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Main motive for SMEs to invest abroad is to expand into new sales markets

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The debate around Germany's future viability as a business location has gained intensity with the energy crisis and is fuelling concerns of growing deindustrialisation. An analysis of SMEs' foreign investment conducted on the basis of the representative KfW SME Panel 2023 revealed that companies still have little desire to relocate business activities abroad. During the 2019–2022 period, only just 1.7% of all small and medium-sized enterprises invested abroad. At around 65,000 companies, that was only around half as many as before the COVID-19 crisis. Most importantly, only 3.8% of all SMEs plan to invest abroad in the coming years as well – and primarily to expand into new sales markets. This likely also involves seizing opportunities for growth presented by the green transformation, which is leading to growing demand for climate technologies and greenhouse gas-neutral products around the world. Thus, companies that intend to further expand their offerings of green products in the future are three times more likely to plan foreign investments than others. However, significantly fewer businesses see lower taxes, less regulation, lower labour costs or a better supply of skilled labour as a decisive reason to invest abroad. Electricity and gas prices also play a comparatively minor role in the decision to invest outside the national border. Europe continues to be the main investment destination, although there has been a significant shift from western and northern Europe towards eastern Europe. Outside Europe, the US has become more attractive while only a very small portion of businesses see China as a worthwhile investment destination. Even if a sharp rise in SMEs' foreign investment and an increasing relocation of small and medium-sized businesses should hardly be expected, Germany's competitiveness as a business location has come under increasing pressure and must urgently be addressed.

Energy crisis is fuelling fears of a deindustrialisation of Germany

Ever since energy prices rose as a result of Russia's war of aggression on Ukraine, a new debate has erupted around Germany's future viability as a business location. However, the KfW Internationalisation Report 2023 has revealed that SMEs are far from regarding energy costs as the main risk to their future international competitiveness. What they are most concerned about is bureaucracy, taxes and levies as well as environmental and climate regulations. Manufacturers in particular are experiencing labour shortages as a growing problem.[1] Moreover, countries such as the US have created incentives for investments from abroad with state subsidy programmes such as the Inflation Reduction Act. This is fuelling concerns over an exodus of German businesses and growing deindustrialisation of the country, which is being associated with a loss of prosperity and growth.[2]

However, an analysis of foreign investment by SMEs as part of the representative KfW SME Panel 2023 does not suggest that locations are increasingly being moved abroad. During the 2019–2022 period, significantly fewer small and medium-sized enterprises invested abroad than before the COVID-19 pandemic. Most importantly, however, only 3.8% of all SMEs plan to invest abroad in the coming years as well – and primarily to open up new sales markets. Past studies have shown that foreign investment usually goes hand-in-hand with domestic investment instead of replacing it. This applies in particular to foreign investment aimed at tapping into new markets and expanding the distribution network.[3]

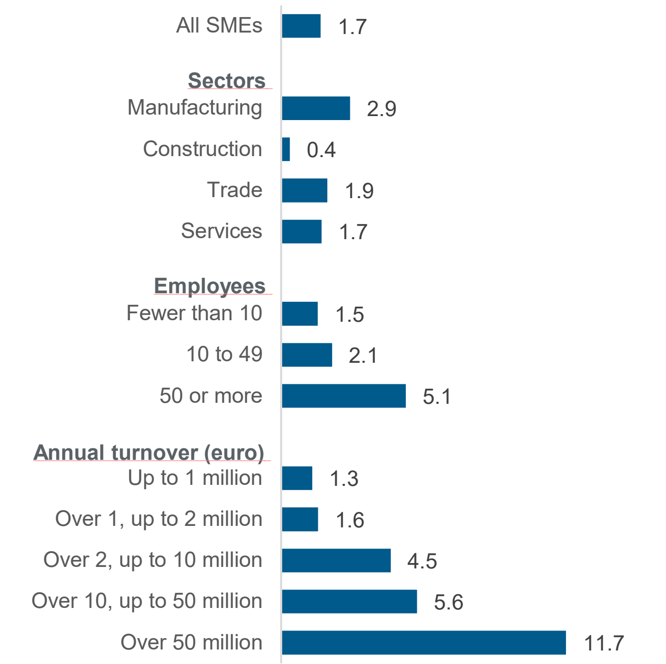
SMEs' appetite for foreign investment declined during the pandemic

In the 2019–2022 period, only around 1.7% of all SMEs invested abroad, which represents around 65,000 of the 3.81 million SMEs in Germany (Figure 1). That means the already low share of small and medium-sized enterprises with cross-border investments fell again during the COVID-19 crisis. During the 2012–2015 period, that share was still around 3.5%. In other words, the number of businesses that undertook foreign investments was twice as high, at nearly 130,000.[4] Foreign investment comprises, among other things, the establishment, expansion or modernisation of an own production or distribution facility outside the country or a participation of at least 10% in foreign enterprises. It does not include the acquisition of purely financial assets such as bonds or shares. Foreign investment therefore should be interpreted as an expression of long-term, strategically oriented corporate decisions and not so much as the result of investment decisions with a short-term horizon.

The volume of SMEs' foreign investment during the 2019–2022 period can be estimated at EUR 10 to 15 billion and is thus on a similar scale as it was in 2012–2015 – despite a lower number of investors. This means the average investment budget has grown considerably since the period before the COVID-19 crisis.[5] Compared with the total foreign direct investment made by all German businesses, which amounted to around EUR 196 billion in 2022 alone[6], SMEs' foreign investment volume remains low. It also continues to play a minor role compared with SMEs' overall investment volume – around EUR 754 billion in the 2019–2022 period.

Figure 1: Share of SMEs with foreign investment in the 2019–2022 period

By sector and size class, in per cent.



Note: Foreign investment includes, for example, the establishment, expansion or modernisation of a company's own production or distribution facility outside the country. It also includes acquiring an interest of at least 10% in an enterprise abroad. Employees in full-time equivalents. Extrapolated on the basis of the number of enterprises.

Source: KfW SME Panel 2023

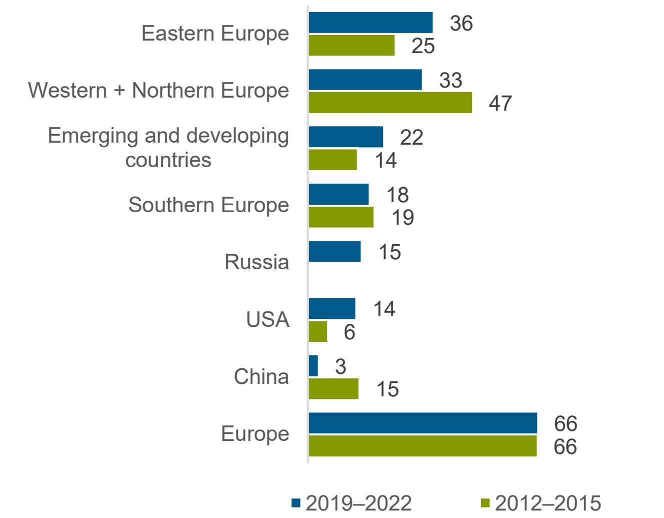
Only larger SMEs with an annual turnover in excess of EUR 50 million carry out foreign investments more often. More than one in ten of them made cross-border investments during the 2019–2022 period. This is mostly due to the enormous human and financial resources required by such investments. It is generally not worthwhile for companies that generate only limited production and sales quantities to distribute them across multiple locations. As a result, large enterprises remain the key drivers of cross-border investment activity. As is the case for SMEs, firms that invest abroad are most likely to be manufacturers.

Europe remains the most important target region of SMEs' foreign investment

Around two thirds of all small and medium-sized enterprises that invested abroad in the 2019–2022 period invested in Europe (Figure 2). Thus, Europe remains the most important target region for cross-border investment by German SMEs. However, shifts have occurred within Europe compared with the 2012–2015 period.[7] Eastern Europe continued to gain in importance as an investment destination for SMEs. Around one in three SMEs that invested abroad did so in Eastern Europe. That was 11 percentage points more than in the four-year period of 2012–2015. Poland, in particular, with its growing transport infrastructure, abundant supply of highly qualified skilled workers and dense network of suppliers has evolved to become an attractive production location directly bordering on Germany. But Poland still has some catching up to do in making renewable energy available, which plays a role for a growing number of businesses that measure their carbon footprint. Still, this can also create good investment opportunities for foreign companies that manufacture heat pumps, wind turbines or electric vans there, for example.[8] Western and northern Europe, on the other hand, has become less attractive as an investment destination. Only one in three SMEs with cross-border investments has been active here, while in the past it used to be around half. Not least, this can likely be traced to Brexit, which was completed in early 2020. Planning and legal uncertainties have led to a retreat of many European businesses from the United Kingdom and to a slump in foreign direct investment in the country that used to be the preferred investment destination in the EU.[9] Southern Europe remains the destination for around one in five foreign investors.

Figure 2: Target regions of SMEs' foreign investment

Share of all SMEs with foreign investment that invested in the respective target region in the 2019–2022 period, in per cent.



Note: Multiple responses were possible. Europe comprises the target regions of eastern, western, northern and southern Europe.

Source: KfW SME Panel 2023

China is becoming less attractive as an investment destination

Also worth noting is China's lower importance as an investment destination for SMEs. Just barely 3% of all SMEs that invest abroad have established or modernised production or distribution locations in the country or acquired a participation in Chinese companies. During the 2012–2015 period, it was still around 15%. The COVID-19 crisis has made the country less attractive. Its economic development has fallen behind expectations, while geopolitical tensions have further escalated. The supply chain disruptions of past years have prompted many companies to reassess their value chains and reduce their economic dependence on China by diversifying their supply chains. Furthermore, state subsidies for domestic enterprises and strict regulation of market access for foreign investors in China create unequal competitive conditions that make it difficult for smaller German SMEs in particular to gain a foothold there.[10]

The US is becoming increasingly important for foreign investment by SMEs

The US, on the other hand, has gained in attractiveness. More than 14% of all SMEs that invested in the 2019–2022 period did so in the US. That was an increase of 8 percentage points on 2012–2015. This trend is likely to continue in the future. In addition to offering high sales potential, the US primarily has lower energy costs than many European countries.[11] At the same time, the US has set targeted incentives for investment by foreign companies in the US with its Inflation Reduction Act. For example, in order to qualify for state support for the manufacture of electric cars, a portion of the battery minerals must be extracted, processed or recycled in the US or a free trade partner country. The final assembly of electric cars must also take place in the US or one of the countries with which the US has a free trade agreement. The failure of the TTIP negotiations means that European Union countries are not among them[12]

Some 15% of the 65,000 SMEs invested in Russia in the past four years, a proportion that primarily reflects the situation prior to the outbreak of the war in Ukraine and is likely to have decreased substantially since then, not least as a result of the state sanctions by the EU and retaliatory measures by Russia.

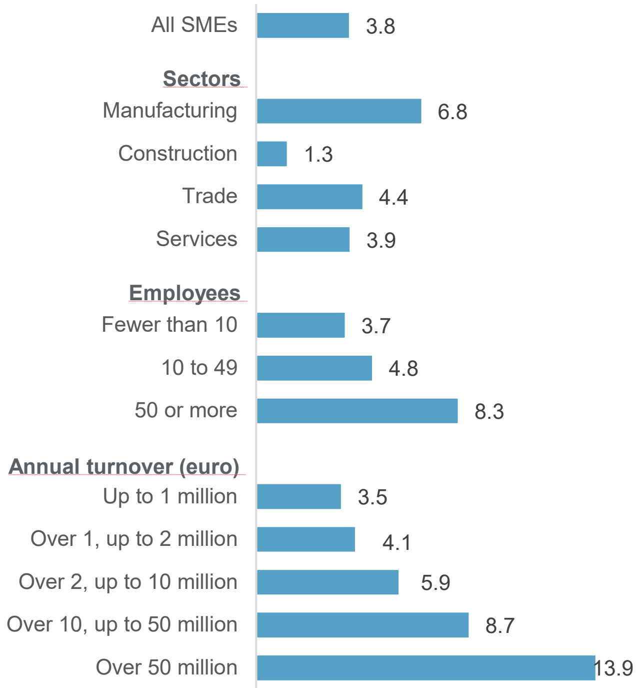
A mass exodus of SMEs should not be expected in the future

Even if individual countries are becoming more attractive for foreign investors, there are no signs that foreign investment by SMEs will rise sharply in the coming years as a result of increasing production relocations of small and medium-sized enterprises. Rather, the representative findings of the KfW SME Panel 2023 suggest that their propensity to invest abroad in the future is likely to remain on a similar level as it was before the COVID-19 pandemic. Thus, not more than 3.8% of all 3.81 million SMEs in Germany plan to invest abroad in the next three to five years (Figure 3).

The share of businesses that ultimately invest abroad is likely to remain below 3.8% because not all of them will actually put their investment plans for the coming years in place. In early September 2023, only around 50% of all small and medium-sized enterprises that had planned to invest at home or abroad in the current 2023 financial year had actually followed through on their original plans. Around 37% of businesses reported that they reduced or deferred the investments they had planned for the year 2023 and around 13% even abandoned their planned projects altogether. Such revisions of investment plans could also be observed in previous years and are likely in the future as well. Besides the economic situation, factors that play a role include the development of the interest rate level, expectations of rising costs and the generally high uncertainty about the future business environment.[13]

Figure 3: Share of SMEs with foreign investments planned in the next 3 to 5 years

By sector and size class, in per cent.



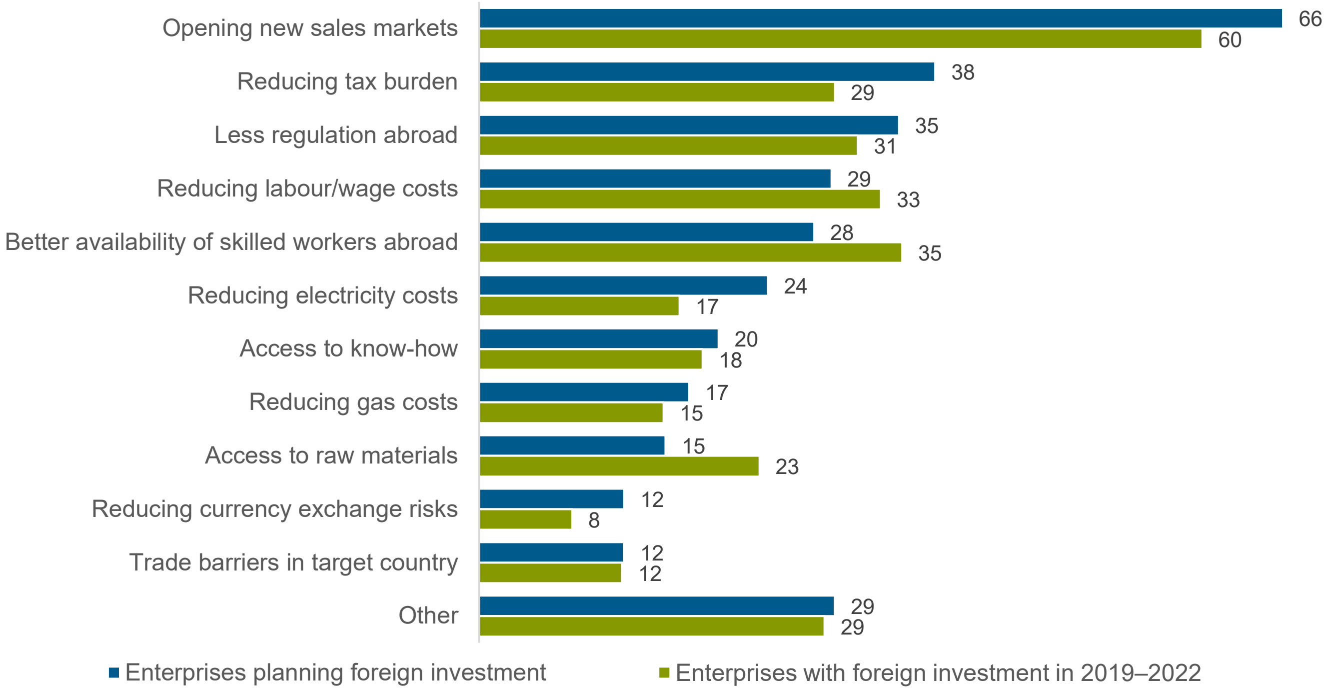
Note: Employees in full-time equivalents. Extrapolated on the basis of the number of enterprises.

Source: KfW SME Panel 2023

There is much to suggest, however, that it will primarily be high-turnover companies and those of the manufacturing sector that will drive foreign investment by SMEs in the coming years as well. The share of SMEs with annual turnover of more than EUR 50 million that are planning to invest is 13.9% – nearly four times as high as among enterprises with less than EUR 1 million in annual turnover. And the share of such businesses in the manufacturing sector is 6.8%, which is significantly higher than, for example, in the services sector or in construction (Figure 3). Traditionally, these structural differences occur not just in foreign investment but, for example, also in export turnover. They can hardly be seen as a sign of advancing deindustrialisation.

Figure 4: Tapping into new markets as a dominant motive for investing abroad

Share of enterprises for which the aspect listed is a key motive for investing abroad as a percentage of all enterprises that completed foreign investments in the 2019–2022 period or plan foreign investments in the next three to five years, respectively.



Source: KfW SME Panel 2023

Main purpose of foreign investment is to open up new sales markets

By far the most important motive for foreign investment is to tap into new sales markets. This was one of the key motives for around 60% of all businesses that invested abroad during the 2019–2022 period. Accessing new markets is also an important motive for around two thirds of businesses that want to invest abroad in the future. This shows that investment activity in the SME sector is clearly driven by the desire to grow.

The green transformation is also likely to play a role here. More and more countries have made net zero commitments, so that global demand for climate technologies and greenhouse gas-neutral products is likely to continue growing. For Germany as the world's second largest exporter of environmental and climate-smart goods, this creates considerable growth opportunities[14] – which business must also seize by setting up production and distribution locations abroad. Against this background, it is hardly surprising that companies that intend to further expand their offerings of green products in the future are three times more likely to plan foreign investments than others.

Lower tax burden and less regulation

While growth motives are clearly paramount, some SMEs also invest with the aim of reducing their tax burden. This is an important motive for 38% of all businesses that plan to invest. A similar proportion – 35%, to be precise – are hopeful that shifting some of their activities abroad will result in a lower burden from regulatory requirements. This does not allow conclusions as to what requirements enterprises in Germany regard as particularly onerous. Labour market regulations, environmental and climate requirements, but also the new German Act on Corporate Due Diligence Obligations in Supply Chains, for example, could play a role here. The fact that SMEs regard taxes, levies and red tape as risks for their future competitiveness at their German location was also highlighted by the KfW Internationalisation Report 2023.

The administrative burden index of the Federal Statistical Office shows a reduction in the administrative burden on businesses. It fell from 100 index points in 2012 to 96 index points in September 2023. However, the administrative burden index only measures the burden posed by the submission of requests, reports, evidence and similar – typically known as paperwork. This creates around EUR 65 billion in annual costs from federal regulations alone.[15]

A more comprehensive measure of the cost of meeting legal regulations is expressed by compliance costs. Besides documentation, reporting and labelling obligations, it includes, for example, the costs involved in complying with minimum technical standards and meeting occupational or environmental safety standards. Compliance costs have continuously increased since 2019.[16]

Lower labour costs and improved availability of skilled workers

Reducing labour costs is a key motive for around three in ten SMEs that plan to invest abroad in the next three to five years. This cost motive is likely to play an important role particularly for investments in eastern Europe.[17] Labour costs in Bulgaria and Romania, but also in Poland, Lithuania, Latvia, Estonia, the Czech Republic and Slovenia, are still well below the level in Germany, where labour costs amounted to EUR 39.50 for each hour worked in the year 2023.[18] Not only do many of these countries have lower labour costs, they also provide access to skilled workers. The share of highly skilled workers – university graduates as well as individuals with qualifications such as master craftsperson or technician – has grown significantly in almost all EU countries in the past years.[19] At the same time, while the shortage of skilled labour is also a growing problem in most EU countries, it is not nearly as pronounced yet as in Germany.[20] And for some investors, this also matters. Around 29% regard the improved availability of skilled workers as a major reason for their planned foreign investment.

Energy costs are not among the main drivers

Reducing electricity costs is a major motive for only one in four businesses, and lowering gas costs even for only one in six enterprises with cross-border investment plans. To be sure, reducing energy costs – especially electricity costs – plays a more important role for companies that want to invest abroad in the coming years than for those that invested abroad during the 2019–2022 period. But it is not among the main drivers of foreign investments by SMEs. This is likely due to the fact that SMEs broadly regard energy costs as manageable and most of them do not perceive them as a serious disadvantage in international competition.[21]

Other studies have also come to the conclusion that energy costs are not among the key drivers of location decisions, although they are important for individual energy-intensive industrial segments such as the metal or basic chemicals industry.[22] With a view to gas prices, analyses have shown that the consequences of the price increases are concentrated on few products with high gas intensity. Most of these are inputs that generate disproportionately low value and, in many cases, are easy to import. Looking ahead, Germany could lose production locations here but this is unlikely to result in a substantial loss of value creation, employment and income.[23]

Access to expertise – and raw materials

For around 20% of all SMEs with cross-border investment plans, access to expertise is also an important motive. This applies to services businesses, which can expand their knowledge and skills by taking over or acquiring an interest in a foreign business, but also for manufacturing SMEs as a way to access new production technologies. On the other hand, access to raw materials – a major motive for around 15% of investment planners – is relevant primarily for manufacturing enterprises. However, shifting capacity abroad plays a very minor role compared with other measures aimed at securing the supply of raw materials. Thus, up until September 2022, only 1% of all small and medium-sized enterprises that source raw materials and inputs had shifted at least part of their production abroad. A much greater number of SMEs increased their stockpiles (30%) or sought new suppliers in other supply regions (24%) in order to reduce their supply risk.[24]

Exchange rate risks do not exist in the euro area and therefore have little relevance for SMEs that mainly invest in Europe. The same applies to trade barriers in the destination country, which play a role primarily outside the EU internal market and are likely to have more significance for large enterprises, which invest more often in the US, China and other non-European countries than SMEs.

Box 1: Foreign investment by large enterprises

Large enterprises are the main drivers of foreign investment. Germany has roughly 2,300 enterprises that generate annual turnover in excess of EUR 500 million. These were also surveyed about their foreign investments as part of the KfW Climate Barometer 2023.[25] Some 43% of them invested abroad in the 2019–2022 period. This demonstrates that here as well, the share of investors declined in the COVID-19 crisis compared with previous surveys.[26] Around 42% of all large enterprises plan to invest abroad in the next three to five years. This shows that a sharp increase in investment appetite is unlikely in this segment as well. The findings point to a very similar set of motives as in the SME sector. Tapping into new sales markets is a key driver for three in four enterprises. Reducing labour costs is the main driver for around one in every three businesses, while not even one in seven companies see saving electricity or gas costs as a priority. Unlike for SMEs, trade barriers in the destination country and exchange rate risks are a major reason for around one in four enterprises wishing to invest abroad.

Foreign investment as a driver of growth

The debate around Germany's attractiveness as a business location and possible deindustrialisation often takes a critical view of the foreign investments of German firms and interprets them as an outflow of capital that reduces growth and prosperity in Germany.[27] There is much to challenge such a view. A very important motive for businesses – both SMEs and large enterprises – to invest abroad is to tap into new sales markets.[28] Establishing new distribution locations or joint ventures with foreign enterprises enables German companies to better unlock growth potentials abroad. Where the priority is to reduce labour or energy costs, shifting some of the production enables them to make use of comparative advantages. Moving labour- or energy-intensive processes to countries with lower wages, electricity or gas prices strengthens the productivity and competitiveness of German enterprises and can therefore also contribute to securing employment in Germany.[29] In most cases, foreign investments do not replace investments at home but supplement them. This was stated by 92% of large enterprises that invested abroad.[30] Investment decisions are rarely made on the basis of single locational factors – such as electricity or gas prices – but always take into consideration the business environment as a whole.

Nevertheless, the concerns over Germany's future viability as a business location must be taken seriously. As the KfW Internationalisation Report has shown, risks are definitely looming for Germany's future competitiveness. Businesses are particularly worried about bureaucracy but also about taxes and levies as well as environmental and climate regulations. The findings of the PISA study recently underscored yet again the fact that there is an urgent need for action around the topic of building capacities and skilled labour. And energy costs need to be taken into consideration as well – even though they are not the main risk. Germany's comparative advantages – highly trained workers, a solid and, most of all, reliable regulatory framework, intense research activity and efficient production technologies[31]– are by no means guaranteed for the future. Preserving them will require good ideas and effective strategies and, most of all, political will and implementation strength.

[1] Cf. Abel-Koch, J. (2023): KfW Internationalisation Report 2023 – Many SMEs currently perform better than their foreign competitors but see need for action to secure their future competitiveness, KfW Research.

[2] For more on this see also Heymann, E. (2022): Industriestandort Deutschland droht struktureller Verlust an Wettbewerbsfähigkeit (*Germany at risk of losing structural competitiveness as a business location* – our title translation, in German), Wirtschaftsdienst, 102(12), p. 941–944 and Fuest, C. (2023): Industriestandort Deutschland (*Germany as an industrial location* – our title translation, in German), ifo Standpunkte 20 October 2023.

[3] Cf. Borger, K. (2016): Large German firms invest roughly the same amounts at home and abroad, Focus on Economics No. 136, KfW Research, and Association of German Chambers of Industry and Commerce (2022): Auslandsinvestitionen der Industrie 2022 (*Foreign investment by industry in 2022* – our title translation, in German)

[4] Cf. Abel-Koch, J. (2016): The happy few: German SMEs investing abroad, Focus on Economics No. 183, KfW Research.

[5] The fact that fewer businesses are investing abroad but planning to invest higher amounts is also illustrated by the results of the economic surveys of the Association of German Chambers of Industry and Commerce, for example. However, these surveys are limited to internationally active companies, see DIHK (2022): Auslandsinvestitionen der Industrie 2022 (*Foreign investment by industry in 2022* – our title translation, in German)

[6] Transaction volumes in accordance with Germany's balance of payments, see Deutsche Bundesbank (2023): Direct Investment Statistics, as at April 2023.

[7] Cf. Abel-Koch, J. (2016), loc. cit.

[8] Cf. GTAI (2023): Deutsche Firmen erweitern ihre Produktionsstätten in Polen (*German firms are expanding their production facilities in Poland* – our title translation, in German)

[9] Cf. Matthes, J. (2018): Brexit führt zu Investitionsschwäche im Vereinigten Königreich (*Brexit leads to investment weakness in the United Kingdom* – our title translation, in German), IW Short Report 44/2018 and, without author (2023): Sieben Jahre Brexit-Referendum: Der Brexit ist ein wirtschaftliches Desaster für beide Seiten des Kanals (*Seven years of Brexit referendum: Brexit is an economic disaster for both sides of the Channel* – our title translation, in German), WirtschaftsWoche of 22 June 2023

[10] Cf. GTAI (2023): Ist weniger China bald mehr? (*Is less China soon more?* – our title translation, in German) and GTAI (2023): Deutsche Unternehmen haben es in China zunehmend schwer (*German businesses face growing difficulties in China* – our title translation, in German)

[11] Cf. German Council of Economic Experts on Economic Development (2022): Managing the energy crisis in solidarity and shaping the new reality, Annual Report 2022/23

[12] Cf. GTAI (2023) Immer mehr deutsche Unternehmen investieren in den USA (*More and more German firms are investing in the US* – our title translation, in German)

[13] Cf. Schwartz, M., and Gerstenberger, J. (2023): KfW SME Panel 2023 – SMEs' resilience is being put to the test. So far, they have come away with few bruises, but now they are increasingly nervous, KfW Research (forthcoming).

[14] Cf. Abel-Koch, J. and Brüggemann, A. (2023): Großunternehmen halten Klimaneutralität und Wettbewerbsfähigkeit für vereinbar (Large enterprises regard climate neutrality and competitiveness to be mutually compatible – in German), Economics in Brief No. 26, KfW Research.

[15] Cf. Destatis (2023): Administrative burden index

[16] Cf. Destatis (2023): Vorstellung des Erfüllungsaufwands

[17] See also Abel-Koch, J. (2016): SMEs' value chains are becoming more international – Europe remains key, Focus on Economics No. 137, KfW Research.

[18] Cf. Destatis (2023): Labour costs comparison across EU countries per hour worked

[19] Bildungsstand der Bevölkerung im europäischen Vergleich (*Education level comparison between EU countries* – our title translation, in German), IW-Report 3/2023

[20] Cf. Peichl, A., Sauer, S. and Wohlrabe, K. (2022): Fachkräftemangel in Deutschland und Europa – Historie, Status quo und was getan werden muss (*Skills shortages in Germany and Europe – history, status quo and what needs to be done* – our title translation, in German), ifo Schnelldienst 75/2022.

[21] Cf. Abel-Koch, J. (2023), loc. cit.

[22] Cf. Bialek, S., Schaffranka, C. and Schnitzer, M. (2023): Kein Grund zur Panik: Die Energiekrise ist kein Game Changer, aber sie beschleunigt den ohnehin anstehenden Strukturwandel in der Industrie (*No reason to panic. The energy crisis is not a game changer, but it does accelerate the already imminent structural transformation in industry* – our title translation, in German), ifo Schnelldienst 3/2023.

[23] Cf. Müller, S. (2023): Strukturwandel zulassen (*Make way for structural change* – our title translation, in German), ifo Schnelldienst 3/2023 p. 11–14.

[24] Cf. Abel-Koch, J. (2023), loc. cit.

[25] For details on methodology, see Brüggemann, A., Grewenig, E., Römer, D. and Schwartz, M. (2023): KfW Climate Barometer 2023: Climate investments by German enterprises grew by 18% in real terms in 2022 – despite the energy crisis, KfW Research.

[26] Cf. Borger, K. (2016), loc. cit.

[27] Cf. Rusche, C. (2023): Deindustrialisierung – Eine Analyse auf Basis von Direktinvestitionen (*Deindustrialisation – an analysis on the basis of direct investments* – our title translation, in German), IW-Kurzbericht 43/2023

[28] Cf. Borger, K. (2016), loc. cit.

[29] Cf. Buch, C., Schnitzer, M., Arndt, C., Kesternich, I., Mattes, A., Mugele, C. and Strotmann, H. (2007): Analyse der Beweggründe, der Ursachen und der Auswirkungen des so genannten Offshoring auf Arbeitsplätze und Wirtschaftsstruktur in Deutschland *(Analysis of the motives, causes and effects of so-called offshoring on jobs and economic structure in Germany* – our title translation, in German).

[30] Cf. Borger, K. (2016), loc. cit. This can also be concluded from more recent surveys, cf. Association of German Chambers of Industry and Commerce (2023): Auslandsinvestitionen der Industrie 2023 (*Foreign investment by industry in 2022* – our title translation, in German) Businesses that planned to invest abroad in 2023 were much more inclined to expand than scale back their domestic investments (12 percentage points on balance). This applies in particular to businesses that plan to invest abroad in order to open up a foreign market (19 percentage points on balance).

[31] Cf. Bialek, S., Schaffranka, C. and Schnitzer, M. (2023), loc. cit. and the sources cited therein.