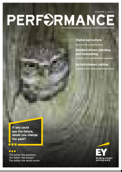

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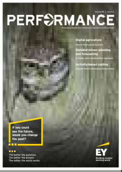
The emerging market expansion of Germany's Mittelstand

Germany's world-renowned Mittelstand companies play a crucial role in the country's economic success, and are the envy of other countries worldwide. But although Mittelstand companies are highly internationalized, many are yet to become active in emerging markets. As European markets become more saturated, and as emerging markets develop, Mittelstand companies are increasingly likely to be considering their options when it comes to overseas expansion.



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Germany is one of the most successful exporting nations on the planet. The country is the world's third-largest exporter, with only China and the US exporting more.[1] And Mittelstand companies play a hugely important role in Germany's economic success. They account for approximately 60% of all jobs in Germany and around 55% of Germany's GDP.[2] They also contribute an estimated 18% of the country's total export revenues.[3]

However, while Germany is a highly successful exporting nation, more than two-thirds of the country's exports go to either the US or to fellow European countries. In 2015, around 10% of Germany's exports went to the BRICS countries (Brazil, Russia, India, China and South Africa).[4] And while Mittelstand companies tend to operate on a highly internationalized basis, they are generally focused on Europe. As European markets become saturated, it is likely that growth for Mittelstand companies will be more likely found through emerging market opportunities.

1. *The World Factbook*, Central Intelligence Agency, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2078rank.html, accessed December 2016.
2. Bundesministerium für Wirtschaft und Energie (BMWi), 2014.
3. Institut für Mittelstandsforschung (IfM) Bonn, 2014.
4. Federal Statistical Office of Germany, 2016.

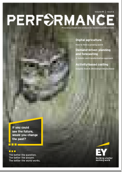

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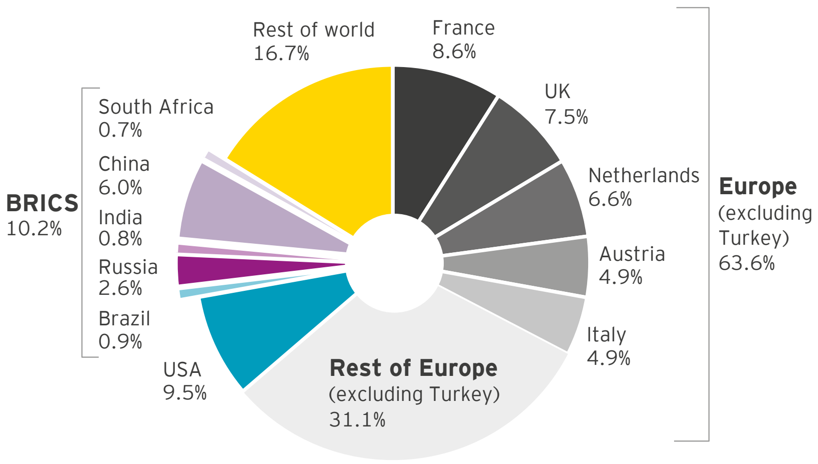
Figure 1. Destination countries of German exports in 2015



Source: Destatis, 2016.

Because they are often family-owned businesses, Mittelstand companies can have a tendency to follow personal reasons in their decision-making, rather than taking a more systematic approach.

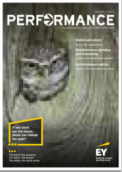
The emerging markets have evolved. And while their importance as sites for lower-cost production has reduced, their importance as potential markets for goods and services has increased. In particular, emerging markets are now major consumers of premium products. This will clearly make them of growing interest to the Mittelstand companies, whose "made in Germany" promise of quality is among their key selling points.

What is a Mittelstand company?

The German Mittelstand is largely made up of what elsewhere might be called midsized businesses. However, in Germany, the definition of what makes a Mittelstand company is about much more than just size. Companies large and small may be considered to be part of the Mittelstand if they have some of the values and cultural traits for which Mittelstand companies are renowned.

Mittelstand companies tend to be:

- Highly focused manufacturing firms that specialize in a single field
- Family owned – and even those that are not tend to show the same family business-like traits, with a focus on long-term sustainability and on stable customer and employee relationships
- Strongly connected to their home region



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What can we learn from Mittelstand companies already in emerging markets?

Expanding into a new and unfamiliar market represents a number of serious challenges, and requires careful planning, preparation and execution. To find out how Mittelstand companies can make a success of emerging market expansion, we conducted a survey of 60 Mittelstand companies that are already active in emerging markets. We sought to discover what drove them to consider emerging market expansion and what lessons could be learned from their experiences.

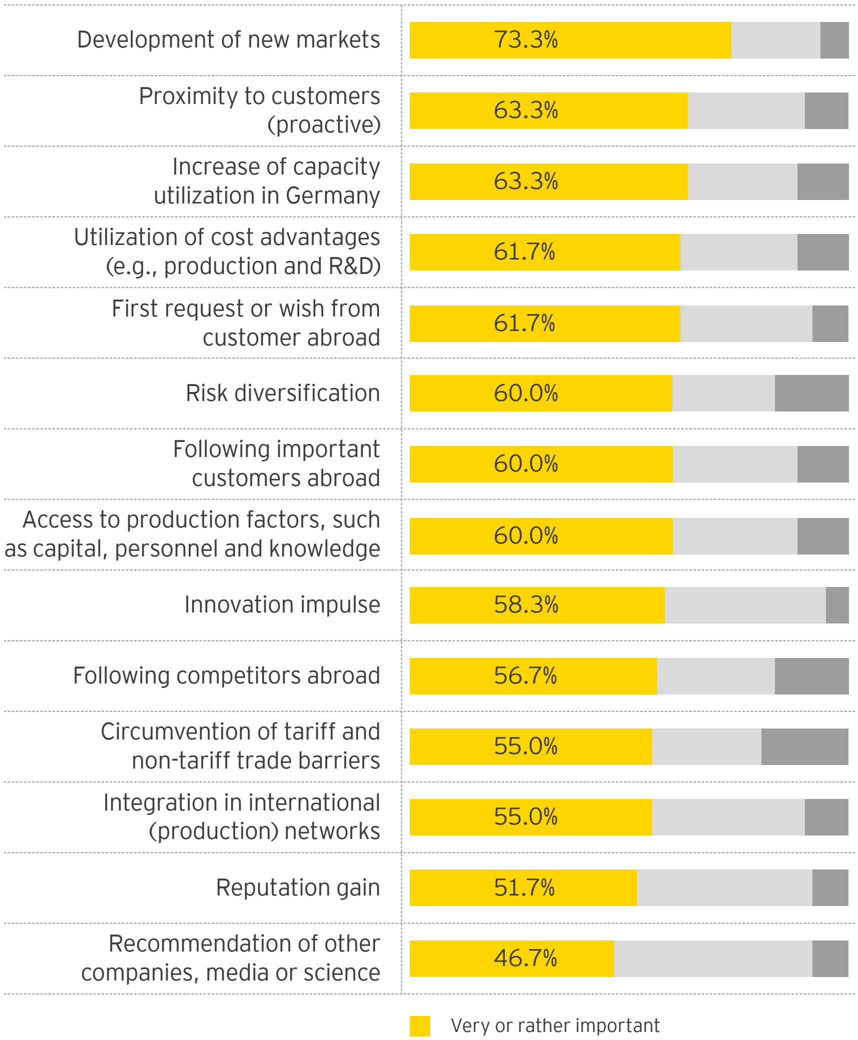
While there are many different definitions of what makes a Mittelstand company, our survey focused specifically on businesses with annual revenues of between €10m and €1b. And 63% of the businesses we talked to were family owned.

What these companies told us will not only be of interest to other Mittelstand companies but also to small and midsized companies from across the globe. And those in the emerging markets themselves may also be able to find insights into how to attract these successful, long-term-focused companies.

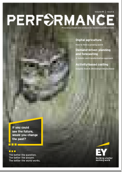
What are the emerging market opportunities?

Our survey revealed that for Mittelstand companies, the emerging markets primarily represent a new opportunity to sell their products. The desire to carry out manufacturing and other processes at lower cost is very much a secondary

Figure 2. How important were the following motives when expanding into emerging markets?



Source: *Mittelstandsbarometer Deutschland und Europa*, EY, 2015.



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consideration. When asked to state the importance of different motives for their emerging market expansion, 73% of the Mittelstand companies we surveyed said that the development of new markets was an important factor – the highest figure for any such answer. In comparison, 63% pointed to cost advantages, such as those for production or R&D, as important.

The companies we talked to expressed a number of different reasons why their interest in new markets led to overseas expansion. Important factors included the demand of customers in the market itself for such an expansion (listed as an important factor by 61.7%), government regulations and tariffs (55%) and the company's own wish to be closer to customers (63.3%).

Where are the opportunities?

Whenever a company embarks on international expansion, picking the right market is of crucial importance. To find out which of the emerging markets the Mittelstand companies see as most favorable for expansion, we asked them to rate a selection of emerging markets on three core attributes.

As can be seen from Table 1, some countries – such as Saudi Arabia, China and Poland – score comparatively highly across all three categories. However, because they are often family-owned businesses, Mittelstand companies can have a tendency to follow personal reasons in their decision-making, rather than taking a more systematic approach. This means that they tend to favor emerging markets they already know something about, and are less interested in lesser-known markets.

What are the challenges of emerging market expansion?

When asked what difficulties they faced in their emerging market activities, our survey respondents pointed to the challenges involved in searching for local business partners, in finding qualified personnel and in adapting products to local market needs. Other key challenges included dealing with different cultures and overcoming the language barrier.

This shows that, despite their high-level of international integration – particularly within Europe – Mittelstand companies cannot afford to underestimate the research, preparation and effort required for a business venture to succeed in a new and very different market.

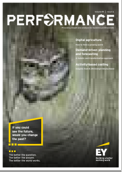

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Table 1. How Mittelstand companies rate emerging markets on key attributes

Rating of the economic situation and sales potential

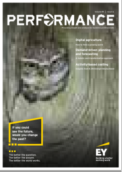
	Very good or good
Saudi Arabia	55.9%
China	54.2%
Poland	51.1%
India	46.4%
Turkey	45.2%
Malaysia	43.3%
Mexico	39.4%
Brazil	39.2%
Indonesia	33.3%
Thailand	33.3%
Argentina	32.4%
Egypt	31.3%
South Africa	30.6%
Russia	29.2%
Vietnam	29.2%
Colombia	27.6%
Bangladesh	25.0%
Iran	23.3%
Nigeria	20.8%
Philippines	20.0%
Pakistan	16.7%

Rating of the legal and tax framework

	Very good or good
Saudi Arabia	55.9%
Turkey	54.8%
South Africa	50.0%
China	47.9%
Malaysia	46.7%
Poland	46.7%
Thailand	41.7%
Mexico	39.4%
Vietnam	37.5%
India	34.2%
Indonesia	33.3%
Argentina	32.4%
Brazil	31.4%
Iran	30.0%
Russia	29.2%
Egypt	25.0%
Colombia	24.1%
Philippines	24.0%
Bangladesh	21.4%
Pakistan	20.8%
Nigeria	20.8%

Very good or good

Source: *Mittelstandsbarometer Deutschland und Europa*, EY, 2015.



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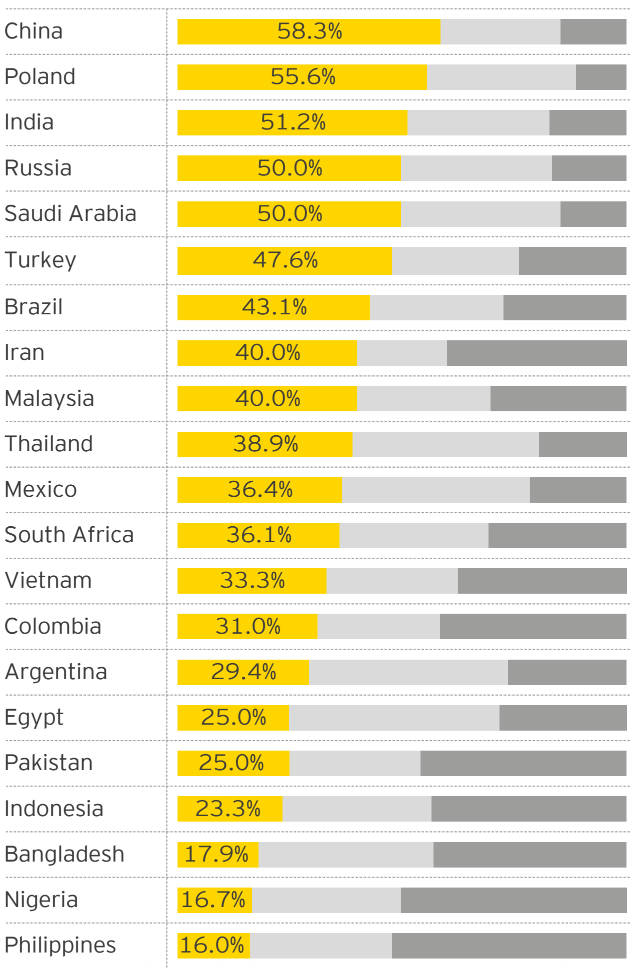
Rating of the educational and skill level



When companies were asked how the risks involved in their expansion could best have been mitigated, the most common answer was by training the company's own personnel.

How to reduce the risks

When we asked the companies how the risks involved in their expansion could best have been mitigated, the most common answer was by training the company's own personnel (selected by 66.7%). This highlights the difficulties of operating across borders and across cultures. And it shows how important it is to have people with the necessary expertise – something that can also be achieved through the recruitment of qualified personnel (a potential way of mitigating risk selected by 55%) if it cannot be attained internally.

The two next most popular suggestions for ways to reduce risk were by establishing local contacts prior to the expansion (60%) and by establishing cooperation with a local partner (58.3%). These responses both highlight the importance of local experience and expertise in international expansion.

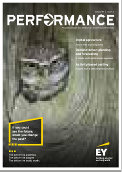


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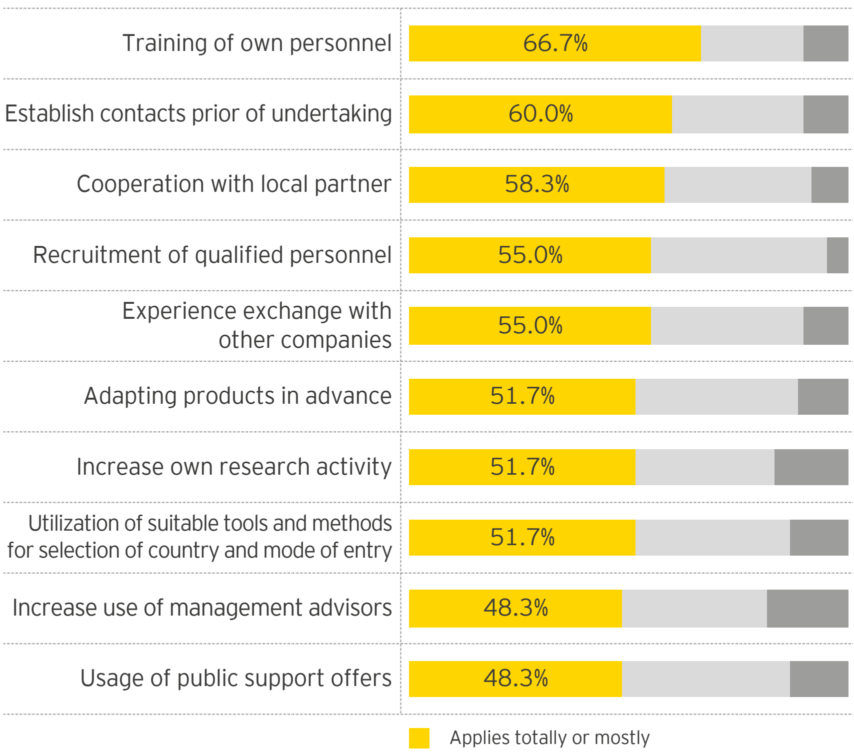
Figure 3. How could risks have been reduced when expanding into emerging markets?



Source: *Mittelstandsbarometer Deutschland und Europa*, EY, 2015.

Where external support could have been most helpful

When asked where external support could have helped in their preparations for emerging market expansion, our survey respondents most frequently identified the following areas:

- Marketing and sales – suggested by 63.3% of respondents
- Search for a partner or first contact – 63.3%
- Selection of target countries – 61.7%
- Search for acquisition targets – 61.7%

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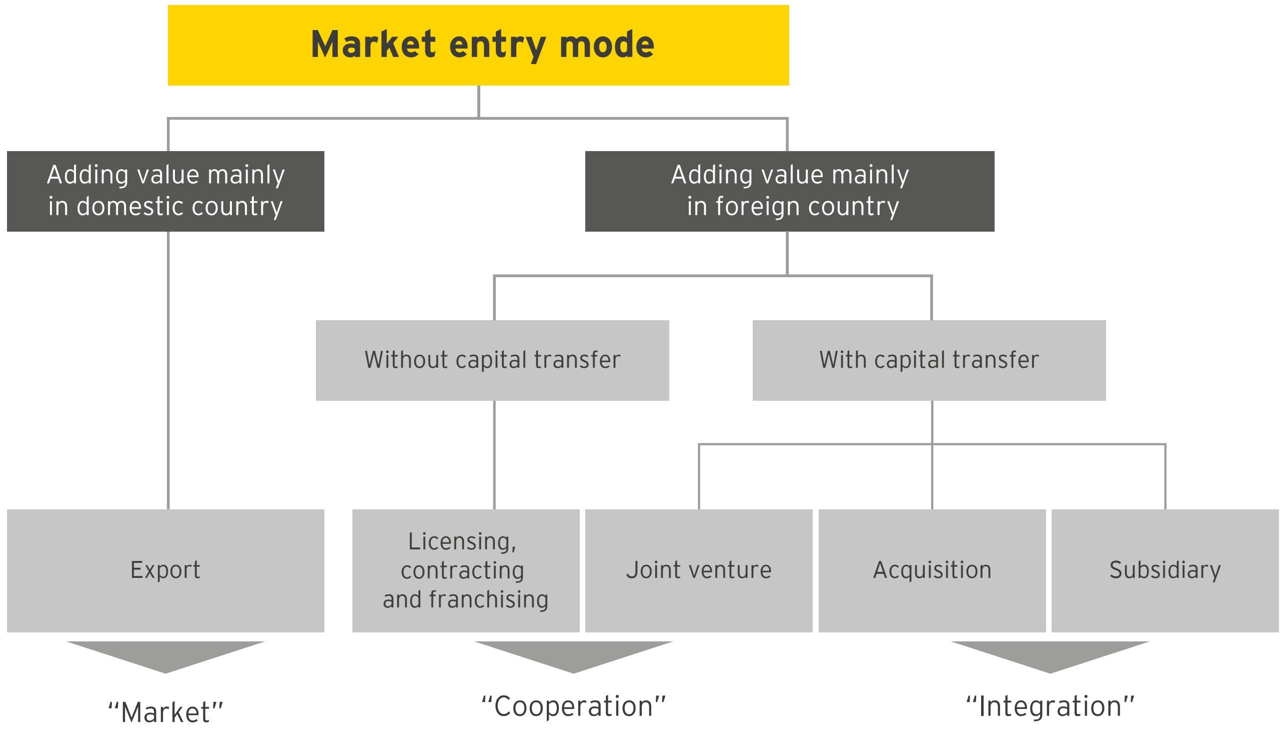
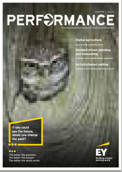
Figure 4. Classification of market entry strategies





A systematic approach to emerging market expansion

To help companies considering an emerging market expansion, we have suggested three key areas where companies need to fully research and then systematically assess their options.

Key considerations when choosing a market

The process of market selection is difficult not only because of the very high number of possible markets, but also because reliable information on them can be expensive and difficult to obtain. This makes it likely that lesser-known countries, which may offer great opportunities, get rejected too early in the selection process.

When going through the process of selecting an emerging market for expansion, companies need to focus on finding the market that has the most potential and that will provide the best fit for the company's strategy. To make sure that markets are not rejected for the wrong reasons, and to ensure that lesser-known markets are considered fully, we would strongly advise companies to take a systematic approach to their market selection process.

Possible stages for a systematic approach to market selection

When selecting a country, it may be worth first considering whether a particular trading bloc – such as the Economic Community of West African States (ECOWAS) – offers the right opportunity. And it should be borne in mind that if a large, diverse country, such as India, is selected, then a particular region within that country will then need to be chosen.

Key considerations when deciding the timing of market entry

When deciding which emerging market to enter, it is important for companies to think about the maturity of the market for their particular offering. How mature that market is will determine many of the challenges they will face.

By the timing of their market entry, companies are divided into three main groups:

- **Pioneers**

  Businesses may wish to choose a market in which they will be the first to offer a particular product or service. They will have to develop the market themselves and generate market demand for their offering. But they will have the advantage, initially at least, of operating without competition.

- **Early followers**

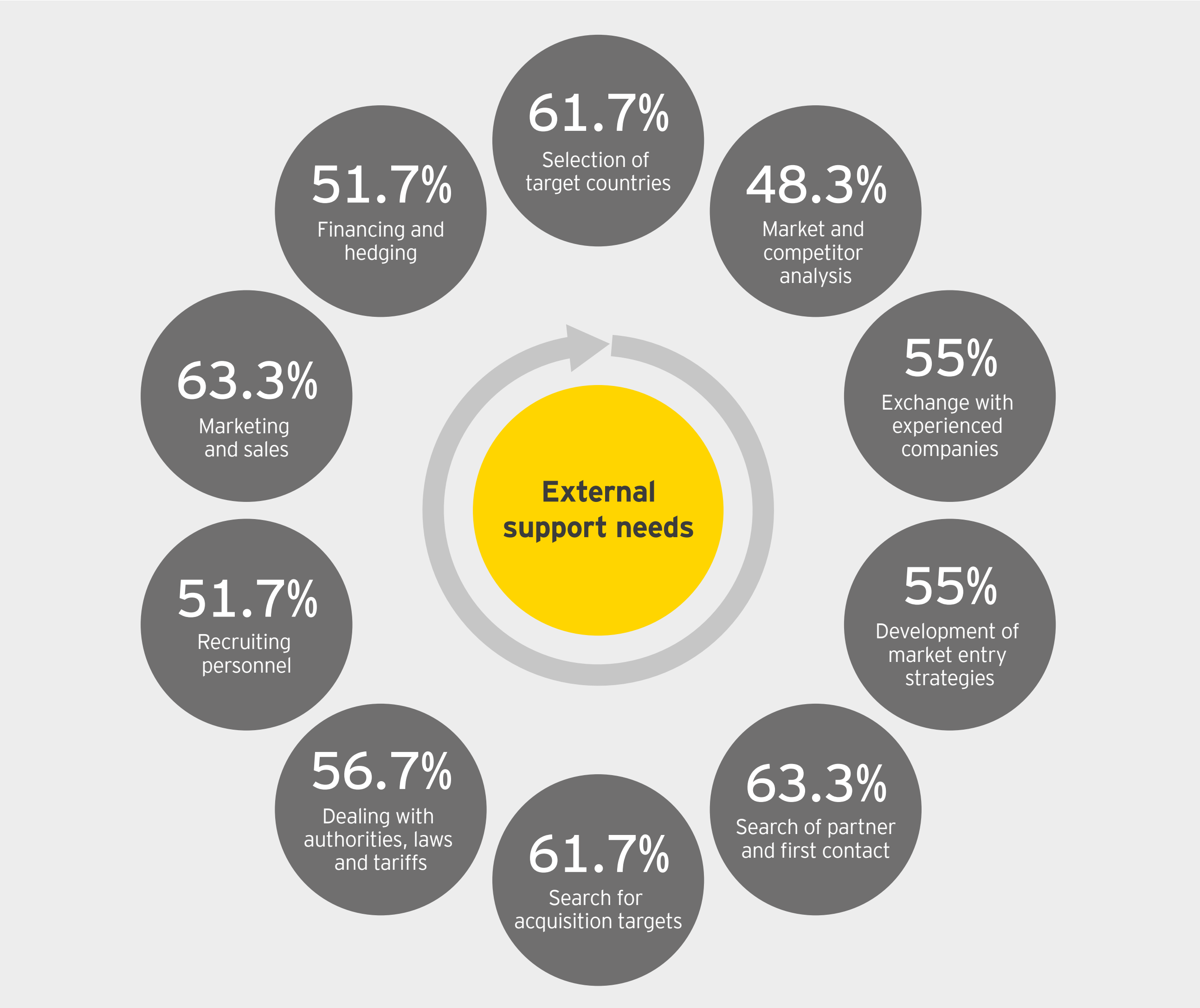
  For those businesses that time their entry shortly after the pioneer, the challenge is to establish a strong market position quickly. Despite facing at least some competition, they enter a market that has already shown demand for their type of offering. If the pioneer has failed to establish a strong position, early followers can soon become market leaders.

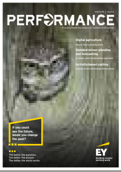
- **Late followers**

  For businesses that choose to enter a market that already has multiple entrants and is growing strongly, the relatively high level of competition will present a challenge. But later entrants can take a more market-oriented approach (tailoring their products to a pre-existing market), and can learn lessons from – and capitalize on the mistakes of – earlier entrants.

The process of market selection is difficult not only because of the very high number of possible markets, but also because reliable information on them can be expensive and difficult to obtain.

Figure 5. When preparing to expand into emerging markets, in which areas would external support have been helpful?





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Businesses that have limited overseas experience often fail to understand the full range of market entry strategies available to them.

Key considerations when selecting a strategy

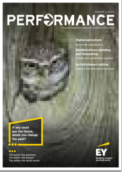
Businesses that have limited overseas experience often fail to understand the full range of market entry strategies available to them. This is an area that is worth investigating and analyzing thoroughly, because the market entry strategy will play a major role in determining the success or failure of any overseas expansion. And changing entry mode, once the decision has been made and implemented, can be very costly and time consuming.

Each different market entry mode carries its own benefits and drawbacks, for example:

- Businesses that choose to **export** can carry out their expansion relatively quickly and easily, but may be more vulnerable to political risks and trade barriers.
- **Licensing, contracting and franchising** all offer businesses a way to expand quickly into an emerging market and to circumvent trade barriers. But they carry the risk that key knowledge will be transferred, so encouraging the creation of local competitors.
- The formation of a **joint venture** (JV) is something that is often requested by host governments, and it may be more to the advantage of the local government than the expanding business. But JVs can help businesses to benefit from a local partner's knowledge, network and reputation.
- Making an **acquisition** can allow businesses to expand rapidly in their target market, and can offer a relatively short payback time. However, finding the right target can be difficult.
- Businesses that establish a **subsidiary** can enjoy the lower production costs available in emerging markets, but they will be subject to a range of political risks and a relatively long payback period.

An international opportunity

As can be seen from the responses of the Mittelstand companies themselves, it is vital for companies expanding abroad not to underestimate either the challenges involved or the research and preparation required. But for those that systematically assess their options, make careful decisions, and establish the right connections, there are expansion opportunities available all around the globe. ■



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