEs) are operating in emerging markets: which markets they are choosing, why they are going there, and the opportunities and challenges that they are encountering. James Watson was the report author and Jason Sumner was the editor.

To support this study, the Economist Intelligence Unit conducted a survey of 618 European SMEs during March and April 2011. Definitions of SMEs vary, but as a rough measure, this report only considered firms with €200m or less in annual revenue. In total, 55% of firms in the sample had up to €10m in revenue, while a further 38% had between €10m and €100m. All respondents hailed from western Europe, primarily from the UK, Italy, Spain, France, and Germany. All firms polled were already engaged in commerce beyond their national borders. The respondents were senior: 68% were managing directors, CEOs or another C-level position. Many are well established, having been in operation for ten years or more, while only a minority are new businesses. All major industry sectors were represented.

To complement the survey findings, the Economist Intelligence Unit also conducted wide-ranging desk research and in-depth interviews with numerous small-business owners, and other experts. Our thanks are due to the following for their time and insights (listed alphabetically, by organisation):

- Horst Kayser, CEO, AEG Power Solutions
- Pablo Caño, partner, Apréndelo
- José-Maria Aulotte, senior vice-president for human resources, communication and sustainable development, Arc International
- Alan Bell, managing director, Bell Design
- James Berkeley, director, Berkeley Burke International
- Alessandro Verduci, global head of sales, Breton

- Antoine Beaussant, CEO, Buffet Crampon
- Bernd Supe-Dienes, managing partner, Dienes Werke
- Robert Ward, country publishing director, Economist Intelligence Unit
- David Murrin, co-founder and chief investment officer, Emergent Asset Management
- Alessandro Del Prete, export manager, Ernestomeda
- Chris Cheung, market access adviser, EU SME Centre
- Andrew Needham, CEO, Face
- Brian Wilson, chairman, Harris Tweed Hebrides
- Kai Büntemeyer, CEO, Kolbus
- Tom van Lambaart, chief operating officer, Marnier Lapostolle
- Armin Bieser, co-founder, mediaman
- Thomas Vogel, co-founder, mediaman
- Christian Arno, managing director, Lingo24
- Andrea Romano, president, Why Not Concept
- Hans Willemsen, managing director, Wila
- Kevin Ibeh, professor of marketing and international business, University of Strathclyde Business School
- Bob Betts, managing director, Smith of Derby

Executive summary

Although their bigger rivals get most of the headlines, small and medium-sized enterprises (SMEs) are Europe's main engine for job creation and economic growth. They account for over 99% of registered businesses and employ about two-thirds of all Europeans. Business, however, is hard for them. As this report details, the financial crisis has derailed growth in their home markets, so many are now looking to new horizons. Following in the footsteps of larger multinationals, they are increasingly entering emerging markets to find and exploit niches for their businesses.

To examine this trend, the Economist Intelligence Unit undertook a wide-ranging study of European SMEs operating internationally, sponsored by FedEx Express Europe, Middle East, Indian Subcontinent and Africa. It asks how and why small and medium-sized businesses are moving into emerging markets, which ones they are selecting, and what kind of operating environments they are finding. Some of the key findings of this research are as follows.

The rise of emerging markets is not just a big business phenomenon. Many European SMEs are deeply engaged as well. Although only a minority of Europe's millions of SMEs overall operate outside their home markets, many of those that do are looking to emerging markets for growth. Almost 90% of the SMEs surveyed for this report, all of which operate outside their domestic markets, are planning to do business in emerging markets in the coming year. Those that do tend to hold specific characteristics, in terms of their size, age, industry and who runs them (see box: *Profiling a global SME*).

Most SMEs are entering these markets in pursuit of new customers. While many businesses used to go to emerging markets in order to lower their production costs, Europe's SMEs are primarily seeking to tap into the rapidly expanding middle classes of emerging markets, either directly or else via the larger multinationals that they supply directly to, such as firms that supply parts to carmakers, for example. Nearly six in ten (58%) say that they are in these markets to sell their goods and services, far ahead of those either manufacturing goods there (11%) or buying services (12%). Indeed, 51% noted the potential for fast revenue growth as the most attractive reason for being in these markets.

The financial crisis acted as a catalyst for expansion abroad. Europe's weak economic prospects and tight fiscal position is accelerating the process of looking for growth outside the EU. In all, 62% of respondents agree that "tepid growth" in Europe makes it imperative to look to emerging markets for growth. Among slower-growing economies, such as Spain and Italy, the proportion is far higher: just 11% of executives disagree.

The BRICs will attract most attention from European SMEs in the coming year, followed by other near-shore markets. Growth rates, the degree of risk, ease of access and historical links all guide the process of how markets are selected to operate in. The top-10 emerging markets that Europe's SMEs plan to do business with in the coming year are, in order of preference:

1. China	2. Brazil
3. India	4. Russia
5. United Arab Emirates	6. Poland
7. Czech Republic	8. Morocco
9. Romania	10. Turkey

Of these markets, Brazil has made the greatest strides in terms of improved perceptions. Given their greater likelihood for volatility, the relative favourability of emerging markets shifts year by year. In the past 12 months it has been Brazil's chance to shine. Nearly half (48%) of SMEs noted improved perceptions of the country, bolstered by a smooth transition of political power and increased infrastructure spending in the run-up to the FIFA World Cup in 2014 and Olympic Games in 2016. Overall, Brazil and China are viewed most favourably. By contrast, 24% noted less positive views of Russia, while, unsurprisingly, perceptions of the Middle East and North Africa as a whole dimmed, even though individual countries within the region will receive more investment.

Inflation and exchange rates are the primary macroeconomic concerns for SMEs. Given the political risks of operating in emerging markets, political stability is generally viewed quite positively. However, inflation and exchange rates are seen as key macroeconomic risks: 23% of firms say inflation has become less favourable in their main target market in the past year. Led by a soaring oil price, the costs of both foodstuffs and various raw materials have shot up in the last 12 months.

At an operational level, bureaucracy and corruption are, by far, the biggest challenges. Selected equally by 46% of respondents, these issues lie far ahead of other challenges, such as credit risk (20%), difficulties enforcing contracts (18%), language and cultural barriers (16%) or bad infrastructure (14%). While bureaucracy affects firms of all sizes, it imposes larger costs on SMEs, in terms of the additional personnel and resources required to deal with it.

SMEs hold both advantages and disadvantages in competing with larger rivals. It is not easy being small. Unlike larger companies, SMEs often operate on a relatively shoestring budget, with reduced access to finance, fewer people or resources, and limited economies of scale. It's not all bad, however. They also bring speed and flexibility, close customer contact and the ability to target smaller niches, with fewer regulations to adhere to than publicly quoted and regulated multinationals. Overall, though, it's still tough going: 57% agree that bigger firms are better placed to tap emerging market opportunities.

Profiling a global SME

SMEs that have expanded beyond their domestic markets to operate internationally tend to hold a range of specific characteristics. In general, those SMEs that have broken into emerging markets tend to:

- be larger; medium-sized firms will far more often be operating internationally than micro-sized businesses;

- be older; this fits the traditional theory of firms first building up a local competence before expanding to seek new markets. However, in some industries, such as the high-tech sector, there is an emerging trend of “global start-ups” bucking this age trend;

- have already had experience operating in another non-emerging market, such as a neighbouring country;

- be run by a founder or founders who have previously either worked for multinationals, or had experience of operating internationally, and thus bring both a clear view of the opportunities and a good list of contacts;

- more often come from countries with smaller domestic markets, at least in relative terms. Limited local markets force firms to think about going abroad more rapidly. In absolute terms, however, far more SMEs hail from the EU15 countries;

- more often come from knowledge-intensive industries, especially those that require at least some research and development, such as manufacturing or IT and technology. Firms engaged in e-commerce are also typically more likely to be operating abroad.

Sources: European Commission, Economist Intelligence Unit survey, interviewees.

Introduction: The rise of emerging markets—for all businesses

The extraordinary rise of emerging markets over the past two decades is now a familiar theme for investors and managers alike. Since 2000, interest in these markets has grown steadily, with both companies and investors seeking new opportunities there. Far from slowing the process, the onset of the financial crisis in 2008 has served to accelerate it. While European markets have weakened considerably in the past three years, grappling with severe public debt burdens and fragile economies, many emerging markets have barely blinked. Indeed, China is more concerned with how to deal with an economy that is potentially overheating from expanding too rapidly.

However, it is easy to assume that emerging markets are mainly the domain of large, multinational firms, from BMW and HSBC, to Unilever, Siemens and Novartis. These are the kinds of names most commonly seen in the media, as they expand their operations and sales. As this report will show, though, the emerging-market story is for multinationals of all sizes, originating from all countries, and representing all industries. Indeed, the overlooked emerging markets story is that of small and medium-sized enterprises (SMEs), which are increasingly following in the footsteps of their larger peers.

This represents a significant trend, as SMEs are far and away the most common size of business found in Europe. According to the European Commission[1], firms employing 250 people or fewer, which constitutes part of its definition of an SME, account for over 99% of all registered non-financial companies and two-thirds of total employment (see box: *The silent majority: Europe's SMEs*). For firms of this size, 14% are involved in importing goods from outside the European market, with 13% exporting outside the EU as well. This survey encompasses a broader group of SMEs, with revenue of up to €200m, but only polls those firms that are already operating outside their home market, to assess their appetites for expansion into emerging markets.

Going global

Of the 618 SMEs polled for this report, more than half (52%) are already active in emerging markets today, with a further one-third (32%) considering such a move in the year ahead. Just 13% say that they do not expect to do business in such markets. Over half (55%) believe that the likes of China, India, Brazil and other high-growth markets will be crucial to their business in the coming year, while just one in five (22%) disagree. "Economic power is shifting from the more mature Western world to especially

[1] *The Internationalisation of European SMEs*, European Commission, 2010

The silent majority: Europe's SMEs

● Of Europe's 20.7m registered non-financial businesses, 99.8% are classified by the EU as SMEs, employing fewer than 250 people. Of these, 92% are considered "micro" in size, employing fewer than ten people.

● These micro firms employ nearly one in three (30%) of the total European workforce, while SMEs overall account for two-thirds of all employment. Job creation rates in these firms were about twice the average of large firms between 2002 and 2008.

● During that same period, some 2.4m new businesses were registered, mostly in the services sector and newer EU member states. Of these, only about 2,000 employ 250 or more people.

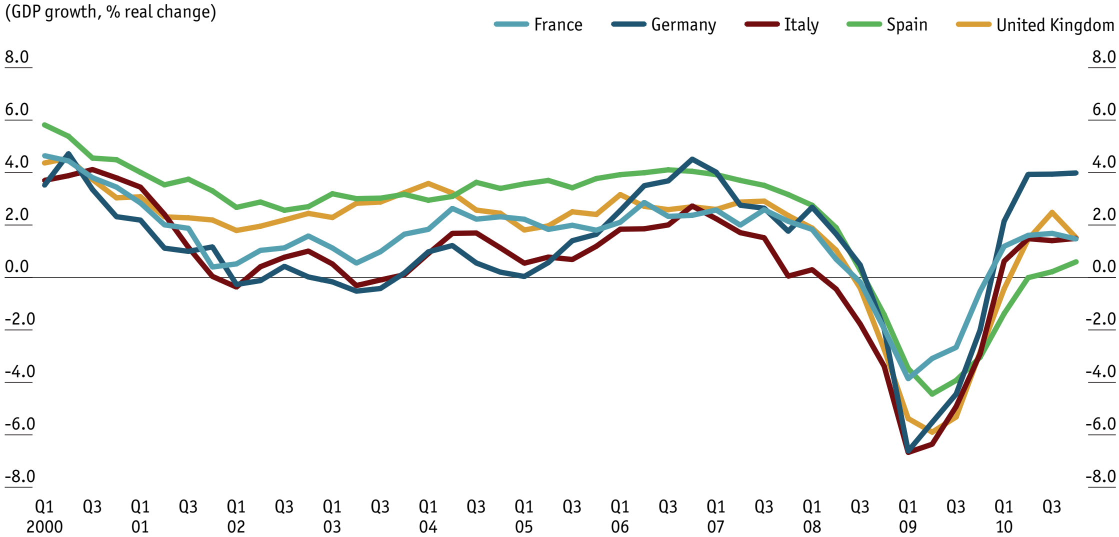
● SMEs typically have lower productivity levels, profitability and average wages than larger companies, but the highest overall propensity to invest.
Source: European Commission

the eastern hemisphere," says Tom van Lambaart, chief operating officer of Marnier Lapostolle. "This shift was significantly accelerated by the recent economic crisis."

At its core, that captures the primary reason why emerging markets are of growing interest to Europe's SMEs. Quite simply, growth prospects in the EU, while recovering from the sharp decline of 2009, remain weak. Germany looks the strongest, bouncing back from recession to post growth of 3.5% in 2010, but across other key European markets, recovery in 2010 saw growth largely remain below 2% (see chart: Pulling their weight? Europe's key growth drivers). In turn, this is forcing businesses of all shapes and sizes to seek new growth abroad. More than six in ten respondents agree that "tepid growth" in Europe makes a move into emerging markets an imperative, while just one in ten disagrees. Among slower-growing economies, such as Spain and Italy, the proportion of those who agree rises to seven in ten and eight in ten, respectively.

"The recession affected many small businesses in their home markets. Many are dependent on larger multinationals, for example as part of their supply chains, so when they struggle, business dries up," says Professor Kevin Ibeh of the University of Strathclyde, an expert on SMEs in emerging

Pulling their weight? Europe's key growth drivers, 2000-10
(GDP growth, % real change)



Source: Economist Intelligence Unit.

markets. “We’re at a tipping point,” agrees Andrew Needham, CEO of Face, a small London-based market research company that helps fast-moving consumer goods companies develop and improve products in collaboration with consumers. “Now 50% of [our] business is overseas, the majority in emerging markets. That’s because clients are focusing their budgets on these markets.” This need to follow bigger clients abroad is noted by several others, such as Thomas Vogel, the co-founder of mediaman, a German digital media company. “We knew that we wanted to serve our clients who are all active in multinational markets, whether it’s a Deutsche Bank or a Mercedes Benz,” says Mr Vogel. “We wanted to be prepared to not have to lose these clients and to be able to maintain our positive client relationships and to take them into these foreign markets.”

All this leads to an important question: why are SMEs seeking to enter these markets in the first place? Firms typically enter new markets for one of four primary reasons: to reduce production costs; to seek new customers, for example by targeting expanding middle classes; to seek strategic assets, such as oil or natural resources; and to develop business relationships with new partners. While all of these motivations apply to some SMEs, the most common reason for European firms entering emerging markets is, by some margin, to sell goods or services. About six in ten (58%) of the SMEs polled cite this as their primary reason for being in these markets, far ahead of those citing manufacturing goods (11%) or buying services (12%). In fact, low-cost labour is regarded by just 1% of the companies polled as a key driver.

Added to this, many European markets are simply too full of competitors anyway. Alan Bell, managing director of UK-based Bell Design, a branding and communication agency, says it became obvious five years ago that there were too many agencies chasing the same business. “It had got so oversubscribed,” he recalls, noting a specific occasion where Bell Design found itself amongst 180 other companies bidding for a tender. He is now expanding his business into China, working to help authorities in larger cities attract foreign direct investment from abroad. His is one of many similar SME stories, exploring new opportunities in China, along with many other markets, as detailed in the next chapter.

CASE STUDY Decades on, emerging markets remain a growth story for Kolbus

Kolbus is a German manufacturer of bookbinding machines that has grown steadily towards being a genuinely large company over its long history, which stretches back to 1775. With revenue approaching €200m in recent years, it is a classic example of Germany’s proud Mittelstand tradition of SMEs. For Kolbus, however, emerging markets are already an old story. It started selling its machines in Brazil 60 years ago, it has been in Russia for 40 years, and has operated in China since the 1970s, when its machines were amongst the first in the country for binding schoolbooks. Today, with some 200m consumers, the Chinese market is already as big as the US market, says the firm’s CEO, Kai Büntemeyer.

Given the limited prospects for expansion locally, emerging markets are the basis of the company’s growth plan. “We’ve had 1-2% growth per year in Germany for the past 20 years, and are now relying on emerging markets,” says Mr Büntemeyer. Following the collapse of the former Communist regimes, eastern Europe helped picked up the slack from falling sales elsewhere on the continent. “It used to be very rich for us in Italy, but Italy has now been replaced by Poland,” he says. Today, the company has its sights set on Turkey, South Africa and Indonesia.

Given its history, emerging markets hold few surprises for Kolbus. However, Mr Büntemeyer notes that as an engineering-dominated company it has sometimes assumed that emerging-market customers would prefer a simpler range of machines. “If you’re not alert, you can run into misunderstandings, as the customer may in fact be wanting the best equipment. They’ll take a bigger risk and think in a bigger framework than you expected. You’ve got to be careful.”

Where are Europe’s SMEs doing business?

In choosing a particular market to target, several themes stand out for Europe’s SMEs, including growth, risk, geography and history.

The most obvious is clearly growth: few businesses seek to expand into a market that is not growing, or one that is expanding rapidly but is excessively risky. This rules out niche high-growth markets, such as Angola, while putting the rapidly developing major markets such as Brazil, Russia, India and China—the so-called BRIC countries—right at the top of the list. A minimum of about one in four SMEs surveyed are already doing business in each of these countries, rising to one in three for China, the most popular. For some, the BRICs are the only game in town. Breton, for example, is an Italian manufacturer of specialist machine tools, especially for the aerospace industry, as well as Formula 1 and automotives, and it sells its equipment almost solely into the BRIC countries when going outside of Europe. “We make advanced top-of-the-range products that are ideal for some emerging markets, mainly where there is a prominent aerospace industry,” says Alessandro Verduci, the firm’s global head of sales. “None of the others have the industry to support what we produce.”

A second consideration is how accessible these markets are, both physically in terms of getting there and culturally, in terms of language. Few emerging markets are as accessible as those in eastern Europe, and Poland, the Czech Republic and Romania are all amongst the top-10 target countries for expansion in the year ahead. For example, when Lingo24, a web-focused translation business headquartered in Edinburgh, sought to expand its business, it went first to Romania. The primary reason was the country’s strong multi-lingual skills, which were also very price competitive, explains Christian Arno, the company’s managing director; this made it ideal for sourcing good, low-cost translators. Moreover, though, the country is also relatively close geographically.

The Middle East and North Africa (MENA) is a popular region, with one in three (33%) firms already operating there. Although parts of the region are grappling with major political upheaval at the moment, countries such as the United Arab Emirates (UAE), Morocco and Turkey are all popular near-shore destinations, and among the top-10 target countries for SMEs in the year ahead. Turkey, for example, is a popular destination for carmakers as a target for low-cost production, “and where carmakers go, SMEs will follow, given their close involvement in vehicle supply chains,” says Robert Ward, a director at the Economist Intelligence Unit.

A third theme is about history. This applies both to nearby eastern Europe, where German or Austrian firms are most likely to explore markets such as Hungary or the Czech Republic ,where they have historical links, while Italian firms will likely show greater interest in Romania. Two-thirds of German SMEs say that they have existing links to eastern Europe in general. "Eastern Europe is very important. The manufacturing landscape changed dramatically after the Berlin Wall came down. Many facilities set up there," says Bernd Supe-Dienes, managing partner of Dienes Werke, a German manufacturer of specialist equipment for industrial cutting originally founded in 1913.

Further afield, history also guides specific country interests in other markets, by providing common cultural links or languages with certain countries or regions. More than half (55%) of Spanish SMEs have an existing business interest in Latin America as a region, even excluding Brazil—well ahead of any other major European economy. Similarly, one in three (32%) British SMEs are active in India, above the average elsewhere. Harris Tweed Hebrides, for example, set up first in India for historical reasons, with an established customer base among older males. It is now targeting the younger customers amid the country's rapidly expanding middle class. "There's something to build on," explains the firm's chairman, Brian Wilson. "There's an emphasis on heritage which we want to transfer to the middle class."

Rising investment

Now that many have established links to their countries of choice, nearly all firms plan either to maintain or increase their commitment in their key trading markets in the year ahead. Slightly more will increase their investment levels than will choose to maintain the status quo (53% versus 45%). Just 2% plan to cut back in some way. Arc International, a French tableware manufacturer, for example, is already well established abroad, with production facilities in China and the UAE, along with distribution subsidiaries in Mexico, Brazil and South Africa. "We have two ways of thinking about expansion. Firstly to grow in places where we are already; we're increasing by 50-60% in China and the UAE. And secondly by building plants elsewhere," says José-Maria Aulotte, senior vice president for human resources, communication and sustainable development at the firm. The firm's main targets for growth include eastern Europe and South America, as it seeks newly affluent middle classes looking to stock their homes with tableware.

Where are Europe's SMEs investing?

The top-20 markets that Europe's small and medium-sized companies plan to do business with in the year ahead are the following:

1. China
2. Brazil
3. India
4. Russia
5. United Arab Emirates
6. Poland
7. Czech Republic
8. Morocco
9. Romania
10. Turkey
11. Hungary
12. Chile
13. Qatar
14. Argentina
15. Malaysia
16. South Africa
17. Bulgaria
18. Colombia
19. Mexico
20. Estonia

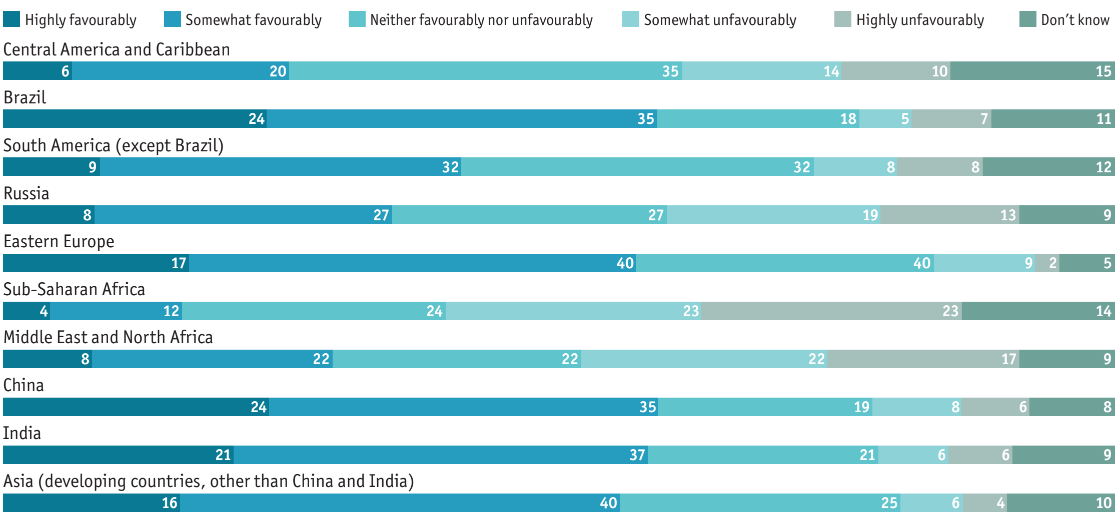
Changing favourites

Of course, each of these markets is unique and brings a specific set of opportunities and challenges for any SME trying to enter. When asked to assess the relative favourability of the BRIC markets, Brazil and China stood out, followed narrowly by India, with all three viewed favourably by nearly six in ten respondents. Russia, by contrast, lags, viewed positively by only one-third—about the same proportion that view it unfavourably. "Russia is probably the most difficult of the BRIC markets," agrees Harris Tweed Hebrides' Mr Wilson. There are numerous reasons for this, ranging from widespread corruption to the likelihood of unexpected shifts in regulations or policy. This is not to suggest that the other BRIC markets are far simpler. In fact, the World Bank's latest Doing Business ranking puts Russia's business environment (123rd out of 183 countries) ahead of both Brazil (127th) and India (134th), while China is far out in front of the others (79th).

Nevertheless, at a perception level, last year was Brazil's turn to shine: nearly half of respondents developed a more positive view of the country. There were plenty of reasons for this, including a sharply increased growth rate in 2010 (see box: *The economic outlook for emerging markets in 2011-12*) and a smooth transition of political power. Being selected as an upcoming venue for both the Olympic Games in 2016 and the FIFA World Cup in 2014 has also unlocked substantial and much-needed infrastructure spending, while the country is also eagerly anticipating future royalties from major oil fields discovered off its coast in recent years. Business has had much to cheer there.

Outside of the BRICs, at a regional level, events in the MENA region this year have shown how the relative favourability of any given market can change rapidly. Unsurprisingly, perceptions of the MENA region overall fell most sharply. More than one in three respondents became more negative about the region over the past year, while about one in four became similarly less optimistic about Sub-Saharan Africa. Meanwhile, perceptions of both Asia and eastern Europe gained most, with about one in three executives saying that they now view those regions more favourably.

Whether or not you are currently doing business with/in the following emerging market locations, how do you view them as places to do business over the next 12 months?
(% respondents)



The economic outlook for emerging markets in 2011-12

One key question for SMEs aspiring to move abroad is where the growth lies, and what trends might be affecting it. The primary reason that firms have not moved into these emerging markets any earlier is because of their heightened risk profile. Furthermore, while the headline growth rates remain impressively strong throughout the Economist Intelligence Unit's forecast period, changes can happen quickly.

In emerging Asia, the concern now is how the region will cope with the need to shift from a heavily stimulus-driven recovery to more autonomous growth. In many countries, containing inflation as food and energy prices rise is also a growing challenge. China is trying to engineer an orderly slowdown from superheated rates of economic growth, with GDP growth expected to moderate slightly this year and next (see table, Where is the growth?).

In eastern Europe, economic recovery is gaining strength. Growth in some countries, notably Poland and Russia, was relatively robust in the fourth quarter of 2010. Overall, GDP growth in eastern Europe is expected to increase to 3.7% in 2011, with a further pick-up in 2012.

Latin America was one of the regions to recover quickest from the global economic crisis, but this also means that it is now poised for an earlier slowdown. The region grew by an impressive 5.7% last year, thanks to a combination of commodity exports, the recovery in the US and unexpectedly strong domestic demand. GDP growth in Brazil in particular will slow in 2011.

Across the Middle East and North Africa, politics continues to take centre stage as the region adjusts to the extraordinary upheavals that have taken place so far this year. The medium-term impact of pro-democracy uprisings may be beneficial, but in the short term they will translate into heightened political risk and economic uncertainty. However, in the region as a whole, the economic impact of the political turmoil will be more than offset by higher oil prices, and by government spending, nudging up the region's growth forecast to 4.5% in 2011.

Table: Where is the growth?
(Real GDP growth by region at constant prices, 2010-15)

	2010	2011	2012	2013	2014	2015
Real GDP growth (%)						
US	2.8	2.9	2.5	2.6	2.6	2.7
Japan	4.0	1.4	1.5	1.2	1.3	1.2
Euro area	1.7	1.7	1.5	1.7	1.8	1.9
China	10.3	9.0	8.7	8.6	8.1	8.0
India	9.1	8.9	8.7	8.5	8.7	8.5
Brazil	7.5	4.0	4.3	4.7	4.9	4.5
Russia	4	4.5	4.5	4.4	4.4	4.3
Eastern Europe	3.3	3.7	4.1	4.1	4.1	4.0
Asia & Australasia (excl Japan)	8.2	6.8	6.8	6.8	6.6	6.6
Latin America	5.7	4.1	4.0	4.4	4.4	4.4
Middle East & North Africa	4.1	4.5	4.3	4.4	4.6	4.7
Sub-Saharan Africa	4.3	4.6	5.6	5.0	4.9	4.8

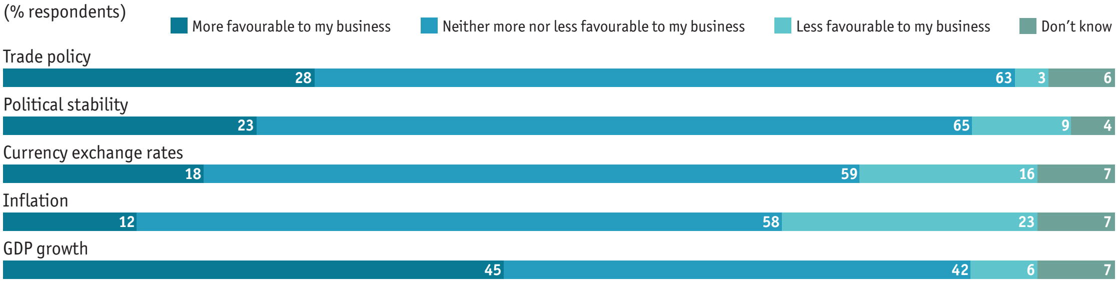
Source: Economist Intelligence Unit.

Dealing with risk and operational challenges

As with any investment asset offering above-average returns, the risks in emerging markets are also higher than what businesses, especially smaller ones, may be used to. At one extreme, it is entirely feasible for a company to lose its entire business, sometimes overnight. In Venezuela, for example, since 2007, president Hugo Chávez has nationalised a huge swathe of the country’s industries, from oil and telecoms, to cement, rice, steel and farming, as well as a supermarket chain. Moreover, seemingly out of nowhere, social unrest in the MENA region this year has been the headline story globally. These are extremes, however. In general, many emerging markets have worked hard over the past decade to reduce their risk ratings and attract investment from abroad.

This is reflected in our survey. Although GDP growth is the headline figure attracting many businesses, nearly one in three SMEs say that trade policies in the primary emerging market they expect to do business with this year have become more favourable. Nearly one in four believe political stability has improved too (see chart, Changing conditions), compared with just one in ten who see a decline. What is often more difficult to control, however, are macroeconomic risks, such as inflation or exchange rates: 23% say inflation has become less favourable in their target market, for example. This is increasingly a global concern though, with heightened inflation fears present in many countries today. The Economist Intelligence Unit’s food, feedstuffs and beverages index points to a 29% global rise in prices in 2011 (see table: Rising commodity prices).

How do you expect the following conditions to change in your top emerging market destination over the next 12 months?
(% respondents)



Rising commodity prices

	2006	2007	2008	2009	2010	2011
Oil (US$/barrel; Brent)	65.39	72.71	97.66	61.86	79.63	101.00
Industrial raw materials (US$; % change)	49.6	11.2	-5.1	-25.6	44.9	26.6
Food, feedstuffs & beverages (US$; % change)	16.1	30.9	28.3	-20.4	11.7	28.9

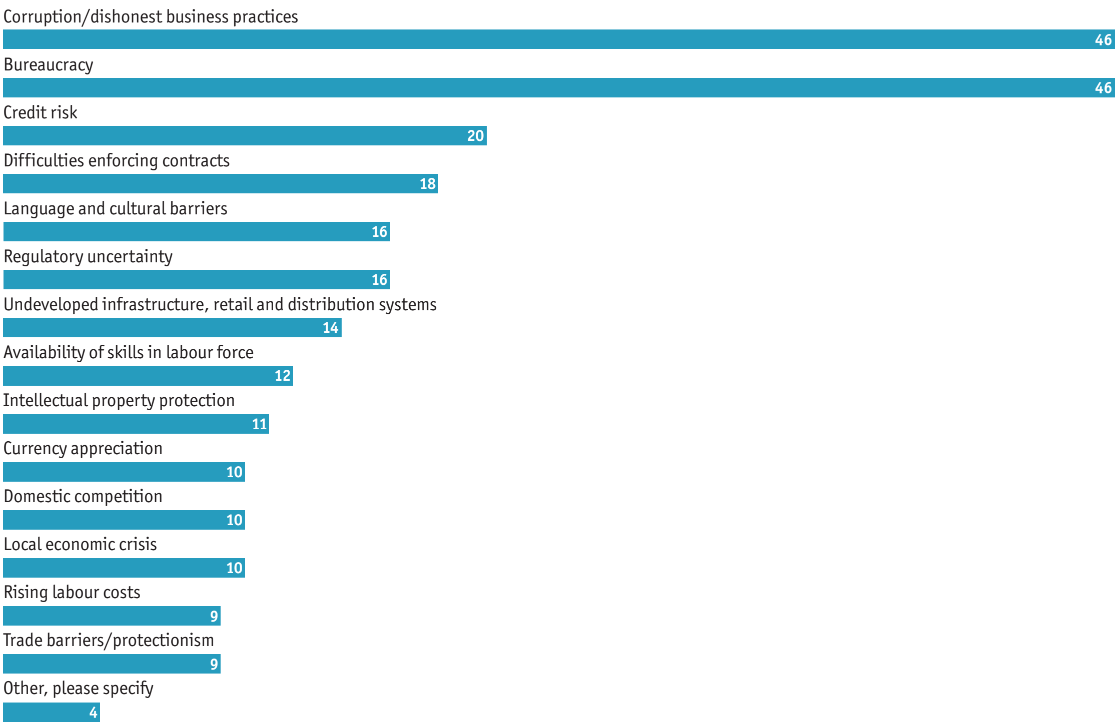
Source: Economist Intelligence Unit.

However, from a macroeconomic perspective, much of Europe faces even more striking threats, not least as countries grapple with severe public debt levels. That process will typically result in higher taxes, including higher payroll taxes. "The world we got to know and love in the past decade, that's gone," notes the Economist Intelligence Unit's Mr Ward. "For SMEs, one issue to consider is the fiscal position in the developed world, as the tax environment in western Europe is unlikely to improve."

Red tape and corruption

While emerging markets may offer relative respite from a macroeconomic perspective, it is the operational challenges on the ground where things get far harder. Two things stand out above the rest: bureaucracy and corruption. Nearly half of respondents chose these as the biggest operational issues faced in the primary market that they plan to operate in, well ahead of credit risk (20%), difficulties enforcing contracts (18%), language and cultural barriers (16%) or bad infrastructure (14%).

What do you view as the biggest potential risks regarding doing business in your top emerging market destination over the next 12 months? Please choose the top three only.
(% respondents)

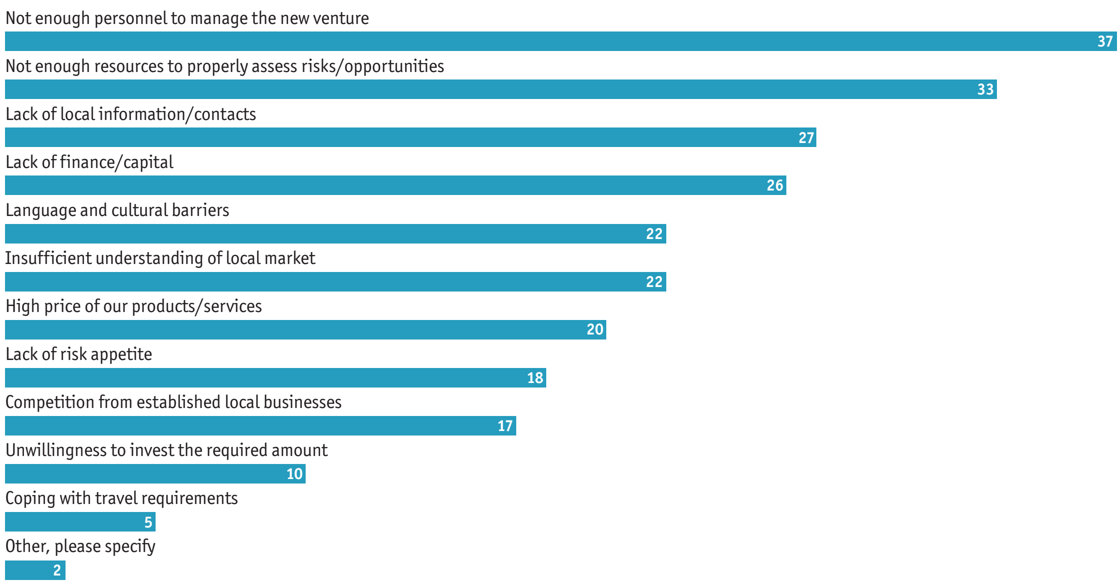


Issues vary by market, but bureaucracy is a common theme, whether India, Russia, or otherwise. "[Russia] has a lot of red tape, duties and customs regulations. This can mean a big stack of paper for little sales volume," says Mr Supe-Dienes of Germany's Dienes Werke. Chris Cheung, a market access adviser at the newly established EU SME Centre in Beijing, which has been set up to support market entry for Europe's small businesses, confirms the challenge that this raises for firms. "What you can do in one to two weeks in Europe can take a few months here. This is a big turn off for European SMEs."

In general, though, executives interviewed are fairly sanguine about the issue. For most, it highlights the need to hire local help to guide them. Dienes Werke, for example, has hired a Russian national to develop relationships in the country, and has an agent in China who deals with red tape in that market. Antoine Beaussant, the CEO of Buffet Crampon, a French manufacturer of upmarket musical instruments originally founded in 1825, which now sells to a range of emerging markets, says the overall challenge for his firm is that of typical management issues, which are exacerbated by being an SME. "It's difficult for a small company to drive big teams 8,000 miles away and to guarantee quality and carry out administration in different countries. Dealing with bureaucracy is a question of having the right partners and advisers," he says.

This in turn highlights the primary internal challenges within SMEs that sets them apart from larger firms, which have the luxury of greater resources on the ground. Nearly four in ten executives flag up a shortage of personnel to manage new ventures in far-flung markets, while one in three say they lack the resources properly to assess both risks and opportunities. A lack of local contacts and a shortage of finance are other primary concerns. As these SMEs expand, however, added resources help them grapple with such operational issues. For example, while Italian SME, Breton, has a distributor in Russia to deal with bureaucracy, and a local office in China to handle paperwork, it is

In general, in your view, what do you think are the biggest challenges within your own organisation in deciding to do business with/in emerging markets? Please choose the top three only.
(% respondents)



also big enough to have an office at its headquarters, to assist with legal and financial issues. "There are about 500 employees and so we've got the resources," says the firm's Mr Verduci.

Market entry

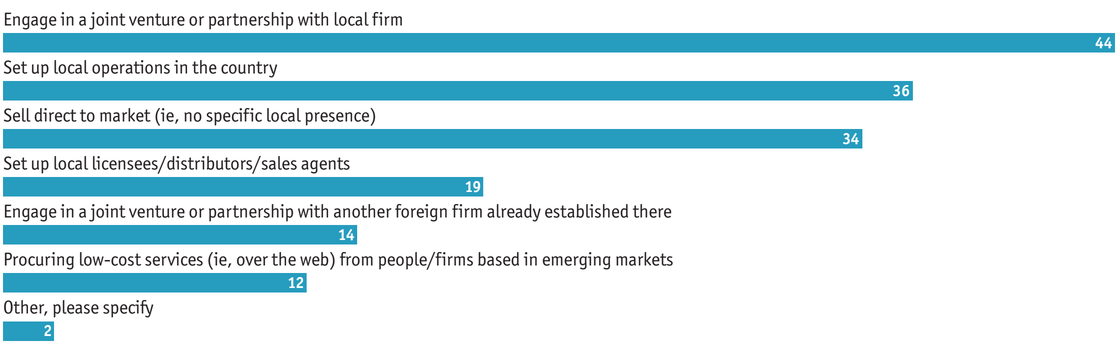
Having to deal with such bureaucratic roadblocks also informs the entry strategy that most SMEs employ when entering an emerging market. The most typical method is for an SME to set up a joint venture or partnership with a local firm. Executives interviewed for this report repeatedly highlight the need to find a reliable local contact, build up a relationship with them and then develop the business from there.

In all, 44% of respondents have started out this way, while a further 34% sell direct into the market without any local presence. Wila, a Dutch manufacturer of brake press equipment, which is used for bending sheet metal in other production processes, gives a typical example of SME expansion in emerging markets. "Over the past three years we have established relationships and started deliveries in China and Brazil," says Hans Willemsen, the firm's managing director. In Brazil, the firm aims to spend the next two years building up more relationships with local press brake builders. In China, it is busy setting up a local sales organisation. "The next step will be local assembly of some products, and then local manufacturing," says Mr Willemsen.

Another firm based in the Netherlands, AEG Power Solutions, which makes power supply and control products, advocates a similar step-by-step approach. "If establishing in eastern Europe, for example, the first thing is to find a good local agent, then set up a permanent base," says Horst Kayser, the firm's CEO. "We study the risk profile of the country, then review the legal situation. We invest in parallel with the increase in business and repeat orders, then build infrastructure."

James Berkeley, director of Berkeley Burke International, a consultancy that advises firms on operating in emerging markets, strongly recommends that SMEs find a local firm to partner with at first. "If you're trying to crack that market solely from a distance without a local partner, you are making life extremely tough for yourself," he says. Of course, a key challenge for SMEs is selecting which partners are the right ones—and which form of partnership is the right one—all of which needs to be done on the basis of a visit to the potential partner's office, typically by the founder on a short fact-finding mission. Mr Berkeley recommends alliance partnerships ahead of more formal joint-venture or equity partnerships that require a longer lead-time to set up and cause greater difficulties

What is/would be your preferred method of doing business with emerging markets? Please choose your top two answers only.
(% respondents)



in the event of needing to exit the relationship. “The question is how much control you are willing to forego.” Many SMEs interviewed for the report also tapped into government-led trade organisations, such as UK Trade & Investment or the German Chamber Network, which aim to support business growth in new markets.

At a basic level, this involves finding some kind of cultural fit with the proposed venture partner. Seven in ten respondents agreed that this is a vital ingredient of doing business in these markets. This also requires as much initial due diligence as the firm can justify. “It’s physically spending time meeting their clients, talking to other people who’ve had business relationships with those individuals and satisfying yourself that the relationship you’re creating equals a significant improvement,” says Mr Berkeley. This applies for employees too: “We’ve just tripled our travel budget because there really is no substitute for getting face to face with people,” says Lingo24’s Mr Arno.

Whatever the approach taken, SME executives warn that entering emerging markets will usually not lead to quick returns. This can be a particular challenge for smaller firms, which face tighter pressures to make more rapid returns that their larger multinational rivals, not least as operations are typically financed directly out of cash flow. About one in seven SMEs polled say they are still trying to work out how to get a decent return on investment in emerging markets, while 28% note that while returns are good, the costs have been higher than expected. “Accept you’re not going to make profits in the short run, especially if you plan for significant growth in the mid and long term,” warns Marnier Lapostolle’s Mr van Lambaart.

The BRICs in profile

Brazil, Russia, India and China are the four most popular individual markets that Europe's SMEs are actively doing business in. So what is the outlook for these key economies, what changes to the business environment do SMEs expect, and what are the key challenges and attractions?

China

Economic outlook at a glance, 2011-15. State measures to support the economy are set to keep GDP growth above 8% a year on average in 2011-15, although this will be at the cost of strains in the banking system and higher inflation. Overall, 41% of SMEs see strong economic prospects in China, while 10% think that growth will be moderate. The Economist Intelligence Unit forecasts that consumer prices will rise by 4.2% a year on average, and the growing threat of a surge in food prices poses upside risks to inflation, which is a consistent worry for SMEs. Currency concerns stand out most for China: 32% of SMEs polled that selected China as their primary trading partner in the year ahead expect less favourable exchange rates to come, the highest of the BRICs, although 21% think they will become more favourable. The government will allow the renminbi to appreciate modestly against the US dollar as capital-account liberalisation edges forward. In general, China's business environment is expected to improve in the coming years: 35% of SMEs expect a more favourable trade policy in the year ahead, compared with just 7% expecting a decline.

Attractions and challenges. The opportunities offered by China's large and fast-growing economy continue to be a strong attraction, with GDP expected to reach nearly US$13trn a year (at market exchange rates) by 2015, while GDP per head will rise to almost US$10,000. As with all the BRIC countries, the allure of selling products or services to the market is high: 50% of SMEs cite this as their key reason for being there. China also remains the world's workshop, with 20% of SMEs going there to manufacture their goods at lower cost. As in other BRIC countries, key challenges include bureaucracy first, and then corruption, while language and culture and regulatory uncertainty are also concerns.

China's economy in numbers

	2010	2011	2012
GDP			
Nominal GDP (US$ bn)	5,878	6,821	8,090
Real GDP growth (%)	10.3	9.0	8.7
Exports of goods & services (% real change)	15.8	8.6	9.6
Imports of goods & services (% real change)	14.0	10.0	10.5
Population and income			
Population (m)	1,312	1,320	1,328
GDP per head (US$ at PPP)	7,803	8,625	9,582

China's economy in numbers

	2010	2011	2012
Prices and financial indicators			
Exchange rate Rmb:US$ (end-period)	6.62	6.34	6.12
Consumer prices (end-period; %)	4.8	4.1	3.8
Producer prices (av; %)	5.5	6.1	3.9

Source: Economist Intelligence Unit.

Brazil

Economic outlook at a glance, 2011-15. The inauguration of Dilma Rousseff to the presidency on January 1st ensures continuity for Brazil in terms of its macroeconomic policy. Europe's SMEs have taken note: 31% of those that see Brazil as their primary trading target in the year ahead expect a more favourable trade policy, while just 2% forecast a decline. Similarly, growth expectations are high: 63% believe that GDP growth will be more favourable this year, with just 3% concerned about a drop. They are unlikely to be let down, as Brazil has resumed the growth dynamic (driven by an expanding labour force, real wages growth and credit expansion) that was interrupted by the financial crisis in late 2008. After rebounding by 7.5% in 2010, annual growth is projected at an average of 4.5% in 2011-15. The country benefits from a solid financial sector, a diversified economy and highly diverse trade partners. Concern from SMEs about inflation is highest here: 34% say this will be less favourable in the year ahead, compared with 12% believing it might improve. However, the Economist Intelligence Unit forecasts that annual inflation will ease towards 4.5% by 2015.

Attractions and challenges. Brazil is Latin America's largest market, the world's fifth-most populous country and the world's eighth-largest economy in GDP terms. Income inequality will continue to decline on the back of income-support programmes, but will remain high. Even so, the gradual expansion of a middle class will underpin the growing attractiveness of Brazil's domestic market. For SMEs, Brazil is easily the most popular in terms of selling goods and services to the market, with 61% saying that this is their primary motive for being there, followed by 12% wanting to tap into the country's skilled labour. From a business perspective, Brazil's burdensome tax system is a challenge noted by many interviewees, while SMEs see credit risk and infrastructure as some of the main challenges, along with corruption and bureaucracy.

Brazil's economy in numbers

	2010	2011	2012
GDP			
Nominal GDP (US$ bn)	2,087.9	2,437.8	2,537.2
Real GDP growth (%)	7.5	4.0	4.3
Exports of goods & services (% real change)	11.5	8.6	7.7
Imports of goods & services (% real change)	36.2	18.9	14.3
Population and income			

Brazil's economy in numbers

	2010	2011	2012
Population (m)	193.3	194.9	196.5
GDP per head (US$ at PPP)	11,283	11,867	12,618
Prices and financial indicators			
Exchange rate R:US$ (end-period)	1.67	1.68	1.75
Consumer prices (end-period; %)	5.9	6.0	4.8
Producer prices (av; %)	5.7	9.8	5.3

Source: Economist Intelligence Unit.

India

Economic outlook at a glance, 2011-15. Despite lacking a reliable parliamentary majority, the Indian National Congress-led United Progressive Alliance (UPA) coalition government is expected to serve its full second term until 2014, ensuring consistent macroeconomic policy. Europe's SMEs are optimistic about this stability: none of the SMEs expecting India to be their primary market in the year ahead predict a less favourable trade policy, although a few (27%) expect an improvement. The key concern from SMEs centres on currency exchange rates, with nearly one in four (23%) thinking this will become less favourable in the year ahead, compared with 9% who believe it might improve. Overall, India's currency is forecast to appreciate slightly, driven by strong inflows of foreign investment. This will also help the economy maintain its strong performance, with GDP growth averaging 8.6% a year until 2015. For SMEs, growth expectations in India are second highest after Brazil, with 49% seeing an improvement in the year ahead. Inflation remains uncomfortably high, though, having averaged 12% in 2010.

Attractions and challenges. India's population of over 1bn is an increasingly important market for consumer goods. The large number of middle-class households in the country offers considerable potential for manufacturers and retailers. For Europe's SMEs, selling goods or services is the prime rationale for being there, selected by 46% of respondents. Producing or manufacturing goods is then the second most popular reason, at 20%, with an interest in skilled labour and local services following at 10% each. However, the availability of skills is one of the challenges identified, although this is surpassed by corruption concerns and bureaucracy, as well as difficulties enforcing contracts and infrastructure.

India's economy in numbers

	2010	2011	2012
GDP			
Nominal GDP (US$ bn)	1,653.2	1,924.8	2,281.5
Real GDP growth (%)	9.1	8.9	8.7
Exports of goods & services (% real change)	13.3	12.2	12.3
Imports of goods & services (% real change)	9.0	8.1	10.7

India's economy in numbers

	2010	2011	2012
Population and income			
Population (m)	1,184.1	1,202.1	1,220.0
GDP per head (US$ at PPP)	3,556	3,892	4,287
Prices and financial indicators			
Exchange rate Rs:US$ (av)	45.73	44.97	43.87
Consumer prices (end-period; %)	12.0	8.3	5.4
Producer prices (av; %)	9.5	5.9	4.9

Source: Economist Intelligence Unit.

4. Russia

Economic outlook at a glance, 2011-15. Russia is forecast to grow at an average of 4.4% during 2011-15. Impediments to faster growth include the country's dependence on natural resource sectors, insecure property rights and bureaucratic interference. In recent years the state has extended its control over broad swathes of the economy, although the leadership has promised to reduce state interference. A moderate amount of SMEs (23%) that will do most of their business in Russia in the year ahead expect an improvement in trade policy, the lowest of the BRICs, although very few (3%) expect any deterioration. Annual average inflation will be driven up by high food prices, although it should ease from 2012. This is the key area of concern for SMEs, with 20% expecting inflation to become less favourable to their business, although most expected this to be fairly flat. After falling sharply in 2009, foreign direct investment (FDI) inflows will gradually pick up from 2011.

Attractions and challenges. Russia's growth prospects remain dependent on world commodity prices, especially oil. Accordingly, the current direction of oil prices is favourable for the country. About two-thirds (68%) of SMEs are in Russia to sell goods and services, while a minority (13%) are there to produce goods. Corruption concerns here are highest of all the BRICs, followed by bureaucracy, credit risk and regulatory uncertainty.

Russia's economy in numbers

	2010	2011	2012
GDP			
Nominal GDP (US$ bn)	1,464.7	1,756.3	1,979.8
Real GDP growth (%)	4.0	4.5	4.5
Exports of goods & services (% real change)	11.1	5.5	5.1
Imports of goods & services (% real change)	25.4	8.4	5.7
Population and income			
Population (m)	141.7	141.5	141.2

Russia's economy in numbers

	2010	2011	2012
GDP per head (US$ at PPP)	15,746	16,806	18,096
Prices and financial indicators			
Exchange rate Rb:US$ (av)	30.38	28.98	27.98
Consumer prices (av; %)	6.9	9.1	7.7
Consumer prices (end-period; %)	8.8	8.5	7.2

Source: Economist Intelligence Unit.

Big versus small: competing with larger rivals

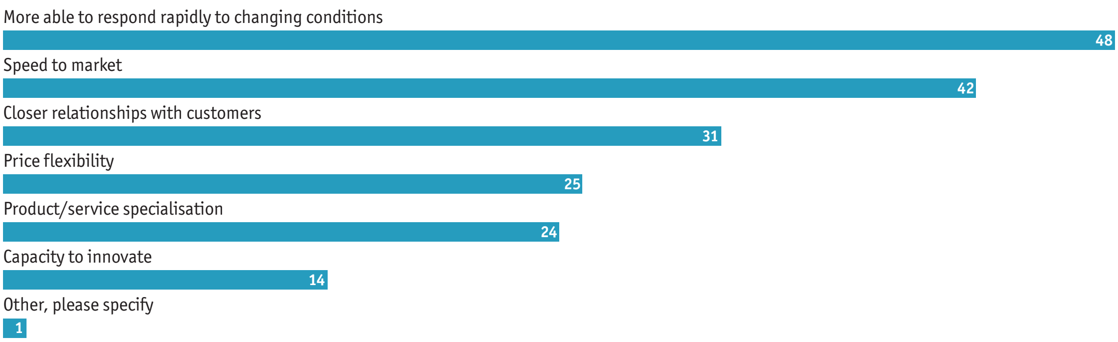
In business, size tends to matter. Bigger firms hold far greater purchasing power, for example, and are thus able to squeeze much lower prices out of their suppliers. Large multinationals are also more able to deal with losses in a particular product or geographic market, by drawing on resources from elsewhere in the business. Smaller firms have advantages too, however, most notably with regard to speed and flexibility, but also in terms of their relative informality, closeness to customers and ability to identify smaller niches.

● Speed and flexibility

Nearly half (48%) of firms polled for this report say being able to respond rapidly to changing conditions is their greatest benefit over bigger rivals, followed by speed to market (42%). “SMEs don’t have layers of management, and don’t have to have so many approvals, so they can move very quickly in terms of making decisions and acting on them,” says Professor Ibeh. “By contrast, the local subsidiary of a bigger multinational may need to go back to head office and get approval, perhaps even require a board meeting, which makes it hard for them to be nimble and fast.”

Apréndelo, a Spanish web marketing firm that specialises in the education sector, has been expanding into Brazil and Mexico, using its size to out-compete rivals. “What we don’t have are the levels of bureaucracy. We can take decisions very quickly. You’re never 100% sure what you’re going

What are the most important competitive advantages that SMEs have over larger rivals operating in emerging markets?
Please choose the top two answers only.
(% respondents)



to find in a new market, and adapting quickly is crucial," says Pablo Caño, a partner at the firm. This operational flexibility also acts as a benefit in terms of how the firm adapts to local conditions. "You don't have the rules or set ways of doing things, which can be 'make or break' for accessing new markets. We've got a small team, we're becoming good at letting local flavours blend into our model," says Mr Caño.

- **Informality and less regulation**

This flexibility and informality extends to another level too. Larger firms, especially those quoted on stockmarkets, face numerous regulatory and shareholder hoops that they have to jump through. Smaller firms tend to have to deal with less regulation, and typically tend to be private firms answerable only to their immediate owners. "They may not have to report on sustainability, or ethical conduct, or other things, so are able to be more informal and squeeze into smaller places that larger firms may not be able to," says Professor Ibeh.

- **Closeness to customers and smaller market niches**

Another benefit comes from closer relationships with customers. While larger firms will be seeking to establish a market across a larger region, SMEs may only have a handful, or even just one, key client in a market, and can thus give those close attention. For example, mediaman works closely with its clients in new markets to ensure that the solutions it suggests are closely in tune with local needs, rather than more generic product offerings. "Clients realise when they talk to us that they are not getting cookie-cutter solutions. When they decide they want to work with us, it's often rationalised by them saying 'you guys are doing things differently, you take on problems specifically for my need,'' says Armin Bieser, the firm's co-founder.

Others agree, such as Andrea Romano, president of Why Not Concept, which is the Americas arm of Rimadesio, an Italian manufacturer of bespoke sliding doors and furniture that sells in Brazil and China, among other markets. "The one advantage of being small is that we customise, everything is customised," says Mr Romano. "We're going to cut the glass in the door to the millimetre for you, with the colour that you want."

SMEs are also able to target smaller-scale opportunities that are not big enough to warrant attention from larger rivals. A €100,000 contract may be considered tiny by a large multinational, but for a firm with just €1m in turnover, it could be a major part of their business.

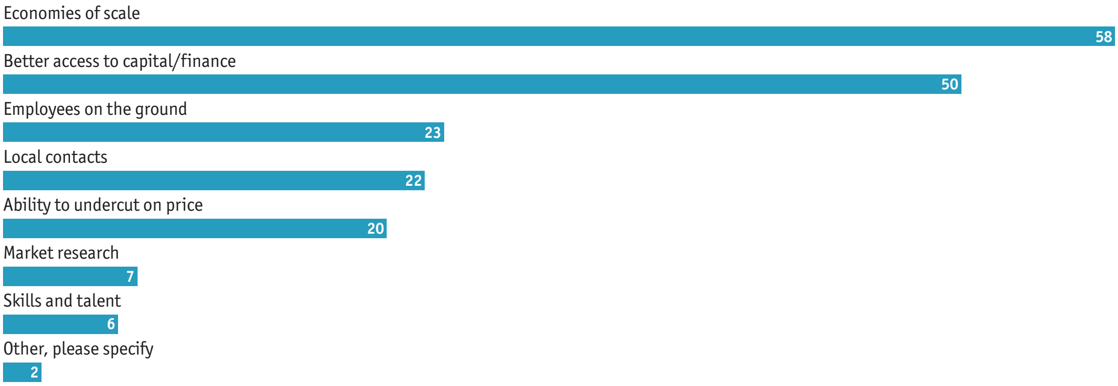
SME setbacks

Of course, a smaller scale can be frustrating too, and can limit options. The most glaring challenges come from an inability to derive the economies of scale that larger firms hold, as well as a tougher time accessing capital. These are the two issues that SME executives identify most strongly as being advantages that larger firms hold over them (see chart, Large firm advantages over SMEs).

- **Economies of scale** affect SMEs' ability to compete on price, meaning that firms will have to offer clients alternative reasons for selecting them as a supplier, typically through the close attention and customisation that they may be able to offer. As a major study on SMEs published by the Economist Intelligence Unit in 2006 identified[2], this scale issue is not just about competing with bigger rivals on

[2] *Thinking big: Midsize companies in Europe and the challenges of growth,* Economist Intelligence Unit, 2006.

What are the most important competitive advantages larger rivals have over SMEs operating in emerging markets?
Please choose the top two answers only.
(% respondents)



price for deals, but also about the ability of large clients to put pressure on price. A further scale issue, albeit a happier one, relates to demand. Mr Wilson of Harris Tweed Hebrides notes that production capacity is a challenge, which could quickly be exposed if, for example, the company's tweed products were suddenly to become fashionable amongst China's middle class.

- **Access to finance** is also challenging for smaller firms, especially as a result of lingering credit constraints from European banks following the financial crisis. Small businesses in general rely far more than their larger peers on lending from banks. In the UK, for example, lending to small businesses fell by £2bn (about US$3.3bn) in the first quarter of 2011, despite promises by banks to expand credit supply, while the average cost of credit rose. This has been a consistent trend across much of Europe since 2009, while conditions for lending have been steadily tightened, with banks demanding additional collateral and securities. There is recognition of this issue at a broader EU level, with some degree of response. In March 2011 a new European microfinance facility was set up, providing loans of up €25,000 to small businesses.

- **Access to management talent.** Small businesses often find it harder to recruit high-quality talent, in large part because they are typically only able to offer lower wages than larger multinationals. Across the EU as a whole, the average labour cost per employee for SMEs was €29,000 in 2009, compared with €38,000 for large firms.[3] "The problem with most SMEs is that they can't attract top talent, because by definition they don't have a lot of resources, or ability to pay top wages. Bigger multinationals have more pay and incentives, so getting the right management can be a challenge," says Professor Ibeh. This feeds into a related point about access to information and contacts, which is directly linked to being able to bring on board heavy hitters. "Most SMEs don't have the contacts to call up a minister in the Chinese government in order to make a meeting, for example," says Professor Ibeh. Although to some degree, government organisations like UK Trade & Investment can assist here, SMEs typically remain at a disadvantage compared with bigger rivals.

[3] *European SMEs under pressure, Annual report on EU small and medium enterprises,* European Commission, 2010.

CASE STUDY Italy’s Ernestomeda targets big spenders in new markets

Ernestomeda is a premium Italian kitchen cabinet manufacturer, with some €30m in annual revenue and just over 100 employees. Its main market is Italy, as well as Europe and the US, but the firm has made a push into Russia in recent years. The target? Russia’s substantial population of high net worth individuals, to whom it sells its high-end kitchen designs, such as its premium Barrique range. “These are very glamorous, one of the most expensive products we have,” says Alessandro Del Prete, the firm’s export manager. He also sees a key advantage in the firm’s size and its consequent ability to be more flexible. “We can consider different options, and we can adapt to the consumer request.”

The firm had noticed growing interest from Russian buyers over the past decade, keen to snap up Italian designs for their new homes and wanting the best quality they could get. Ernestomeda had participated in some local exhibitions as early as the late 1990s, but in 2006 it appointed a local agent, with offices in Moscow and Kiev, which acts on its behalf to target the country. “At the end of day, for us from Italy, it would be difficult to know the market,” says Mr Del Prete.

Building on its success in Russia, the company is now looking elsewhere for premium buyers and has its sights set on the Middle East. “In terms of purchasing power and taste, it’s becoming interesting,” says Mr Del Prete. The firm has opened a showroom in Dubai and is currently opening one in Lebanon, while it is at an exploratory stage in Egypt. The consistent theme is pursuing the high end of the market. “We have to target rich people who want the best, who want the high quality.”

Conclusion: A new world outlook for SMEs

Small and medium-sized businesses are Europe’s primary source of employment and growth. However, the scale and severity of the financial crisis has had a profound effect on these firms, which shed over 3m jobs during 2009 and 2010. This is leading to a significant change in their outlook, in terms of where they go in the pursuit of growth. Conditions at home are limited. Europe’s fragile economies are trying to repair their balance sheets from the vast stimulus and bailout funding they took on board, meaning governments will look to both spending cuts and tax increases. In general, European economies are unlikely to offer much in the way of growth in the foreseeable future. In short, more and more SMEs will need to look for new markets to do business in.

In this, SMEs are following in the footsteps of their bigger multinational rivals. To compete, they will seek to find and exploit smaller niches than their more prominent siblings, while moving more swiftly and offering greater flexibility to clients. However, for more of these firms to succeed, Europe’s policymakers must support them. Progress is underway: in 2008, the EU’s Small Business Act was introduced, with two specific aspects aimed at aiding the expansion of SMEs into emerging markets by easing access to finance and improving market-specific support.

For their part, the world’s major emerging markets are also developing rapidly, as the world’s economic centre of gravity shifts towards them, often making for surprising findings when SMEs get there. “There’s a misperception about emerging markets,” says David Murrin, the co-founder and chief investment officer of Emergent Asset Management, which is growing rapidly in South Africa and other African markets. “They’ve got the new infrastructure, ours is old. The world’s turned upside down.”

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