



BDC'S ENTREPRENEURIAL INSIGHT

Spring 2009



GOING INTERNATIONAL? INSIGHTS FROM SMEs

To help Canadian businesses understand the profile of internationalized small and medium-sized enterprises (SMEs), BDC surveyed¹ a group of SMEs active at the international level or seriously considering expansion beyond Canada.

- The potential for getting engaged in global value chains (GVCs) clearly exists in all industrial sectors.
- A clear, distinctive trait of the SMEs surveyed is that fragmentation of production takes place to help them focus on core value-added activities.
- SMEs understand the need to make strategic and operational changes in order to internationalize.
- SMEs work their way through GVCs steadily by carefully choosing their international partners, building on experience to get more deeply involved over time.

Some prerequisites apply

- A solid understanding of the structure of the value chains of the industry — from design to production and from marketing to distribution — is key.
- SMEs need to have a clear understanding of their competitive advantage within the value chain.
- A managerial culture favouring research and development (R&D), innovation and training is also a fundamental aspect of engaging in GVCs.
- Compliance costs need to be considered.

Successful SMEs focus on one of four key strategies when deciding to conduct business at the international level.

- A supply chain strategy
- An R&D strategy
- A manufacturing strategy
- A sales and marketing strategy

¹ The survey was posted on BDC's website during the months of June and July 2008, and a total of 466 firms participated voluntarily. The survey is considered accurate within a range of $\pm 4.5\%$, 19 times out of 20.



WHAT IS AN INTERNATIONALIZED FIRM?

For an SME to qualify as internationalized involves more dimensions than most believe. The perception is that an internationalized firm has to export its products or services outside Canada. The reality is far more inclusive. An internationalized firm refines its competitive edge, breaking down its supply chain, importing inputs, investing in plants and equipment abroad, encouraging investment by foreigners in its own operations, selling to domestic firms that are export-oriented and, finally, possibly exporting its products or services directly abroad. This explains why the term *global value chains* is regularly used to describe trade dynamics at the broader level. Therefore, SMEs become internationalized when deciding to get involved in these GVCs.

This is a strategy that can lead to significant benefits. By fragmenting production, sourcing some activities outside the firm and focusing its actions where most of the value is created, a company can deploy resources more effectively, which contributes to improving its

competitive edge in the marketplace. Markets are changing rapidly with growing opportunities stemming from fast-developing regions such as Asia, Brazil and Russia. Tapping into these markets directly or indirectly is one avenue that can help SMEs deal with a volatile exchange rate and rising competition from these same regions.

Companies have engaged in internationalization for many years. Recently, this trend has accelerated due to low trade barriers, lower transportation and communication costs, and broader economic diversity, including players from low-wage and developing countries. As a result, significant opportunities exist for Canadian SMEs, and understanding these dynamics is imperative. To remain competitive, firms need a strategy around GVCs. Getting involved is not mandatory but having a proactive strategy about being in or out of GVCs is critical.

SMEs become internationalized when deciding to get involved in GVCs



REASONS TO INTERNATIONALIZE

Evidence suggests that SMEs that decide to engage in GVCs benefit from this strategy. A 2007 Organisation for Economic Co-operation and Development (OECD) study² including case studies in five industrial sectors among 20 countries indicates the following.

- Being part of GVCs improves SMEs' international presence and growth.
- SMEs can secure their position in the marketplace in specialized and niche markets as they become conscious of their competitive strengths, often associated with their flexibility and the quality of their products and services.
- Outsourcing of non-core activities allows them to focus on the activities they are best at, which in turn improves competitiveness.
- SMEs become more efficient as a result of the information flow that helps them improve technology and learn from the experience of other partnering firms.

In other words, companies that decide to get involved in GVCs become more productive because they focus on core activities creating value. This translates into better profitability and a more stable business environment due to a wider client base. Also, innovation takes place more easily due to access to information resulting from state-of-the-art technology flowing more efficiently. Finally, a better knowledge of the competitive landscape helps firms differentiate their products and address needs of niche markets.

However, some prerequisites are required for companies to become involved in GVCs. First, a solid understanding of the structure of the value chains of the industry is key. Understanding the dynamics of the value chains — from design to production and from marketing to distribution — can be challenging in certain industries. For example, it is typically easier to grasp this dynamic in manufacturing industries than in service industries such as tourism. Second, SMEs need to have a clear understanding of their competitive advantage within the value chain. Again, this can be a challenge, given the rapid pace of change in the global marketplace. It requires time and effort that companies must be willing to invest. Third, a managerial culture favouring R&D, innovation and training is a fundamental aspect of SMEs engaging in GVCs. Changing and more complex tasks typically characterize the way firms conduct their business in GVCs. Finally, costs of complying with various standard requirements from contractors need to be planned for at the outset. In some instances, involvement in GVCs can force companies to fulfill private standards and be transparent about aspects of their business operations beyond levels typically found in their domestic market.

SMEs that decide to engage in GVCs benefit from this strategy



² Organisation for Economic Co-operation and Development, *Enhancing the Role of SMEs in Global Value Chains*.



CHARACTERISTICS OF INTERNATIONALIZED SMEs

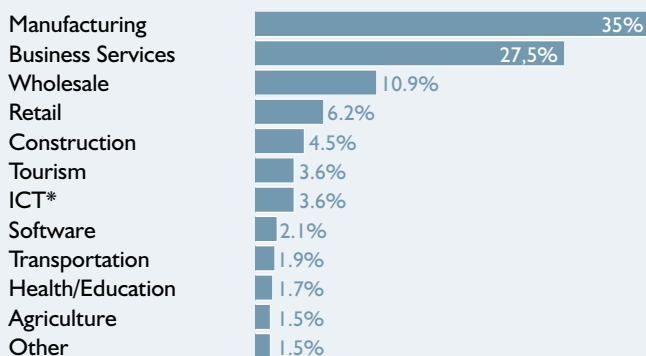
Despite the increasingly important role of international trade as a driver of economic development, only a small proportion of Canada's SMEs are internationally active. Research shows that about only eight percent of Canadian SMEs export their products and services.³ SMEs employing fewer than 50 employees account for roughly three quarters of all exporting establishments while making up only about a third of the total value of exports. Conversely, a minority of exporting establishments (six percent) that employ more than 200 people account for over 40 percent of the total value of exports. While the bulk of Canada's exports is clearly concentrated in the hands of a few larger firms, it remains key to understand the broader question of how Canadian SMEs engage in GVCs.

To help Canadian businesses picture an internationalized SME, BDC surveyed⁴ a group of SMEs active at the international level or seriously considering expansion beyond Canada. The survey included respondents from most industrial sectors (Chart 1). The profile of respondents represented a good image of Canadian SMEs in terms of size and region. Despite the high concentration of firms in manufacturing and business services industries, it is important to highlight the fact that internationalized SMEs are not limited to these areas. The potential for getting engaged in GVCs clearly exists in all industrial sectors.

The other striking characteristic is that Canadian SMEs in that group are deeply engaged in GVCs (Table 1). About a quarter of their sales come from exports, while imports are also extremely important, representing 15 percent of sales. Another sign of strong engagement in GVCs stems from the fact that over a quarter of imports are used to produce goods or services for foreign markets. Therefore, a clear, distinctive trait of these SMEs is that fragmentation of production takes place to help them focus on core value-added activities.

Chart 1: Good Industry Diversification

Respondents, by industry (percentage)



Source: Business Development Bank of Canada, 2008.

*Information and Communications Technologies.

Table 1: Canadian SMEs Are Deeply Engaged in GVCs

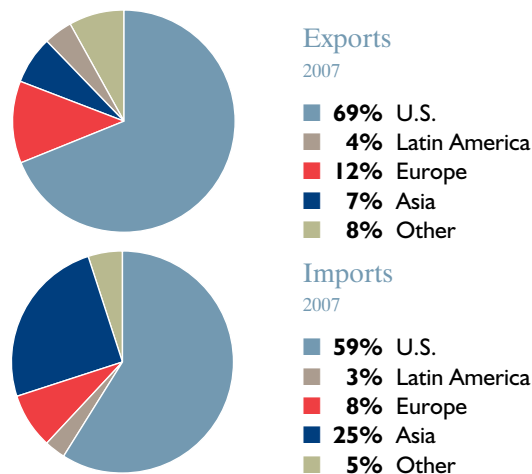
Average value of exports, 2007 as % of sales	\$2.9M 24%
Average value of imports, 2007 as % of sales	\$2.1M 15%
Share of the company's imports used to produce other goods or services	62%
Share of the company's imports used to produce other goods or services for a foreign market	28%
Share of the company working with a foreign supplier	60%
Average value of the company's total sales in 2007	\$4.7M

Source: Business Development Bank of Canada, 2008.

Chart 2 illustrates that while the U.S. remains an important trading partner, Asia has become crucial as a source of imports but remains less important on the export front. It is important to underline that these SME figures are consistent with total trade statistics of the Canadian economy including larger companies. Other studies also confirm companies' engagement in GVCs in Asia. For example, a recent study by The Conference Board of Canada⁵ suggests that "Canadian companies ... appear increasingly to be using Asian inputs, such as machinery parts, to make Canadian supply chains more competitive." Again, this reveals that GVCs are used to help Canadian firms keep their competitive position in the marketplace.

Chart 2: Europe and Asia Are Key Trading Partners

Share of trade, by region (percentage)



Source: Business Development Bank of Canada, 2008.

Top business decisions (Table 2) made by Canadian SMEs in GVCs are consistent with research conducted in other countries. Penetration of niche markets, new business development, improvements to products and services themselves or to delivery processes, and better marketing strategies illustrate that SMEs understand the need to make strategic and operational changes to operate as an internationalized company.

Underscoring these results is that SMEs understand that they can adopt a step-by-step strategy to get engaged in GVCs. It is clearly not an “all or nothing” option open to large companies only. Evidence suggests that SMEs will work their way through GVCs steadily by carefully choosing their international partners such as suppliers, distributors and clients, building on experience to get more deeply involved over time.

Foreign investments are another key dimension of GVCs and Canadian SMEs are taking advantage of this avenue to improve their competitive position. The number of Canadian SMEs that have relocated some operations is about a fifth of all respondents. These companies moved some of their business operations, mainly to focus on core business, introduce a new product, improve quality, reduce labour costs or gain access to new markets. Lower barriers to capital flows have contributed to important growth in foreign direct investments via greenfield investments or mergers and acquisitions in recent years. This component of GVCs is a fundamental tool helping SMEs adapt to increasing international competitive pressures.

Table 2: Canadian SMEs Make Clear Choices When Engaging in GVCs

Top changes made in the last five years (percentage of respondents)

Developed niche products/services	60%
Improved product/service quality	59%
Increased/improved marketing activities	59%
Undertook new business activities	53%
Responded with shorter lead times	52%
Enhanced product design and features	50%

Source: Business Development Bank of Canada, 2008.



³ Orser et al., *Canadian SME Exporters*.

⁴ The survey was posted on BDC’s website during the months of June and July 2008, and a total of 466 firms participated voluntarily. The survey is considered accurate within a range of $\pm 4.5\%$, 19 times out of 20.

⁵ Goldfarb et al., *Stuck in Neutral*.



BDC'S ENTREPRENEURIAL INSIGHT

BDC CAN HELP

BDC identified four key strategies that successful SMEs focus on when deciding to conduct business at the international level.

A SUPPLY CHAIN STRATEGY where a company imports inputs at lower costs while holding prices firm, thus improving margins, or where it develops capabilities such as short runs, customization and just-in-time delivery that allow it to become one of the links in the supply chains of multinational corporations.

A RESEARCH AND DEVELOPMENT (R&D) STRATEGY where a company develops a business culture that supports innovation while precisely understanding its competitive advantage in the market. The focus will typically be on a product or service not easily replicable, aimed at specific clients in niche markets. The use of R&D tax credit programs is a key tool to help companies adopt this strategy. On this front, Canada ranks first among 22 OECD countries in terms of the best tax incentives per dollar spent on R&D.

A MANUFACTURING STRATEGY where a company reduces its unit cost through economies of scale, access to lower wage labour and payment in foreign currency. This type of strategy can take several forms.

- Production in Canada, using state-of-the-art manufacturing technologies and methods
- A move of production outside Canada to be closer to global customers
- A move of plant(s) outside Canada to decrease costs and improve competitiveness
- A move of plant(s) to preserve proximity to major customers that are moving abroad

A SALES AND MARKETING STRATEGY where a company aims to be recognized in the market, typically by selling high-end products or services aimed at select clients. Thereafter, various avenues can be adopted to enhance a company's presence and protect its market, including the following.

- License brands or technologies to independent foreign companies
- Build trust in business relationships via a domestic sales force travelling to foreign markets or hire a sales force in a foreign market while producing in Canada
- Produce in a foreign country and hire a domestic sales force on location or partner with a foreign distributor

Over the years, BDC has found that the most successful SMEs typically use at least one of these four strategies when deciding to become internationalized. In some instances, companies might move on to other strategies, or even develop others simultaneously, but the lead strategy usually represents the core strength of the company. It acts as a reference point in an unfamiliar environment.

The recent BDC survey also revealed that for the vast majority of firms, access to financing can hamper their plans. Research⁶ confirms that this is a real obstacle, since SMEs at their early exporting stage are more than four times as likely to have applications for operating loans denied than are established firms. In addition, early-stage exporters are more than twice as likely to have applications for operating loans rejected than are early-stage companies that do not export. BDC can help these firms access financing.

BDC can help firms access financing



⁶ Riding et al., *Minding the Gap*.

A RISK/REWARD ASSESSMENT IS CRUCIAL

Experience suggests that the decision to become an international player is made one step at a time. Engaging in the internationalization process, given the current climate of economic uncertainty, may appear a difficult task to undertake. Alternatively, this period of uncertainty can be employed as a first step to plan for the next phase of growth, since globalization will always remain a driving market force. Resources need to be allocated to decide which plan is the most appropriate for the firm, since important questions such as access to financing, customer and supplier relationship management from a distance, and fiscal implications have to be sorted out beforehand. Many factors will influence the planning process, such as the following.

- The degree of competition from foreign companies operating domestically and from the local industry cluster
- The niche market to be served, its relative growth phase and the degree of competition in the international market contemplated
- The innovative capacity of the firm relative to its competitors
- The participation of foreigners as part of the management team or as owners
- The business network of the management team, its international experience and perceptions of internationalization

Clearly, a risk/reward assessment based on these factors may indicate that becoming internationalized is not appropriate for everyone. However, all firms need to recognize the importance of making an informed decision about their business strategies to face this reality.

A volatile currency market and fast-emerging players from non-traditional trading countries such as China, India, Bangladesh, Vietnam, Brazil and Russia require reflection that could lead to tremendous opportunities. Ultimately, identifying a competitive advantage and adapting the business model accordingly are key to ensuring the long-term prosperity of Canadian SMEs.

SMEs must identify their competitive advantage



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CONTRIBUTORS

Jérôme Nycz

Vice President, Strategy and Planning

Karen Kastner

Director, Corporate Planning and Strategy Management

Sylvie Ratté

Senior Economist, Strategy and Planning

Susan Hughes

Manager, Public Policy and Legislative Review

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