

SMES AND GLOBAL GROWTH: FINDING LOCAL PARTNERS



SMEs venturing into new countries find a wide range of partnership forms between the two extremes of formal joint ventures and go-it-alone subsidiaries.

Hoping to profit from a wave of investment in China by large multinationals, small and mid-sized enterprises (SMEs) based in Germany flocked to that country in the 1990s. China's government welcomed them: like many other countries, China was intrigued by Germany's *Mittelstand* firms—usually stable, technologically sophisticated, family owned firms—and wanted to learn from them. But despite the welcome—or perhaps because of that desire to learn from the newcomers—China often required the newcomers to establish formal joint ventures with Chinese partners. This requirement did not diminish the German SMEs' interest; indeed, many *Mittelstand* firms saw the joint ventures as a way to get acclimated in China.

Today, though, the partnership requirements have eased for the approximately 5,200 German firms invested in China. As a result, most German firms have decided to go it alone in the Chinese market. Turck Technology, a family-owned German industrial automation company with annual sales of around €500m, is a case in point. It established a wholly owned subsidiary in China rather than partner with a Chinese firm. Its aim was to maintain control, ensure consistent quality, and protect its designs. The firm's Chinese sales are about €40m a year, “the same level as our competitors,” says Christoph Kaiser, Turck's managing director.

By now, only 12% of the German companies invested in China use formal joint ventures, says Alexandra Voss, executive director of the German Chamber of Commerce in north China. “Where the former joint venture requirements no longer exist, German companies tend to purchase the joint venture shares from their former partner rather than extending the agreement,” she says.

JOINT-VENTURE “LIGHT”

Between the two extremes—a formal joint venture and a go-it-alone subsidiary—there is a wide range of looser partnerships possible between SMEs in different countries. Among the most popular such tie-ups are those involving licensing and technical co-operation agreements. The challenge for SMEs in these arrangements—as in full-fledged joint venture deals—is to preserve their proprietary information while benefitting from enhanced access to the local market.

For example, James Cropper, a family-owned UK paper maker, expanded internationally in recent years, to the point where around half of its £88m revenue now comes from export markets. In

SPONSORED BY



SMES AND GLOBAL GROWTH: FINDING LOCAL PARTNERS

China, it signed a technical co-operation agreement with a local firm to design fibres for high-end carbon bicycles. Despite cooperating on adapting products for the local market, the agreement sets strict guidelines to protect James Cropper's know-how. "We wanted to keep control of intellectual property," says its CEO Phil Wild.

Licensing agreements are another way to boost foreign sales without requiring a formal joint venture. Under such agreements, a local company buys the rights to market (and sometimes produce and develop) the exporting firm's brand or products. The local partner does not have equity rights, making such agreements popular among small exporters with limited capital.

Australian pharmaceuticals firm Suda and its Chinese partner Eddingpharm provide an example of a licensing agreement. Suda, with revenues of just A\$6.3m a year, would have struggled to afford to expand into China in its own name, or to invest in a joint venture. In late 2015, it signed a licensing agreement with Eddingpharm to produce and sell its drugs in China. Among the sweeteners for Suda: an upfront payment of US\$300,000 and another US\$200,000 when its product is registered in China. For small companies, licensing can offer an immediate cash injection, as well as a way to enter new markets.

A "lighter" variant of a licensing agreement is a simple sales-representative deal, in which a local firm contracts to market, sell and distribute the exporting firm's products in the target market. David Butler, CEO of the South African Chamber of Commerce in London, says many of his country's food exporters take this approach in the UK, benefiting from the market reach of UK retail chains and specialist distribution firms.

Such arrangements can help to avoid the biggest danger inherent in full-fledged joint ventures: their high failure rate. McKinsey, the management consultancy, estimates that up to 60% of international ventures fail.¹ Among the major problems: partners may have incompatible objectives, for example with one wanting to maximise long-term market share and the other wishing to make a quick profit. The US advisory firm Water Street Partners finds that around two-thirds of joint venture CEOs say the owners are misaligned on long-term strategy and on budget issues.² A more limited technical co-operation agreement can sidestep such fundamental issues.

¹ <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/avoiding-blind-spots-in-your-next-joint-venture>

² <https://www.waterstreetpartners.net/blog/why-joint-ventures-fail-and-how-to-prevent-it>

MATCH-MAKERS

What all these partnerships—the full-fledged joint venture agreements and the "lighter" variants—share in common is the marriage of an exporting firm's product know-how and a local firm's market expertise. Regardless of the form that a partnership takes, the fundamental questions

SMES AND GLOBAL GROWTH: FINDING LOCAL PARTNERS

apply: how to find the right local partner, and how to structure the agreement to avoid common pitfalls.

"That's the million dollar question," says Dan Harris, a founder of the US law firm Harris Bricken, which specialises in joint ventures in China. "[The answer] is usually based on the [specific] business involved. If you are an educational software company, you think about partnering with the top one or two companies in China that distribute or sell educational software. If you make high-end [technical] widgets, you may partner with the one or two best high-end widget companies in China—whose widgets, though high-end for China, are not nearly as good as yours, and therefore they could use your help. You find these companies yourself, or you hire a consultant to help you find them."

The routes to finding foreign partners vary. James Cropper found its Chinese partner via the contacts it had made in the country by selling there directly. It sought out Chinese partners with expertise and complementary skills for its high-end fibres division. It also looked for Chinese firms with industry contacts and specialist expertise to sell to high-end bicycle manufacturers.

Indeed, the search for such partners is often mutual, with Chinese firms eager for foreign partnerships. Eddingpharm, the pharma company licensing products from Suda, first entered the business via licensing deals with multinational pharma companies Novartis and Baxter in the early 2000s. In 2012, backed by international investors, Eddingpharm established a US subsidiary to seek out other product lines for distribution in China, as well as deals to develop and market such products. Among its wins: an agreement with Suda to develop and market an insomnia drug which the small Australian company would have struggled to sell in China on its own.

Companies that lack contacts in a target foreign market often turn to consultants for help. Firms such as Prospect Chinese Services, which is staffed by Chinese nationals and has offices across the UK and China, advise clients ranging from hotels and universities to car manufacturers wishing to enter the Chinese market. It claims to offer a 'one stop shop' for UK companies, comprising market research and market entry strategy services, support with first contacts, and advice on negotiations.

Other match-makers include government export promotion agencies, which compile large databases of foreign companies and can put exporters in touch with potential foreign partners. Erin Butler of the US Export Assistance Centre says that US SMEs supplying the oil industry approached her for contacts in growth markets such as North Africa. Like James Cropper, the US oil industry suppliers also used their domestic sales forces to make initial contacts with potential

SMES AND GLOBAL GROWTH: FINDING LOCAL PARTNERS

foreign partners. The search criteria for finding the right local partners tend to be similar, across a range of businesses: that is, local partners who supply expertise, skills and contacts that are complementary to those of the exporting SME.

ACQUISITIONS-PLUS

Exporters making a long-term commitment to a foreign market often acquire a local company to establish a stable presence in that market. One example is Palfinger, an Austrian SME and construction-machinery maker, which bought companies across the world to access their markets and to diversify away from over-reliance on building mobile cranes. Its foreign plants gave Palfinger a lower-cost, more flexible production base to supply new markets, which in turn helped it to withstand a series of economic storms.

A buying spree was not Palfinger's sole expansion tool, however. It also established joint ventures with local companies in some major export markets, particularly in China and Russia, using the partners' local market dominance to boost its own sales. In 2012 Palfinger established two joint ventures with SANY, China's biggest manufacturer of construction equipment. One of the ventures was established to sell Palfinger products in China, and the other to distribute SANY products outside of the country. In 2013 the companies agreed to a share swap, with SANY taking a 10% stake in Palfinger in exchange for an equal stake for Palfinger in one of SANY's operating units. For Palfinger, this helped to cement a deep presence in China, while for SANY the deal boosted its own globalisation efforts.

In 2014, Palfinger set up two more joint ventures, this time with Russia's largest truck maker Kamaz. One builds chassis to hold Palfinger's mobile cranes, and the other produces cylinders for construction machinery. Under the deal, Palfinger agreed to invest in modernising the production plant. In return, Palfinger gained entry to Russia's specialist construction machinery market. "We couldn't buy them [SANY and Kamaz]," spokesman Hannes Roither says drily when asked why the firm chose joint ventures.

Significantly, the local ventures provided a buffer when local markets weakened, due to their strong local customer base. "There have been serious market crashes in both countries" in recent years, Mr Roither says. "But we were able to protect our own sales by increasing market share when foreign competitors withdrew from the country."

Similarly, the German luxury hotel group Steigenberger set up a joint venture with a local company to accelerate its expansion into India. Steigenberger owns 116 hotels in 12 countries,

SMES AND GLOBAL GROWTH: FINDING LOCAL PARTNERS

generating 2013 revenues of €500m. In 2016 it announced a joint venture with MBD, an Indian hotel group, with Steigenberger retaining a controlling stake. MBD will manage the joint venture including sales, while the German company will manage international marketing, training and brand development.

The companies have complementary skills, with Steigenberger a leader in five-star hotel management and MBD an established player within India. Also, and equally crucially, they share the same aim: the rapid roll out of luxury hotels in India. The joint venture plans to open 20 hotels over the next 15 years. Managing Director Sonica Malhotra Kandhari says it would take between three and five years for either partner acting alone to open a single hotel.

KEYS TO SUCCESS

Structuring any type of partnership agreement with a foreign partner can be tricky, says Mr Harris, the US lawyer. He advises clients to keep a majority stake in a joint venture, and to protect their intellectual property zealously regardless of the nature of the co-operation. He offers the cautionary tale of a US firm whose Chinese partner began to manufacture the US partner's products under the Chinese firm's name. Some remedies are simple: "Many times we find that the [US] company had not registered a patent in China," Mr. Harris says.

Beyond that, a key to success is to look carefully at the fundamentals: ensuring that the partners' skills and expertise are complementary to those of the exporting SME; establishing that the aims of both partners are aligned; and making long-term commitments to the target markets. These elements—complementary skills, similar aims, and long-term commitments—are as close as an SME can come to finding a recipe for success in forming international partnerships.