NEW ZEALAND CENTRE FOR SME RESEARCH

UNDERSTANDING INTERNATIONALISATION BEHAVIOUR

Final Report: Executive Summary

Report prepared for Ministry of Business, Innovation and Employment, Ministry of Foreign Affairs and Trade and the Treasury

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This document provides an Executive Summary of the in-depth findings from a qualitative study that involved a programme of 98 face-to-face interviews, undertaken as a follow-up investigation to the 2011 Statistics New Zealand Business Operations Survey (BOS) which included a module of questions on the international engagement of New Zealand businesses. The full detailed and in-depth findings are reported in an Annex to this Executive Summary. The aim of the study is to provide an in-depth understanding of firms' motivations to internationalise, the process by which internationalisation occurs and the challenges that firms face in internationalising. A range of forms of internationalisation were considered, including exporting and both inward and outward foreign direct investment. The study was jointly commissioned by the Ministry of Business, Innovation and Employment (MBIE), Ministry of Foreign Affairs and Trade (MFAT) and the New Zealand Treasury. The study has been guided by a project Steering Group with representatives from each of the commissioning bodies.

New Zealand is a small, open economy that is distant from its major overseas markets and highly dependent on international linkages. These features of our economy are often put forward to account for the relatively low proportion of New Zealand's businesses that are active internationally. The 2011 Statistics New Zealand Business Operations Survey indicated that only 18 per cent of businesses surveyed had current overseas income. However, in this study, we report cases of businesses that are successful internationally, operating in distant overseas markets, such as Europe and North America, and many who are operating successfully in our nearest overseas market, Australia and/or in the economies of South-East Asia. We examine the factors behind the process of successful internationalisation. Supporting the development of a more internationally competitive economy is a key policy target for the Ministry of Business, Innovation and Employment (MBIE), the New Zealand Treasury and the Ministry of Foreign Affairs and Trade (MFAT). As part of its Business Growth Agenda, the Government aims to increase the contribution of exports to the economy from 30 per cent to 40 per cent of GDP by 2025.

The programme of 98 face-to-face interviews has been undertaken with businesses that had different levels of engagement and experience with internationalisation. The research programme consisted of two stages. The first stage involved 60 interviews across a diverse sample of internationally active and non-active businesses. This stage was completed between June and July 2012. Following a review and guidance from the Steering Group, the focus for the second stage was narrowed to the service sector only.[1] This stage was completed in October 2012.

The sample of 98 businesses was diverse in terms of business experience, age of firm and size. It included small, medium and large businesses; 35 per cent were small in size (6-19 RME[2]), 41 per cent medium (20-99 RME) and 24 per cent large (100+ RME). 70 per cent of firms in our sample were currently internationally active, compared to 30 per cent who were non-active firms. The sample included 24 companies that were foreign-owned multi-national corporations (MNCs). Eight businesses were engaged in overseas direct investment (ODI), although others also had sales teams and employees located overseas. Businesses may be engaged in global supply chains, or global value chains (GVCs) where value is added to raw materials or a partially manufactured product, 16 of the sample of 98 businesses, were engaged in GVCs with varying degrees of complexity.

[1] In the second stage, 20 interviews were undertaken with businesses that were actively engaged and 18 interviews with that were non-active.

[2]RME is rolling mean employees. It is a twelve month moving average of the monthly employment count obtained from taxation data.

A special acknowledgement is offered to the business owners and managers that participated in the research by allowing us to visit them and for their willingness to provide their valuable time. Without their cooperation we would not have been able to gain the rich, in-depth insights reported in this study. The authors are grateful for constructive comments made by independent reviewers on a draft version of this report[3]. We are also grateful to an independent proof reader of the final report[4].

The rest of this Executive Summary reports the main findings and conclusions of the study using the headings from ten thematic topic areas which are covered in full detail in the Final Report Annex[5]: the process of internationalisation; international activities and behaviour; challenges faced by New Zealand businesses in the internationalisation process; service sector businesses; competitiveness, productivity and innovation; lessons learned; sources of information and advice; the New Zealand environment; observations on policy and future development. Where relevant, results from the 2011 Statistics New Zealand BOS have been included to place the qualitative follow-up findings in the light of that survey and context. In our last section, we provide concluding comments and suggest areas for further research.

1. The process of Internationalisation

Engagement in internationalisation is the outcome of a dynamic process that may be initially motivated by saturated and limited domestic markets, or by enquiries from overseas. However, the interviews revealed that successful engagement depends on the ability of the management to recognise and exploit opportunities and ultimately commit resources towards building international markets. Entrepreneurial orientation and commitment to overseas markets was important as a precursor. Factors that were important in the process of internationalisation included previous overseas experience, client enquiries and relocation of clients overseas. For many businesses, the limited size of the domestic market in New Zealand has been the main spur for export activity, permitting business growth and the achievement of economies of scale through larger operations. The indications are that this factor was particularly important for New Zealand-owned manufacturing businesses. Businesses in the primary sector, such as forestry and related areas, like agri-businesses, reported additional motivations for exporting including better risk management through operating in a diversified range of overseas markets.

Examples of internationally non-active businesses allowed us to identify an additional construct that moderated the relationship between triggers related to the market, triggers related to the management and the decision to internationalise: the nature of the product and/or service. Figure 1 serves to illustrate this relationship. It is important to note that internationalisation is only one possible strategy that businesses can pursue and it depends on the nature of the management and the nature of the product if internationalisation is considered to be the best option.

[3] Three independent reviewers made highly valuable and constructive comments on the draft final report; Professor Sally Davenport, Victoria University, Associate Professor Joanna Scott-Kennel, University of Waikato and Michael Freudenberg, New Zealand Treasury.

[4] This was undertaken by Dr Jo Bensemann, Massey University.

[5] The Annex contains additional sections on a literature review, sample and respondent businesses' profile details and the methodology employed in the study.

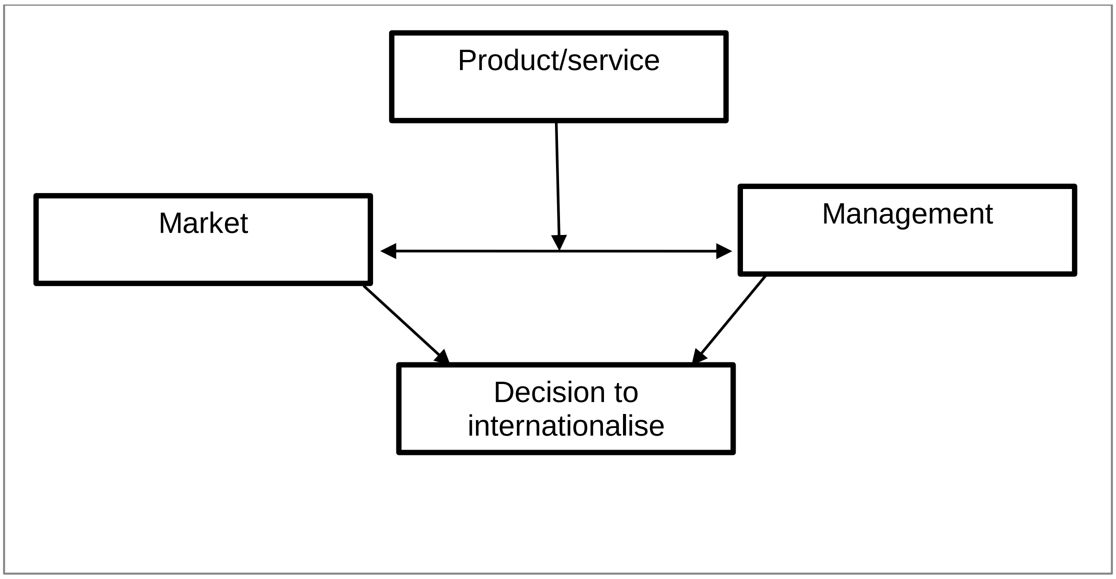

Figure 1: Understanding the internationalisation decision: forces that influence the strategic decision to internationalise

2. INTERNATIONAL ACTIVITIES AND BEHAVIOUR

New Zealand businesses may be engaged in a range and variety of patterns of internationalisation activity. To help place the qualitative data in context, Figure 2 and the remaining charts (Figures 3, 4 and 6) are compiled from the 2011 Statistics New Zealand BOS[6] tables. Figure 2 indicates the relative prevalence of sources of income from activities undertaken by businesses that currently generate overseas income.

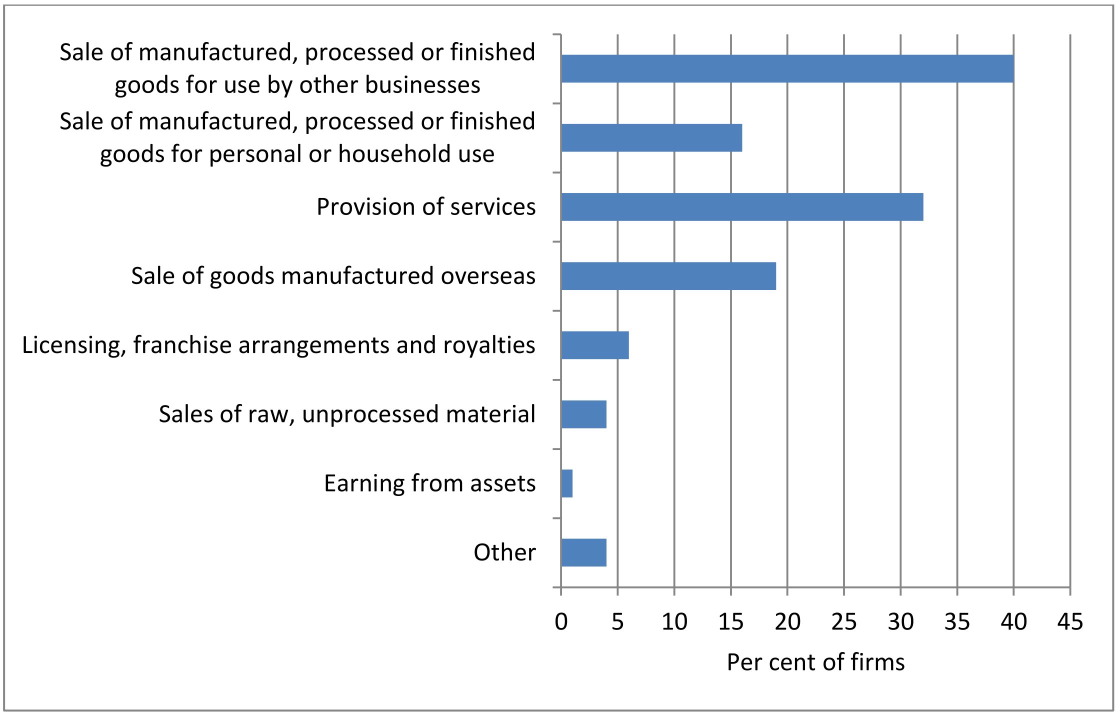

Figure 2: Relative prevalence of source of overseas income indicated by activity

[6] Statistics New Zealand (2012) Business Operations Survey: 2011, Wellington, Statistics New Zealand

(Source: Statistics New Zealand BOS 2011 Tables, Table 45)

The interview data revealed that a range of internationalisation activity was reported from the businesses interviewed, including overseas production, overseas sales and overseas purchases. Whether a business was involved in overseas production was influenced by the nature of their product, freighting costs and the appreciation of the exchange rate (see below, section 3). However, a strategic investment overseas also had advantages in meeting overseas regulations and through acting as a launch pad to enter additional overseas markets. The importance of such factors varied dependent on individual company sectors, product and markets. Although there is an assorted degree of complexity from one-off contracts to volume production, the interview data indicated that what seems to be important for manufacturing companies is the ability to invest in a strategic presence as well as to ensure quality of supply. It is also apparent that the interaction between an overseas presence and overseas sources could lead to additional market opportunities for those in high value niche product areas.

Figure 3 indicates the relative prevalence of different company strategies for generating overseas income. The figure indicates the importance of pre-existing networks or contacts as well as customised goods and services. The interview data from this study, lent further weight to the relative importance of such pre-existing networks, as reported in BOS 2011. The interview data revealed that networks and trusted relationships were an important determinant of a business's ability to develop internationalisation activities. Opportunities to internationalise may arise through a combination of factors, however, it was important to have established networks and trusted relationships with contacts to exploit such opportunities. The importance of customised goods and services was also supported by our findings.

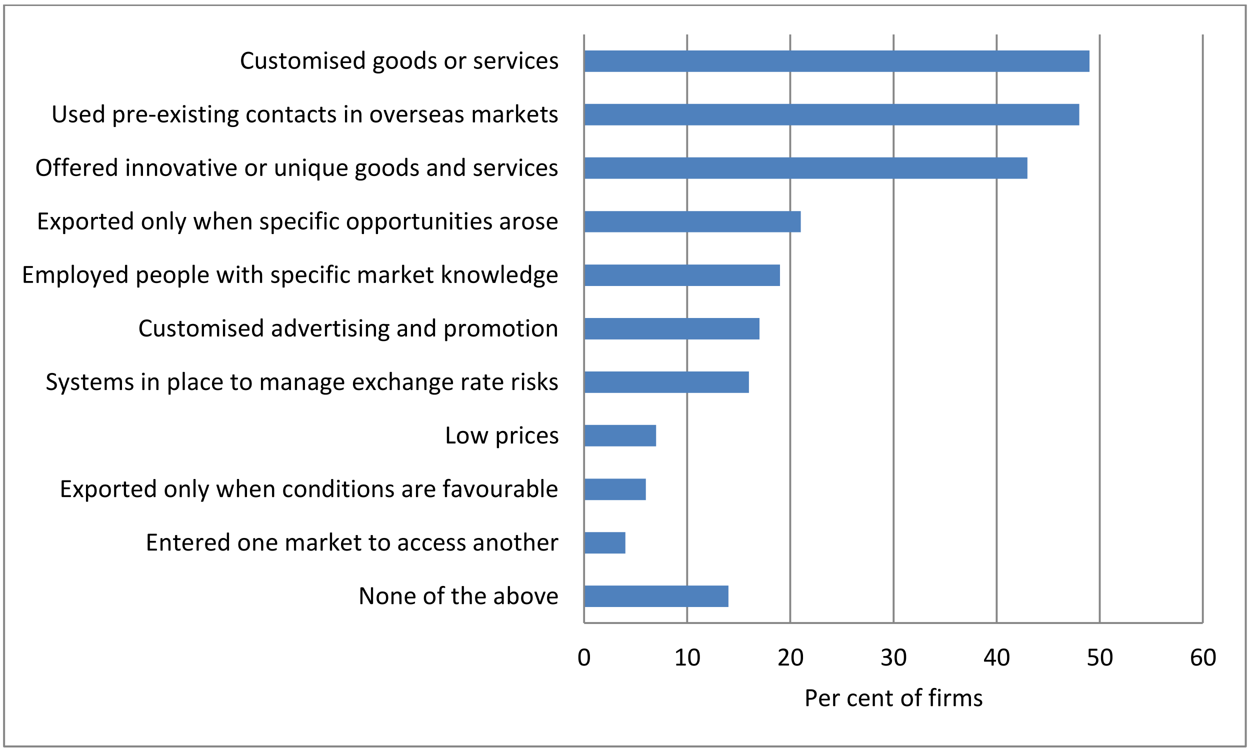

Figure 3: Relative prevalence of strategies for generating overseas income

(Source: Statistics New Zealand BOS 2011 Tables, Table 57[7])

For the purposes of this report we define foreign direct investment as an investment that that involves a commitment to a long term relationship, reflecting a lasting

[7] The key in Figure 3 for the second most prevalent strategy has been slightly altered from that in the BOS 2011 tables, the full description is: 'Used pre-existing contacts and networks in overseas markets'.

interest[8]. A small number of our sample companies, eight, were active in establishing subsidiaries to exploit overseas markets, or outward foreign direct investment (ODI), including both manufacturing and service sector companies. It was likely to be undertaken by high intensity exporting companies in their major overseas markets and could represent both short term and long term commitments. Taking a dynamic view of exporting, ODI could be seen as a longer term outcome of the internationalisation process. ODI could also exist where companies sought to source production overseas, this is particularly the case with New Zealand manufacturing companies in traditional sectors such as textile and clothing production. Those firms that had undertaken the more advanced form of ODI, requiring investment in production capability overseas, tend to be longer established, for example, manufacturing companies seeking to operate in relatively distant markets such as Europe and North America where there can be some obvious advantages. However, what is also apparent is that there does need to be some minimum scale and time involved to make such advanced ODI worthwhile.

24 of our companies were subsidiaries of large foreign-owned MNCs. FDI for New Zealand businesses is an important phenomenon. Companies that were subsidiaries of foreign-owned MNCs enjoyed varying degrees of autonomy, but FDI could be crucial in the context of dynamic resource capabilities and in entering new export markets. In some cases, FDI led to additional export markets for New Zealand subsidiaries, which could also benefit from additional resources.

An emergent phenomenon is the growth of global value chains (GVCs). We could identify 16 companies that were involved in GVCs that had varying degrees of complexity. These varied in complexity from relatively simple supply chains, exploiting natural resources in New Zealand such as radiata forests, gas and other natural resources to much more complex global supply chains involving manufacturing of imported materials and re-exporting semi-manufactured products. Companies involved, being for the most part owned by MNCs, perhaps seeking to secure supplies globally, undertook strategic decisions globally, although New Zealand subsidiaries could still secure a niche reputation even within such complex GVCs. Due to the variation in complexity across the 16 cases that were identified, it is not possible to identify issues or practices that are common across all such cases. However, it is worth noting that dynamically the pattern of manufacturing location could vary and change over time. This reflects the fact that, as in our examples, most of these cases are New Zealand subsidiaries and part of a global MNC that had ability to switch production and resources overseas. In some cases this was driven by the need to reduce costs or to respond to changing market conditions. It is clear in these cases, that such companies take strategic decisions on a global basis.

3. CHALLENGES FACED BY NEW ZEALAND BUSINESSES IN THE INTERNATIONALISATION PROCESS

Figure 4 shows the relative frequency of reported barriers to the participation in overseas markets and to the generation of overseas income for all New Zealand businesses. This data indicates that for those businesses that currently generate overseas income. It is barriers associated with the exchange rate level and volatility that are the most frequently reported. (For businesses that do not currently generate overseas income, but are interested in doing so, limited knowledge and limited experience are most frequently reported barriers).

The interview data from this investigation revealed that the continued increase in the value of the New Zealand dollar (NZD) in recent years has affected some New Zealand businesses' ability to export, maintain and develop overseas markets. At the

[8] UNCTAD (2002) *World Investment Report*, New York, United Nations

time the interviews were undertaken, the NZD was at a near high of 1 NZD = 0.80 USD and was continuing to appreciate. However, in most cases companies were able to manage appreciation and fluctuation in the short term, although such appreciation did limit the scope of export activity for some companies where their markets are price sensitive. A more subtle effect was noticeable through strategic changes in business behaviour, with evidence that some companies had brought forward plans to produce abroad as a longer term strategic response.

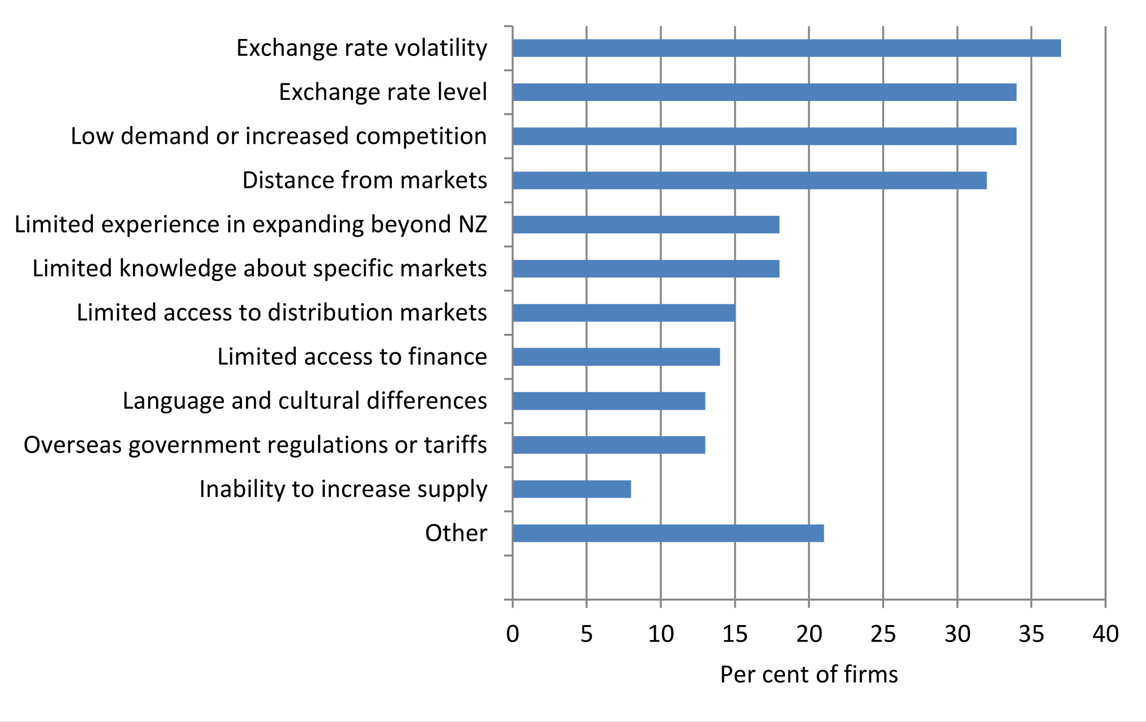

Figure 4: Most frequently reported challenges for businesses that currently generate international income

(Source: Statistics New Zealand BOS 2011 Tables, Table 58)

Funding and liquidity issues, associated with the longer lead times for businesses engaged in export activity, did not significantly prevent the development of overseas markets, but rather illustrated the need for businesses that are seeking to enter export markets to be well prepared with a sound financial base and with a good banking relationship. Tariffs in some overseas markets were found to be restrictive for some companies affecting the scope of their international activity. Differences in regulations in overseas markets were also reported as an important challenge reinforcing the need for adequate preparation and investment.

Cost, time and availability of freight were all important challenges which, in some cases, limited businesses' ability to penetrate new overseas markets. These challenges partly account for the predominance of Australia as an overseas destination market for New Zealand manufacturing businesses[9]. Such challenges could be overcome with the more distant markets such as USA and Europe, but only if the business was in strong market position with a strong demand for its product.

Business commitment and up-front investment in time and resources were critical to overcoming challenges and can be explanatory factors behind why some firms withdraw from overseas markets because of a lack of time or resources. Having the right person, perhaps dedicated to international development, was a critical factor for

[9] Australia was an overseas source of income for 76% of all businesses that were internationally active (Statistics New Zealand Business Operations Survey: 2011, Table 49).

successful development of export activity and overseas markets. Difficulties in recruitment of such individuals were found to be a limiting factor, especially with New Zealand-owned manufacturing companies. In some cases, an additional factor requiring investment was the need to educate an overseas market, perhaps where the product is new to the market or technology-based, requiring additional commitments in time and resources.

Our sample included 28 firms who were not internationally active, although a small number were actively considering overseas markets and were seeking information and contacts that would lead to an initial presence. For those companies that were non-active, these challenges were significant enough to prevent international activity, but in addition other factors were identified including a lack of appropriate contacts and networks, concern with maintaining reputation, a focus on local markets and entrepreneurial orientation. It is important to realise that these factors are *indicative* of the reasons that prevent internationally non-active businesses from participation in overseas markets. The sample of non-active businesses for the purposes of this study was effectively a convenience sample and is unlikely to be representative, hence it would not be appropriate to generalise on the importance of these factors. To make comparisons with active businesses, it would be necessary to have a matched pairs sample so that valid comparisons of behaviour with active and non-active businesses could be drawn.

With these riders in mind, however, it was noticeable that there were examples of well managed and successful businesses that had thought carefully about entering overseas markets and decided against such activity because of a lack of trusted contacts and networks and the recognition of the long term investment requirements, rather than other factors such as a failure to compute the long term costs and benefits. Where there was some similarity in businesses and sector, it was clear that entrepreneurial orientation and motivation was an explanatory factor.

4. SERVICE SECTOR BUSINESSES

The relative prevalence of service sector companies and the provision of services overseas can be seen in Figure 2. The study included 38 second stage interviews which were conducted exclusively with service sector companies and for the findings reported, in this Executive Summary, and in the Final Report Annex, we draw more heavily on the second stage interviews.

Service sector firms place greater value on networks and personal relationships which can determine their competitive advantage in overseas markets. They rely upon the importance of personal relationships, strong human capital and their information resource base for the quality of their service provision[10]. We found that the key to understanding internationalisation behaviour of such companies lies in the importance of personal relationships and the improvements in their knowledge base. We found that they are more likely to need to establish a domestic market and to have lower export intensity than manufacturing companies. We also found that they are more likely to be in overseas markets that are similar to New Zealand, including Australia, UK and Canada, attracted partly by similarities in culture and those markets where English is a first language.

Despite the apparent benefits of operating subsidiaries in such markets, outward FDI seems to be relatively rare in this sector. One reason may be that such companies become targets for overseas based MNCs seeking a way into the New Zealand market, since they benefit from having a subsidiary operating in New Zealand.

[10] Much of the previous research and the development of theory have been based upon manufacturing companies. The Final Report Annex provides more detailed coverage of previous research and evidence on the nature of the internationalisation process for service sector firms which indicates the importance of personal relationships and networks.

However, in theory service sector firms can more easily service overseas markets from their administrative base in New Zealand and have less pressure to reduce costs than similar firms in the manufacturing sector.

Internationally active service sector companies tend to have been less affected by the appreciation in the NZD in recent years, compared to manufacturing companies. In some cases, companies were effectively paid in NZDs even though their end customers were overseas such as travel and tourism based businesses.

5. Competitiveness, productivity and innovation

Sources of competitive advantage for exporting companies lay in a range of factors which included: the nature and superiority of product and an ability to compete through lower costs, through quality, greater knowledge and the existence of IP. However, we report that reliance solely on cost advantages is relatively rare and the role of innovation is critical to maintain competitive advantage. There is a cycle of innovation from involvement in overseas markets, illustrated in Figure 5. The initial innovation may establish a competitive advantage, but is reinforced through a cycle of open innovation.

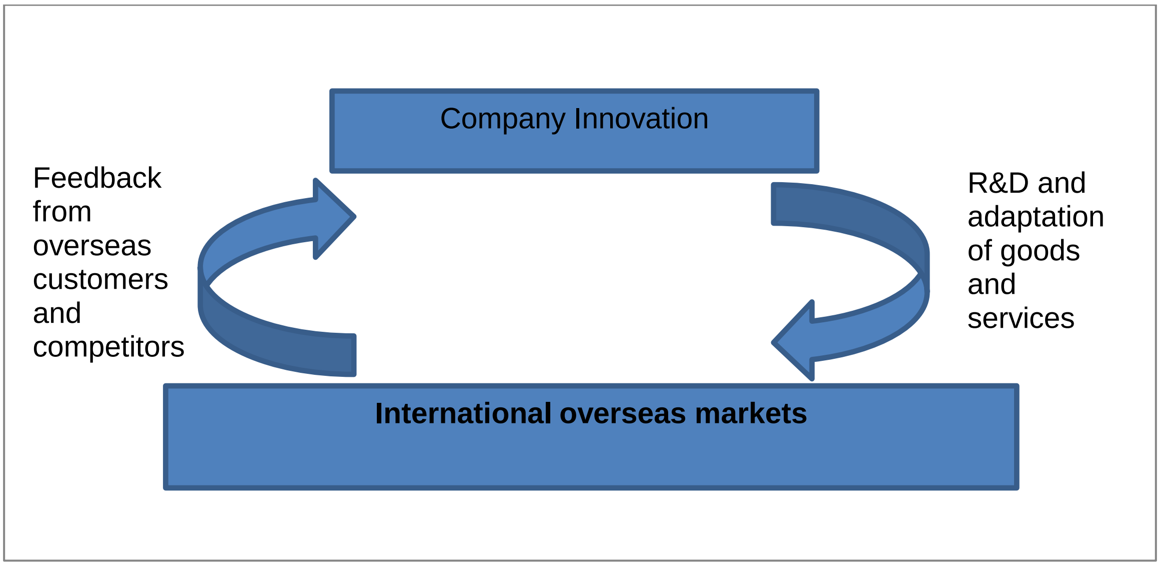

Figure 5: The Cycle of Innovation for Exporting Companies

6. Lessons learned

It is important for businesses to be able to absorb lessons from both successful and unsuccessful strategies in overseas markets. A perfectly valid outcome may be disengagement from some overseas markets as experience is gained and lessons are absorbed. As illustrated in Figure 6, businesses may find that competition has increased or revenues and profits are lower than expected causing withdrawal and disengagement from overseas markets.

The interview data revealed a number of important factors that affected engagement and continuity in overseas markets. The most important lessons learned included: the need for investment in resources and presence in a target market; choosing overseas agents with care; precursor assessment of the market, including gathering of information from contacts and industry sources; a long term commitment to that market, including time required to establish a market presence; for service sector firms, having a strong and established domestic market and identifying similar markets; having a capability to learn from experience; feedback systems that enable review of operations; building strategic partnerships that can enable joint ventures and establishing robust reporting systems from the beginning including forecasting.

A further factor is the nature of opportunistic activity. Entrepreneurs may identify opportunities in overseas markets that are essentially temporary and will not necessarily lead to a long term presence. For example, these opportunities may arise from previous domestic market clients who have moved abroad, additional referrals from existing overseas clients, referrals from existing partnerships and personal networks, additional opportunities from existing corporate buyers who may be large MNCs and additional market opportunities from existing operations and activities.

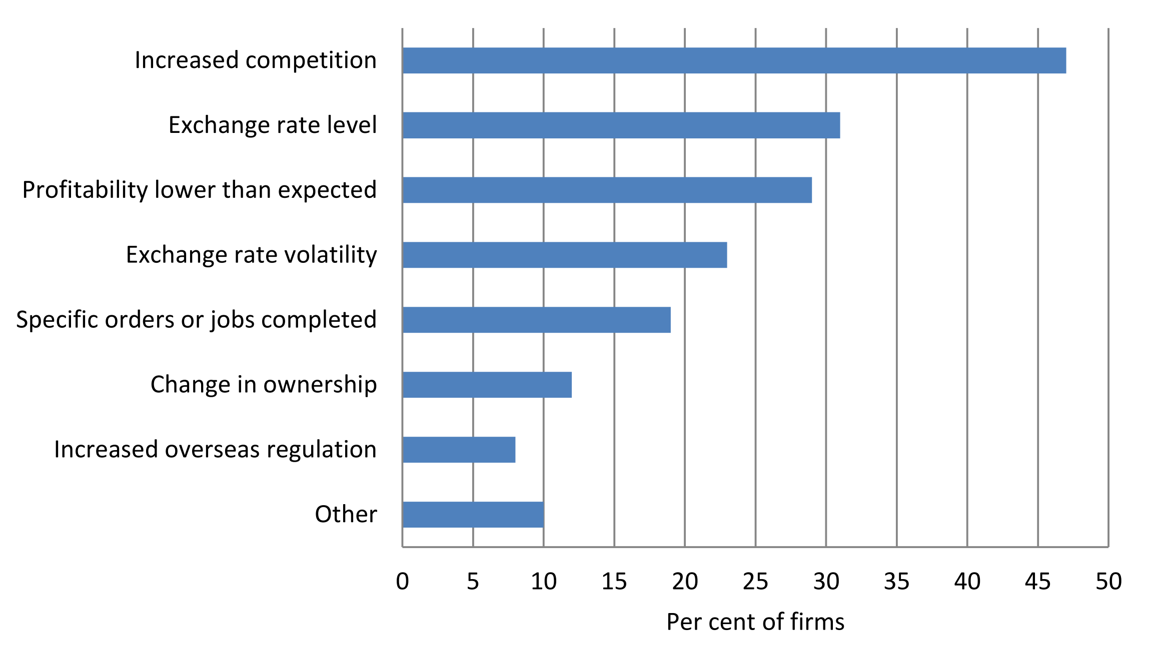

Figure 6: Most frequently reported reasons for disengagement from overseas markets

(Source: Statistics New Zealand BOS 2011 Tables, Table 54)

7. Sources of Information and Advice

Despite the range of support and advice available to businesses seeking to export in New Zealand, we found that businesses relied predominantly on their own networks to source information and advice. These included sources such as business peers, professional advisers, industry bodies and other contacts such as clients and distributors. The most important source of advice from the public sector was New Zealand Trade and Enterprise (NZTE). Although the majority of our respondents were aware of the services offered by NZTE, most had not used them. In some cases this was due to a perception that they would be too small to meet NZTE's requirements (perhaps through the nature of target markets and ambitions). However, in some cases, notably growing companies with specific target overseas markets, the support and advice from NZTE had proved to be "significant" and important to their capability to exploit overseas markets.

We suggest that there is a "support gap" for small New Zealand-owned businesses that do not meet the criteria set by NZTE. In addition there seems to be a perception issue with such smaller firms on the value of such support. We suggest that a suitable mechanism be examined for such channels of advice and support, perhaps through the raising of awareness of the role of Regional Development Agencies and their network of advisers and mentors. This could be seen as additional 'light-touch' support for a specific type of exporter which usefully add to existing provision. The KEA network is already useful, some companies may be able to benefit through additional direction that could lead to additional utilisation to provide a source of trusted contacts that small companies need to enter overseas markets.

8. The New Zealand environment

Comments on New Zealand's business environment were positive, particularly on the regulatory environment. New Zealand's reputation was important in a number of areas, such as the 'clean and green' reputation. However, outside the agri-business sector, respondents considered that the reputation of their brand was ultimately more important than New Zealand's reputation. The importance of bio-security varied between different businesses, creating additional costs in some cases, but benefits in others. A more difficult area to pin down is New Zealand's perceived reputation overseas for innovative capacity, which, in the experience of some respondents, was perceived as being relatively low. However, in other areas where quality was important, such as engineering, New Zealand was considered to have a good reputation.

9. Observations on policy

Respondents' observations made on policy were largely related to developments in Free Trade Areas (FTAs). Respondents were asked if New Zealand's current bi-lateral and multi-regional trade agreements have influenced their international activities and future plans. If and how FTAs impact on a business depends on the nature of the product and the firms' competitive advantage. Such impacts on businesses are quite complex and sometimes ambivalent with positive and negative effects at the same time. Respondent comments were varied and depended on individual business circumstances.

High-value manufacturers, for example, were mostly unaffected by duties and tariffs and were therefore not facing any market entry issues *per se*. Instead they were facing other challenges such as finance, exchange rate or visibility in the market. Although they weren't currently affected, they were constantly monitoring the development of FTAs and considered them to be important for New Zealand in general. By contrast, low value manufacturers reported that FTAs were beneficial through the reduction of tariffs in overseas markets and would welcome continued pursuit of such policies. There was support for the continued pursuit of FTAs (with additional countries) with respondents recognising the benefits for general trading conditions in New Zealand.

Apart from the comments on FTAs, there were a small number of other observations that were concerned with policy. These were on visas and immigration policy and where relevant on the Overseas Investment Act (OIA). On the former, for the most part, obtaining visas for skilled labour migrants was not seen as an issue. On the latter, the OIA affected relatively few companies, but those that it did affect indicated that it is a process that they had to go through and it was not regarded as a major issue.

10. Future development

We also looked to the future in our discussions with New Zealand businesses. Respondents were also asked about their internationalisation plans for the next three years.

The predominant approach of entering new overseas markets for most of our respondents was a carefully managed staged approach that depended on the importance of initial contacts, networks and relationships. The envisaged future activity depended on which stage the business was currently at. According to the stages approach, or Uppsala model[11], firms start by serving their domestic market and move through distinct stages, until they are committed to serving geographically dispersed markets. This includes serving these markets via entry modes other than the exporting route e.g. subsidiaries. It has been typically suggested that entrepreneurial decisions often follow a systematic and sequential process commencing with a culturally similar country, e.g. New Zealand firms going to Australia to obtain experience in a country perceived as possessing a limited risk. Subsequently, decisions are taken to serve international markets that are seen as more culturally dissimilar and possessing more risk. For example, it has been suggested that this process develops on the basis of entrepreneurs gaining information and perceiving risk differently based on experiential learning. Entrepreneurs typically analyse the costs and risks of internationalisation while taking into account their own resources, especially regarding their knowledge when entering new markets. International market selection is an important component of the firm's internationalisation efforts. Not all markets have the same potential and so entrepreneurs need to consider where to expend their efforts and limited resources.

The interview data from our respondents indicate that the following factors are important in determining businesses' future internationalisation activities: similarity of language; culture and regulatory systems; existing networks and trusted relationships; ease of market access; physically-related issues such as freighting and distance; knowledge and familiarity with the market; the infrastructure in the overseas market and balancing market size with internal business capacity.

11. CONCLUDING COMMENTS

In a recent review of the previous evidence on New Zealand firm internationalisation, Scott-Kennel (2013, page 114)[12] comments that "[It] is characterised by plethora of case studies of small groups of individual, pairs or small groups of firms." This study, then, is the largest systematic research undertaken on internationalisation behaviour in New Zealand. The 98 case interviews illustrate the diversity of internationalisation activities across a range of manufacturing and service sector firms. We indicated earlier that we report cases of businesses that are successful internationally, operating in distant overseas markets, such as Europe and North America. Although there are differences in experience and intensity of export activity, it is possible to identify common, but indicative critical factors for internationalisation activity to be successful and maintained:

- Taking a long term view, with long term investment and commitment in time and resources in the overseas market
- Maintaining and building personal and social relationships and networks, especially for service sector firms
- Building networks based on trust-based relationships
- Having an entrepreneurial orientation that can drive internationalisation and/or the commitment of key personnel
- Having resources that provide dynamic capability of response and the absorptive capacity to learn from experience in overseas markets, recognising that disengagement may be a valid strategy as economic conditions change.
- An ability to respond flexibly and quickly to changing market conditions overseas, such as recessionary economic conditions.

[11] The interested reader is referred to a fuller discussion in our literature review In the Final Report Annex where a thematic framework for the findings is proposed.

[12] Scott-Kennel, J. (2013) "Models of internationalisation: the New Zealand experience", *International Journal of Business and Globalisation*, vol 10, no 2, pp 105-135.

- Identifying and recognising the basis for a comparative advantage, or a competitive edge, in overseas markets.

There is still a need for further research, in particular:

- Longitudinal research, perhaps following some of the case firms from our study over time, to gain a greater understanding of the dynamic nature of the internationalisation process and how this is influenced by firms' dynamic capabilities.
- Further research with firms involved with GVCs to increase our understanding of the complexity of global supply chains.
- Further research into aspects of both FDI and ODI to better understand the process, influences on flows of investment and, in particular, the behaviour of firms that are involved.