

# **Dissertation**

## **German small and medium-sized enterprises in China**

A theoretical and empirical study on their expansion process and their current and future business environment

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## List of Abbreviations

AHK	Deutsche Außenhandelskammer
EC	European Community
GDP	Gross domestic product
GIC	German Chamber of Industry & Commerce
IAB	Institute für Arbeitsmarkt und Berufsforschung
IfM	Institut für Mittelstandsforschung (Institute for SME research)
JV	Joint venture
MOFCOM	Ministry of Commerce of the People's Republic of China
NBS	National Bureau of Statistics in China
RO	Representative office
SME	Small and medium sized enterprise
UNCTAD	United Nations Conference on Trade and Development
WFOE	Wholly foreign owned enterprise
WTO	World Trade Organisation

# 1 Introduction and goals of the dissertation

„Crisis? Which crisis?“

The expression “economic crisis” is still omnipresent in many countries of the world. European countries like Greece, Ireland and Portugal are verging on national bankruptcy. When asking a Chinese about the economic crisis in 2009, he will answer that the crisis only caused a small breakage in the ambitious economic plan and that the short-negative effects are already surmounted or forgotten as the World Bank summed up in the latest report bay saying that 'East Asia has recovered itself from the economic and financial crisis'<sup>1</sup>.

Though by the end of 2008 China was also situated in a threatening situation. Ten thousands of people lost their jobs, the property market collapsed and social riots were about to come up. China's development model was on the rocks. Analysts and international organizations amended their estimations constantly downwards concerning China's economic development.<sup>2</sup> In 2009 they had to accept a throttling economic growth of 8.7 %. As a result, in March 2010, the Chinese government predicted a 'complicated situation` for the upcoming years insofar as the former strategies that had created the economic miracle, such as exports and investments and being the workbench of the world would not function anymore. Consequently, the Chinese government focused on serious infrastructure programs, export and agricultural aids and the opening of the credit tap of the banks in order to establish a new sustainable model in favor of the domestic market that was supposed to protect China from the negative global economic effects.<sup>3</sup>

Nevertheless, despite the fact that China predicted for themselves to leave aside the former strategies, such as export and investments, an increase in imports and direct investments can be detected particularly after 2009 by foreign companies.<sup>4</sup> The blatant reasons, especially for direct investments in China, were among others on the one hand the huge market potential with more than 1.3 billion citizens and on the other hand the

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<sup>1</sup> Worldbank (2011)

<sup>2</sup> www.wiwo.de (2008); www.wiwo.de (2009)

<sup>3</sup> www.welt.de (2010)

<sup>4</sup> See also figure 14

cost efficient business environment. Including German companies were and still are fascinated by the possibilities and the advantages that China can offer and hence hazard the expansion towards China.<sup>5</sup>

## 1.1 Goals of the dissertation

The goal of this paper is to look at small and medium-sized companies (SMEs) and their way to China depicting and analyzing how they organized their way to China, how they evaluate their current situation in China, and, in their opinion, how the economic situation in China will change in the future.

The underlying examination questions are as follows:

- Why and how do German SMEs expand to China?
- How do German SMEs master their current operations in China?
- How do German SMEs evaluate their future within the Chinese market?

The real novelty of the dissertation is the empirical study and its detailed analysis in chapter 6. Especially the part of the study that focuses on the estimation of the SMEs on their current business situation in China after the world economic crisis and their estimation of future broadens the understanding of German SME in China on the one hand in the literature and on the other hand in the practical world.

The answers to the above mentioned research questions are supposed to serve as information and assistance for SMEs, which are looking for a way to internationalize successfully to China or to further establish their competitive position there against the backdrop of constantly and faster changing conditions of the market.

The contemporary literature answers the research questions unsatisfactorily. Though, a glut of works dealing with 'internationalization of companies' concerning strategies of market entry, can be found in the German-speaking as well as in the English-speaking literature. Similarly, there are many works about China or papers about SMEs. But looking for information about German SMEs and how they have entered the Chinese market, which strategies for market cultivation they currently follow, how they evaluate their current and future economic environment, the results are unsatisfactory. It is even more unsatisfying when one searches for information on this topic in English.

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<sup>5</sup> EU SME Centre (2011)

Hereinafter, a brief overview of the currently available works and literature about these themes will be presented.

When expanding to a new country one of the most important questions a company has to answer is which market entry strategy to take. The theories of direct investment by Fayerweather (1975), Aharoni (1966), Tesch (1979), Hymer (1960) and Dunning (1979) provide various explanations why companies start expansion and go international. Of great importance are also the theories by Vernon (1966) and Johanson/ Vahlne (1977) which differ from the theories of direct investment insofar as they do not present static views on internationalisation. These studies can be seen as an analysis of the internationalization process over time.

The theoretical model to evaluate the advantages and disadvantages of various market entry strategies and their underlying context factors is the theory of transaction cost. The work by Williamson (1990) set the basis for this theory. Anderson/ Gatignon (1986) have analysed the relation by distinguishing between the determining factors and the dimensions of control of market entry activities and relating it with the theory of transaction cost. Kappich (1989) has also used the theory of transaction cost in order to illustrate the various cooperation models in internationalization strategies. Contractor (1990) and Hill/ Hwang/ Kim (1990) have discussed international contracts, Joint Ventures and fully-owned enterprises with the help of the transaction cost theory. In 1990 Kutschker has related internationalization strategies with the transaction cost theory. Research on the theory of transaction cost as an explanation for internationalization strategies has also been done by Weiss and Helm, but those studies did not focus on a specific country.

Within the last two decades China became more and more popular for German companies in terms of sourcing, production and/ or as a country to market their products. Within the same time period more studies related to the China engagement of German firms evolved. Important contributions that describe all context factors regarding China have been presented by Hiemenz/ Li (1986), Siemsen/ Geissbauer (1996), Vanhonacker (1997), Wang/ Zhang/ Googfellow (1998), Ambler/ Witzel (2000), Boos/ Boos/ Sieren (2003), Nippa (2004), Teng (2004), Holtbrügge/Puck (2005), Kaufmann, L. et al. (2005) or Hofer/ Ebel (2007). Most of the research that was done on market entry modes in China was done on 'joint ventures' even if the entry mode 'acquisition' is more common worldwide. With special regards to China, the entry mode 'acquisition' can be neg-

lected due to the fact that before China entered the WTO in 2001 the acquisition of Chinese companies was prohibited by the Chinese government. The empirical study of Lubritz (1996) shows that the fit of quality understanding, market orientation, flexibility, strategy and goals in international alliances of SMEs are of very high importance. Chinese entry barriers for German industrial goods manufacturers were analysed and supported by case studies by Schwaderer (1993). Zomer (1998) conducted a survey on factors that determine market entry strategies of German industrial and consumer goods manufacturers. He concludes that the choice of entry strategy is influenced by internal company factors and external market framework like companies' monetary resources or Chinese market entry barriers. In recent years several studies have been conducted on the analysis of success factors of China engagements of German companies. On the basis of a questionnaire that was sent to 150 German enterprises who were involved with China, Hilger (2001) compared the success factors for different China engagements. Hilger's work has given valid insights to the research of internationalization strategies and, hereby, has offered managers, eager to enter the Chinese market, help in decision making and strategy formulation. Nevertheless, his analysis just focused on German companies in general, which means that his findings would hold for SMEs as well as big companies. Therefore, authors started to concentrate more on the differences in market entry strategies between SMEs and big companies.

In comparison to big companies SMEs have limited resources in terms of capital, personnel, management and know-how. The question how German SMEs should choose their expansion/ market entry strategy for China while taking into account limited resources and limited experience within the internationalisation process has not been answered properly.

Lin (2000) discussed the choice of location of German medium sized companies within China. The analysis of potential success factors for specific entry modes (joint venture and wholly owned enterprises) in China of German and Swiss medium sized companies was conducted by Bülk (1997). As a criterion he used the duration of amortisation. Haeusgen (2000) researched the determination factors of market entry modes for medium sized companies with the help of case studies. His sample selection of companies just focused on the machine building industry. Haeusgen also lacks of presenting an in-depths analysis of the market entry process.

## 1.2 Outline of the dissertation

The dissertation is divided into two major parts. The first part, covered by chapters 1 to 5, builds up the theoretical background for internationalization of German SME to China and the second part, covered by chapter 6, challenges the theoretical findings with an empirical study conducted among German SME who mastered their expansion to China successfully in the past.

Chapter 2 gives a definition and distinction of SMEs. After that, their special significance in the context of the German economy will be described. Furthermore, within the scope of this paper, it will be particularly pointed out why especially those companies have the need for internationalizing processes to China.

In chapter 3 the People's Republic of China as the country of opportunities for German SMEs will be analyzed. Firstly, the determining factors for Germany are illustrated from the economic, politico-social and legal perspective. Moreover, the German-Chinese economic relations will be displayed.

The fourth chapter will deal with the internationalization process which has to be the basis for the transnational trade. The first part will discuss the motives for an international expansion which can be cost-, market- or competition-oriented. Furthermore, special characteristics or determining factors for SMEs will be shown with regards to their foray abroad. The second part of the chapter will deal with the forms of strategies of market entry. The forms of foreign market cultivation, such as export, joint venture or subsidiary companies abroad, will be described in detail. In addition, the individual advantages and disadvantages will be contrasted. Finally, it will be pointed out which strategies of market entry are chosen by German SMEs.

Chapter 5 will focus on factors that are necessary for German SMEs to be successful abroad. Chapter 5.1 will deal with the external factors of success to the company, whereas chapter 5.2 will shine a light on the internal factors of success to the company.

Chapter 6 will present the results of the empirical study about the way German SMEs coped with the expansion, how they evaluate their current situation in China and how, to their mind, will change the economic situation in the future. The themes that will have been mentioned in the theoretical chapters before will be taken up again by means of concrete practical questioning in the scope of the study. For example, the motives for an

expansion to a foreign country, the forms of strategies of market entry, the internal and external factors for a successful market entry or the successful market cultivation.

Finally, chapter 7 will summarize the results and will look out on possible questions that could not be answered in the scope of this paper, but could serve for future investigations.

### **1.3 Methodology**

Chapters 2-5 of the dissertation, e.g. the theoretical considerations of the given theme, entirely rely on secondary research. The main sources for this research are German and international literature that focus for example on the following topics SME, China, internationalization and success factors for expansion. Statistics by government institutions are taken to support the analysis with substantial data. Studies of institutes like the German Chamber of Commerce in China and a case study of a German SME that pursued the expansion to China are utilized as well to further enrich the understanding of internationalization from a more practical point of view.

The empirical study and its detailed analysis in chapter 6 on the other hand are primary research. This part of the dissertation is a real progress in the understanding of the given topic of the dissertation and is used to test or verify the literature base presented in the previous chapters.

The research method is a survey which relies on questionnaire containing 27 core questions with a choice of multiple given answers. The questionnaire has been used since it is one of the most appropriate tools to reach German SMEs in China and to get insights of a large number of enterprises:

- Questions and answers are predefined to give guidance and to simplify the answering process for the participating SMEs – easy to handle and quick to do
- The SME can decide when it has the time to answer the questionnaire since the time frame for answering has been set to 6 months (Oct. 2010 – March 2011)
- The distance between Germany and China eliminate research methods like personal interviews or group studies
- Case studies would have give a more depths analysis but the sample size would not have been big enough to serve for the entire German SME community in China

- Sending the questionnaire via email is inexpensive

The design of the questionnaire is based on 27 questions which cover 4 main research topics:

1. Information on the German SMEs in China (9 questions)
2. Expansion process of the SMEs to China (8 questions)
3. Evaluation of their current business evaluation in China (6 questions)
4. Forecast of their future business environment in China (4 questions)

The structure, the questions and the options for reply of the questionnaire are defined by the author but geared to other surveys conducted for example by German Industry and Commerce or private Consulting firms like Roland Berger or Fiducia Management Consultants.

The sample for the survey should contain of German SME operating in China. Therefore at first German SME had to be defined according to the criteria of the German Ministry of economic affairs, small businesses, technology and traffic (classification see in chapter 2.1). Then the list of all German companies (GCD<sup>6</sup>) operating in China had to be screened according to the given criteria to define the sample size.

The questionnaire was send out to 512 valid German business addresses in China that fulfilled the predefined criteria and the return quota of completed surveys was as high as 9% (46 SMEs). According to comparable studies<sup>7</sup> the panel's composition is representative for the total number of German SME operations in China and the findings and opinions are representative for the majority of German SME business communities as well. However, this report is only meant to provide valuable insights for German SMEs interested in China expansion or SMEs, already operating in China, from which they can derive ideas and proceedings for their own business strategy. Since every company has

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<sup>6</sup> The German Company Directory is the only official directory of all German companies in China. It is the primary source of information for determining which German companies are already in China. The German Company Directory is created and maintained by DEinternational/German Industry & Commerce (GIC) and Real SoftService. DEinternational /German Industry & Commerce (GIC) is the service provider of the Delegations of German Industry and Commerce (AHK) in China. AHK and GIC belong to the worldwide network of some 120 overseas German Chambers of Commerce, Delegations, Representative Offices and DIHK-Service Companies in more than 80 countries under the umbrella of the Association of German Chambers of Industry and Commerce (DIHK) in Berlin. The offices and subsidiaries of AHK and GIC in Beijing, Shanghai and Guangzhou support German companies in establishing and extending their activities in China on a bilateral basis.

its individual company background and business environment this survey cannot serve as an individual layout for a solid, successful China strategy that suits every German SMEs. Moreover, it has to be clarified that those SMEs who were not successful in their China expansion have not been able to participate in the survey since they have ceased their businesses and left China again already, therefore, their opinions and experiences are not included in the findings. Taking this fact into account it may be the case that the results of this survey are slightly painted in too good light.

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<sup>7</sup> „Survey on Business Confidence in China“, conducted by the German Chamber of Commerce and Fiducia Management Consultants, Shanghai August 5th, 2009

## 2 Small and medium-sized enterprises (SME)

Within the literature it is often referred to SMEs as the spine of the German economy.<sup>8</sup> They earn the main part of the German GDP and offer the workplace to more than 20 million Germans. The economic success of the SMEs cannot only be ascribed to customers in Germany. As early as possible, the SMEs followed the German large-size enterprises, which became the forerunner for the global internationalization and promoted the exports, which took place at first in the European countries and later, as part of the globalization, in more remote countries of the world that offered promising sales markets.<sup>9</sup>

The following paragraph will illustrate in detail the SMEs in Germany. To begin with, a definition and distinction will be made in chapter 2.1 followed by a description of the special significance of these companies with regards to the German economy. Furthermore, the question will be discussed why especially these companies are in need of the already mentioned internationalization process towards China.

### 2.1 Definition of German SME

Although the terms 'large-scale industry' and 'small and medium-sized' companies are used frequently, a clear definition and distinction appears to be very difficult.<sup>10</sup> This can be exemplified by the following comparison. Can a medium-sized enterprise that makes profit compared to a large-scale enterprise, but with a smaller number of employees, still be defined as a SME?

This is approved by *Kaufmann*<sup>11</sup> and *Wiebe*<sup>12</sup> who also point out that the manifold definitions and distinctions of SMEs in the literature lead to inconsistency of the same.

Some works make a basic and definitional distinction in terms of quantitative and qualitative criteria.

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<sup>8</sup> Geulen (2001), p.25ff

<sup>9</sup> Meyer (2000), p. 19ff; Bamberger/ Evers (1997), p. 103ff

<sup>10</sup> Phohl, H.Ch/ Kellerwessel, P. (1990), S. 18ff

<sup>11</sup> Kaufmann (1993), p. 10

<sup>12</sup> Wiebe (1991), p. 56

Quantitative criteria include, among others, the classification by the number of employees according to the size of company. According to this, small and medium-sized enterprises are said to employ from 2 to 1,000 employees. Other quantitative criteria are turnover, numbers of machines, capacity etc.<sup>13</sup>

In contrast to the quantitative criteria the qualitative criteria contain a clearer definition of the small and medium firm sector. A crucial characteristic for a small and medium-sized enterprise is the role of the entrepreneur who embodies investor and executive director at the same time. The entrepreneur, motivated by his entrepreneurial commitment, organizes all company-internal and external activities and, hence, forms the company's identity and the value system. The enterprise is the entrepreneur's means of existence as well as his/her life's work.<sup>14</sup>

Another important qualitative criterion for the medium-sized sector is the financial and personnel resource restriction owing to the small size of small and medium-sized enterprises. The financial deficit can be explained by the antagonistic interests of the business owner. On the one hand there is the wish to enhance the financial situation of the firm by means of external investors. On the other hand it is preferred by the owner to keep as many rights of control and monitoring in his/her hand as possible. The personnel deficit can be characterized by the small number of employees as by their insufficient qualification. On their way to internationalization SMEs have to face their lack of experience when it comes to business abroad and of cultural knowledge as well as insufficient language proficiency.<sup>15</sup>

Another criterion for SMEs is the spatially and factually very small range of products. However, this fact is not only considered negatively, but is also regarded as a chance to meet customers' special and individual needs.<sup>16</sup> Besides, SMEs are more flexible and adjustable by virtue of short decision making processes due to less influence within the hierarchical levels. This enables SMEs to react to changing market situations differently and to work on, for example, market niches with detected international sales and export

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<sup>13</sup> Wasner (1984), p. 12ff

<sup>14</sup> Müller (1995), p. 33ff

<sup>15</sup> Kaufmann (1995), p. 202ff., Koller/ Raithel/ Wagner (1998), p. 176, Steinmann (1989), p. 1510ff

<sup>16</sup> Steinmann (1989), p. 1517

potential. In contrast, this specific and efficient flexibility can be realized only to a limited extent within large-sized enterprises.<sup>17</sup>

Nevertheless, compared to large-sized enterprises, SMEs are lacking the possibilities to offset their risks within the internationalization process. Hence, ill-conceived-investments harm the less financially powerful SMEs very negatively which is why careful planning of the risks of the foreign business is of high significance.<sup>18</sup> Beyond that, further external factors that cannot be influenced have to be considered during the internationalization process. These are, for example, the nature of market, the quality of local input factors, cultural differences as well as trade barriers, political instability and legal and exchange rate uncertainty.<sup>19</sup> All these factors will be explained in more detail in the following paragraphs of this paper.

The 'Institut für Mittelstandsforschung'<sup>20</sup> (German Research Institute for SMEs) defines SMEs as the following. The SME sector implies all self-employed in liberal professions, craft as well as industrial enterprises that fulfill the following criteria:

- less than 500 employees
- an annual turnover of lower than 50 million euro

Within the given definition, smaller enterprisers are further differentiated according to the following criteria:

- less than 10 employees
- an annual turnover of lower than 1 million euro

In addition to the quantitative criteria related to sales and employment figures, the above-mentioned institute also names qualitative criteria that are characteristic for SME:

- entity of property, accountability and leadership
- firm's independence from other enterprises
- accountability to a certain degree of the owner concerning company-relevant decisions.

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<sup>17</sup> Kaufmann (1993), p. 11ff

<sup>18</sup> Kaufmann (1993), p. 14 f

<sup>19</sup> Brassen/ Behnam/ Gilbert (2001), p. 422 f

<sup>20</sup> [www.ifm-bonn.de](http://www.ifm-bonn.de) (2010)

According to this definition more than 99% of all enterprises belong to the SME sector in Germany.

The present paper will use a definition of SMEs based on the interpretation of the 'Ministerium für Wirtschaft und Mittelstand, Technologie und Verkehr'<sup>21</sup> (Ministry of economic affairs, small businesses, technology and traffic) since this definition meets best the characterization of the German companies on-site in China. Referring to this SMEs are enterprises

- that employ less than 1,000 employees
- that generate an annual turnover of 250 million euro at the most
- whose capital or voting stock is not to 25% or more under the possession of one or more enterprises that do not meet the definition of small and medium-sized enterprises.

## 2.2 Importance of German SME in Germany

Due to the above outlined problematic nature of defining or distinguishing SMEs, it is difficult to quantify the actual significance of SMEs for the German economy in absolute numbers.<sup>22</sup> Nevertheless, it is needless to say that SMEs are of high importance for the German economy, which is supported by Fritsch who comes to the result that 'SMEs are a crucial component of the German economy and especially young companies give new incentives.'<sup>23</sup>

According to estimations of the 'IfM Bonn' (Research Institute of small and medium-sized businesses), about 3,200,000 companies existed in Germany in 2009. 99.7% of them meet the SMEs' characteristic entity of property and leadership and, hence, have to be considered as family businesses, or more specifically, generate less than 50 million euro.<sup>24</sup>

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<sup>21</sup> Deutsches Ministerium für Wirtschaft und Mittelstand, Technologie und Verkehr (2009)

<sup>22</sup> Acs/ Audretsch (2005), p. 205-234.

<sup>23</sup> Fritsch in Acs/ Audretsch (1992), p. 38.

<sup>24</sup> IfM Bonn (2009)

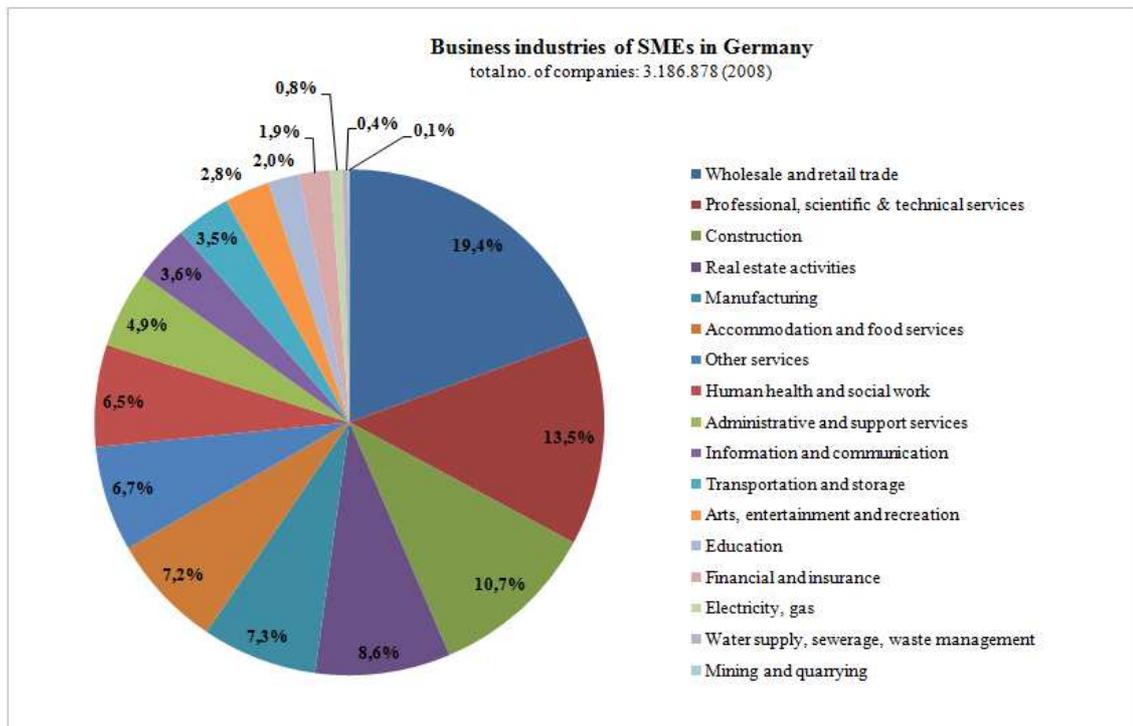


Figure 1: Business industries of SMEs in Germany (own illustration)

Source: IfM Bonn - Institute for SME in Germany (2009)

Figure 1 gives an overview about all business industries within Germany. Furthermore the illustration shows the relative share of companies within each branch. Due to the fact that 99.7% of all companies can be qualified as SME this distribution holds for SME as well and shows the importance of SME within the German economy and its various industries. Wholesale and retail (19.4%), professional, scientific and technical services (13.5%), construction (10.7%) and real estate (8.6%) rank first in number of companies.

This ranking changes when it comes to the turnover that each business industry is generating. In 2009 the total sales of all German companies was 4,978,937,502,000 Euros. The turnover share of SME accounts for 1,947,970,550,000 Euros which is approximately 39.1%. Out of this turnover the strongest five SME branches in regard of turnover are:<sup>25</sup>

- Wholesale and retail trade (33.4%)
- Manufacturing (21.3%)
- Construction (9.6%)

- Transportation and storage (5.0%)
- Real estate (4.7%)

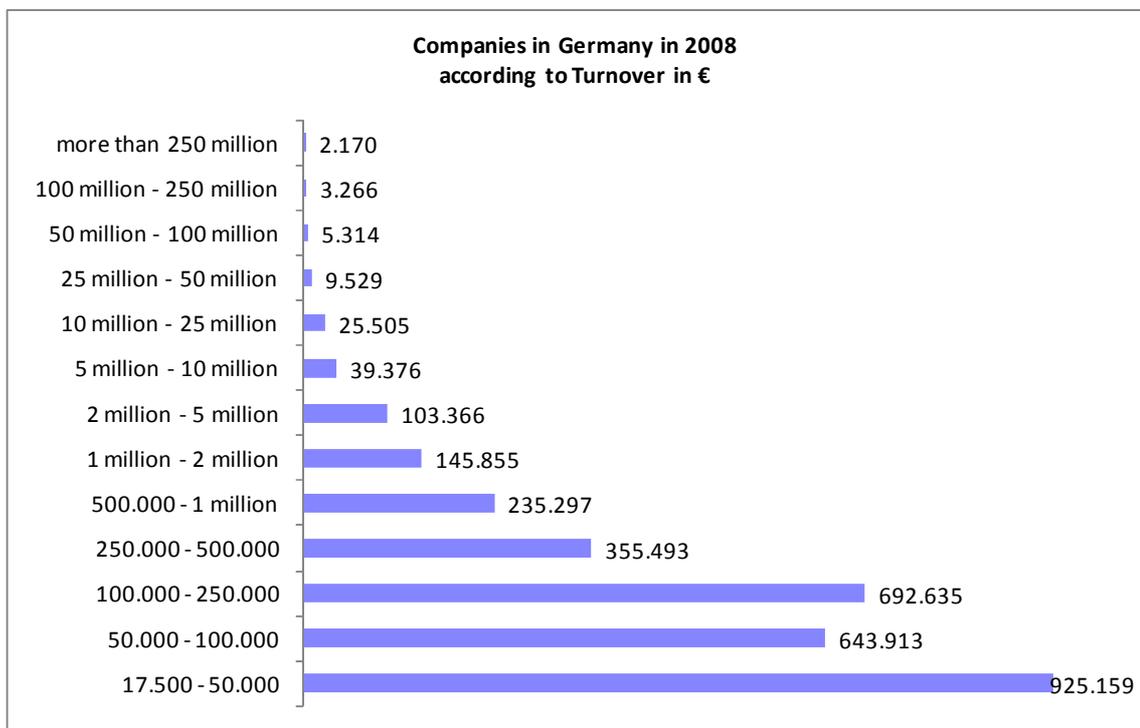


Figure 2: Companies in Germany in 2008 according to turnover (own illustration)

Source: IfM Bonn - Institute for SME Business Research (Institut für Mittelstandsforschung) (2011)

The particularity of SMEs results from their limited size. These companies do not by any means represent a sort of miniaturized large-sized enterprises since large firms have the possibility to compensate losses by means of other areas of operations, whereas SMEs are not able to do so due to their limited range of products. On the other hand they are more flexible than large-sized companies and can react faster to changing customers' demands. In many cases SMEs incorporate a high specialization that facilitates to operate successfully in market niches, where no other companies operate. Hence, SMEs contribute to a market and product diversity that customers can benefit from, and which promotes competitiveness of the entire economy.<sup>26</sup>

As already described above by *Fritsch*, especially young companies give incentives to the economy. Furthermore, new work areas are generated and, as a result, new jobs are created. 79% (20,855,045) of the jobs in Germany are currently generated by SMEs

<sup>25</sup> IfM Bonn (2009)

<sup>26</sup> Acs/ Audretsch (2005), p. 205-234.

(figure 3). It has to be mentioned that approximately 81% (2,573,442) of the companies are operating with only 1 to 9 employees (figure 2). Only 0.02% (7,310) of companies employs 500 or more employees in order to operate their business.<sup>27</sup>

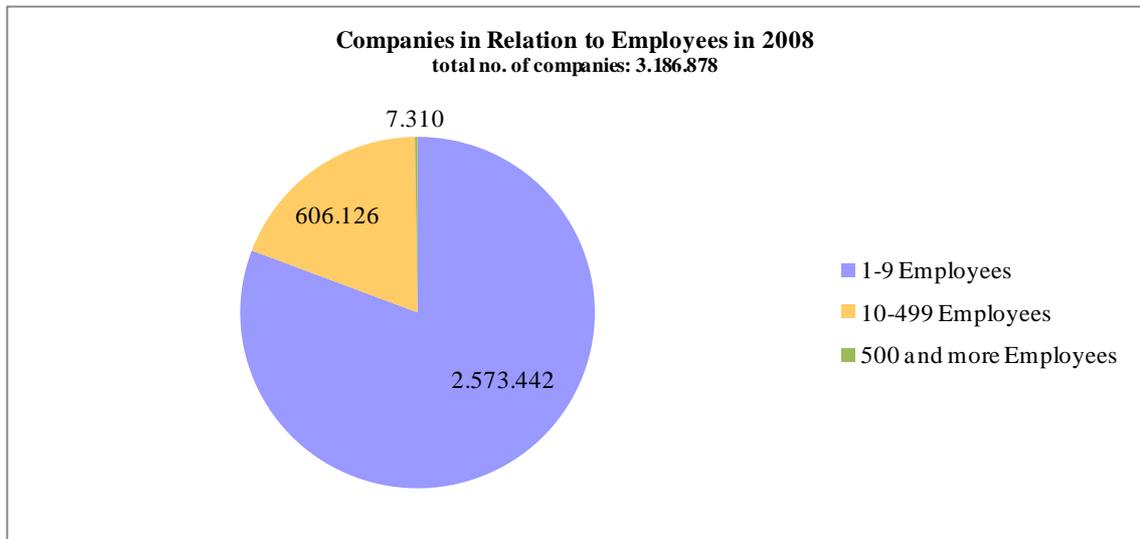


Figure 3: Distribution of companies by size of companies in 2008 (own illustration)

Source: IAB - Institute for Employment Research (Institut für Arbeitsmarkt- und Berufsforschung) (2011)

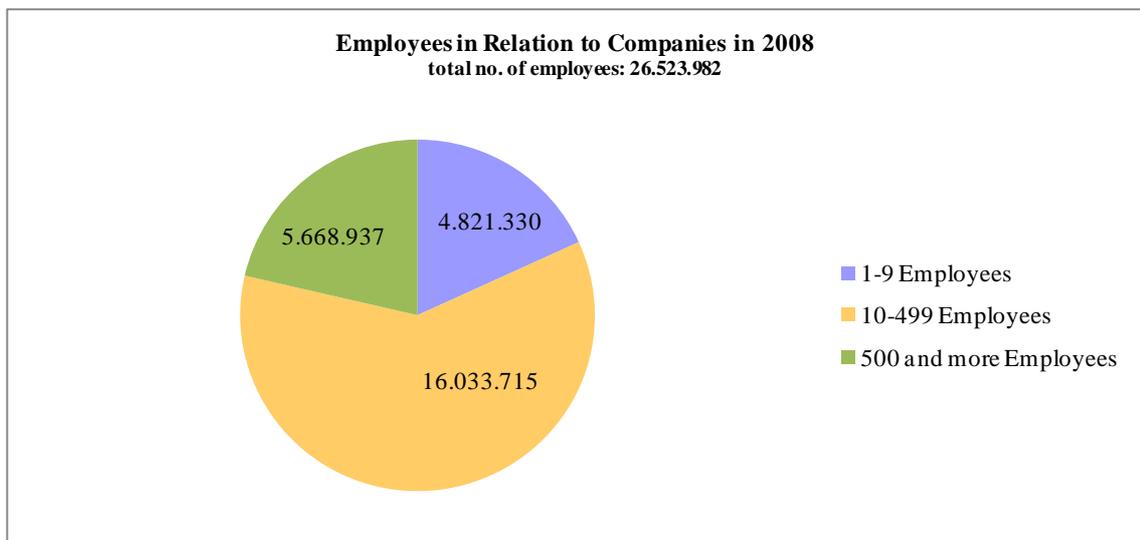


Figure 4: Distribution of employment by size of companies in 2008 (own illustration)

Source: IAB - Institute for Employment Research (Institut für Arbeitsmarkt- und Berufsforschung) (2011)

However, the importance of SMEs has just been noticed by the economy or the population 20 years ago. At the beginning of the 20<sup>th</sup> century many scientist still predicted that SMEs would be displaced by large-sized companies in the course of the future econom-

<sup>27</sup> IAB (2011)

ic development and that they would not have a positive future prospect with an increasing concentration of capital and mass production.<sup>28</sup> Today, SMEs are paid more attention on the part of the politics. Hence, there exists a number of promotion programs for SMEs provided by the EU and the German federation. Moreover, there are an increasing number of so-called technology and start-up centers that can be rented by SMEs for especially favorable conditions during their building and consolidation phase and where they can use a high range of supervision and consulting programs.<sup>29</sup>

The strong export orientation of the German economy implies that even SMEs generate an increasing share of their turnover abroad. This is reflected by a study, conducted by Venohr in 2008, which assumes that in the German economy there are probably more than 1000 medium-sized global leaders. They can be found in the especially important sectors for export, such as the mechanical engineering where many companies can be classified as SMEs. Therefore, the assumption that smaller companies are automatically regionally limited due to their shortage of financial resources is not bound to occur.<sup>30</sup>

Nevertheless, it has to be noted that especially for the last 20 years many small and medium-sized companies have undertaken foreign trading activities mainly within Europe and have hesitated to enter more remote growth markets.<sup>31</sup> Since the end of the last millennium this has changed as a result of an increasing globalization due to a wider propagation and usage of the internet or globally linked logistics, which has facilitated foreign trading activities beyond Europe's frontiers for German SMEs.<sup>32</sup> The spread of German trading activities can be illustrated by figure 4 that shows the trading activities of German companies.

Until the world economic crisis of 2008 - 2009 the trade balance of the German economy increased continually. However, the crisis also had an impact on Germany, but only for a short period, since the total development of the German foreign trade already reached its record high of approximately 1,800 billion euro by the end of 2010.<sup>33</sup>

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<sup>28</sup> Mugler (1995)

<sup>29</sup> Webpage of the German Federal ministry of Economics and Technology - [www.bmwi.de/BMWi/Navigation/mittelstand.html](http://www.bmwi.de/BMWi/Navigation/mittelstand.html)

<sup>30</sup> Venohr (2008)

<sup>31</sup> Nunnenkamp (1996), p. 252.

<sup>32</sup> BMWI (2007), p. 27ff

<sup>33</sup> German Federal Statistical Office (Statistisches Bundesamt) (2011)

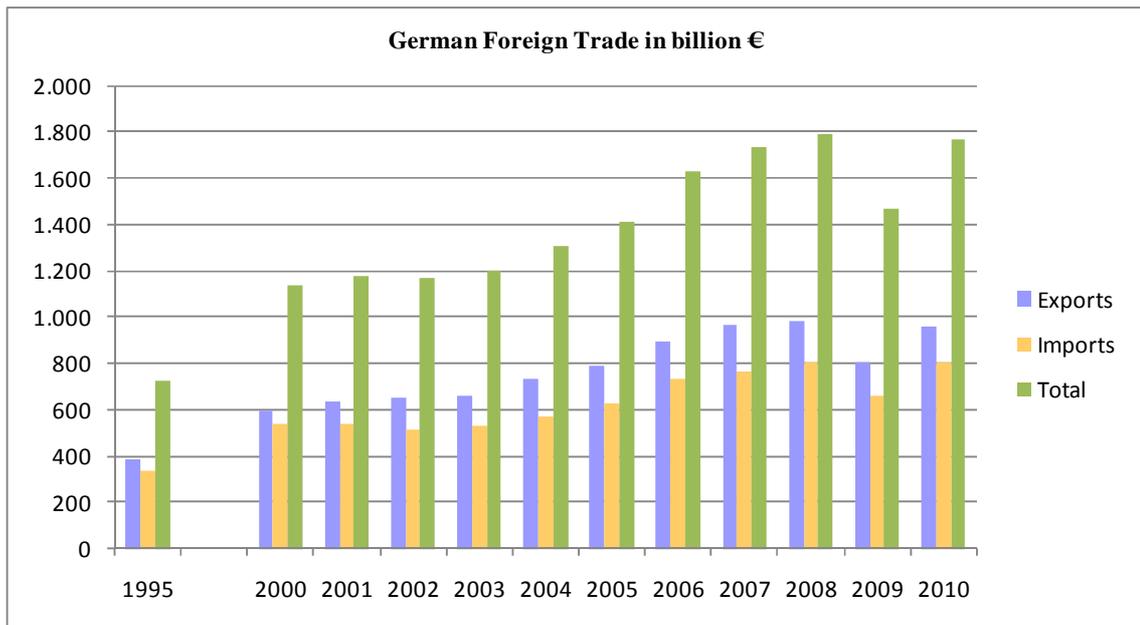


Figure 5: German Foreign Trade in billion € (all German companies) (own illustration)

Source: German Federal Statistical Office (Statistisches Bundesamt) (2011)

### 3 China

With 1.3 billion inhabitants, China is the most populous country of the world; the state with the largest area in East Asia and the fourth largest behind Russia, Canada and the USA. Meanwhile, with an average economic growth of 8 %, the People's Republic of China has become the most important Asian trading partner for many international companies. This cannot least be proved by the inward investment of almost 90 billion \$ in 2009.<sup>34</sup> The increasing interest of foreign companies can be ascribed to three central reasons: First, the high volume and the potential of the Chinese consumer market. Secondly, the favorable costs of production due to the low wages. Thirdly, China's location in the centre of Asia and, to go along with, the proximity to other growth markets of this region.

In 2010 the People's Republic of China generated a GDP of 3.446 billion \$ and was on second place of the world's biggest economic nations behind the USA.<sup>35</sup> Yet in 2006 China was on 4<sup>th</sup> place of the world's biggest economic nations with 2.618 billion \$.<sup>36</sup> Despite governmental actions aiming at moderate growth since the fear that several areas would overheat, it is not in sight that the growth is about to stop. Apart from reforms that China already committed itself internationally, such as a progressing opening of the markets within the scope of the accession to the World Trade Organization (WTO), there are also other themes that have taken on great significance. These are, amongst others, the reformation of the state-owned enterprises, the extension of the infrastructure and the prevention of the disequilibrium of the individual regions in China.<sup>37</sup>

The following paragraph will comment on the People's Republic of China as a country of opportunities for German small and medium-sized enterprises. First, the determining factors for German companies will be presented from the economic, politico-social and legal point of view. After that the German-Chinese economic relations are further described.

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<sup>34</sup> NBS - National Bureau of Statistics in China (2010)

<sup>35</sup> NBS - National Bureau of Statistics in China (2010)

<sup>36</sup> The Boston Consulting Group (2006)

<sup>37</sup> Harvie (2000), Gore (1998)

### 3.1 China as a country of unlimited business opportunities

For the last 30 years the People's Republic of China has expended an enormous effort to reform the country. The successes of this transformation process can be understood by reference to economical, politico-social and legal determining factors that German SMEs face when entering the Chinese market.

A reflection of those company-external factors is furthermore of high interest when analyzing the market entry modes to China. Transaction costs, reflecting inter alia external uncertainty, have a strong influence on the choice of the market entry modes, which will be shown in chapter 4.

In chapter 5.1 the company-external factors for SMEs in China will again be explained in detail.

#### 3.1.1 Economic framework

A country's economic framework is one of the most important criterion for an inward investment.<sup>38</sup> This economic framework in China has radically changed for German companies within the last decades. Until today, China has passed through six phases of transformation that came along with basic governmental reforms.<sup>39</sup>

##### Phase 1: Agricultural reform (1979 - 1984)

The reform policy and the political turn started in December 1978 and were said to be introduced by four modernizations. The 'four modernizations' concerned the agriculture, the military, the industry and the science. The goal was the improvement of the living conditions and the increase of productive forces by means of material incentive systems and market-based elements, if necessary.<sup>40</sup> Albeit, this 'modernization policy' was already replaced after half a year by the 'readjustment policy' since this step was only of benefit for the heavy industry and not the neglected light industry and the agricultural sector.<sup>41</sup> Means of reforms focused primarily on the agricultural sector with high effect. Agricultural production increased annually by 10% between 1981 and 1984. At the

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<sup>38</sup> Hungenberg (2004), p. 86-91

<sup>39</sup> Harvie (2000), White (1993)

<sup>40</sup> Schier (1981), p. 7ff

<sup>41</sup> Kloten (1985), p. 13

same time the agricultural income per head increased by 70% between 1979 and 1983. One main factor was the permission of non-governmental small businesses and other types of company that liberalized the market partly.<sup>42</sup> After years of international isolation, the foreign trade gained in importance in other sectors. A good example is the contact to Volkswagen AG that was first established in 1978 in order to support and promote the automobile industry modernization.<sup>43</sup> Besides, diplomatic relations with the USA as well as the EC or Germany were established which resulted in foreign investments of approximately 15 billion US dollars between 1979 and 1983.<sup>44</sup>

#### Phase 2: Industrial reform (1984 – 1988)

Motivated by the success of the agricultural reforms, the Chinese government decided to successively push forward the economic reforms and to especially integrate the urban industry which resulted in more personal responsibility in decisions concerning production and employment.<sup>45</sup> The economic structure was fundamentally changed by virtue of the reforms. While the economy grew, a non-governmental economic sector emerged which was regarded skeptically by the leaders in Beijing since those sectors were more difficult to control.<sup>46</sup>

#### Phase 3: Recentralization (1988 – 1991)

The expansive investment policy in the second phase resulted in a constant inflationary pressure so that the price reform was abandoned in 1988 and centralized price controls were reintroduced. The Chinese government could gain control of the inflation for the most part, but economic growth weakened at the same time so that China fell into a stagnancy phase till 1991.<sup>47</sup>

#### Phase 4: Socialist market economy (1992 – 1997)

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<sup>42</sup> White (1993), p. 53

<sup>43</sup> Bergmann/ Posth (1995), p. 155

<sup>44</sup> Kloten (1985), p. 53

<sup>45</sup> Kloten (1985), p. 46ff

<sup>46</sup> White (1993), Harvie (2000)

<sup>47</sup> White (1993), Harvie (2000)

After the collapse of communism in East Europe, the Chinese government was forced to promote further economic reforms in order to maintain the power in the country.<sup>48</sup> The social market economy was created that provided for a further opening of the Chinese market and at the same time further decentralization of economic competence<sup>49</sup>, which resulted in an escalation of the foreign inward investments (see also figure 4).<sup>50</sup> The reforms showed a positive effect and the average annual economic growth amounted for 12.6%.

#### Phase 5: Asian crises and the accession to the WTO (1997 – 2001)

China did not suffer from the Asian crisis in 1997 as much as its Asian neighbours. The reason was the interlinking of the Chinese currency Yuan with the US dollar, so that currency speculation failed to appear. Nevertheless, the Chinese had to face a stagnating economy that was, amongst other, provoked by credit restrictions that had been introduced to embank the inflationary pressure.<sup>51</sup> Drastic changes came up with the accession to the WTO which disallowed barriers to market entry completely. Chinese economic planning admittedly tried to terminate ecological reforms within the following years and to realize the rules of the WTO.<sup>52</sup>

#### Phase 6: China after the accession to WTO (2001 - 2010)

Even after 25 years of the reform and opening policy, China is still a 'socialistic market economy', developing from a primarily agricultural to an industrial and service society, and at the same time, from a closed to an open economy. With the accession to the WTO in 2001, the People's Republic of China bound itself by contract to integrate it into the world economy system.

Nevertheless, important and decisive aspects of a market economy are missing: investments, lending and prices are controlled by the state in many sectors of the economy.

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<sup>48</sup> Schüller (1998)

<sup>49</sup> Harvie (2000), Seitz (2000)

<sup>50</sup> Luo (2000)

<sup>51</sup> Woo/ Sachs/ Schwab (2000), p. 14

<sup>52</sup> [www.wto.org](http://www.wto.org), Magarinos/ Yongtu/ Sercovich (2002)

The foreign trade as well as the engagement of foreign investors is still underlying interventions or partly restrictive regulation by the state.<sup>53</sup>

The economic growth of the People's Republic of China was again accelerated due to the accession to the WTO. Before the accession, the economic growth amounted to 8.4% in 2001 and increased in the following years up to 12% till 2008. At the same time, the GDP increased many times, from \$1.1 billion in 2001 up to \$3.4 billion in 2009.

Though, even China had to face the effects of the world economic crisis and had to accept a throttled economic growth of 8.7% in 2009, which was still respectable compared to other countries. However, the Chinese government realized that China is part of a complex network of global economic connection involving positive as well as negative effects on their own country. In his speech from 2 March, 2010, addressed to 3,000 Members of Parliament, Wen Jiabao, Prime Minister of the People's Republic of China, predicted a 'complicated situation' for the years 2010 till 2012. The former strategies that implied a focus on exports and investments and joining the World Bank, which were the success factors of China, do not function anymore. Nonetheless, Beijing set the course for a new domestic market-oriented, innovative and sustainable model as recently as the outbreak of the crisis. As part of the prevention of the adverse consequences of the world economic crisis for China, the government relies on massive infrastructure programs, export and agriculture subventions and the bank's opening of the credit tap which will be continued in the future by means of further aids and relaxed financing.<sup>54</sup>

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<sup>53</sup> Teng (2004)

<sup>54</sup> Welt online (2010)

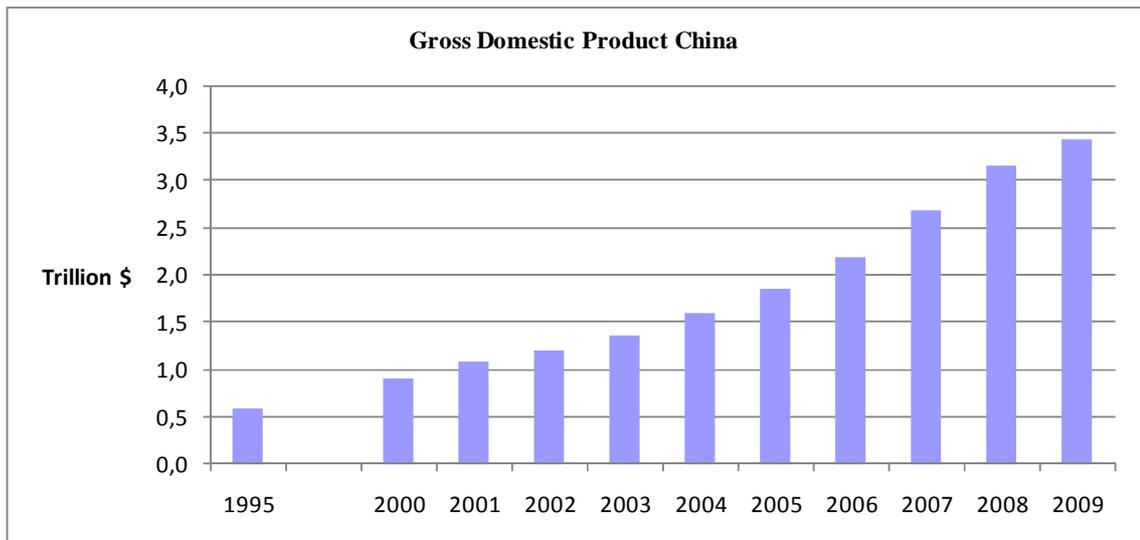


Figure 6: Gross Domestic Product China (1995 - 2009) (own illustration)

Source: National Bureau of Statistics in China (2010)

Foreign trade is primarily responsible for the recent positive economic developments in China. The import and export increased by 27.7% up to \$956 billion, respectively 25.7% to \$1,218 billion, in 2007 due to the ongoing strong demand in the USA and the revival of the European market. Hence, the trade volume increased from \$413.1 billion to \$2,173 billion in 2006. In 2008 the figures increased again until it deteriorated in 2009 due to the global economic crisis, so that the imports accounted for \$1,006 billion and the exports \$1,202 billion. However, the trading volume is comparable to the figures from 2007 (see figure 6). The import is primarily dominated by electronic products (approx. 25%), fuel (approx. 11%), chemical products (approx. 11%), raw material (approx. 11%) and machines (approx. 10%). The export primarily involves electronic products (approx. 26%), textiles and clothing (approx. 15%), electronics (approx. 8%) and machines (approx. 6%).<sup>55</sup>

<sup>55</sup> NBS (National Bureau of Statistics of China) (2010)

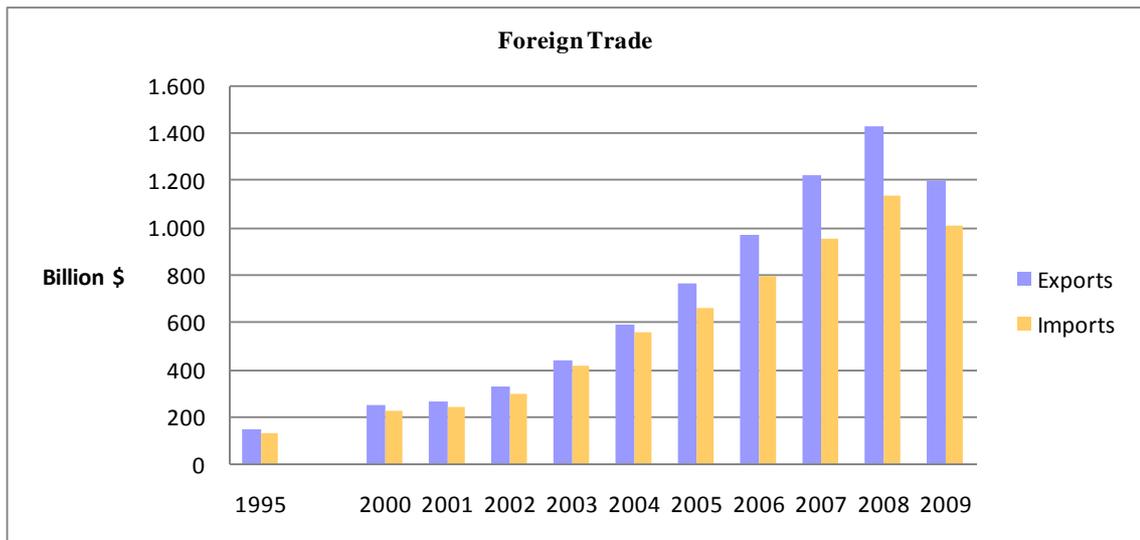


Figure 7: Foreign Trade China (1995 - 2009) (own illustration)

Source: National Bureau of Statistics in China (2010)

The main business partner of the People's Republic of China is the USA and Japan. Germany can be found on 6<sup>th</sup> place with a trade volume of approx. \$106 billion. The EU countries account for \$511.3 billion which equates a share of 19.3%.

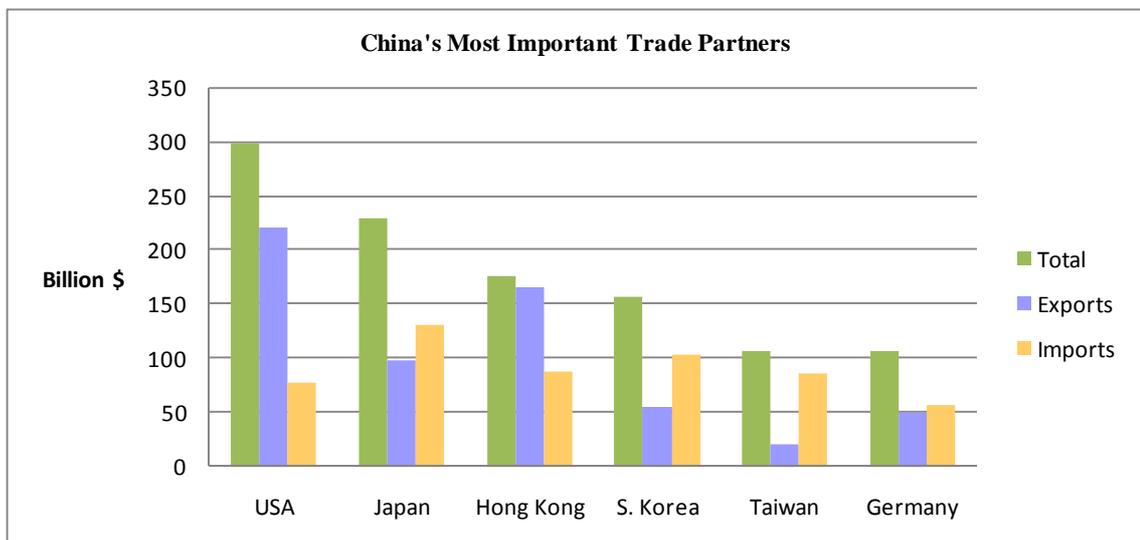


Figure 8: China's Most Important Trade Partners (own illustration)

Source: National Bureau of Statistics in China (2010)

Foreign companies invested \$74.8 billion in China in 2007. The main part of the realised new investments of approx. 58% flowed in the manufacturing industry, approx. 12% in the property sector, approx. 10% in the finance sector, approx. 6% in the leasing

and business services, whereas transport, warehousing and logistics and mail accounted for approx. 3% and, finally, approx. 2,5% flowed in wholesale and retail.<sup>56</sup>

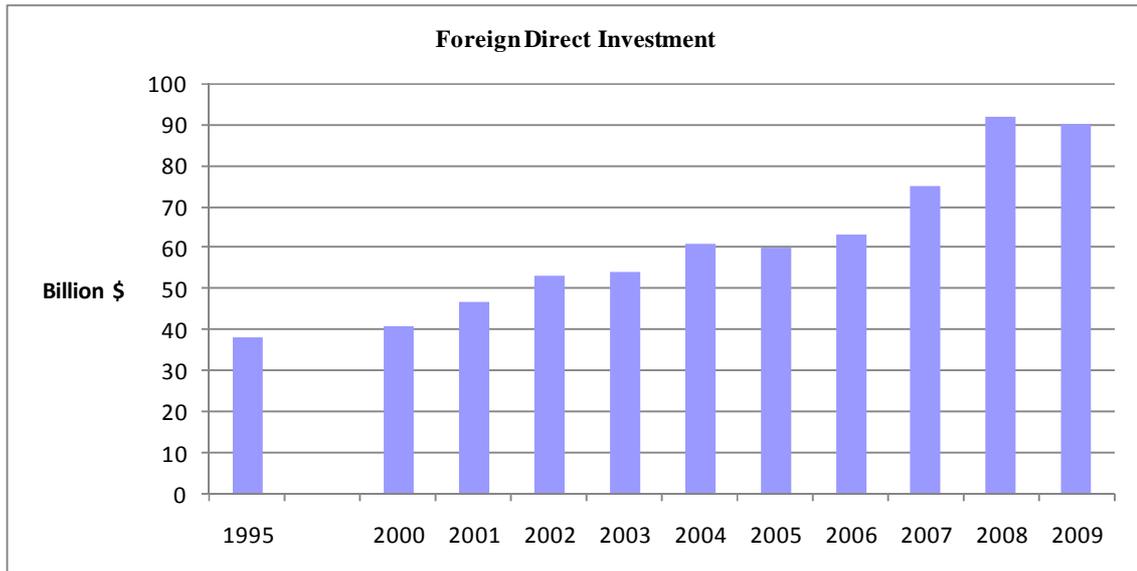


Figure 9: Foreign Direct Investment in China (own illustration)

Source: National Bureau of Statistics in China (2010)

According to the figures of the Department of Commerce MOFCOM, the controlled Chinese outward investments abroad accounted for \$70 billion in 2009. For quite some time, Chinese companies have been encouraged to invest abroad by the government in order to secure raw material and market shares.

Regarding the above-mentioned figures in its entirety, they appear to be very impressive. Nonetheless, they are delusive because they obscure a range of deficiencies and fail to reflect the quality of the economic growth which can be exemplified by the fact that China's rural regions have shown constantly a zero growth.<sup>57</sup> In their reports, Standard&Poors (S&P) warns that the Chinese finance system suffers from the fact that the banks sit on bad loans which are estimated to account for 30% of all Chinese bank credits which equates to \$500 billion. Moodys agrees with this and claims in its report, titled 'China's banking- danger thin ice!', that China has actually been bankrupt.<sup>58</sup> Furthermore, it has to be taken into account that the average income of the Chinese population varies extremely within the different provinces. Referring to that, the data quality of the Chinese government with regards to the official figures of the economic situation

<sup>56</sup> MOFCOM (Ministry of Commerce of the People's Republic of China) (2007)

<sup>57</sup> Chings-hsi (2004), p. 3, Reisach, U./ Tauber, T./ Yuan, X. (2003), p.128ff

<sup>58</sup> Moodys (2004)

has to be scrutinized. It is quite likely that data forgery plays a role in order to maintain many foreign investments and to encourage the Chinese people to save.<sup>59</sup> Besides, China's growth rates are mainly based on governmental investment spending and only secondarily on an increase of private spending.<sup>60</sup> For these reasons, a more detailed analysis of the components of the Chinese economic growth should qualify the general optimism of many German investors.

### 3.1.2 Political & social framework

The political system of the People's Republic of China was changed abruptly by virtue of the communist takeover and the proclamation of the People's Republic of China in 1949. As a consequence a centralized, socialistic single-party dictatorship to be modeled on Lenin was brought into being, where the Communist Party determined completely China's development as the central arbitration.<sup>61</sup> The totalitarian system prohibited foreign companies to enter the Chinese market until 1978. The change from a totalitarian to an authoritarian system occurred when in 1976 Mao Tsetung passed away and Deng Xiaoping acceded. As a result, the market was opened for foreign companies.<sup>62</sup>

The Communist Party of China has the power of decision with view to central political, social and economic questions.<sup>63</sup> It is considered the biggest political party of the world with approx. 60 million members.<sup>64</sup> The cadre of the party is divided into a top cadre (approx. 2400), a superior governing cadre (approx. 42,000), a governing cadre (approx. 500,000) and simple party cadre (approx. 15 million). The members of the superior cadre can be found in all important positions of the Chinese administration such as the public administration, security forces especially the police and the army, but also the trade union and the judiciary. A membership of the party offers manifold advantages, for example, by means of faster authority decisions or priorities with regards to job promotions.<sup>65</sup>

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<sup>59</sup> Oberender (2004), p. 14

<sup>60</sup> UBS Research Report (2004), p.14, The Economist (2003), p. 10 and 38ff

<sup>61</sup> Heilmann (2002)

<sup>62</sup> Hartmann (2006)

<sup>63</sup> Heilmann (2002)

<sup>64</sup> Staiger (2000)

<sup>65</sup> Schlevogt (2000a); Hartmann (2006), p. 93ff

The government consists of the National People's Congress and the State Council. The National People's Congress represents the legislature, whereas the State Council represents the executive. Albeit, the system does not incorporate a division of power in terms of the Western democratic notion since important positions of the government and the party are often manned by the same person. The National People's Congress consists of 3,000 members and is responsible for the legislation. The State Council, also named central government, is the executive power that all ministries and commissions with approx. 10 million officials are subject to.<sup>66</sup> This outrageous number of ministries and their complex organizations, and often accompanied by unclear decision-making powers, caused an immense entrepreneurial obstacle for German investors. The relatively inflexible decision-making processes within the organizations and the high number of non-transparent requirements restrained the economic freedom of action massively and raised the external uncertainty when entering the Chinese market.<sup>67</sup>

Internal stability is one of the main risk factors of foreign investments. At the beginning of the market opening, the internal stability was a crucial decision factor for German SMEs with regards to inward investments in China. Though, today, those concerns are completely or partly set aside.<sup>68</sup> In the last 30 years China has shown that it has urged the transformation and reform process. At times though facing some difficulties, but, finally China pursued a continual opening of the market and an approaching to Western economic principles.<sup>69</sup>

Along with the beginning of the transformation process and hence with an internal stability, the People's Republic of China also shows a high interest in the external stability. This can be seen in the changing relationships to countries such as Japan and the Soviet Union, which were dominated by conflicts in the past, and have improved over the time due to economic advantages.<sup>70</sup>

When entering a new market, the societal stability is also of high interest and represent a crucial factor of risk assessment because social mischief, riots or breakups can have an impact on foreign investments. Since the increasing decentralization of the power some problematic factors can be observed, such as corruption among members of the cadre,

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<sup>66</sup> Schlevogt (2000a), p.89

<sup>67</sup> Forney (1998), p. 46-47

<sup>68</sup> Meyer (1987), p.1ff; Seitz (2000), p. 148

<sup>69</sup> Oberender (2004), p. 1-4

an increasing unemployment as well as the rising differences in the average income. These are factors that can have a negative impact on the societal stability.<sup>71</sup> Nevertheless, risks like social riots or disequilibrium are only partly taken into consideration by German investors.<sup>72</sup>

### 3.1.3 Legal framework

The present legal system is an important criterion for investors especially from highly-developed countries when considering an expansion to foreign countries. One problem can be that the legal systems differ crucially from each other which raises the uncertainty of direct investments. Fields of legislation that are of high importance for German SMEs are, among others, the right of profit transfer, the protection of intellectual property and law enforcement as well as the tax, employment and social law.<sup>73</sup>

The Chinese law system has always differed from Western law systems. Especially during the Imperial era there did not exist any written law which is why, according to the tradition, the judge pronounced sentence by means of common sense or according to the amount of bribe money. Until today, the Chinese people rather prefer the out-of-court settlement than time-consuming trial.<sup>74</sup> Though, the Chinese law system has increasingly adapted Western rules and practices within the scope of the transformation process and especially after the accession to the WTO. This has led to a higher legal security for German companies in China for the last 10 years. However, there are still facts that contradict this. In 1995 the Chinese government published a catalogue (Guide Catalogue of Industries for Foreign Investment) that contained economic sectors that were prohibited for foreign investors. Another example for a restriction for foreign investors is the prohibition of fully owned subsidiaries in China. Accordingly, cooperation with a Chinese company was only possible in form of a Joint Venture in order to enter the market.

The reason for this protectionist procedure was to protect Chinese companies in sectors that were underdeveloped.<sup>75</sup>

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<sup>70</sup> Möller (2005)

<sup>71</sup> Cannon (2000)

<sup>72</sup> GCC (2009)

<sup>73</sup> Roloff et. al. (1994); Wang (2006)

<sup>74</sup> Senger (1994), p. 181

<sup>75</sup> Schwantes (1999); Wrigley (2000)

The protection of the intellectual property is another important legal point that is especially mentioned in the media and the literature. Due to the fact that especially German companies are famous for their high standards, they have concerns about the mistreatment of commercial safety and copyright when it comes to direct investments to China. For Chinese people it is difficult to consider intangibles as certain individual's or creator's property. They do not consider the appropriation of ideas, concepts or even design as something wrong to morality or even chargeable. On the contrary, this demonstrates for thirst for knowledge and learning ability, and even more, it shows respect towards the content or form of foreign intellectual property. Hence it is unsurprising that the appropriation of intellectual property of foreigners is considered legal. In case that the foreigners do not agree with this practice, it is up to them to protect themselves.<sup>76</sup> Referring to this situation, the German Chamber of Industry and Commerce gives the following advices to protect intellectual property:<sup>77</sup>

1. Tap the full legal possibilities
2. Plan a common approach with people concerned and
3. Consider marketing strategies

Since the realisation of the adjudicated rights was still deficient on average, it was important for German companies to take preparatory measures before their market entry. Referring to that, the Chamber of Foreign Trade in China recommends the following preventative measures:<sup>78</sup>

1. Mind sufficient legal measures
2. Catalogue all relevant documents that are necessary for protection of your intellectual property
3. Provide for a thorough market monitoring
4. Put the topic protection of the intellectual property on a high business level
5. Avoid outflow of know-how by your own employees
6. Chose reliable affiliates
7. Think carefully about which technologies 'to hand over'

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<sup>76</sup> Zinzius (2000), p. 152

<sup>77</sup> AHK (2007), p. 3-4

8. Conduct public relations specifically
9. Check possibilities for product safety
10. Cooperate with others

Nevertheless, the risk of appropriation of intellectual property did not stop globally acting German large businesses to invest in China, whereas German medium-sized companies abstained from production or direct investments especially when the Chinese requirements implied the foundation of Joint Venture.<sup>79</sup>

To sum up, those legal determining factors, from the point of view of pragmatic economic planning, represent a considerable market cultivation and market entry barrier for German SMEs now and then.<sup>80</sup>

## 3.2 German companies in China

Germany's political and economical relations to China have always been interwoven closely. Hence, it is necessary to begin with a depiction of the political relations from the beginning of the 19th century. This will be followed by an analysis of the increasingly intensive intertwining of both economic nations supported by statistic figures.

### 3.2.1 Political relationship

The relationship between China and Germany, which was mainly economically oriented, was positive before the Second World War. It then suffered from the pro-Japanese policy of the National Socialists and resulted in a termination of all political relations between the two countries until 1972.<sup>81</sup> The renewal of the political relations after 1972 was due to military strategies. Germany possessed the biggest army in Europe and was a crucial factor of the endeavors of an integration of Western Europe.

Another important incentive for the positive relations was the technological progress in Germany that China wanted benefit from.<sup>82</sup> Good relationships to China were also in Germany's interest. German companies could use the political contacts to promote

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<sup>78</sup> AHK (2007), p. 1-3

<sup>79</sup> Roland Berger (1998)

<sup>80</sup> Luo (2000); Roland Berger (1998)

<sup>81</sup> Leutner (1995), p. 47-177

<sup>82</sup> Luther/ Opitz (2000), p. 12-14

projects, to establish co-operations or abolish bureaucratic obstacles<sup>83</sup>, such as the following successful business transaction of German large businesses that benefited from the political relationships to China:

- 1984: Signing of contract about the Joint Venture of the VW AG with Shanghai Automobile Industry Corporation (SAIC) in the presence of the German Chancellor Helmut Kohl and the Minister President Zhao Ziyang<sup>84</sup>
- 1987: Signing of contract about the cooperation in the sector high technology (Siemens AG & Chinese cooperation partner) in the presence of the German Chancellor Helmut Kohl und Zhao Ziyang<sup>85</sup>
- 1994: Signing of contract between Siemens AG and the Chinese state about four coal power station, extension of the mill and the telephone network of Beijing<sup>86</sup>
- 1999: Signing of contract about a Joint Venture between BASF AG and the seven OPEC (biggest Chinese chemistry company) with the support of the Chinese Minister President Zhu Rongji and the German Chancellor Gerhard Schröder<sup>87</sup>

These 4 examples already show that the political relationships of both countries are primarily based on economic interests. Although politico-ideological topics, such as the human right violation or the persecution of critical intellectuals, were known and repeatedly mentioned, it was not dealt with insistently.<sup>88</sup>

To conclude, with the beginning of the Chinese reform processes and the breakup of the Eastern and Western blocs, bilateral relations were mainly dominated by economic aspects. At the same time, the interest of German companies in China resulted in a consolidation of the political relations. The closer they developed, the higher was the willingness of German companies to establish them in China so that both circumstances influenced each other in the course of time. The positive relation limited political uncertainties by virtue of economic co-operation and the support of the commercial sector and hence promoted indirectly the investments of German companies after the market opening.

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<sup>83</sup> Büchel (1998), p. 69

<sup>84</sup> Bergmann/ Posth (1995), p. 155ff

<sup>85</sup> Weggel (1987), p. 557

<sup>86</sup> Siemens-Welt (2005), p. 5

<sup>87</sup> China aktuell (1999), p. 1140f

<sup>88</sup> Leutner (1995), p. 179ff

### 3.2.2 Economical relationship

An analysis of the German-Chinese trade relation is provided here with view to the German market entry strategies.

As already described in the previous chapter 3.2.1, the economic development between Germans and Chinese was always bound reciprocally to the political relations.

Even though both sides were interested in reviving the contact, the open trade was very difficult since Germany did not maintain official contact with China till 1978. Hence, exports and imports had to be done via third countries.<sup>89</sup> Until the end of the 60s the most important German exports to China were machines, chemical products, iron, steel and textiles so that one can say that the German industry contributed to the development of a civil industry in China already at that time. After 1978, when both countries intensified the diplomatic relations, the relation developed positively.<sup>90</sup> China focused on a modernization policy, firstly also raised foreign credits and stimulated the German exports in China. From 1984 till 1985 the exports to China increased by 116% to 6,4 billion Deutschmark.<sup>91</sup> During the 90s China was the second most important destination of German exports in Asia and in 1999 on 16<sup>th</sup> place on the list of German exports. With view to imports, China was on 11<sup>th</sup> place (3% of the total import volume) from the German perspective. For China the share of German products accounted for 5% of the total import in 1999; that made Germany the sixth most important trade partner of China. Exports to Germany accounted for 4% of the share of Chinese exports.<sup>92</sup>

Today Germany is the most important trade partner for China within the EU and is ranked on 6<sup>th</sup> place with a volume of approx. \$106 billion behind the USA, Japan, Hong Kong, South Korea and Taiwan (see also figure 7). On the other hand, China is the most important trade partner for Germany in Asia even before Japan. Compared to all trade partners of Germany, China is on place three with a volume of approx. 130 billion € in 2010. Regarding the imports, China heads the table with 76.5 billion € and looking at the exports it is ranked seventh place with 53.6 billion € (figure 10).

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<sup>89</sup> Majonica (1971), p. 158-171

<sup>90</sup> Leutner (1995), p. 97

<sup>91</sup> Eberhard (1987), p. 7

<sup>92</sup> German Federal Statistical Office; NBS

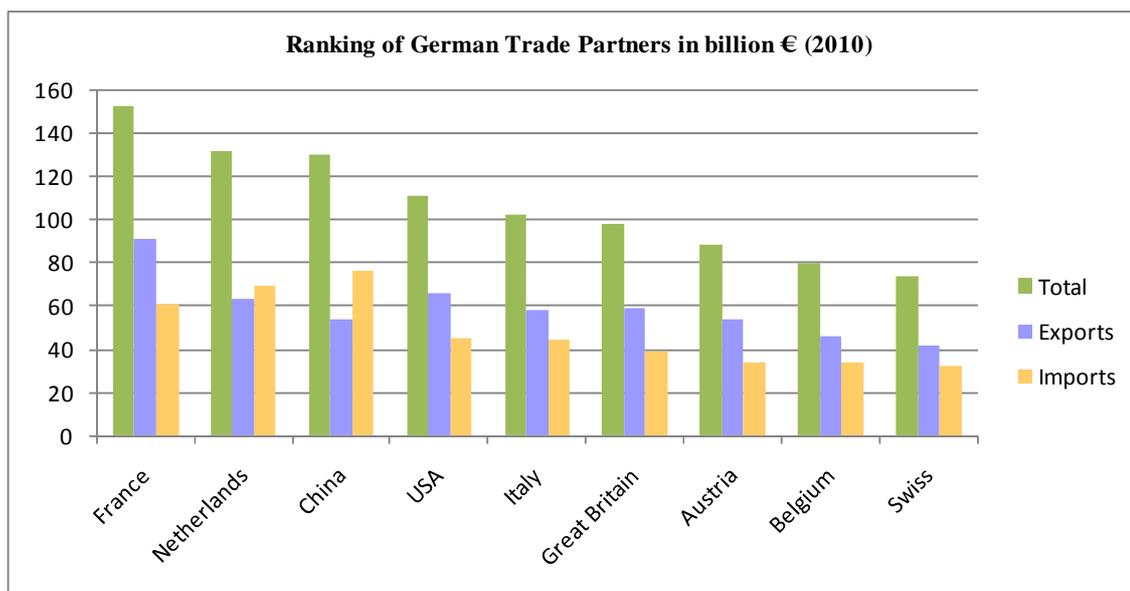


Figure 10: Ranking of Top German Trade Partners in billion € (own illustration)

Source: German Federal Statistical Office (Statistisches Bundesamt) (2011)

As can be seen in illustration 11, the main import products that Germany obtained from China in 2009 were first IT technology with 20.2%, followed by multimedia and news electronic with 18.2%, textile and clothing with 12.4%, electronics with 8.3%, machines with 4.2%, metals with 3.8% and chemical products with 3.2%. The rest of 30% include other import goods.

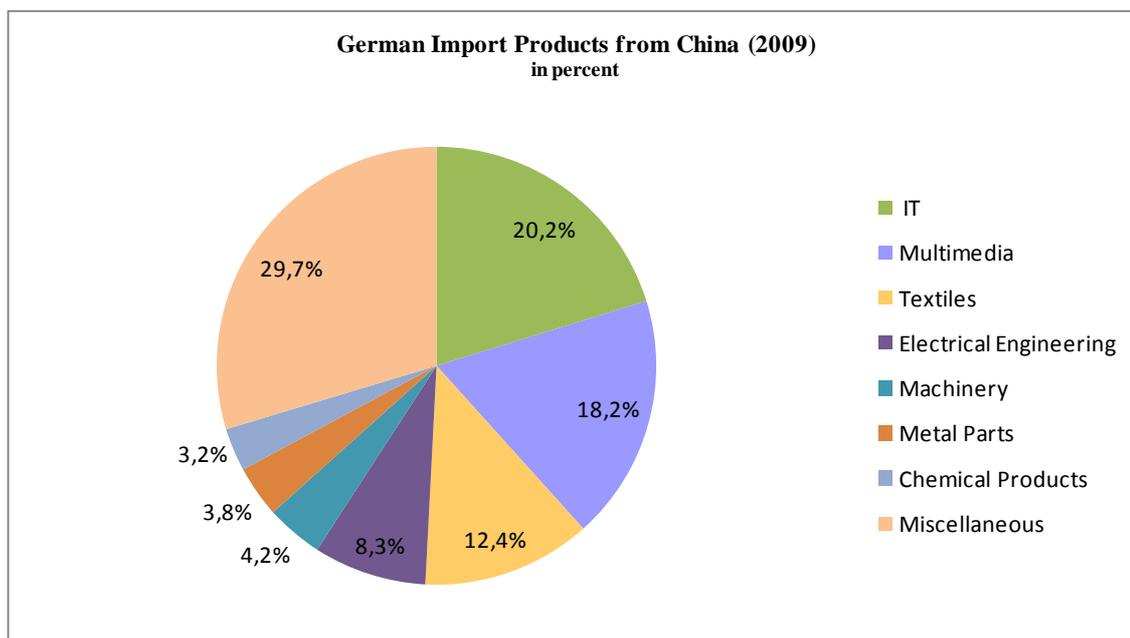


Figure 11: German Import Products from China (2009) (own illustration)

Source: German Federal Statistical Office (Statistisches Bundesamt) (2011)

With view to the export, products other than in the case of imports top the list, as can be seen in illustration 12. Machines are the most important export sector with 33.3%, followed by automobiles and automobile products, electronics with 9.4%, chemical products with 8.5%, iron and steel with 4.6%, electronics with 4.6% and measurement equipment with 4.3%. The rest of 22.2 % are further exports.

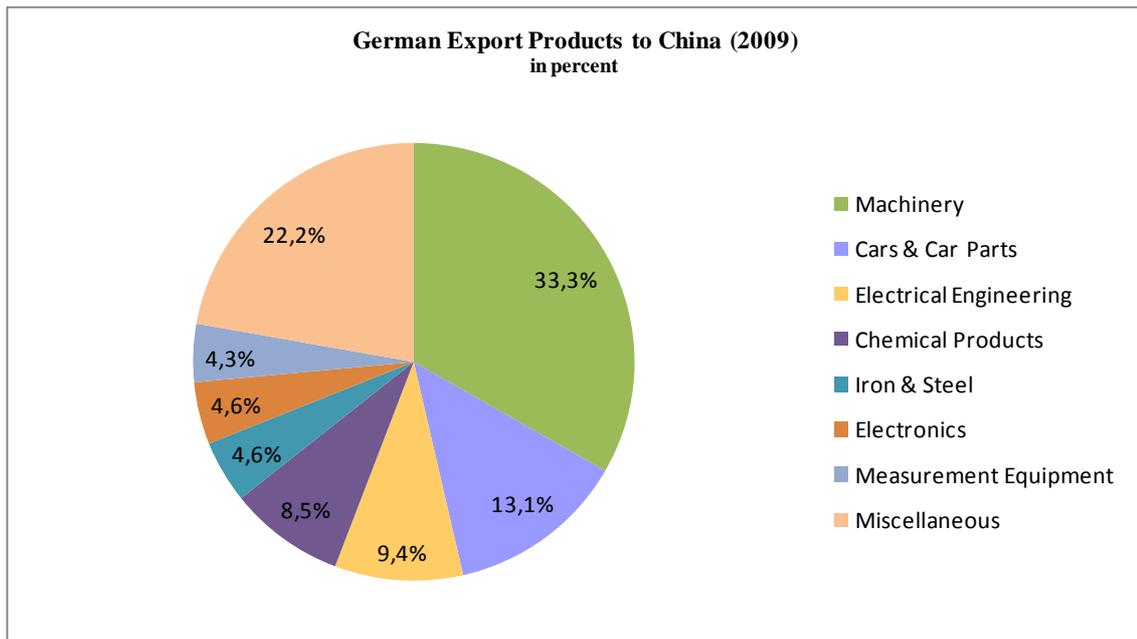


Figure 12: German Export Products to China (2009) (own illustration)

Source: German Federal Statistical Office (Statistisches Bundesamt) (2011)

German direct investments to China are clear signals that the German economy makes ideal use of the chances and possibilities that China and the Chinese market are offering. According to the MOFCOM Germany is ranked on ninth place considering its inward investments in China compared internationally. However, there exist different statistics about the figures of German direct investments to China. The German Central Bank bases their published data about German outward investments abroad on financial figures. This information is received by domestic companies due to the duty to inform about the number of investments abroad.<sup>93</sup> On the contrary, the figures of the Chinese Department of Commerce (MOFCOM) are based on the flow of the annual inward investments.<sup>94</sup> Illustration 13 shows the historic development of the German outward investments in China between 2001 and 2009. The depicted data show the results of the Chinese Department of Commerce from 2010. Obviously, there is an enormous decrease of inward investments of 63% in 2007 compared to the previous year although the number of accepted projects decreased by 5% only from 576 to 548. This can be explained by the realization of different large projects in 2006 as well as the recovering of the German economy and along with it the increased investments in Germany. Since

<sup>93</sup> Deutsche Bundesbank (2010)

<sup>94</sup> MOFCOM (2010)

then the direct investments to China have increased which will also be expected for 2010.

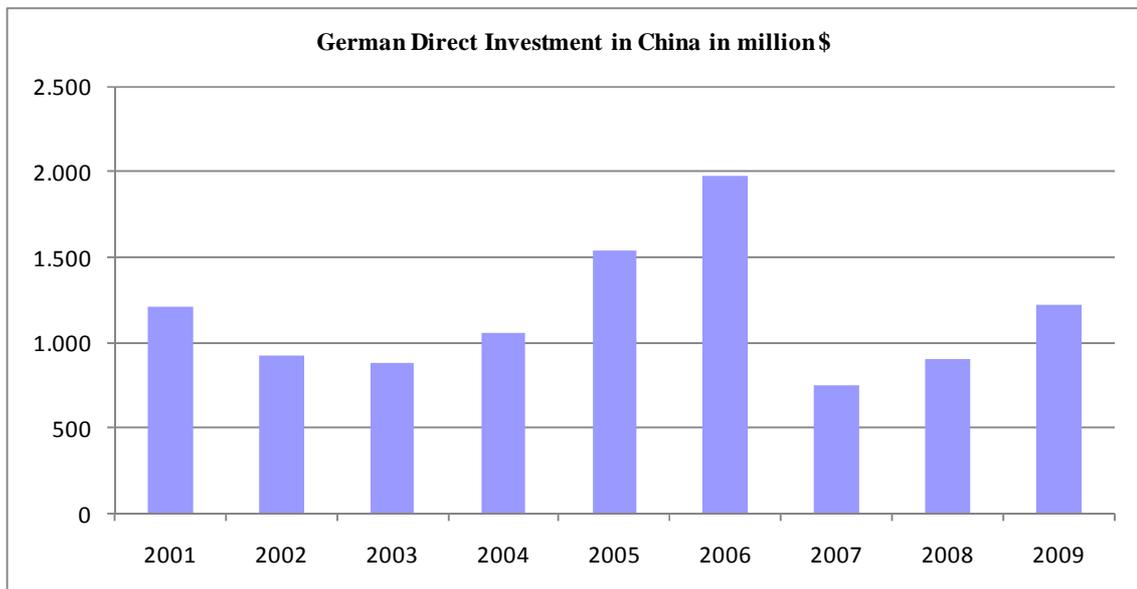


Figure 13: German Direct Investment in China (own illustration)

Source: MOFCOM (2010)

It can be basically stated that after the Chinese opening of market German direct investments supported the sustainable economic modernization and also, in an indirect way, the new increase of China up to a global great power by means of the transfer of know-how and capital.<sup>95</sup>

Regarding the historic investment behavior there are differences between large, small and medium-sized companies. German large businesses, especially the manufacturing sector, already entered the Chinese market via representations or small Joint Ventures in the 80s and at the beginning of the 90s. Almost all German large businesses were present on the Chinese market in 2001.<sup>96</sup> On the contrary, the number of medium-sized representations was still very small in the 80s and at the beginning of the 90s. One main reason was on the one hand the political and legal uncertainties. On the other hand, the sustenance of a representation in China was very expensive and often exceeded the small and medium-sized companies' financial and personnel means. Additional to the high rents and maintenance costs of a perpetual presentation, there were bureaucratic

<sup>95</sup> Bruche (1998), p. 72; Harvie (2000), p. 12; Seitz (2000), p. 287ff

<sup>96</sup> Deutsche Bank Research (2004)

obstacles that often protracted the engagement which overstrained the capacity of smaller businesses.<sup>97</sup> During the 90s the main part of medium-sized companies distributed their products mostly via the direct and indirect export since they deferred a local production. This changed in the scope following the accession to the WTO, although, the market entry of the small firm sector was mainly realized via representations and not via a foundation of joint ventures. The goal of the most middle-sized companies was to distribute their own products in China without taking the risk of local production.<sup>98</sup>

The German small firm sector especially benefited from the foundation of the delegation of the German economy in Shanghai in 1994. This instrument of the foreign trade promotion served as the first contact for SMEs regarding investments. It created a high potential of cost savings that started with a cost-free consulting up to a cooperation of a joint company pool with joint offices. Hence, SMEs had the possibility to share costs and expend small resources.<sup>99</sup>

The German direct investments to China were primarily divided into 5 sectors. Illustration 14 shows that the companies within the sectors engineering generates the highest share of investments with 29.6%. Independent services are ranked second place with 25%, followed by electronics with 10.5%, automobiles and automobile products with 7.2% and the chemical industry with 6.7%. The rest of 21% are other sectors.

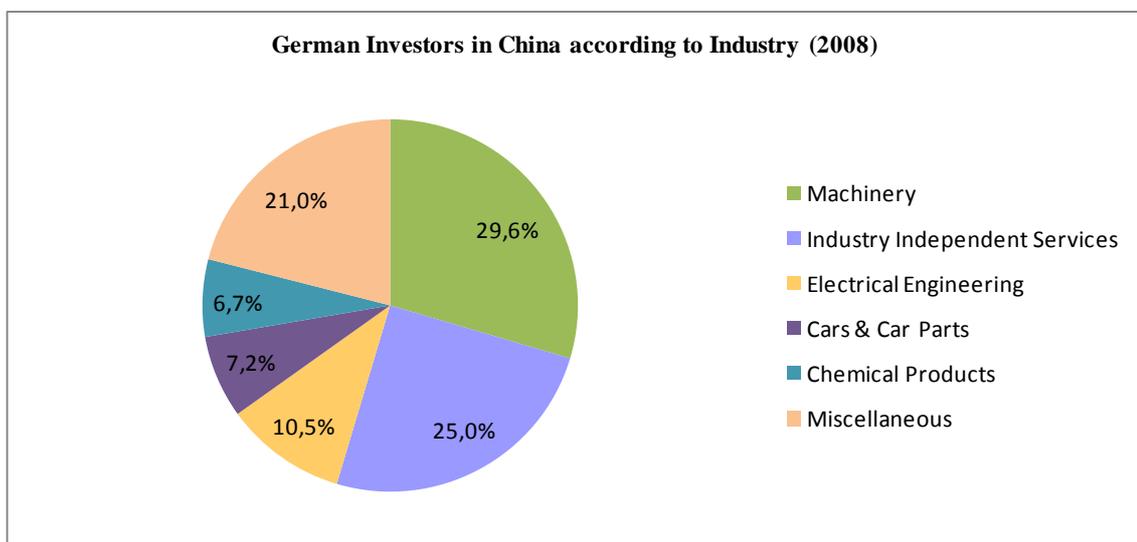


Figure 14: German Investors in China according to Industry (own illustration)

Source: GIC (German Industry and Commerce) (2008)

<sup>97</sup> Eberhard (1987), p. 7ff

<sup>98</sup> Sommer (2000), p. 1-5; Samson/ Sydow (2006), p. 18-21

<sup>99</sup> www.china.ahk.de

The regions where German investments are situated can be seen by illustration 15. Approx. 80% of the German investments are done in three main zones at the East coast of China:

- Yangtze Flussdelta incl. Shanghai
- Wider area of Beijing
- Perl river delta Province Guangdong.

Shanghai is by far the most famous location for German investments in China with 47% where more than 1,100 investments, twice more companies as in Beijing, are located. Additionally, 590 companies are located in the neighbor provinces of Shanghai. Especially small and medium-sized production companies choose the proximity of Shanghai for their establishment in China due to the closeness to other German companies and a good infrastructure. Contrary to the latest reports or recommendations to relocate the productions to the West of China due to increasing costs, many German companies withstand that option although the Western provinces allure with benefits and incentives.



Figure 15: Local presence of German operations in China

Source: GIC (German Industry & Commerce) (2008)

In the last years foreign companies were especially formed in the form of wholly foreign owned enterprises (WFOE). This trend coheres with legal changes and hence simplification of the establishment process. While formerly representations were formed, today more and more German companies decide for a direct foundation of an establishment or a joint venture (JV). According to German Company directory (GIC) the share of representations in form of foreign organizations only accounted for 39% in 2008 compared to WFOE with 41% and JV with 20%.

It has to be mentioned that the organization forms differ from region to region. In Shanghai they prefer the foundation of WFOE, whereas in Beijing they rather prefer representations by virtue of the proximity to the political decision makers who can be crucial for the success of German large businesses.<sup>100</sup>

<sup>100</sup> GIC – German Company Directory (2008)

In the following chapter 4 'International expansion' it will be further explained the different forms of market entry possibilities, such as exports to China, representations, joint ventures or WFOE of German companies in China.

## 4 International expansion

In the last decades the international competition has intensified due to the global economic transformations which has affected export-oriented firms as well as companies that act on the domestic market. Political, technological and economical changes are the main incentives for the increasing internationalization of companies.

After having pointed out the German-Chinese relation in the previous chapter, this chapter will deal with the internationalization processes that are the basis for further expansion of international trade.

Firstly, the motives for an international expansion will be discussed, which can be cost, market and competition-oriented. Moreover, the special characteristics or determining factors for SME when going abroad will be demonstrated.

The second part of the chapter deals with the forms of the market entry strategies. The forms of the foreign market cultivation, consisting of, for example, the export, the joint venture or the own subsidiary are described in detail. Furthermore, the particular advantages and disadvantages are contrasted. Finally the chapter will describe the form of the market entry strategy that is chosen by German SMEs.

Since in chapter 6 the empirical study will refer to and discuss the forms of direct investments, the profound illustration of the forms of foreign market cultivation is inevitable.

### 4.1 Definition of international expansion

In the literature the term internalization is often used along with foreign business, international activity and operational foreign economy.<sup>101</sup> According to *Rath, Steinmann* and *Wasner* the basic idea of internalization has to be seen in transnational economic business transactions.<sup>102</sup> According to *Pausenberger* international activities are characterized by '[...] the fact that they allocated their production potential to more (at least two)

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<sup>101</sup> Kaufmann (1993), p. 6; Wiebe (1991), p. 146

<sup>102</sup> Rath (1990), p. 6; Steinmann (1989), p. 1508; Wasner (1984), p. 14

countries and are integrated permanently in different national economies beyond the mere distribution'.<sup>103</sup>

#### 4.1.1 Motives for expansion

When depicting the motives for the internalization abroad, identical pattern for classification can be found quite often in the literature. It is differentiated between cost-, sales- and market- as well as competition-oriented motives.<sup>104</sup> When cost-oriented motives determine the decision for an international expansion, the company wants to utilize, for example, low costs in the host country concerning personnel, area, construction, transport, production as well as environment protection. Further cost motives are governmental support measures of the foreign country in form of lower tax burden, favorable credits and subventions.<sup>105</sup>

*Rath* refers to sourcing-oriented motives when companies can acquire resources of the host land, such as human resources, technologies, marketing advantages and organizational abilities to low costs.<sup>106</sup> In this paper, these sourcing-oriented motives are attributed to cost-oriented motives due to their equal characters. *Caspers* regards the cost-oriented motives as the main incentives for internationalization abroad.<sup>107</sup>

For the sales and market-oriented motives the opening and protection of the market of the host country are in the foreground. The dynamic and the size of the host country, in our case China, represents an impressive sales potential with manifold possibilities for many SMEs. Especially with view to the saturation of the domestic markets the prospects are stimulated by the hope of a successful internationalization.<sup>108</sup> Companies, which want to build up a production abroad, are sometimes also inspired with confidence of higher productivity that cohere with the expectations of higher returns.<sup>109</sup> The sales-oriented direct investment is transacted most frequently according to the UNCTAD.<sup>110</sup>

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<sup>103</sup> Pausenberger (1988), p. 2610

<sup>104</sup> Broll (1993), p. 52f; Kromphardt/ Bathe (1997), p. 367

<sup>105</sup> Helmes (1996), p. 52ff; Deuster (1996), p. 85ff

<sup>106</sup> Rath (1990), p. 250f

<sup>107</sup> Caspers (2001), p. 6

<sup>108</sup> Kebschull (1989), p. 980

<sup>109</sup> Kaufmann (1993), p. 8ff

<sup>110</sup> UNCTAD (2001)

Expanding companies in the host countries have the possibility to build up closeness to their purchasers. Hence customers' requests can be directly and exactly in order to adapt the products. Besides, there is a chance to face the dominating culture. Moreover, the chance to higher market share raise since customers prefer products that are made in their country as well as the fact that maintenance work and service can be done locally.<sup>111</sup> Furthermore, representations abroad can be an advantage for the companies concerning the entry to public contracts of the host country, the advantage of avoiding exchange rate differences and the surmounting of import barriers.<sup>112</sup>

Further motives for the expansion abroad are, among others, the progress in research and technology, a better infrastructure, flexibility of the job market and better qualification of the employees. These motives are, of course, relevant for the developed countries and are not fully transferable to China.<sup>113</sup>

The reason why companies transact expansions due to competition-oriented reasons is mostly a reaction to an attitude of the competition. When the competition expands abroad, many companies are only left with the possibility to choose the same way in order to maintain competitive and/or not to lose their market shares. Alternatively, the company forestalls their competition as a first mover in order to guaranty the first mover advantages of the young market.<sup>114</sup>

By means of the new location the company practices risk spreading over markets, trade cycles and customer groups that increases the protection against crises.<sup>115</sup> Besides, the additional location can function as the so-called 'bridgehead'. For *Helmes* this is the usage of one residual country as the operational basis or steppingstone for the cultivation of adjacent countries, for example, in form of exports.<sup>116</sup> Another completion-oriented motive is the production life cycle process strategy. Accordingly, a product is introduced as a new product for production and marketing in less developed countries after having entered the phase of saturation in the highly industrialized home country. This is called a push factor.<sup>117</sup> There is talk about a pull factor when foreign purchasers

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<sup>111</sup> Koller/ Raitchel/ Wagner (1998), S. 181f

<sup>112</sup> Müller (1995), p. 134ff; Jürgens/ Klingel (1996), p. 35f

<sup>113</sup> Pausenberger (1994), p. 15

<sup>114</sup> Meffert (1989), p. 447

<sup>115</sup> Dürr (1981), p. 409

<sup>116</sup> Helmes (1996), p. 60f; Kebschull (1989), p. 982

<sup>117</sup> Kormann (1981), p. 127

demand for the product without being asked or, more frequently, when an important customer asks the company to accompany to a foreign market.

A sharp distinction between the investment motives is not very easy since the goals of an inward investment are often reciprocal and poly-causal as well as changeable in the course of time.<sup>118</sup>

Studies about the motives of Asian investors in China show that in the last decades after the market opening, cost-oriented motives have mainly been the reason to build up trade relation to China.<sup>119</sup> In 2007 the DG Bank in cooperation with the delegation office Shanghai published the results of the study about the motives of the internationalization of German companies in China. They state that at that point of time the companies that acted in China were mainly classified as sales-oriented.<sup>120</sup> Further research proved that the opening of the Chinese market is the main incentive for German investments in China.<sup>121</sup> According to the delegation office of the German economy in Shanghai 80% of the products produced in China by German companies are also sold locally. The mere processing by means of cheap production, the motive of a cost-oriented investor, only played a subordinate role for most German companies in China until 2000.<sup>122</sup> This should change with the relocation of R&D (research and development) departments.

#### **4.1.2 Specialities within the internationalization of SME**

In chapter 2.1 German SMEs have been defined by means of quantitative and qualitative scales. These criteria are mainly responsible for how SMEs internationalize. Typically, SMEs are characterized by limited financial resources, a narrower and specialized offer, less developed management functions, a rather unsystematic decision-making process and the personnel union of leadership and property that contribute to an inter-leaving of family interests and enterprise policy.<sup>123</sup> The IfM (Institute for SME research) sees the main qualitative definition of a SME in the unity of economic existence of the company and its leadership and the responsible participation of the leadership in all re-

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<sup>118</sup> Dunning (1996), p. 56ff

<sup>119</sup> Luo (2000), p. 17; METI survey (2001), p. 17

<sup>120</sup> DG Bank & Delegiertenbüro Shanghai (2001), p. 7-19

<sup>121</sup> Siemsen/ Geissbauer (1996); Roland Berger (1998)

<sup>122</sup> Delegiertenbüro der deutschen Wirtschaft (1998)

<sup>123</sup> Steinmann (1989), p. 1510

levant decisions concerning the company policy.<sup>124</sup> Middle-sized companies have at command internal particularities that influence the internationalization behavior. The simple bureaucracy and the informal communication cause small complexity costs<sup>125</sup> and fast reaction times.<sup>126</sup> Plane hierarchies and short information ways allow SMEs a fast adaption to the challenges of the foreign markets. The proximity to the customers raises the sensibility for market niches and allows an individual service.<sup>127</sup> Specialized and innovative products can help to overcome market entry.<sup>128</sup>

The low organization and leadership level often result in an overload of time and competence of SMEs.<sup>129</sup> The lack of strategic planning brings unsystematic decisions and raises the risks that are connected with a market entry.<sup>130</sup> Short financial and personnel facilities limit the organization options of the internationalization, whereas high-qualified employees are often not offered sufficient possibilities of development.<sup>131</sup>

Eventually, it is still a question of mentality in many SMEs whether there is the willingness to face the challenges of the new market.<sup>132</sup> Generally, the question of an international engagement has to be asked individually for each company taking into account the size, sector, product, capital intensity and available resources. There are three main reasons to withdraw from internationalization that can be considered typical for SMEs: too low financial potential, insufficient information and insufficient internationalization know-how.<sup>133</sup> The forms of the internationalization implying a high demand of capital like direct investments are difficult to realize as an alternative for small firm companies. As a consequence, the internationalization is often realized, especially at the beginning, via the export. Should a foreign export market appear to be profitable, SMEs think about expanding their engagement on this foreign market.<sup>134</sup>

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<sup>124</sup> IfM Bonn (2006)

<sup>125</sup> Hoppe/ Rickes (2000), p. 185

<sup>126</sup> Bülk (1997), p. 51

<sup>127</sup> Geulen (2001), p. 35f and p. 70

<sup>128</sup> Hoppe/ Rickes (2000), p. 185

<sup>129</sup> Geulen (2001), p. 34

<sup>130</sup> Haeusgen (1997), p. 132

<sup>131</sup> Bülk (1997), p. 52ff

<sup>132</sup> Müller (1998), p. 20

<sup>133</sup> Schmidt/ Menke/ Hesppe/ Künzel (1995), p. 94

<sup>134</sup> Backer-Gellner/ Huhn (2000), p. 177ff

The individual forms of the market entry variants will be described in the following chapter.

## 4.2 Modes of market entry strategies

The search for a promising market entry strategy is regarded as the core of the strategic decisions in the scope of internationalization processes.<sup>135</sup>

Following *Müller* illustration 16 shows a systematization of the foreign market cultivation according to the increasing degree of the international engagement and the strain of resources. Behind this systematization lies the presumption that the company undergoes several phases during the internationalization process. The easiest form of the foreign expansion is the export with a low resource strain with a low intensity of the foreign engagement at the same time. The comparable 'middle resource' strain can be found within the cooperation forms. Co-operations with an independent company as partner can be divided into two sections, the 'strategic alliance' and 'joint ventures'. However, the option with the highest foreign intensity is the foundation of a subsidiary that represents the total supply chain abroad and, hence, needs the highest amount of resources. The WFOE emerge either from 'acquisition' or 're-foundation'.<sup>136</sup>

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<sup>135</sup> Müller-Stewens/ Lechner (2002), p. 233; Niehoff/ Reitz (2001), p. 9

<sup>136</sup> Müller (1995), p. 211

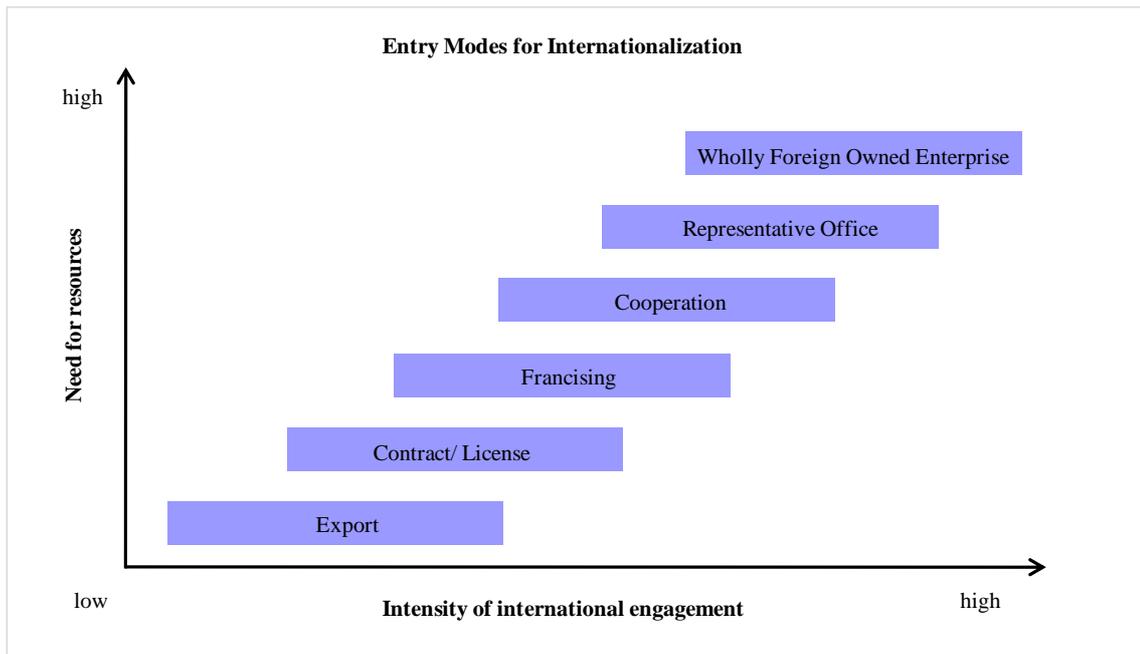


Figure 16: Entry Modes for Internationalization (Version 1)

Source: Müller (1995), p. 211

Another systematization logic of different market entry modes are illustrated by *Helm* (Figure 17).<sup>137</sup> *Helm* differentiates between internationalization by means of internal or external growth or with or without direct investment. While self-reliant market entry is limited to the resources of the enterprise, the dependent market entry tries to shorten the development by means of acquisition or enterprise co-operations, insofar as the needed resources are available through other companies.<sup>138</sup>

<sup>137</sup> Helm (1997), p. 36ff

<sup>138</sup> Waning (1994), p. 177

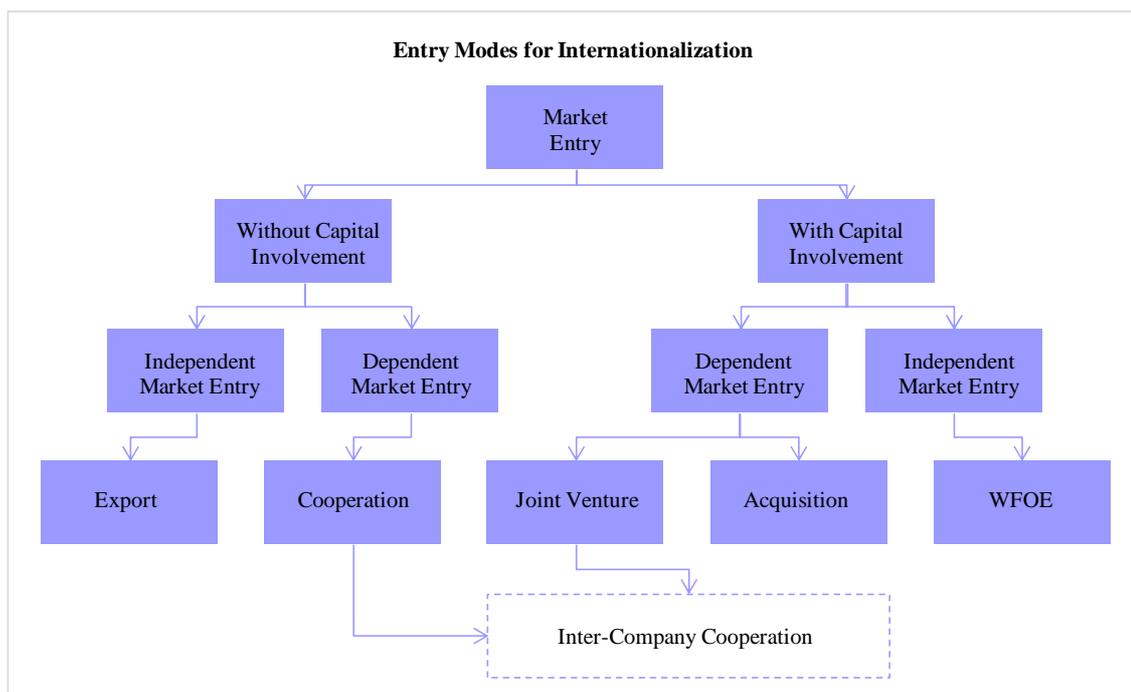


Figure 17: Entry Modes for Internationalization (Version 2)

Source: Helm (1997), p.36

In the following, market entry modes will be further explained on the basis of the systematization described by *Müller*. Furthermore, it will be looked at the advantages and disadvantages. The strategy of the direct investment that is not literally presented in the two systematizations by *Müller* and *Helm* involve the possibility of the representation office, the cooperation or the own company abroad.<sup>139</sup>

In the scope of the empirical study in chapter 6, the modes of direct investments will exclusively be considered. Exports, contracts and franchising are not part of the study.

#### 4.2.1 Export

The export can be defined as a transnational transport process that results from the spatial division between the production in the domestic country and the sale abroad.<sup>140</sup>

The question whether the export can be regarded as a form of an international market entry is still disputed in the literature. Several authors doubt whether the export fulfils the criterion of the long-term intensity taking into account the short-term commitment of enterprise resources, the possibility to undertake exports one-time only and the gen-

<sup>139</sup> Müller (1995), p. 211; Deuster (1996), p. 33

<sup>140</sup> Root (1994), p. 27; Pausenberger (1994a), p. 2

erally regarded low risk.<sup>141</sup> Nevertheless, the majority of the authors account the export for the basic modes of internationalization. For *Wesnitzer* the reason for these varying definitions of exports lies in the lapidary observation that 'export is not like the other'.<sup>142</sup> Classically, the basic mode of international market entry can be divided into indirect and direct export.

The indirect export uses domestic producers of a domestic foreign trade company in order to sell its products abroad. The trade maintains a mere domestic trade concerning its commercial processing. The organizational connection can be conducted via the domestic distribution. The contact to the customer, the acquisition and the delivery is conducted by interconnected, legal and self-reliant thirds. Usually these are national trading houses, self-reliant trading representatives based in the home country, domestic export traders, export contractors or other domestic manufacturers for piggy-back exports that function as the broker between the producer and the foreign customers. The export trader is responsible for the financing of the export trade and bears the risk.<sup>143</sup>

The mere rendition of the export initiation and processing for a domestic broker requires a low engagement on the side of the producer company. Referring to that there is not only missing the necessity of a specific foreign know-how and an enterprising adaption to the foreign trade, but also the establishment of a long-term relation to the customer abroad. Although this appears to be ideal for small and internationally inexperienced companies, it cannot be classified as an international market entry due to the very low requirements for the company.<sup>144</sup>

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<sup>141</sup> Zinser/ Roth (1994), p. 137; Davidson (1983), p. 441

<sup>142</sup> Wesnitzer (1993), p. 21

<sup>143</sup> Bamberger/ Evers (1997), p. 120; Backhaus (1982), P. 150

<sup>144</sup> Wesnitzer (1993), p. 49

<b>Indirect Export</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• low capital expenditure</li> <li>• low application of resources , e.g. costs, time, personnel</li> <li>• existing experiences of partner can fully be utilized</li> <li>• no development of export know-how necessary</li> <li>• gathering for information on the foreign country, initiation of business contacts, the development and running of an export department are not necessary</li> <li>• high organisational control</li> </ul>	<ul style="list-style-type: none"> <li>• complete market cultivation done by an external partner with all consequences</li> <li>• no image or brand development possible, low information on foreign market changes, no customer contact, no influence on marketing, no control on price level</li> <li>• no economies of scale and no real market penetration</li> <li>• an unreliable partner causes loss of goodwill</li> <li>• negative for investment goods because no pre- or after sales service can be implemented</li> <li>• even though low application of resources there has to be a development of partner relationship</li> </ul>

Figure 18: Indirect Export: Advantages vs. Disadvantages (own illustration)

The direct export implies a direct sale of products to the customer on the respective markets. This means that the necessary business abroad has to be realized by the domestic companies. This means the domestic sales team comes directly in contact with the customers, distributors, retailers and ultimate buyers. In this case, the actors are either the own export department, the export subsidiary, the employed travelling export representatives or foreign importers, wholesalers, retailers or foreign merchants in the target market.

With view that the production of durable goods involves a high necessity of explanation, maintenance and reparation it has to be guaranteed that this service can be conducted domestically or by the traveling agents without establishing a constant representation in the respective country. The direct export requires excellent customer contacts and the care of customer relation on the foreign market.<sup>145</sup> The phase of direct exports generally represents a learning phase of the internationalization and can be regarded as an alternative especially when a company does not intend to cultivate the market with a high a resource commitment.

In comparison to other market entry strategies, the influence of external parties, such as brokers, on the total business activities as well as the risk is lower with direct exports.<sup>146</sup> If the company does not intend to open up a representative office the investment cost for

<sup>145</sup> Apfelthaler / Fuchs (2002), p. 166

exports are low due to the lack of cost intensive transfer of human and capital resources into the foreign country.<sup>147</sup> Furthermore, unused capacities within the domestic production can be utilized in order to decrease unit costs. Moreover, the export provides the possibility to expand living production processes cycles by means of shifted market cultivation. It is quite common that products that cannot be sold anymore on the domestic market are in demand in other markets.<sup>148</sup> Furthermore, exports can help to reduce the dependability from the domestic market.<sup>149</sup> Crisis-induced shocks in a market can be balanced in another market by means of sales increases. This also applies for seasonal sales decrease.<sup>150</sup> Exports do not come into question as market entry strategies in case that the export costs, referring to production, transport and transaction costs are higher than they would be compared to direct investment.<sup>151</sup> Besides, regarding exports as a market entry alternative, it is not advantages in case of high protectionist measures in the target country, such as tariff and non-tariff trade barriers. With view to services, export can either be considered as a potential market entry alternative.

<b>Direct Export</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• low capital expenditure</li> <li>• low application of resources , e.g. costs, time, personnel</li> <li>• retaining of the strategic flexibility</li> <li>• quick time to market</li> <li>• gathering for information on the foreign country, initiation of business contacts, the development and running of an export department are necessary – know-how gathering</li> <li>• quick retreat from foreign market possible</li> <li>• often first step in internationalization process</li> <li>• better capacity utilization</li> </ul>	<ul style="list-style-type: none"> <li>• currency exchange risk</li> <li>• transport cost</li> <li>• administrative and judicative restraints</li> <li>• no image or brand development possible, low information on foreign market changes, no real customer contact</li> <li>• no economies of scale and no real market penetration</li> <li>• negative for investment goods because no pre- or after sales service can be implemented</li> <li>• protectionist measures from foreign country</li> <li>• waive of locational advantages</li> <li>• possible acceptance problems</li> </ul>

Figure 19: Direct Export: Advantages vs. Disadvantages (own illustration)

<sup>146</sup> Albaum/ Strandkov/ Duerr (1998), p. 193

<sup>147</sup> Sachs, von (2001), p. 110

<sup>148</sup> Meyer (2000), p. 30

<sup>149</sup> Albaum/ Strandkov/ Duerr (1998), p. 17

<sup>150</sup> Holland (1997), p. 13

<sup>151</sup> Sachs, von (2001), p. 112

### 4.2.2 Contract/ Licensing

The second classic mode of market entry is licensing. Until the end of the 70s, licensing was not regarded relevant considering market cultivation.<sup>152</sup> This strategy implies that the know-how (product or production technologies) is not commercialized abroad by the company itself, but the rights of processing are assigned to thirds. The basis of this agreement is a license contract that implies that the licensee is granted the economic realizable partial rights resulting out of this legal position.<sup>153</sup>

The subject of this contract can be different forms of immaterial economic goods, such as governmentally lent right (such as commissions, registered designs, design patents or brands) or factually existing monopolistic knowledge advantages (clandestine technical knowledge, marketing know-how, not protected, but established brands etc.).<sup>154</sup> The licensee is allowed to use the assigned knowledge within the contractual frame of the set barriers, for example, by means of the deployment of the corresponding technologies, production of the corresponding products, usage of corresponding names, signs or patent designs. In return the licensee pays charges for the assignment.

The drafting of the contracts can be very different taking into account the amount of assigned rights, the restrictions that the licensor imposes on the licensee as well as the amount and the form of the charges. Referring to the amount it has to be distinguished between exclusive and non-exclusive licenses. In order to maintain own interests, the licensor limits the assigned right, for example, by means of a spatial and temporal limitation, ban of exports or sublicense, non-aggression treaties and requirements of a determined quality level with view to assignment of brand names. License fees can be paid as a lump sum or usage-dependent. Another possibility is an offset agreement against licenses.

The allocation of licenses can be understood as the purchase or leasing of know-how.<sup>155</sup> However, there are a range of differences comparable to a 'normal' sale of goods or services resulting from the special characteristics of the immaterial good 'know-how'. The sale of know-how on the market is problematic since the value of know-how is known by the seller, but not by the potential buyer. This information asymmetry cannot be ab-

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<sup>152</sup> Schmidt/ Fellermann (1993), p. 749

<sup>153</sup> Kriependorf (1989), p. 1323

<sup>154</sup> Daniels/ Radebaugh (1995), p. 535ff

<sup>155</sup> Kappich (1989), p. 125ff

olished since a more detailed evaluation of the know-how could only happen, if the interested party could get access to the know-how which is not possible because the seller would have then already given away the information without being payed. According to *Arrow* (1971) this problem of the quality uncertainty of know-how transfer is referred to as 'fundamental information paradox'.<sup>156</sup>

High transaction costs are necessary in order to guarantee that a transfer of know-how between independent thirds happens without uncontrolled diffusion. These costs include high costs of initiation, agreement, transaction, control and subsequent adaption of the contracts.<sup>157</sup> The transfer of know-how is simplified by an already existing mutual trust between the two parties which could have been built up through former export and import relations. Still a high amount of legal certainty is necessary due to the long-term effect of the contracts.<sup>158</sup>

Another problem is the danger that the licensor creates potential competitors in the long term. Companies that are able to imitate these products or technologies are built up to potential competitors in the long view. Hence, companies have to establish appropriate strategies. Especially in less transparent regions like China, where marketing and processing know-how is necessary, precautionary measures have to be taken. As already described in chapter 3, China does not entail the same brand and patent rights as Western partners.<sup>159</sup>

The granting of a license is a stronger commitment to a foreign market than a mere export of goods, whereas the commitment to a foreign market is weaker than an establishment of the own representative offices, a cooperation or a subsidiary.

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<sup>156</sup> Arrow (1970), p. 152; Mandler (1992), p. 364f

<sup>157</sup> Picot (1991), p. 344

<sup>158</sup> Buckley/ Casson (1988)

<sup>159</sup> Kutschker/ Schmid (2002), p. 834f

<b>Contract</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• use of company know-how in countries which are hard to reach/ cultivate</li> <li>• access to resources of the partner, (restrictive)</li> <li>• low use of internal resources (financial, personnel)</li> <li>• quick time to market</li> <li>• low business risk</li> <li>• relative customer proximity</li> <li>• minimal exchange risk</li> <li>• income via license charges</li> <li>• low information on foreign market needed</li> <li>• no transport cost</li> </ul>	<ul style="list-style-type: none"> <li>• dependency on licensing partner</li> <li>• low control on licensing partner</li> <li>• complex and time intensive partner search</li> <li>• support of a potential competitor via know-how transfer</li> <li>• possible image damages through foreign partner</li> <li>• no optimal utilization of technological advantage on the foreign market</li> <li>• information paradoxon</li> </ul>

Figure 20: Contract: Advantages vs. Disadvantages (own illustration)

### 4.2.3 Franchising

Franchising is another form of foreign market cultivation. The franchise concept is primarily based on the granting of a 'business format' implying a profound know-how of marketing and processing. The franchisee uses the defined marketing and processing concept against a fee, often against an admission fee and the running fees depending on the turnover and/or the profit of the franchisee.

In the last couple of years franchising has been converted to a successful concept of international market cultivation, for example McDonald, Body Shop, Pizza Hut, Hertz, Arcor). The main reason for this lies in the apparent equal allocation of the risks between franchiser and franchisee. On the one hand the franchiser receives a direct market entry by means of local knowledge of the franchisee including a low risk of distribution. On the other hand the franchisee can make recourse of an established concept consisting of brand, product, service and marketing without having risky advanced payments.<sup>160</sup>

Referring to SMEs that try to expand via franchising there cannot be found very much in the literature. Especially with view to German SMEs that want to establish a franchise concept in China, there is no information at all and hence seems to be non-relevant for the analysis of market entry modes of German SMEs in China.

<sup>160</sup> Kutschker/ Schmid (2002), p. 841

<b>Francising</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• especially for companies who have standardised market penetration concepts</li> <li>• low capital expenditure due to the fact that franchisee bears the expenditures</li> <li>• quick internationalization in case of a good concept</li> <li>• direct control on the market cultivation process through instruction and control rights</li> <li>• high motivation of the franchisee</li> </ul>	<ul style="list-style-type: none"> <li>• conflict with local needs of the foreign market with the standardized concept</li> <li>• elaborate control and management on quality, cost and business goals</li> <li>• no consistent corporate identity among the franchisees</li> <li>• high dependencies on the quality of the franchisee</li> <li>• constant marketing innovations needed (high amonz of creativity and capital)</li> </ul>

Figure 21: Francising: Advantages vs. Disadvantages (own illustration)

#### 4.2.4 Cooperation

The cooperation is a form of direct investment and hence belongs to the most profound ones of market entry strategies.<sup>161</sup> In comparison to exports or contractual market entry strategies the company can better expand its monopolistic advantage, for example, technical superiority, and hence exhaust enterprising potentials.<sup>162</sup>

One characteristic for the cooperation is the shared fulfillment of tasks between the companies. As a result, companies for example exchange capital, technology and material which vary with regards to their form and amount.<sup>163</sup>

The legal and economic independence of two or more involved companies remains safe by the cooperation, whereas their authority and autonomy is restricted.<sup>164</sup> All relevant specifications of the cooperation are written down in detail.<sup>165</sup> The contractual cooperation is the possibility to establish a permanent engagement of SMEs abroad.<sup>166</sup>

Companies that come into consideration are either companies with an equal net product structure, or companies with upstream or downstream net product levels. The first-mentioned is referred to as a horizontal cooperation, whereas the latter one is called a

<sup>161</sup> Backhaus/ Meyer (1993), p. 330

<sup>162</sup> Pausenberger (1994a), p. 9

<sup>163</sup> Von Behr (2001), p. 19; Hardock (2000), p. 20

<sup>164</sup> Kaufmann (1993), p. 27ff

<sup>165</sup> Hardock (2000), p. 20; Rath (1990), p. 9ff

<sup>166</sup> Kumar (1989), p. 923

vertical cooperation.<sup>167</sup> By means of operational cooperation SMEs gain the possibility to conduct transnational activities while saving their own resources and minimizing or distributing the risks.<sup>168</sup>

Companies always accept cooperation in case that the commonly generated profit surmounts the costs<sup>169</sup> or in case that the profit is higher than without the cooperation.<sup>170</sup> For SMEs it is significant that they strive to establish mergers with controlling share in order to secure the goals of the their company.<sup>171</sup>

Co-operations are still distinguished in 'strategic alliance' and 'joint venture' in the literature. Strategic alliances are therefore all models of enterprising partnerships without the foundation of an association, with ongoing legal and economic autonomy of the partner.<sup>172</sup> In other words, the strategic alliance is a formalized, permanent relation to another company with the aim to compensate one's own shortcomings by means of strength potentials in order to enhance the competitive ability of the own company.<sup>173</sup>

In contrast to the strategic alliances, joint ventures are associations of two or more companies that commonly contribute capital, company share and experiences to a new enterprise which is operated according to their capital relations.<sup>174</sup> Hence, joint ventures are partnerships with foundation and are also called 'equity joint ventures'.<sup>175</sup>

Moreover, joint ventures aim at a closer form of cooperation since resources like capital, know-how and employers are elaborately provided for the establishment and the functioning of the common subsidiary.<sup>176</sup> The amount of common resources for the joint venture project is individually written down in the contract. Although close cooperative relations with shared responsibility exist, the companies mostly maintain their identity in order to keep up with other projects.<sup>177</sup>

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<sup>167</sup> Backhaus/ Meyer (1993), p. 330; Welge (1995), p. 2399

<sup>168</sup> Zanger (2000), p. 498; Müller (1995), p. 244

<sup>169</sup> König/ Kukuk/ Licht (1997), p. 229

<sup>170</sup> Winkelmann (1997), p. 62

<sup>171</sup> Steinmann (1989), p. 1514

<sup>172</sup> Müller (1995), p. 242

<sup>173</sup> Welge (1995), p. 2398

<sup>174</sup> Eisele (1995), p. 10ff

<sup>175</sup> Hellwig (1989), p. 1064

<sup>176</sup> Müller (1995), p. 211; Rath (1990), p. 57

<sup>177</sup> Meffert/ Bolz (1998), p. 128

<b>Cooperation</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• avoidance of import restrictions via partner</li> <li>• quicker time to market than implementation of a WFOE</li> <li>• use of market know-how of the partner</li> <li>• economies of scale via joint production and sourcing</li> <li>• cost and risk sharing</li> <li>• know-how transfer</li> <li>• lower need for resources in comparison to the implementation of a WFOE</li> <li>• joint enforcement of interests</li> </ul>	<ul style="list-style-type: none"> <li>• only possible under compliance of current law</li> <li>• high conflict potential</li> <li>• high need for coordination and control</li> <li>• often a limited lifespan</li> <li>• brain drain</li> <li>• profit separation</li> <li>• success high dependent on choice of partner</li> <li>• elaborate drawing of contracts</li> <li>• development of a strong CI often never reached</li> </ul>

Figure 22: Cooperation: Advantages vs. Disadvantages (own illustration)

#### 4.2.5 Representative office (RO)

The foreign bureau is another form of direct investment. There are different forms of foreign branches such as contact office, a service centre or a branch establishment with or without an own warehouse. In contrast to a fully-owned subsidiary, the representative office is not independent legally.<sup>178</sup> For this reason, the fully-owned subsidiary will be further analyzed in chapter 4.2.6.

Hence, representative office can be defined as the contact office, the service centre or the establishment. This classification was used for the companies that participated in the empirical part of the study which will be referred to in chapter 6.

In case that a company considers establishing a foreign bureau, generally there are already good contacts and first successes on the corresponding foreign market. In order to fully exhaust further potentials, a local presence is necessary due to the customers' demand for a stronger commitment or a more intensive adaptation to local demands on the market (frequency of the visits, intensity of consulting and training, delivery of spare parts within one day, after-sales service in the region).<sup>179</sup> Another reason for a foreign representation is motivated by a high competition orientation. In this case the close relation orient itself towards strategies of the most important competitors. In contrast to

<sup>178</sup> Köller (2006), p. 2ff

<sup>179</sup> Waning (1994), p. 183

already mentioned market entry strategies, the main advantage of the establishment is the fact that the way, the amount and the quality of the market cultivation can be taken control of. The more intensive the competition is in the region, the more important is the contact to potential customers in order to protect the competitive advantages.<sup>180</sup> As a result, the business is focused on the consulting of customers, the performance of services, trainings and the project management as well as the organization and initiation of contracts. Other businesses are the monitoring and information transfer to the parent company. It seems comprehensible that the exhaustion of the market with the establishment of a local entity is by far the better market entry alternative than export or contractual partnerships.<sup>181</sup>

Due to the higher risk, based on the lone responsibility for the personnel, organization and financial demands, a high planning intensity and competence is necessary. The consequence of the employment of internal resources is the limited flexibility of the company with view to the faster adaption to changing environmental conditions. As a result, the shortages of resources often force foreign bureaus of SMEs to concentrate on special core markets and to conduct a limitation of the geographical expansion.<sup>182</sup>

<b>Representative Office</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• complete control over the business actions</li> <li>• implementation of pre sales and after sales services</li> <li>• proximity to customers</li> <li>• stringent strategy implementation</li> <li>• market cultivation in the way the mother company planned</li> <li>• efficient company intern communication and transfer of know-how</li> <li>• insider positioning brings flexibility and market knowledge</li> <li>• reduction of political resistance</li> <li>• quicker time to market and lower startup cost in comparision to WFOE</li> </ul>	<ul style="list-style-type: none"> <li>• no utilization of cost advantages in foreign country</li> <li>• not entire supply chain in foreign country</li> <li>• relatively high requirements on local and home management</li> <li>• cost for control and management of RO</li> <li>• exchange rate risk</li> <li>• transport costs</li> <li>• high information on foreign country needed before expansion</li> <li>• no quick reaction to market changes since information has to be feedbacked to mother company</li> </ul>

Figure 23: Representative Office: Advantages vs. Disadvantages (own illustration)

<sup>180</sup> Simon (1988), p. 464f

<sup>181</sup> Peren/ Clement (1999), p. 74ff; Helm (1997), p. 37

<sup>182</sup> Pausenberger (1994a), p. 9f; Menke/ Scheu (1997), p. 157

#### 4.2.6 Wholly foreign owned enterprise (WFOE)

A direct investment abroad as a fully-owned subsidiary is the most complex possibility to be represented on the international markets. SMEs are forced to take higher risks and to provide for the most resources. Compared to all internationalization strategies, the strategy of subsidiaries is the most permanent one. Due to the enormous effort and the needed experience, it is also the most difficult one.<sup>183</sup>

Typical for the internationalization form of the subsidiary is that the investing companies act without a partner in the foreign country. The needed resources, such as technological know-how, management abilities or capital, have to be provided by the parent companies and transferred to the subsidiaries.<sup>184</sup> As a result, the parent companies have the unrestricted influence on the subsidiaries.<sup>185</sup>

With view to the goal and strategy-oriented leading of subsidiaries, the original parent company has several possibilities to take on control. For this purpose there are controlling systems that pursue, for example, analysis of cost divergence. Besides, personal meetings between the representatives of the parent association and the subsidiaries, dealing with the goals and planning for the future, support the operational coordination.<sup>186</sup> The foundation of a subsidiary can be conducted via two different ways. Either the investing companies decide to acquire an existing company or to found a new company.<sup>187</sup>

Should the SME decide to expand or to be presented abroad via the acquisition of another company, this is called external growth.<sup>188</sup> This decision is dominated by the conviction to get access to resources by means of buying-in and to promote the own market power by means of expanding market shares.<sup>189</sup> Acquisition is often equally defined as cooperation since it is also reverted to resources of a foreign company in order to enhance the competitiveness. It is also referred to as ownership structure or company share of foreign companies of 0 to 100%<sup>190</sup>

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<sup>183</sup> Müller (1995), p. 256

<sup>184</sup> Kaufmann (1993), p. 91; Hardock (2000), p. 18

<sup>185</sup> Kaufmann (1994), p. 184; Koller/ Raitzel/ Wagner (1998), p. 192f

<sup>186</sup> Winkelmann (1997), p. 223ff; Fayerweather (1989), p. 944

<sup>187</sup> Steinmann (1989), p. 1515f

<sup>188</sup> Pausenberger (1994), p. 16f

<sup>189</sup> Kutschker (1989), p. 3ff

<sup>190</sup> Müller (1995), p. 260

This paper follows the opinion of *Eisele* who characterizes the acquisition only in connection with a one-hundred-percent purchase of the company that is about to be acquired.<sup>191</sup> Analog to the internationalization form of the cooperation, the buying-in enables the companies to acquire horizontally and vertically related firms.<sup>192</sup>

Founding a new subsidiary is synonymous to internal growth.<sup>193</sup> The original parent company builds up its own subsidiary (WFOE) without the help of partners or using the existing infrastructure of acquired companies. This generates or produces independently as an enterprise in the future but under the control and the guidelines of the parent company. The parent companies have the right to determine and control the whole company policy of the subsidiaries.<sup>194</sup> Foreign engagements in form of new foundation are long-term decisions accompanied by a high risk. The needed resources for the setup and maintenance are provided by the parent company.<sup>195</sup>

<b>Wholly Foreign Owned Enterprise</b>	
<b>Advantages</b>	<b>Disadvantages</b>
<ul style="list-style-type: none"> <li>• complete control over the business actions</li> <li>• entire supply chain in foreign country</li> <li>• use of cost advantages of the foreign country</li> <li>• low transport cost to customers</li> <li>• complete utilization of the success potential of the company specific know-hows</li> <li>• optimal market cultivation via production in foreign country</li> <li>• efficient company intern transfer of know-how</li> <li>• avoidance of export specific costs</li> <li>• reduction of exchange rate risks</li> <li>• reduction of political resistance</li> </ul>	<ul style="list-style-type: none"> <li>• high risk due to high capital expenditure</li> <li>• high requirements on local and home management</li> <li>• loss of economies of scale</li> <li>• high cost for control and management of a international company</li> <li>• cost of cross-border know-how transfer</li> <li>• cost for alignment of production processes according to local needs</li> <li>• high startup cost</li> <li>• high time to market</li> <li>• no quick retreat from foreign market possible</li> </ul>

Figure 24: WFOE: Advantages vs. Disadvantages (own illustration)

#### 4.2.7 Advantages and disadvantages of expansion modes

The previous sub points have described the individual forms of the foreign market cultivation in detail and have pointed out the individual advantages and disadvantages. Illu-

<sup>191</sup> Eisele (1995), p. 15

<sup>192</sup> Meyer/ Rühmann (1993), p. 63f

<sup>193</sup> Pausenberger (1994), p. 16f

<sup>194</sup> Wasner (1984), p. 275ff

stration 25 again shows a comprehensive overview of the evaluation of the market entry strategies by means of relevant criteria. The criteria are the most important ways of distinction of expansion modes that can be found in the literature. These are the following ones:

- the time that a company needs to enter the favored foreign market
- the resources that have to be provided by a company
- the control that a company has when cultivating the market
- the risk that goes along with the expansion abroad
- the expected costs
- the proximity to the customer
- the experience that a company needs to choose this form of internationalization

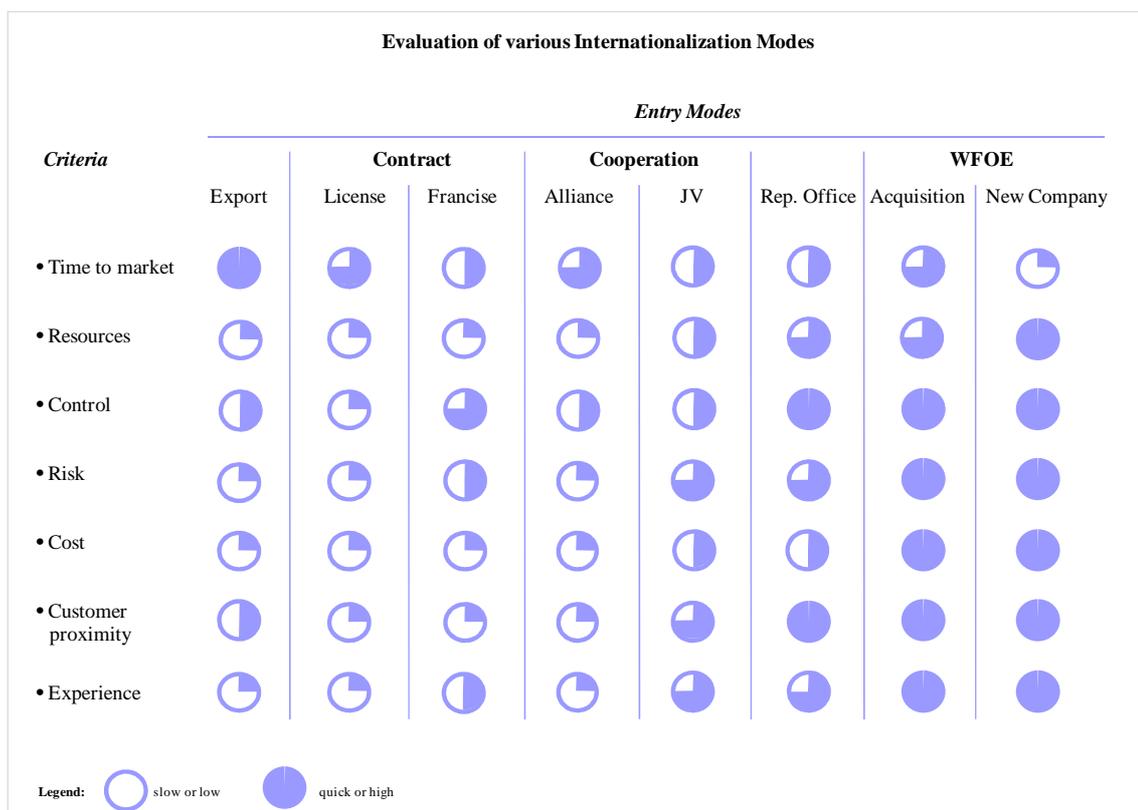


Figure 25: Evaluation of various Internationalization Modes (own illustration)

Each market entry mode contains advantages and disadvantages. Hence, it is impossible to identify the ideal internationalization strategy for the SMEs in general but also with special regards to the expansion in China. Certainly one can follow the opinion of *Müller* who describes the internationalization as a step-by-step process that starts with the simple form of exports and, in case of a successful establishment on the target market, finishes with the foundation of an own subsidiary.<sup>196</sup> This dynamic consideration of the internationalization process as a series of sequenced phases during which the companies collect experiences step by step was found by a few international studies about SMEs (e.g. from Island<sup>197</sup> and Spain<sup>198</sup>) as well as by the transnational Inter-Strato SME Study conducted in 1993.<sup>199</sup> However, other studies also found out that the internationalization process of a large group of SMEs stagnated due to the fact that these SMEs remained on a certain level of internationalization. Others jumped directly from the first level to the last level without going through the successive process.<sup>200</sup>

In the end each SME has to decide for itself which phase fits best or which strategic goals are to be pursued in the foreign market and which internal resources are available for this.<sup>201</sup>

#### **4.2.8 Entry modes of German SME in China**

Neither in the literature nor in studies conducted by the industry is there any, or only in excerpts, analysis of entry modes of German SMEs in China. The forms of direct investments (representation offices, cooperation or subsidiaries) can be checked nominally due to the investments.<sup>202</sup> As already mentioned in chapter 3.2.2 there are more than 3000 German companies that have processed the expansion in China by virtue of inward investments. A distinction between SME and large enterprises has not been made in this statistics.

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<sup>196</sup> Müller (1995), p. 261f; see also Gankema (1997), p. 185-199

<sup>197</sup> Jonsdottir (2001)

<sup>198</sup> Pla Barber (2001)

<sup>199</sup> Gankema (1997), p. 185-199

<sup>200</sup> Etemad/ Wright (2003)

<sup>201</sup> Kokalj/ Wolff (2001)

<sup>202</sup> GIC – German Company Directory (German Industry & Commerce) (2008)

On the contrary, there is no number for those SMEs that export to China or have entered a form of contractual relationship with a Chinese company on-site. Even the German customs office could not provide any information for this.

Nevertheless, it can be assumed from the results of various studies<sup>203</sup> that SMEs, due to their lack of resources compared to big size firms, choose a version of market entry strategy which is resource saving. After being established in the market SMEs will successively extend their businesses and ideally want to finally develop an own subsidiary in the long run.

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<sup>203</sup> European Network for SME Research (ENSR) (2004)

## **5 Success factors for China business expansion**

After having described the international expansion in detail in chapter 4, the following point will deal with the factors that are necessary for a success of German SMEs abroad. Chapter 5.1 will shed a light on external success factors, whereas chapter 5.2 will outline internal ones.

### **5.1 Specific external success factors for SME in China**

The external success factors are of high importance for the analysis of the market entry modes because the external uncertainties have a determining impact on the choice of foreign market cultivation and the following competition strategies. Companies that want to act successfully in a foreign country have to be able to adapt to the external conditions. Ideally a company can anticipate its future external environment. Especially in the present increasingly changing environment, a company has to be able to identify these relevant factors and to react to them at best. In the following, the external uncertainties of German inward investments in China will be analyzed by means of industry-sector specific factors and consumer specific factors.

#### **5.1.1 Industry specific success factors**

Among the industry-sector specific factors are the acquisition of relevant data (market, customers, competition etc.) that are necessary for the entry and the cultivation of the future market, the location from where to start and the recruitment of qualified personnel in order to realize the foreign strategy.

##### **5.1.1.1 Gathering of market information**

A majority of literature that deals with market entry into China gathering market information is the most critical problem that companies face when they define their entry strategy.<sup>204</sup> Until the end of the 1980's information on Chinese markets or Chinese economy has rarely or basically not existed for foreign companies. The Chinese government had a high interest in not revealing economic data from its state-owned busi-

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<sup>204</sup> DG Bank & Bureau of Delegates, Shanghai (2001), p. 7-19

nesses which still operated in planned economy at that time. The aim of the Chinese government was to create the picture of a prospering country and, therefore, if data on the Chinese economy was published it was sugarcoated.<sup>205</sup>

By the end of the 80's the first market studies have been conducted according to Western standards. Unfortunately, the markets changed rapidly due to a lot of market entries of Western companies into China. Therefore, the data basis for market entry was outdated when it was published and only useable as an indicator.<sup>206</sup> Furthermore, official statistics were not reliable due to the fact that the data had been gathered from several regions and provinces where the data had often been manipulated positively by regional heads in order to open up better career chances for them within the Chinese communist party. Another reason why the data was not reliable is that statistics mainly focused on planned economy measures, such as production quantity, and not on common Western measures such as cost, prices and revenue. Even today, after having standardized the accounting system by the Chinese government and having introduced standard guidelines for gathering economic data within companies and regions, there is still a lot of doubt whether the data can be considered reliable.<sup>207</sup>

In the 1990's German SMEs were in favour of the option to collaborate with a Chinese firm in form of a joint venture in order to obtain necessary market information.<sup>208</sup>

Today the means to gather information about China, about specific regions or branches are manifold. Firms use economic institutions like the chamber of commerce, China business fairs, and consulting companies specializing in China, or the internet. Recently the internet has become one of the most important information channels. In addition, big companies use their already established representative offices and political contacts which smaller companies cannot do since they have not been active in China.

Nevertheless, even though the information being offered today is extensive, German companies complain that they still feel confused and left alone with their China engagement. Therefore, the ways to get information for them is rather pragmatic. The companies use the help and know-how of companies which are already active in the

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<sup>205</sup> Wang/ Zhang/ Goodfellow (1999)

<sup>206</sup> Hagen/ Wöllich (1999), p. 31-35

<sup>207</sup> Reisch/ Tauber/ Yuan (2003)

<sup>208</sup> Zinzius (2000)

Chinese market, which, to some extent can serve as a practical example for the newcomers.<sup>209</sup>

#### 5.1.1.2 Choice of location

The choice of location is a key aspect of the market entry because once a decision is made it has long lasting effects which can only be revised at high costs. Especially in China the importance of the location is evident since the regional differences are manifold.<sup>210</sup> Companies have to take various aspects into account when deciding on an ideal location. The most important aspects are analyzed below:

- Different regions stand for different industries: the heavy industries such as steel or car industry is located in the north east due to the high coal and oil resources. The light industry and industry that has high needs for water is primarily positioned along the Yangtse delta. Export-intensive industries such as the textile industry are based in the south of China where good connections to harbors and for garment resources are provided.<sup>211</sup>
- The per capita income (PCI) of Chinese residents, an indicator of purchasing power, is of high interest for the consumer goods industry. In 2009, the PCI in Shanghai was the highest in China with approx. 30.000 RMB (Chinese currency) which equates to approx. 3.000€ per year. In Beijing the PCI is already lower with 20.000 RMB. In most provinces the PCI lies at about 5.000 RMB and lower.<sup>212</sup>
- Labour costs define the choice of location of the manufacturing industries. In 2001 a Chinese worker earned 0.53€ per hour on average, whereas a German worker earned 22.00€ per hour. Nevertheless, the labour costs differ between the Chinese regions. In higher qualified regions a manufacturing worker earns around 3.20€ per hour and in Shanghai the costs perhour are already at 16.50€

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<sup>209</sup> Brede/ Nerb (2004), p. 357-383

<sup>210</sup> Oppenländer (2002), p. 361-379

<sup>211</sup> Haas/ Rehner (2003b), p. 114-144

<sup>212</sup> China Statistical Yearbook (2009)

<sup>213</sup> Reisach/ Tauber/ Yuan (2003)

- The availability of resources is another crucial factor when looking for the right location. In this case one has to consider the electricity and water supply, the transportation system or the differences in climate<sup>214</sup>
- The choice of location may also depend on the local authorities' flexibility. Only in case a company gets a guarantee for a certain working environment, it will make long lasting plans and invest in a location.<sup>215</sup>

Unfortunately, a dilemma occurs when, on the one hand, companies want to be at low cost locations where land, workers, production, etc. are cheap, but at the same time also want to have a well-established transportation system, a perfect functioning electricity and water supply system, e.g. a good infrastructure. These conditions are usually not available at the same locations therefore the company must make hard choices when deciding on the best location when entering the Chinese market.<sup>216</sup>

Today, more than 50% of all German companies that are involved in China are either based in Shanghai or Beijing even though other regions have been catching up in recent years. According to the German Chamber of Foreign Trade in Shanghai this can either be explained by the still good balance between low-cost environment and at the same time good infrastructure and good supply of other necessary resources. Though, it can also be explained by the fact that German companies that enter China locate themselves where other German firms are already present which can serve as "big brothers" and ease the first steps into the new market.<sup>217</sup>

#### 5.1.1.3 Personnel recruitment and development

The recruitment of the right employees is another crucial external success factor for German companies entering the Chinese market. Before deciding on the staff, a company has to question itself what kind of strategy it will pursue, either a cost-oriented or a sales-oriented strategy. Each strategy has a different need for employees. Whereas a cost-oriented strategy is looking for a low-cost production facility possibly with low-skilled workers who will not earn much, the sales-oriented strategy is looking for high

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<sup>214</sup> Zinzius (2000)

<sup>215</sup> Haas/ Rehner (2003)

<sup>216</sup> Zinzius (2000)

<sup>217</sup> GIC (2008)

sales in the new market and therefore needs qualified employees, e.g. salesmen who cost more but will boost up the new company.<sup>218</sup>

Companies who set up a low-tech production plant in China have the luck to select from a broad range of low-skilled and cheap workers who mostly come from the countryside to earn more than they could earn on their farms. On the other hand, foreign companies that enter China and pursue a sales-oriented strategy or set up a high-tech production facility are in high need for qualified Chinese employees. As a result, skilled employees are rare and at the same time not cheap. Moreover, due to the competition of foreign firms for qualified staff, Chinese workers are not loyal and the fluctuation rate is extremely high. Foreign companies implemented incentive programs in order to tie Chinese workers to their companies.<sup>219</sup>

The search for qualified employees is still a huge problem within China. No system is in place to support foreign companies in their staff search. Head-hunters are present in China but they are expensive and especially SMEs cannot pay this amount of money each time, especially with regards to the high fluctuation rate. Moreover, the evaluation of Chinese workers is tricky since, on the one hand, foreign companies cannot properly evaluate between good or bad résumés, for example with regards to which universities have a better or worse reputation. On the other hand, Chinese employees tend to fake their résumés in order to get better jobs. Therefore, foreign firms work with a mouth to mouth system among themselves to possibly avoid the risk of an “unsound” worker.<sup>220</sup>

German large-sized companies started cooperating with universities in order to generate future employees who were already trained the way the companies needed them. SIEMENS or SAP are mentioned here as examples who collaborate with the Tongji University which already had a German chair and was teaching German/ Western way of business (c.f. [www.siemens.de](http://www.siemens.de) and [www.SAP.de](http://www.SAP.de)). At the same time BOSCH implemented the German vocational school system and opened up several of these schools to offer employees a dual system of working in its Chinese plants and attending the school (c.f. [www.bosch.de](http://www.bosch.de)). This way of training has been a huge success for these companies

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<sup>218</sup> Holtbrügge (2004a)

<sup>219</sup> Holtbrügge (2002)

<sup>220</sup> Holtbrügge (2002)

and more and more other German companies follow their example and send their Chinese employees to these schools.<sup>221</sup>

The question whether a German firm should send a German expatriate to run the Chinese subsidiary or take a local executive cannot be answered easily and many factors have to be considered. The opinions differ. The advantages of a German expatriate are the know-how transfer for the subsidiary, the German corporate culture and the better communication with the mother company in Germany. The advantages of a local executive are the knowledge of the local markets, the understanding of the Chinese mentality and Chinese business behaviour. The company's decision should depend on the overall corporate strategy: does the German company want a German subsidiary which is mainly controlled by the parent company's decisions or a local and relatively autarkic operating firm.<sup>222</sup>

#### 5.1.1.4 Competitive environment

The competitive environment of a country where companies will invest in is another important success factor for direct investment.<sup>223</sup> Foreign direct investment rose in China in 1992 when Deng Xioping started his opening politics and even more when China joined the WTO in 2001. In these times competition became more severe when companies captured for market share. Already-established firms like Volkswagen, who were market pioneers in the 1980s, lost their market share. Volkswagen's market share in 1985 was by 75%, whereas in 2005 it dropped to 18.9% and Volkswagen had to give up its market leader position to General Motors. Not only foreign companies gave themselves a hard time but also the Chinese companies kept up fast and achieved market leader positions, for example in the sectors cigarettes or vodka production already before joining the WTO.<sup>224</sup>

German companies operate mainly in the upper market segments. The middle segments are occupied by the Taiwanese, and the lower segments, which are coeval with the volume segments, are served by the Chinese companies.<sup>225</sup>

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<sup>221</sup> Reisach/ Tauber/ Yuan (2003)

<sup>222</sup> Haas/ Rehner (2003)

<sup>223</sup> Porter (1988)

<sup>224</sup> Wihofzski (2005), p. 56-57

<sup>225</sup> Deutsche Bank (2004), p. 1-11

A survey by the consulting firm Roland Berger, conducted in 1998, illustrates that German companies feel that the competition in China is one of the highest risk factors for business success.<sup>226</sup>

Another survey on SMEs in China by the German Chamber of Foreign Trade in Shanghai, conducted in 2007, shows the fear of German investors of Chinese competition even though their products were of higher quality. Most of the time German companies could not compete with the low price ranges of the Chinese products. As a result, German companies either had to resign from the market or lower their production cost. Furthermore, Chinese state owned enterprises had the advantage of having big market shares and loyal customers and still the protection and support of the national regime. This could be seen, for example, when those state owned firms easily received bank loans or closed big transactions although German companies were obviously in a better position to make the deal.<sup>227</sup>

The goal of German companies is said to conduct a careful and accurate market and product segmentation in order to choose the right market entry strategy. In a highly prized competitive environment as it is in China, German companies need to set up an efficient and cost-effective production facility to have a good starting base.

### **5.1.2 Consumer and sales specific success factors**

Among the customers and sales-specific success factors a prominent role is played by the profound comprehension of the customers in order to approach and win the customer with the right products as well as the right marketing instruments that meets the customer's needs.

#### **5.1.2.1 Customer preferences**

The development of long-term ties to customers is an important success factor for German companies in the increasing competition within the Chinese markets. German companies need accurate overview on the preferences of their Chinese customers. Even though it is difficult to cluster Chinese customer preferences due to the heterogeneity of the Chinese provinces and the axiomatic problem of receiving the right information, a

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<sup>226</sup> Roland Berger (1998)

<sup>227</sup> GIC (2008)

segmentation of preferences of Chinese consumer goods customers and Chinese industrial goods customers is illustrated below.

A Chinese consumer goods customer has a high affinity for brands. Hence, good advertising has a high impact on the success of a brand in China. German companies take this into account when preparing an advertising campaign in China. For example, Adidas is using both Chinese and German top athletes to convey their advertising messages and to create a positive corporate image.<sup>228</sup>

A survey by Deutsche Bank in 2004 states that most of the German direct investments was invested within the industrial goods sector.<sup>229</sup> Most of the customers of industrial goods are companies and not private customers. A survey conducted by Semetkeova in 2001 ranks the customer preferences in the industrial sector:<sup>230</sup>

1. Product quality
2. Price of a product
3. Service
4. Reputation of the company
5. Brand name
6. Product design
7. Country of origin of the product
8. Product availability
9. Advertising
10. Miscellaneous

The situation of German companies and their industrial goods sold in the Chinese market is explained in the following way: German products are highly technical and German companies ask for adequate pricing. Nevertheless, Chinese buyers rather would buy less-sophisticated products at lower price levels. In conclusion, German companies have to find a balance between good quality and reasonable price levels.<sup>231</sup>

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<sup>228</sup> Zinzius (2000)

<sup>229</sup> Deutsche Bank (2004), p. 1-11

<sup>230</sup> Semetkeova (2001), p. 50-55

<sup>231</sup> GIC (2008)

### 5.1.2.2 Sales strategies

The sales strategy plays an important role within the successful exploitation of the Chinese market. Even if all the other above-mentioned success factors are accomplished, the engagement of sales-oriented companies ends up in failure when their products do not reach their customers.

Customer relationship management is another key aspect of a successful sales strategy in China. Chinese business culture highly depends on strong ties between business partners. These ties rely on trust. German companies that want to sell their products need to engage in these rules of business relation. Building business partnerships in China are different from what German companies are used to. Not only a good price, product quality or service builds up the business relationship, but more important by the overall interaction among the parties is of crucial importance. An example would be the instant interactions on private level to familiarize with the other party before even a business meeting can take place.<sup>232</sup>

Another general difference between the Western and Asian customer relationship approach is that Western companies emphasize R&D and advertising, whereas Asian companies emphasize sales-force marketing and the granting of longer payment terms.

After sales, service is another key element of a successful sales strategy. Chinese customers attach great importance to sellers with good after-sales service. The establishment of a wide network of service units within China and its 31 provinces would result in high investments for German companies.<sup>233</sup>

The difficulties that German firms face in terms of customer relationship management are manifold. Nevertheless, the importance of the establishment of after-sales service units and customer proximity is seen as a crucial factor given the need of explanation of highly technical products, the increasing competition and the demand of the Chinese customers.

Another element of the sales strategy is to define the best distribution channels. A study conducted by Semetkeova in 2001 about German companies and their distribution strategy in China lists the following results:<sup>234</sup>

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<sup>232</sup> Haas/ Rehner (2003)

<sup>233</sup> Luo (1997), p. 185-199

<sup>234</sup> Semetkeova (2001), p. 50-55

- 42% of the German companies work on the entire Chinese market, whereas 58% concentrate on a regional distribution of their products.
- 58% of the firms use indirect and direct distribution channels. Only 31% use exclusively direct channels and only 8% use exclusively indirect channels.
- The reason why approx. over 84% of the German companies favour the direct distribution approach lies in the studied sample. The majority of companies sell complex technical products which need a high level of expertise and a direct approach of the customers
- 68% of the companies with direct sales have built up their own sales unit in China

A notable conclusion of the study is also that most of the consulted companies state that the coeval use of several distribution channels enhance a successful market entry.

As a conclusion, it has to be stated that the sales strategy in China plays an important role of a successful market entry. The specific characteristics and problems of the Chinese sales system, e.g. underdeveloped infrastructure, size of the country, bad payment moral, etc. result in higher transaction cost of the direct investment which can only be reduced by increasing market knowledge.<sup>235</sup>

### **5.1.3 Closing remarks on external success factors for German SMEs in China**

The external success factors for a market entry of a German company into the Chinese market that were valid in the 1980s, when the first companies started their China engagement, are still valid today. Nevertheless, the characteristics of the factors have been changed over the time. In many ways the environment has changed positively, either due to the development of the country or to the dedication of the German companies who learned from the Chinese markets and adapted to them. On the other hand, many factors did not turn out to be easier for the foreign investors. Even though markets have become much more transparent and information has been easy to access, there are still many misunderstandings, especially due to the huge cultural differences. Furthermore, competition becomes fiercer each year due to new market players which mainly come

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<sup>235</sup> Conry/ Seifermann (1998), p. 29-31

from China and give the German companies a hard time because their products become much more competitive.

The keys to success in a foreign country have been and are still today an in-depth research on the market, the customers, the location, the competition, etc. in order to develop a successful market entry strategy. German companies have a lot of information and the chance to learn or get help from other German firms who already made their way to China and have market experiences. If new market entrants make use of this information and make a solid plan for their entry, the chances of prospective success are given.

## **5.2 Specific internal success factors for SMEs in China**

This section will analyze the internal uncertainty for German direct investment in China by means of the competitive strategies defined by Porter. The section will start with a definition of the internal success factors in general followed by the illustration of the special factors needed for a market entry strategy into China, e.g. the core competences factors of the company. Core competences of a company are divided into the firm's resources and the firm's skills. A company's resources contain tangible and intangible assets. A company's skills are the aptitude of a company to allocate its resources well in order to function effectively. Afterwards, Porter's different competitive strategies will be introduced and be related to the internal success factors.

The analyzed factors are the most important internal success factors for direct investment according to several studies conducted in the 1990's.<sup>236</sup>

### **5.2.1 Internal success factors of a market entry strategy for China**

Internal success factors are significantly responsible to what extend a company is able to make use of the opportunities of the markets and to avoid the risks of the market environment.<sup>237</sup> Porter defines the internal success factors as the assets and skills of the company in comparison to its competitors including financial means and recognition of the brand.<sup>238</sup> According to Hamel and Prahalad the internal success factors account for the core competences of an enterprise. These core competences are divided into re-

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<sup>236</sup> Johnson/ Tellis (2008)

<sup>237</sup> Warren (2002)

sources and skills. Resources are defined as tangible assets (financial means, assets and raw materials) and intangible assets (know-how of the employees, patents, corporate image). The skills, on the other hand, are defined as the aptitude of a company to allocate its resources well in order to function effectively.<sup>239</sup>

Therefore, an analysis of internal success factors of a market entry strategy for China has to review the resources and skills, e.g. the strengths and weaknesses of a company. The goal of every enterprise in this case should be the “strategic fit” between the internal strengths and weaknesses and the external chances and risks of China. The “strategic fit” defines the market entry strategy.<sup>240</sup>

One theory of direct investment formulated by Fayerweather illustrates under which conditions German firms operate successfully in China and relates it to resource-oriented international management. This theory states that multinational companies are able to transfer their resources to various countries and obtain competitive advantages in comparison to truly national-operating firms. The competitive advantages are lower when the host country prevents the multinational company from transferring their resources or when the company is not able to transfer the resources due to, for example, high transfer cost or bad fit of resources to the host country.<sup>241</sup>

### **5.2.2 Evaluation of internal success factors according to Porters theory of competitive strategy**

During the 80's and 90's most German enterprises entered the Chinese market with the goal of selling their products to Chinese customers. In order to analyze the underlying internal success factors of the market entry of the German SME Porter's theory of competitive strategy is used as a framework. Porter states: “The competitive strategy demands that a company places itself within the market in such way that the highest value for its resources is given and competitive advantages are being created.”

Porter differentiates between three basic types of competitive strategies: the cost leadership, the differentiation and the niche strategy. The cost leadership is based on a cost advantage compared to the competitors which is realized through low costs in all busi-

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<sup>238</sup> Porter (1999)

<sup>239</sup> Hamel/ Prahalad (1993), p. 75-84

<sup>240</sup> Hamel/ Prahalad (1993), p. 75-84

<sup>241</sup> Fayerweather (1975)

ness areas. Differentiation is based on the principle of qualitative inimitable products or services which can hardly be copied by competitors. The niche strategy is defined by a focus on a specific niche market, a specific customer group, a geographical boundary or a specific part of a product program.<sup>242</sup>

Taking into account the increasing competitive environment in China from the mid nineties, German companies had to define a clear competitive strategy. Competitive advantages had to be developed in order to face the newly entered competitors in the Chinese market.

#### 5.2.2.1 Cost leadership strategy as an option for German SME in China

Regarding this from a retrospective point of view, it must be said that the cost leadership strategy for German companies in China was not a successful option. German companies that had been cost leaders on the German market and tried to be cost leaders within the Chinese market often failed due to the fact that many Asian competitors were having much lower cost structures with regards to cheap labour or to financing their business with cheap loans. Moreover, Chinese customers are very patriotic and rather buy a product from a Chinese company than from a foreign enterprise, if it is sold for the same price and no other differentiation attribute is in place. Only companies that are world leaders within their business field were able to enter the Chinese market and operate successfully with the cost leadership strategy. The reasons are the low cost structures, well known brands, the huge experience in internationalization/ entering new markets and of course the strong financial background.<sup>243</sup>

#### 5.2.2.2 Differentiation strategy as an option for German SME in China

Higher success rates were accomplished by German companies that followed the differentiation strategy. Due to advanced technology and inimitable products German enterprises outperformed their competitors and gained or defended their market share. Furthermore, the market segments with the high quality products promised high profit margins in comparison to the volume segments where the price was most important and not the quality. Another advantage of the differentiation strategy in comparison to the cost leadership strategy is that high quality products are harder to copy than low cost products. Especially Chinese competitors compete in the way that they copy the products of

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<sup>242</sup> Porter (1999)

the market leaders instead of developing products on their own. Due to the low costs of production within the Chinese firms, this strategy of copying was very successful in the past and harmed many German companies who entered the Chinese markets with their products.<sup>244</sup>

The company internal requirements for a successful differentiation strategy were very high taking into account the increasing competition. Sufficient personnel, market experience and financial resources were needed to fulfil this type of strategy in China.<sup>245</sup> Personnel management, as an important success factor for the differentiation strategy, is divided into personnel recruiting and personnel development. German companies pursuing a low cost strategy were in need of cheap labour and, therefore, did not put such an enormous effort in personnel recruiting or personnel development. The differentiation strategy asks for qualified employees who can, for example, establish a strong marketing and sales organization. Of course, finding the right qualified employees in China is costly and extensive. Furthermore, the competition for skilled workers is harsh and in conclusion German firms have to offer special deals, e.g. salary and company training for Chinese workers in order to keep them with the company.<sup>246</sup>

#### 5.2.2.3 Niche strategy as an option for German SME in China

Many companies on top, following the differentiation strategy, pursued a niche strategy. One reason to focus on was, for example, the huge country in China where it was impossible for a new market entrant to coevally provide all regions with its products right from the beginning. Therefore, German companies often started in regions around Shanghai and Beijing where many other German firms were already located and from whom the new entrants could obtain help for their China venture. Starting from these cities as home base, German companies focused on customers in the more developed areas on the east coast of China.

Another niche strategy that was aligned to the differentiation strategy was to focus only on the rich customers in China. An example for a German company that was using differentiation strategy and niche strategy at the same time was “Burmester Audiosysteme GmbH – Handmade in Germany”. The company produces high-end audio systems and

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<sup>243</sup> Williamson/ Zeng (2004), p. 56-57

<sup>244</sup> Fischer/ Junkes/ Reden (2004), p. 87-105

<sup>245</sup> Fu (2004)

is one of the top brands in the audio market worldwide. Burmester has already pursued a niche and differentiation strategy in Germany since their audio systems are sold to very few customers who look for this high-end sound and, of course, sold at very high prices which also narrows down the customer base. The development of the strategy for China was rather pragmatic for Burmester. They just continued with what they were already doing in the rest of the world: selling to a small amount of people who have the desire to listen to high end music and who are able to pay for that.<sup>247</sup>

In general, it can be noticed that almost all German firms started with a niche strategy in China. Of course the German large-sized companies had the mid to long term strategy to leave the niche market, broaden their customer base and be present on the entire market. Many German SMEs kept to their niche strategy since a broader strategy would have also meant much more investments that those companies do not have.<sup>248</sup>

### **5.2.3 Competitive strategies in the need for the best allocation of companies' resources**

After having discussed the different market cultivation strategies defined by *Porter*, the next chapter will discuss which resources have to be provided by the company so that the international expansion is successful.

#### **5.2.3.1 The best allocation of financial resources as source for success**

Among the competitive strategies the cost strategy has not been successful for German enterprises in China and is therefore not pursued by many companies. As a result, only the differentiation and niche strategies have been analyzed for the best allocation of resources in the following part of this chapter.

Good financial resources have been defined as one of the most important internal success factors for German direct investment in China. Resources like raw materials or company equipment are not very important in this context since in almost all cases these resources are not transferred to China. The reasons for this are that, first, it would be too expensive since the distance is so long and, secondly, in most cases these resources can

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<sup>246</sup> Semetkeova (2001), p. 50-55

<sup>247</sup> [www.manager-magazin.de](http://www.manager-magazin.de) (9<sup>th</sup> Feb 2006)

<sup>248</sup> Brede/ Nerb (2004), p. 357-383

easily be bought in China as well.<sup>249</sup> Therefore, the analyses of resources start with the financial resources of a German firm entering China.

Financial resources are needed as a basis of the differentiation and niche strategy of German companies in China. German firms have to offer extensive performance, e.g. service support in order to satisfy the price sensitive Chinese customer who will easily change to cheaper suppliers. Therefore, ample financial resources are inevitable to establish those tight customer ties.<sup>250</sup> Many German firms faced financial problems since it took very long to establish them on the Chinese market. Strong competition accompanied with price wars is only one example why the financial resources of German enterprises were overstrained.<sup>251</sup>

Moreover, German companies, pursuing a differentiation strategy, faced the problem that their refinance options in China were limited.<sup>252</sup> In general, German firms had access to the following financial instruments which were all aligned to the way German firms were instructed to use their bank accounts in China. The Chinese government approved three different accounts: the current account, the capital account and the loan account. The current account is used for the daily payments, such as invoices of suppliers. The capital account is only approved one-time. German companies can only transfer their equity to this account once in order to pay the liabilities of the firm in China, e.g. investments, marketing and sales expenses. If the capital on this account is used up, German companies are not able to transfer further money. Instead, the account is terminated.<sup>253</sup> Therefore, the recommendation of the AHK (German Chamber of Foreign Trade, Shanghai) for German companies planning their China market entry was/ is to fill up this account with enough equity. In 1997 the Chinese government required the following minimum equity rates for German direct investments in China. If the investment sum was below 3 million US\$, the equity rate had to be at least 70%. In case that the foreign firms wanted to invest between 3 to 10 million US\$ the equity rate had to be minimum 50%. Investments between 10 to 30 million US\$ required a minimum equity rate of 40% and investments above 30 million US\$ a minimum of 33%.

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<sup>249</sup> Zinzius (2000)

<sup>250</sup> Haas/ Rehner (2003a)

<sup>251</sup> Brede/ Nerb (2004), p. 357-383

<sup>252</sup> Zinzius (2000)

<sup>253</sup> Seimetz (1997), p. 34-38

German companies who needed debt financing in China were also restricted to do so via two ways. One possibility was the shareholder loan and the other one the RMB (Chinese currency) bank loan. Both loans were booked on the loan account of the firm. The shareholder loan, for example, was a loan given by the mother company in Germany. Unfortunately, the loan had to be registered with the Chinese banking authorities and additionally these authorities had to approve the currency exchange to RMB. This approval was only given in exceptional cases. Therefore, German companies were sometimes handicapped because they could not use their transferred money due to the adherence of the Chinese banking authorities.<sup>254</sup> Until the beginning of 1997, the RMB bank loans were only offered to German enterprises by Chinese banks. After this date foreign banks were also permitted to provide bank loans, but due to very restrictive loan laws the option to receive money for German firms was very limited.<sup>255</sup> The allocation of loans was done by the centralized allocation system which defines duration times, interest rates, volumes and the designated use. It is an open secret that Chinese federal companies were always favoured in loan allocations in comparison to foreign companies.<sup>256</sup> According to experience, German companies were able to receive short term loans limited from 6 to 12 months. Mid to long-term loans had to be approved by the federal planning authority. This allocation process was interminable and in most cases ended unfavourable for the German enterprises. A good relationship with a Chinese bank could help to accelerate the approval process. Once the loans were granted the disadvantage was that the interest rates were higher than the interest rates which the German companies would have received from the German banks in Germany.<sup>257</sup>

German companies had also difficulties in refinancing since their investments had long amortization durations in China which were four years on average. In comparison to German direct investments in India or other Asian countries the amortization duration of the investments was higher.<sup>258</sup> An example of a German direct investment in China with long amortization duration is the “Deutsche Chemie AG”. Deutsche Chemie already entered the Chinese market in 1986. At this time the only favourable entry strategy was the joint venture with a Chinese firm. During the first five years after the entry the prof-

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<sup>254</sup> Seimetz (1997), p. 34-38

<sup>255</sup> Chai/ Fan/ Kueh (1999)

<sup>256</sup> Dai (2002)

<sup>257</sup> (Seimetz 1997), p. 39-47

<sup>258</sup> Roland Berger (1998)

its were lower than expected and the company operated with losses. In the early 1990s, Deutsche Chemie was able to generate profits and started recovering the original investments. It is needless to say that during the first five years Deutsche Chemie had to finance the operations and, therefore, needed a strong financial nest egg to stay within the Chinese business. Due to the small amount of internal financing Deutsche Chemie had to bring in money from the parent company in Germany which was not always easy to accomplish. For example, Deutsche Chemie had to change currency on the “grey swap market” in Shanghai where money exchange was expensive and not 100% legal.<sup>259</sup>

A recent study conducted by the German Chamber of Industry and Commerce and Euro Asia Consulting in Shanghai has shown that the financial environment for German companies has changed much due to the fact that China entered the WTO and the country opened up and a less restricted financial system was implemented. The positive outcome for German companies has been the easier access to refinancing capital which is offered by Chinese and foreign banks. The loan processes have been aligned to international standards and the interest rates have fallen to international standards as well. German companies and especially German SMEs benefit a lot from these changes and can focus more on other difficult aspects of the market entry in China rather than the financing.<sup>260</sup>

#### 5.2.3.2 The best allocation of the employees as sources for success

Another important internal success factor is the resource “employee”. German companies have two main choices for their employee strategy in China: either they send German staff to China and thereby transfer German know-how or the companies hire Chinese workers and train them locally. German employees which are sent to China are called “expats”. In most cases only a few German expats per firm go in order to build up the business in China. They are the source of know-how, implement the German strategy for China and develop the business accordingly. Expats mostly run the business as CEO’s or are the technical staff that start production and train the local workers. Since not many German employees are willing to spend a longer period of time in China, expats are paid a premium for their stay in China. Of course, these expenditures raise the cost for the market entry into the Chinese market and especially SMEs struggle with

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<sup>259</sup> Trommsdorff (2000), p. 495-512

<sup>260</sup> GIC & EAC (2008)

those high costs. Another reason why there are only a few German workers in China is that not many people are open for this kind of working environment. Of course, one can imagine that it is a hard step for an employee to decide on living in a foreign country with a total different culture which on top is so far away that visits to Germany are rare.<sup>261</sup>

The recruitment of the right employees in China can be seen as another key internal success factor for German companies entering the Chinese market, even though the workers are taken from the external working environment. Before deciding on the staff, a company has to consider the strategy it will pursue, either a cost-oriented or a differentiation strategy. Each strategy has a different need for employees. Whereas a cost-oriented strategy is looking for a low-cost production facility with low-skilled workers who will not earn much, the differentiation strategy is looking for qualified sales or high technological production in the new market and, therefore, needs qualified employees, e.g. staff who costs more but will also boost up the new company.<sup>262</sup>

Companies who set up a low-tech production plant in China have the luck to select from a broad range of low-skilled and cheap workers who mostly come from the countryside to earn more than they could earn when working on their farms. On the other hand, foreign companies that enter China and pursue a differentiation strategy are in high need of qualified Chinese employees. Since demand is higher than supply, skilled employees are rare and at the same time not cheap to get. Moreover, due to the competition of foreign firms for qualified staff, Chinese workers are not loyal and the fluctuation rate is extremely high. Foreign companies implemented incentive programs in order to tie Chinese workers to their companies.<sup>263</sup>

The search for qualified employees is still a huge problem in China. No system is in place to support foreign companies with view to their staff search. Head-hunters are present in China but they are expensive and especially SMEs cannot pay this amount of money each time, especially when thinking of the high fluctuation rate. Moreover, the evaluation of Chinese workers is tricky since, on the one hand, foreign companies cannot properly evaluate between good or fair résumés, for example with regards to which universities have a better or worse reputation. On the other hand, Chinese employees

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<sup>261</sup> Holtbrügge (2004a)

<sup>262</sup> Holtbrügge (2004a)

<sup>263</sup> Holtbrügge (2002)

tend to fake their resumes in order to get better jobs. Therefore, foreign firms work with a mouth to mouth system among themselves to possibly avoid the risk of an “unsound” worker.<sup>264</sup>

Big German companies started cooperating with universities in order to generate future employees who were already trained the way the companies needed them. Examples are SIEMENS or SAP who collaborate with the Tongji University which already had a German chair and was teaching the German/ Western way of business (c.f. [www.siemens.de](http://www.siemens.de) and [www.SAP.de](http://www.SAP.de)). Whereas BOSCH implemented the German vocational school system and opened up several of these schools to offer employees concurrent work in its Chinese plants and attend the school (c.f. [www.bosch.de](http://www.bosch.de)). This way of training has been a huge success for these companies and more and more further German companies follow their example and send their Chinese employees to these schools.<sup>265</sup>

#### 5.2.3.3 The allocation of patents as a source of success

Patents are always a strong competitive advantage in the business world and therefore an internal success factor for German direct investment. Nevertheless, the advantages of patents on the Chinese markets are much lower in comparison to the Western business world. The original meaning of the patent is to protect the idea or the product from being copied by another company. Due to a functioning law system and deep-rooted ethical beliefs in the Western business world patents work. In China the situation is different since two disadvantages harm the power of the patent: the first disadvantage is the Chinese belief that it is an honour for the inventor if his idea or product is copied. In other words copying a successful product of a competitor is nothing bad in the perception of the Chinese. The second disadvantage is aligned to the just illustrated belief: the Chinese law does not prosecute the copying of patented products since it does not see the infringement. In the early 90's German firms had to suffer from this situation because their new technologies that they put high efforts and R&D cost in were easily copied by Chinese competitors. Today, German companies respond to this environment and pursue two strategies, among others, to prevent the harm of copying. The first strategy is that German firms do not sell their latest technology products in China but in-

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<sup>264</sup> Holtbrügge (2002)

<sup>265</sup> Reisach/ Tauber/ Yuan (2003)

stead offer products which are predecessors to the products which are currently sold in the Western markets. One example is Volkswagen who sells its cars in China with the engines of predecessor cars. The second strategy of German companies pursuing a differentiation strategy is that the products are not fully manufactured in one plant in China. Various parts are produced in different facilities and they are assembled together in one plant. By this it is harder for the Chinese competitors to copy.<sup>266</sup>

#### 5.2.3.4 The allocation of brands/ corporate image as source of success

Brands or the corporate image are another important internal success factor. However, there are differences between the brands or the corporate images. If a company is already well-known in the Western world before entering the Chinese market the chances are high that this brand is already known among the Chinese consumer and, therefore, the brand or the corporate image is a big advantage. On the other hand, German companies, who are market leaders in Germany but do not have worldwide recognition yet, do not only have to build up their businesses in China but also their corporate image. Generally, the Chinese goods customer have a high affinity for brands. A high impact on the success of a brand is related to good advertising in China. German companies take this into account when preparing an advertising campaign in China. ADIDAS, for example, is using both Chinese and German top athletes to transport its advertising messages and to create a positive corporate image.<sup>267</sup>

#### 5.2.4 Competition strategies in the need for the best allocation of companies' skills

Companies who enter the Chinese market have to make the best out of their given resources. Within the scope of this paper the skills are defined as the aptitude of a company to allocate its resources well in order to function effectively. The skills of German companies have advanced in the course of time. Of course, big German companies who had been operating internationally long before they entered the Chinese market already had had the skills to allocate their resources well since they were experienced. Nevertheless, also the large-sized companies had to learn and adjust to the Chinese culture and Chinese business culture. Companies who were not that experienced in internationalization made several mistakes when entering the Chinese market since they devolved

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<sup>266</sup> Haas/ Rehner (2003), p. 114-144

their German strategies to the Chinese market which did not work since business does not function the same way in China as it does in the Western world. In many cases this happened in the 80's and early 90's when China was not a common place to invest, as it is today, and still was a closed communist country.<sup>268</sup>

Today, the skills of allocating their resources well are much more developed among the German companies who are willing to move to China. The reason is that today companies can rely on their own experience from the internationalization process but also rely on external help which were not there in the 80' and 90's. For example, the network of German companies which already made the successful step into the Chinese market helps new entrants to find their way. Furthermore, many institutions are in place to offer information and assistance for the China venture. For example, the AHK (German Chamber of Foreign Trade) in Shanghai helps with information and contacts. German companies can also hire consulting companies specialized on market entry in China. These consulting companies go along with the process of expansion. The internet is another important element which helps German companies to search for information which they can use for their China strategy.

Even though there are still several German companies who fail to enter China market due to a badly developed entry strategy, the environment today offers much more information and certainty for German companies eager to enter the Chinese market. Therefore, today the majority of German firms are much more successful in China than in the past. Of course, not only the improved skills are the reason for success but also the change of China as a country to be more open for foreign business partners.<sup>269</sup>

### **5.2.5 Closing remarks on the recent evolution of internal success factors for German SME in China**

The internal success factors for a market entry of a German company into the Chinese market that were valid in the 1980', when the first companies started their China engagement, are still valid today. Nevertheless, the characteristics of the factors have been changed over time. Ample financial resources have been and still are one of the most important success factors for German companies entering China. Changes have taken

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<sup>267</sup> Zinzius (2000)

<sup>268</sup> Hagen/ Wöllich (1999)

<sup>269</sup> GIC & EAC (2008)

place over time insofar as in the 80's and early 90' German firms had difficulties in re-financing themselves in China, whereas today the financial markets are open and this disadvantage has mainly dissolved. In the past and still today, employees or the know-how of employees are important internal success factors. German companies need their know-how in China in order to build up their businesses successfully. The costs of the know-how transfer to China are notably high. Therefore, German companies need to develop strategies which incorporate a perfect ratio between cost and know-how transfer. Due to external assistance, e.g. trade institutions, consulting firms and internal experience the allocation of the resource "employee/ know-how" is better performed today than in the past. The same can be stated for the use of patents. Today, German companies know that they need to protect their ideas or products with special protection strategies. Corporate image or brands are important internal success factors since the Chinese customer looks for brands. This culture has not changed much over the past decades. Due to a fiercer competition German companies face hard times in creating a positive corporate image in China. Furthermore, a lot of advertising is needed which results in higher corporate spending. German companies have to evaluate the benefit of those expenditures and incorporate this into their China strategy.

In conclusion, it can be stated that German companies have learned over the past decades and are much more experienced in the internationalization process. Today, the firms clearly know that the keys to success in a foreign country have been and today still are an in-depth research on the market and an in-depth research on the own resources in order to develop a successful market entry strategy.

The upcoming empirical study will try to comprehend the expansion processes of SMEs in China. Additionally, the internal and external success factors will be scrutinized and analyzed within the scope of the study with the aim to determine how companies assess their China engagement retrospectively.

## **6 Empirical study on German SME in China (expansion, current operations, future prospects)**

The empirical study aims at providing a better understanding of the German SME expansion process to China, an evaluation of both their current operations in China and a forecast of their future on the Chinese market.

Therefore, the survey is based on the following three main research questions:

- Why and how do German SMEs expand to China?
- How do German SMEs master their current operations in China?
- How do German SMEs evaluate their future within the Chinese market?

In order to provide valuable insights to the underlying main research questions stated above the study was divided into four main sections:

- Information on the SMEs in China (9 questions)
- Expansion process of SMEs to China (8 questions)
- Evaluation of current business operations in China (6 questions)
- Forecast of future business environment in China (4 questions)

The first section will characterize the German SMEs operating in China with regards to qualitative and quantitative measures: annual turnover of the parent company, number of employees, business industry, date of market entry, local presence in China, branch, form of operation and reasons for choosing the form of operations.

The second section will illustrate the expansion process of German SMEs to China. Herein, the motives for China expansion will be discussed, followed by an analysis of the strategy that German SMEs have formulated. Questions will be examined considering how the SMEs evaluate their strategy retrospectively and if and to what extent they have changed their initial strategy during the expansion process. Further on, the market entry preparation and coeval the satisfaction with the entry preparation will be mooted. The second topic will close with an illustration and discussion of the important internal and external success factors of China expansion for German SMEs.

The third section will deal with the current business situation of German SMEs in China. The SMEs were asked to evaluate the Chinese business behavior and Chinese personality traits, Chinese legal & public authorities, their own operations (internal value creation, costs of operation, etc.) and sales environment in China (opportunities, threats). The third topic will conclude with an evaluation of the overall China engagement.

The fourth section will give an overview of the future prospects of German SMEs in China. For this purpose the SMEs were requested to evaluate the identical business areas (Chinese legal & public authorities, own operations and sales environment in China) as in the third section but this time as an estimation of the future.

Principally, the answers of the respondents within this study are appraised and portrayed as if the group of German SMEs in China were homogeneous. In reality, of course, not every German SME that has expanded and is operating in China acts and thinks alike. One main reason is that all companies come from a different internal and external business environment. It is undoubted that a small trading company with low capital and manpower resources is much more limited in its China strategy than a bigger medium sized company with more experience and resources. Therefore, a variety of dimensions (see figure 26) has been created which allows to categorize and to classify the SMEs in order to spot differences and similarities. Certainly, not all possible differentiations could have been applied for the purpose of this report.

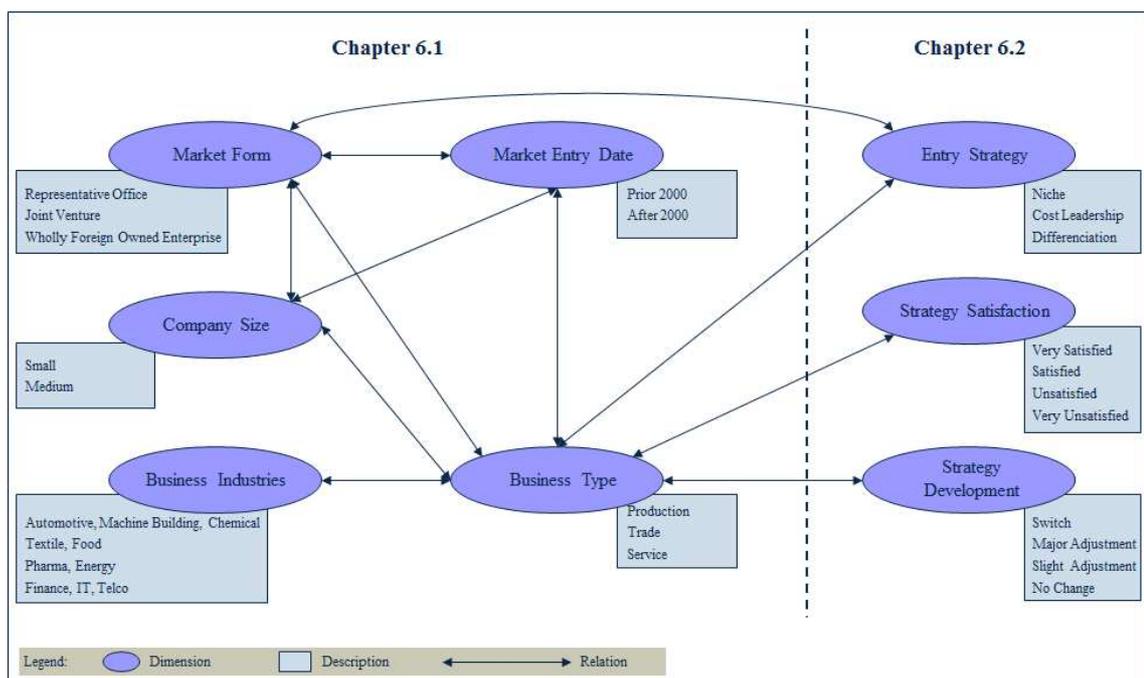


Figure 26: Relation of dimensions to characterize SME in China (own illustration)

The survey was conducted from October 2010 to March 2011. All questions were gathered in an easy to use Excel document<sup>270</sup> and sent out via email to German SMEs operating in China. The addresses were taken from the database of the German Company Directory in China (GCD<sup>271</sup>). 512 valid German business addresses in China were identified that fulfilled the predefined criteria to fit in the group of SMEs in China according to the previously given classification of a maximum of 1.000 employees in total or a turnover of 250 Mio. € in the parent company worldwide. Furthermore, only German SMEs were chosen that currently pursue operations in China and establish either a representative office or a co-operation or a wholly foreign owned enterprise. Despite the comprehensive nature of the questionnaire with a total of 27 core questions, the return quota of completed surveys was as high as 9% (46 SMEs).

According to comparable studies<sup>272</sup> the panel's composition is representative for the total number of German SME operations in China and the findings and opinions are representative for the majority of German SME business communities as well. However, this report is only meant to provide valuable insights for German SMEs interested in China expansion or SMEs, already operating in China, from which they can derive ideas and proceedings for their own business strategy. Since every company has its individual company background and business environment this survey cannot serve as an individual layout for a solid, successful China strategy that suits every German SMEs. Moreover, it has to be clarified that those SMEs who were not successful in their China expansion have not been able to participate in the survey since they have ceased their businesses and left China again already, therefore, their opinions and experiences are not included in the findings. Taking this fact into account it may be the case that the results of this survey are slightly painted in too good light.

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<sup>270</sup> See Appendix for the excel document

<sup>271</sup> The German Company Directory is the only official directory of all German companies in China. It is the primary source of information for determining which German companies are already in China. The German Company Directory is created and maintained by DEinternational/German Industry & Commerce (GIC) and Real SoftService. DEinternational /German Industry & Commerce (GIC) is the service provider of the Delegations of German Industry and Commerce (AHK) in China. AHK and GIC belong to the worldwide network of some 120 overseas German Chambers of Commerce, Delegations, Representative Offices and DIHK-Service Companies in more than 80 countries under the umbrella of the Association of German Chambers of Industry and Commerce (DIHK) in Berlin. The offices and subsidiaries of AHK and GIC in Beijing, Shanghai and Guangzhou support German companies in establishing and extending their activities in China on a bilateral basis.

<sup>272</sup> „Survey on Business Confidence in China“, conducted by the German Chamber of Commerce and Fiducia Management Consultants, Shanghai August 5th, 2009

The following paragraphs illustrate and discuss the answers which were given by the German SMEs in the four main areas of the survey.

## 6.1 Company information

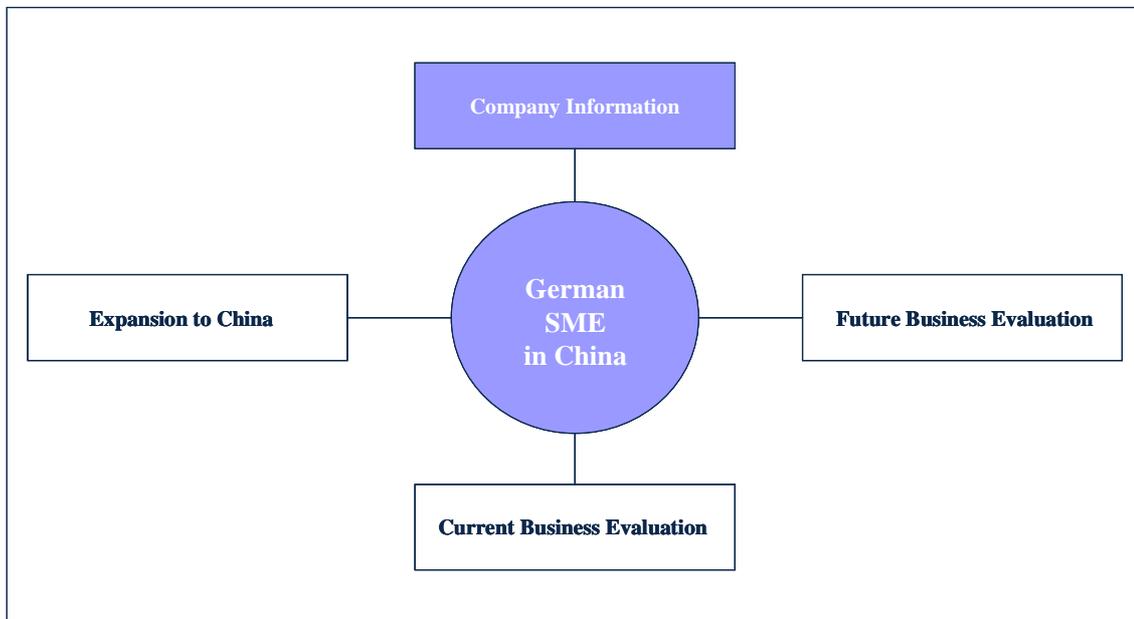


Figure 27: German SME in China – first chapter: company information (own illustration)

The upcoming chapter 6.1 will follow up with a detailed analysis of the German SMEs that responded to the questionnaire.

First, the basic information of the enterprises like turnover and number of employees were inquired. This was done in order to classify them as small or medium sized firm.

Then participants were asked to tell in which industry or branch they operate. All respondents were afterwards summed up in five different groups. One group, for example, consisted of the machine building, automotive and chemical companies whereas another combined the textile and food enterprises.

In order to gain insights in the experience and in the Chinese business environment in which the SMEs expanded, the participants were questioned when they entered the Chinese market. For interpretation purposes companies were graded in the companies that entered before the year 2000 and after the year 2000.

One of the main success factors for a China engagement is the right location. Therefore, the SMEs had to state where they settled in China and what the reasoning behind their decisions had been.

A survey provides the best benefits for interested readers when they can relate to it. Therefore, all respondents were classified as production, trade or service companies so that readers can recognize themselves among one of those three business types.

The question on the form of operation was the last one to be discussed in section 6.1. Due to the fact that the survey only analyses firms that did a direct investment in China, exports, as a possible form of operation were not included. Only companies that either established a representative office, a joint venture or a wholly foreign owned enterprise were allowed to participate in the study. These enterprises were then asked to state their reasons why they had chosen their particular form of operations.

Figure 26 illustrates all characteristics of the SMEs which were mentioned above. The arrows display the relation between those characteristics. The relations serve for the purpose to deepen the analysis of the SMEs that responded to the questionnaire. For example, the arrow between “size” and “market form” sheds light on the questions: what type of market form is favored by small enterprises and what type of market form is favored by medium sized enterprises? What are the similarities and differences?

### **6.1.1 Annual turnover of the parent company**

According to the survey definition, a company belongs to the group of SMEs when its turnover does not exceed EUR 250 million worldwide. Figure 28 shows that all respondents were classified in four groups on the basis of their turnover in the year 2008. The chart displays a relatively homogeneous distribution of the SMEs within the four groups.

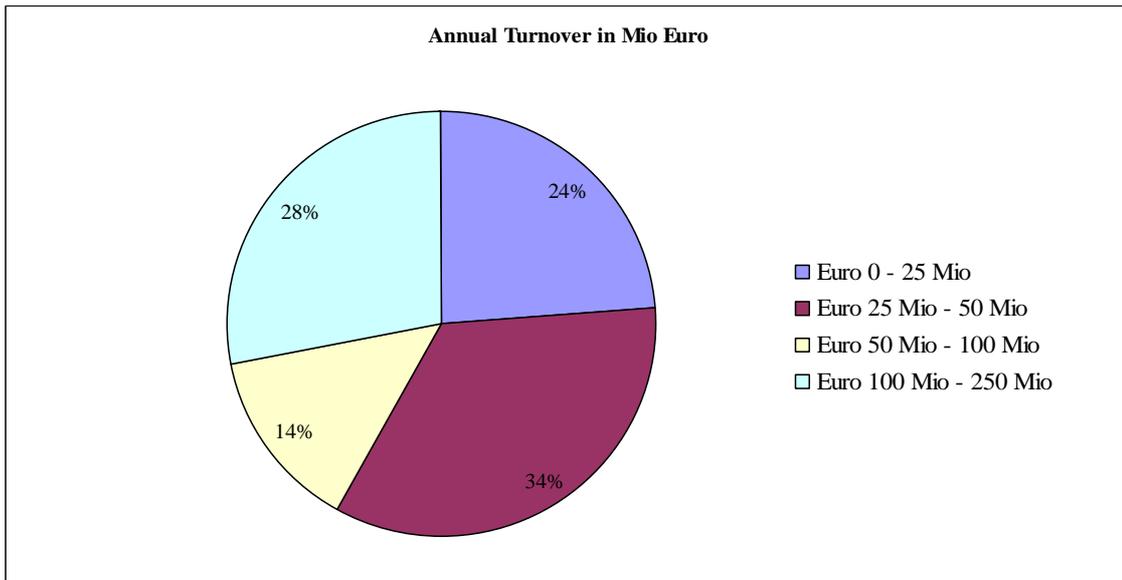


Figure 28: Annual turnover of parent company worldwide: distribution within the sample

Especially remarkable is the share of companies that have a turnover lower than EUR 25 million in the parent company reached 24%. Even though they have limited resources these companies have already made a huge effort and have taken the opportunity and have expanded to China. The received data also reveals that many of them even earned a turnover less than EUR 15 million in the year 2008 and still made their way into the Chinese market.

The annual turnover in 2008 was taken in order to separate the small from the medium sized enterprises. Those companies that earned less than EUR 50 million were categorized as the small group of enterprises and the companies that earned between EUR 50 million and EUR 250 million were pooled as the medium group of enterprises. The distinction between small and medium sized enterprises fulfills the purpose of spotting differences and similarities in opinions, approaches and proceedings among both groups later in the survey.

Figure 29 illustrates the distribution of small and medium sized enterprises. It is noticeable that the small firms have a share of 58% and therefore the opinions and findings of this study have a great value to other small German firms interested in entering the Chinese market or already operating in it. At a later stage of the survey it will be displayed that more and more small German firms are willing to expand to China. In the past, before 2000, the majority of companies that were present in China were rather medium

and big-sized enterprises and, therefore, related studies focused on opinions and responses of those companies. Even today reports about small businesses in China or information about the expansion process of comparable companies are rare and hard to find.

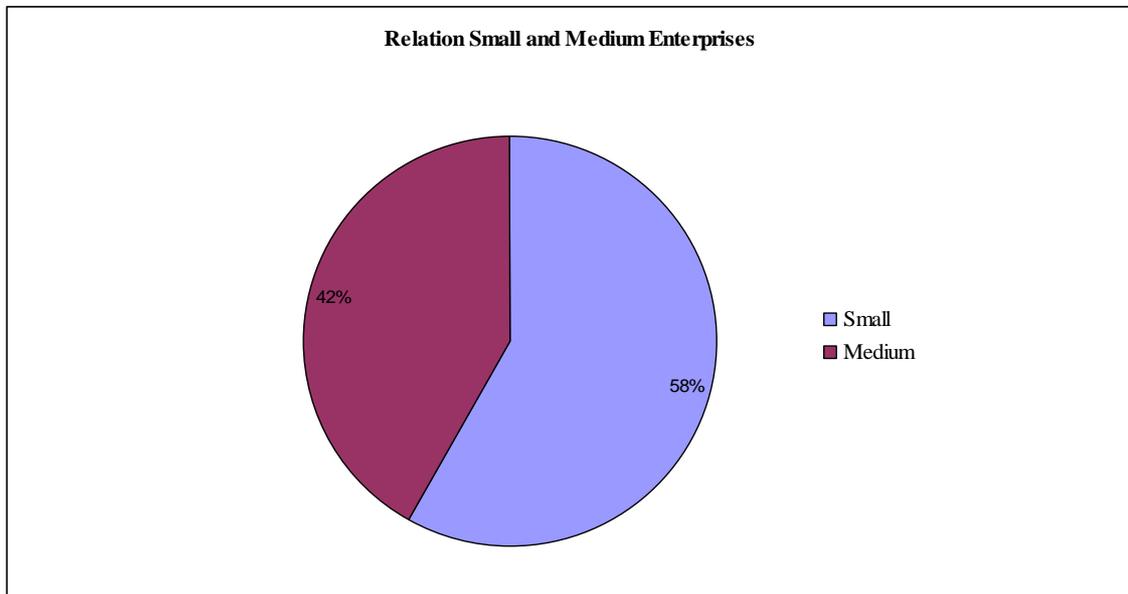


Figure 29: Distribution within the sample: small and medium enterprises

### 6.1.2 Number of employees

The pie chart in figure 30 illustrates the number of employees of the respondents of the survey. Again, all SMEs were classified in four groups. It is interesting to note that only 9% of all respondents have less than 50 employees worldwide. This low percentage indicates that setting up a presence in China depends on manpower. In almost all cases an expansion to China has not been done when there has not been a solid business basis in Germany. On the one hand, the companies need staff to administer their home market and on the other hand the companies need personnel to accompany the expansion to China and serve as a counterpart for the team on-site in China. In most cases these tasks ask for a larger number of employees worldwide than 50.

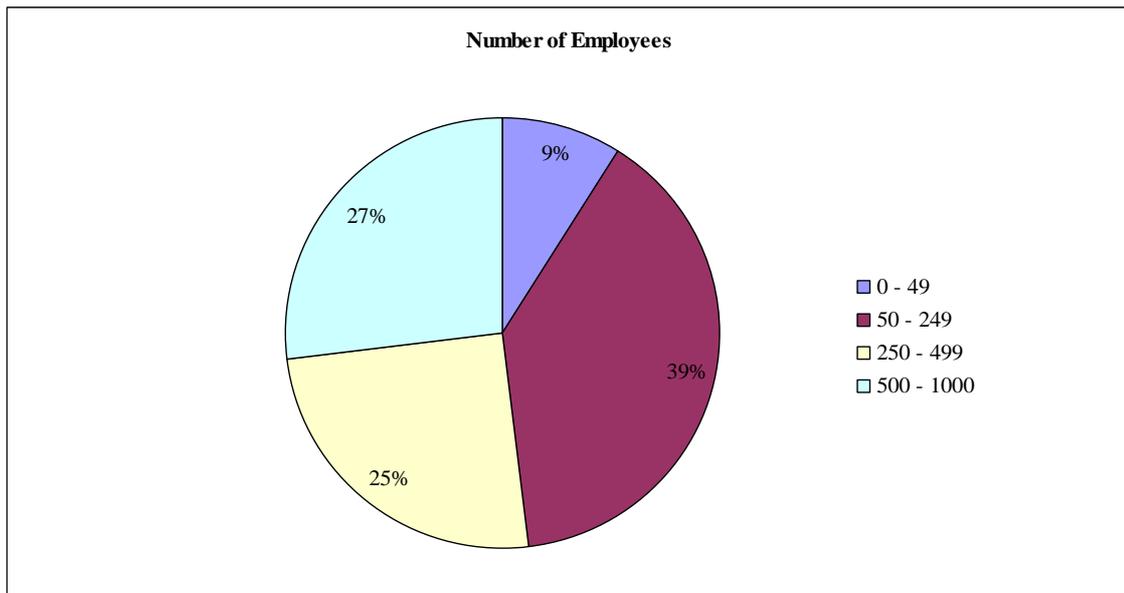


Figure 30: Number of employees in parent company worldwide

Corresponding with the fact that our share of small companies has been 58% is the number of staff. Almost 50% of all respondents have companies with less than 250 employees. Nevertheless, the share of enterprises with more than 500 and up to 1.000 employees which has been the upper barrier by definition for SMEs still is 27%.

### 6.1.3 Business industries in China

The goal of the study is to accomplish representative views and findings from the perspective of German SMEs in China. Therefore, the panel's composition was especially important. Figure 31 shows the distribution of the area of business industries of the respondents. The automotive, machine building and chemical industries are the dominant industries in Germany and, therefore, were also the first to enter the Chinese market.<sup>273</sup> The share of 35% of all respondents in this category reflects this fact. The textile and food industries also belong to the old industries in Germany that had to cope with saturated markets and the need for lowering cost already a long time ago. Those industries were forced to open up new markets and, eventually, landed in China.<sup>274</sup> The share of 21% of the textile and food category validates these findings. The pharmaceutical and energy sector accounts for 18% of all responses. Especially the boom of renewable energies in Germany in the last 10 years with view to solar, wind and biogas energy put

<sup>273</sup> Rohroff (1997)

forth many new startup companies that saw opportunities in the Chinese market in terms of low cost parts sourcing, low cost production, business partnerships with Chinese companies in the same industry and of course sales potential. As a result, many of those firms quickly established strong binding with the Chinese market.<sup>275</sup> The finance, IT and telecommunication sector belongs to the relatively new industries worldwide. In particular, the IT and telecommunication companies are in the need for low cost production of their devices and hardware. Early on China has made a name as an ideal place for production due to low cost operations and skilled personnel.<sup>276</sup> In the present survey this industry accounts for 14%. The remaining 12% are allocated among other industries.

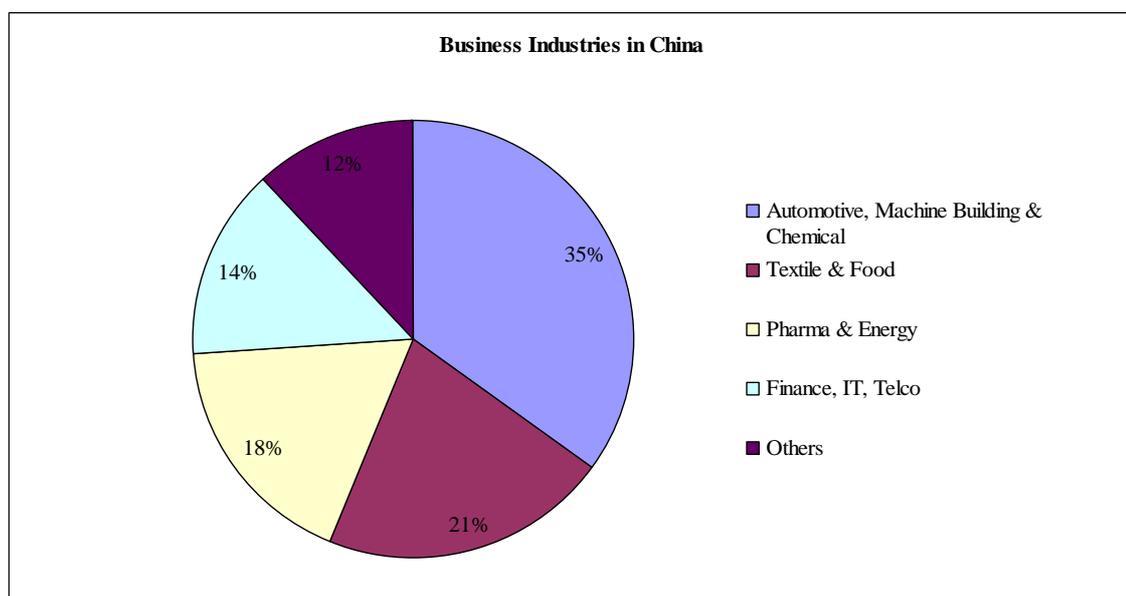


Figure 31: Distribution of companies in the sample according to their area of business

The survey responses in terms of the area of business are representative of the entire population of German businesses in China, e.g. the machine building industry's share is 26% in this survey and 30% in the GIC<sup>277</sup> company directory.

<sup>274</sup> Fishman (2005)

<sup>275</sup> Keller (2011)

<sup>276</sup> Qu/ Brocklehorst (2003)

<sup>277</sup> GIC – German company directory is the only official directory of all German companies in China. It is the primary source of information for determining which German companies are already in China. The German Company Directory is created and maintained by DEinternational/German Industry & Commerce (GIC) and Real SoftService.

#### 6.1.4 Date of market entry

In 2002 and 2003 a real hype in Germany regarding China started. Business newspapers, magazines and TV proclaimed huge opportunities for the German industry and the impression was created that if a company did not do business with China or sold its products on the enormous market it would lose the connection and miss chances for exceptional business.<sup>278</sup> In the same period (exactly in 2001) China achieved membership in the World Trade Organization (WTO). This step opened up the Chinese market, regulations were dropped and trade laws and were simplified, respectively unified.<sup>279</sup> Among others both of these factors laid the ground for more and more German companies, especially SMEs to enter business relationships with China.

Figure 32 displays the distribution of SME respondents of the survey regarding their market entry date. For evaluation purposes it is interesting to see how many companies expanded to China before 2000 and later. The majority of German SMEs made their way to China after the 2000 with a percentage of 67% which allows the conclusion that many German firms got infected by the proclaimed “gold rush” in China by the German press. The remaining respondents entered China before 2000. This result demonstrates that 67% of German SME respondents are relatively young market participants in China with not much experience yet. Nevertheless, especially their opinions and perceptions are very important for the report, e.g. for other German SMEs eager to start business with China since one of the main goals of this study is to get insights from the point of SMEs in their early stages of expansion and establishment.

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<sup>278</sup> Roland Berger (2004)

<sup>279</sup> Cheng (2005)

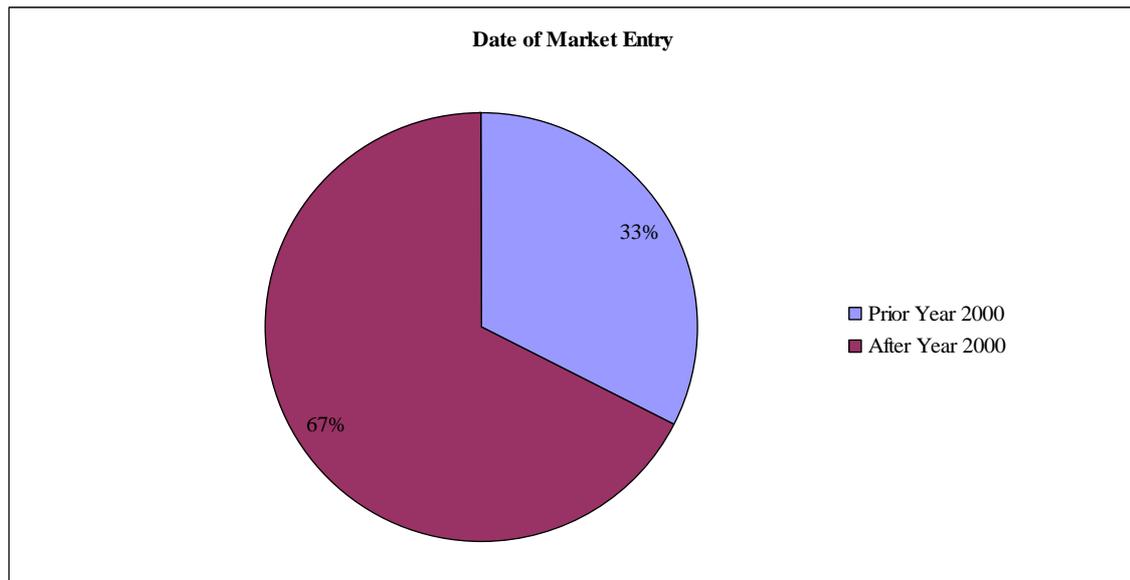


Figure 32: Date of entering the Chinese market: distribution in the sample

Figure 33 illustrates the relation between company size and the market entry date. This relation presents the precise picture that the majority of small German enterprises chose to expand to China after the year 2000 (81%). Later in the study it will be pointed out that especially those small firms benefited from the improvements in IT and communication systems, e.g. the internet which lowered their transaction cost and made it easier to get in contact with China. The availability of information on the Chinese market and access to Chinese suppliers, customers and other partners via internet or other institutions like the German Chamber of Commerce made expansion possible for the first time.

In contrast, 53% of the medium sized enterprises already made their way to China prior to the year 2000. As discussed earlier in figure 3 “number of employees”, medium sized companies have bigger resources than the small ones which serve as a good basis for expansion. Therefore, medium sized companies are earlier at a stage where resources are sufficient to internationalize than small firms with low resources.

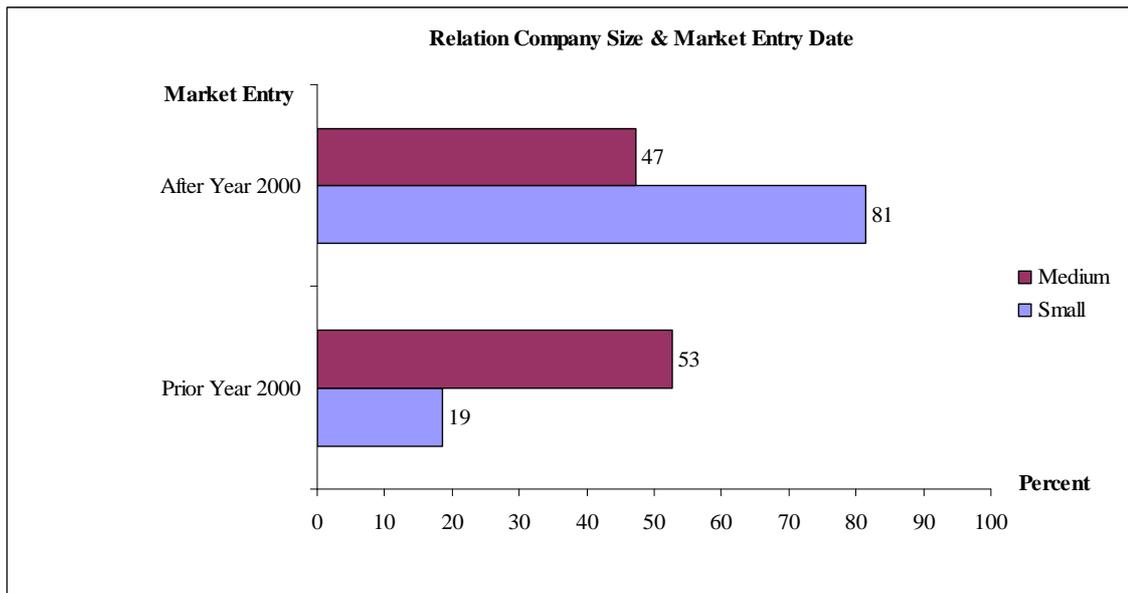


Figure 33: Relation between company size and the market entry date

### 6.1.5 Local presence in China

In chapter 3.2 it was referred to that the modern economy in China is primarily located in the Eastern coastal areas. There the Chinese government has developed the infrastructure and initiated the trade zones to attract both domestic and foreign investors, e.g. companies. German companies established their businesses also in these areas, especially in the Greater Shanghai (47%), the Greater Beijing (12%) and the Greater Guangzhou (8%) regions with more than 65% in total. Provinces closer to the Western parts of China are still avoided by German enterprises even though they allure with benefits and incentives.

Figure 34 displays the distribution of the German SME headquarters in China reflected by the respondents of our survey. It is remarkable that the allocation is closely oriented to the overall distribution of all German enterprises in China. It can be seen that the majority (65%) of SMEs cluster themselves in the region around Shanghai and the surrounding provinces Jiangsu and Zhejiang. 13% expanded to the Beijing area. Also noticeable is the fact that 11% established their businesses in the Greater Guangzhou region which is specialized in the production of textiles, IT hardware and small electronic devices. The survey responses reveal that in fact those companies chose this region that operated in these business fields. Therefore, one of the reasons why German SMEs set-

tle in a specific region has to do with the technological knowledge and expertise that can be found there that suits their businesses.



Figure 34: Local presence of German operations in China (blue) & survey participants (yellow)

Source: GIC (German Industry & Commerce) (2008) & own illustration

Figure 35 lists the reasons why the respondents decided on their particular location. With 84% the most frequent response was to be close to business partner, e.g. suppliers and customers. This answer partly reflects what has just been said in the paragraph above. German companies see the need to establish their business where they can get access to expertise and know-how. In chapter 3.2 it has been stated that Chinese firms cluster themselves according to business background. Consequently, German SMEs have to look for those clusters and locate themselves nearby. This strategy ensures quick access to suppliers and also skilled Chinese personnel who also locate themselves in those cluster areas.

Almost equally important is the reason that the SMEs find other German companies around that already settled in the area. This behavior has already been discovered by many studies. German firms tend to feel more comfortable when there are other German

companies around that “sit in the same boat”. They can rely on the experience of companies which have been settled for a long time. Most of the time novices can benefit from strong ties with local authorities, suppliers and other business partners by using the same networks as the more experienced German companies. Moreover, the private social life plays an important role. When there are already several German enterprises around German novices step in a German community where everyone speaks German and German traditions are lived. This is especially crucial when German managers come along with their families.<sup>280</sup>

79% of the participants of the survey state that the low cost supply of raw materials, energy or manpower are essential reasons for choosing the location. These types of reasons are always cited by German companies but if we look at these arguments it is rather a general benefit of China in comparison to Germany as a specific benefit of a location since everywhere in China the supply is cheaper than in Germany. Moreover, the established regions in the Eastern coast of China have in comparison to the Western provinces a much higher cost level for any supplies. If the low cost supply was as essential as the survey percentage of 79% demonstrates, then German enterprises would locate themselves in the Western provinces of China. Since this is not the case the other positive benefits of the Eastern coastal provinces outweigh the relatively higher cost for supply here or the cost for supply here is still low enough for German SMEs.

German companies, interested in expanding to China, often encounter negative news on the Chinese regulations, the high level of bureaucracy, corruption, etc. An expansion to China is complex and costly and German enterprises have more or less one shot to choose the right location for their headquarter. Taking this into consideration it becomes obvious that also German SMEs are looking for a stable business environment for their location. Therefore, 69% of the participants of the survey voted for this reason.

With an almost identical percentage of 68% the good infrastructure was named as a relevant basis for an ideal location. As it has been illustrated in chapter 3.1 China is still a country where most provinces are undeveloped. This means that, for example, a reasonable road network or energy supply is not given. Even though the Western provinces catch up in terms of their infrastructure they are still far behind the Eastern coastal regions. Businesses all over the world flourish when they have ideal conditions to operate.

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<sup>280</sup> GIC (2008)

This includes the access to a good road network, to ports and airports, to business parks with water and energy supply, etc. The Eastern coastal regions, especially the Greater Shanghai area offer conditions and therefore 70% of the survey participants chose this location.

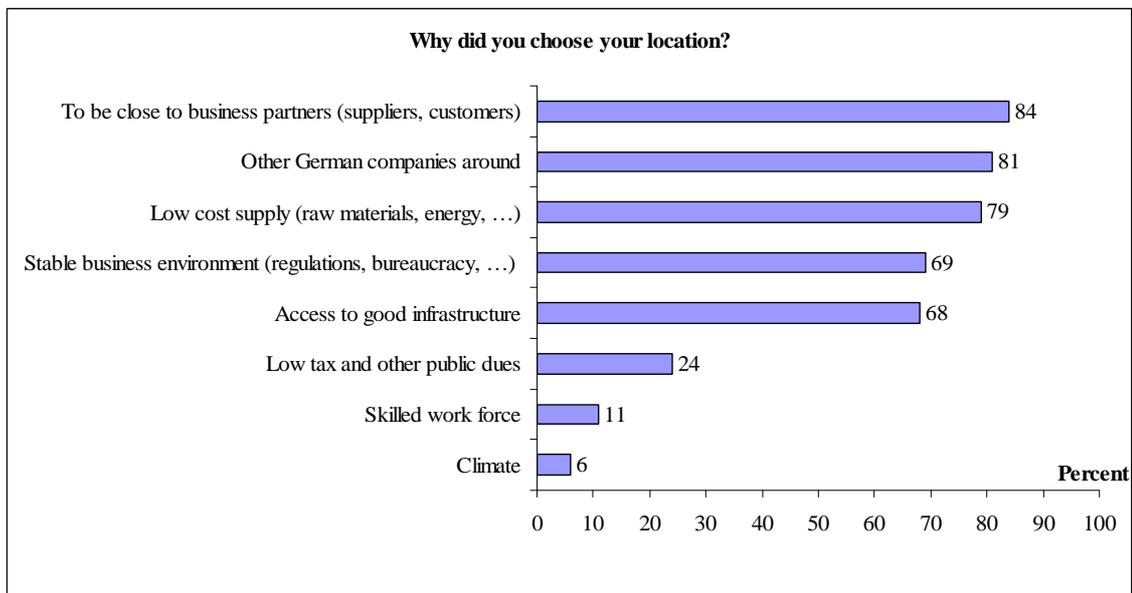


Figure 35: Underlying reasons for deciding on the location in China

Low tax rates and public dues are not seen as relevant to the German SMEs. Only 24% of them decided for choosing their location in consideration of these attributes. In contrast to German taxes and public burdens Chinese dues are comparably low. Therefore, the SMEs do not experience these costs as a dominant factor for the location decision.

In terms of the responses to the reason for choice of location “skilled workforce” to make an evaluation is rather difficult. First of all it seems surprising that only 11% see qualified personnel as an important reason for choosing the ideal location. The obvious answer that German firms do not need skilled labor and, therefore, do not favor this reason is not true in this case. Almost all German enterprises expanding to China operate in areas that are technologically advanced, and in Germany as well as in China properly trained staffs are essential for producing the goods or delivering the services. Therefore, skilled workforce is indeed needed by German SMEs that carry out business in China. Another obvious answer would be that German SMEs already find enough trained employees in the areas where they would like to settle. Unfortunately, this answer is wrong, too. Later in the survey it will be stated that in fact the respondents have trouble finding the right trained personnel. It can be considered that even though skilled

staff is essential and needed for smooth business operations in China still the SMEs do not see this criterion as important for the location decision in comparison to the first named reasons in this chapter.

Another surprising response is the climate as an important factor for location fixing. 6% of all respondents had the climate in mind when looking for the right spot. This response can be explained by the fact that several SMEs produce products that do not favor warm climate, for example, the goods spoil quickly or the consistency of materials is negatively influenced by the warmth. Even though in the summer time it is quite warm in every area on the Eastern coast it is definitely much hotter in the southern provinces. Hence, those German SMEs who have to take into account the hot climate are in favor of the colder provinces in the north of Eastern China.

Summarizing, the survey shows that the majority of respondents chose identical reasons as essential for their location decision. Most important are the closeness to other business partners and other German enterprises and to have a low cost and stable business environment. Nevertheless, the right mix of all features and characteristics of a location has to fit the prospective market entrant.

#### **6.1.6 Type of business**

The dimension “type of business” adds another dimension to the survey. In this case the German SME respondents were separated in three groups: production, trade and service. The special interest is to discover differences among those groups. Figure 36 illustrates the distribution of the three groups.

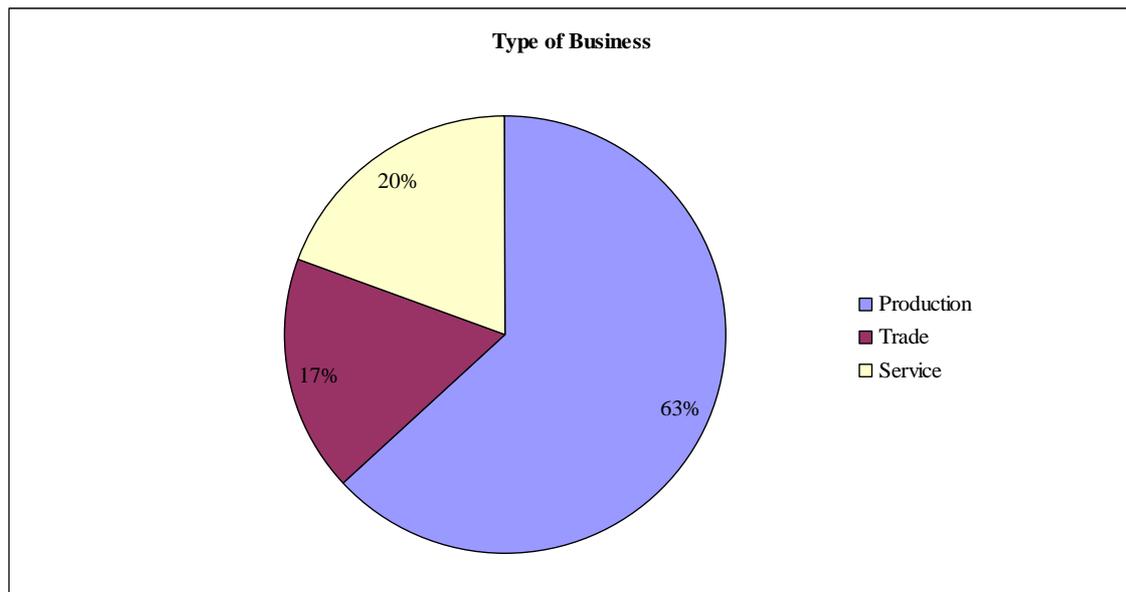


Figure 36: Distribution according to type of business

The production enterprises account for the largest share of the German SMEs with 63%. It was earlier discussed that the main business industries in Germany are automotive, machine building and chemical industries. All these industries belong to the manufacturing industry. Therefore, the high share of production firms in this survey is comprehensible.

The Chinese government opened up the trade, logistics, finance and insurance sectors to foreign investment as late as the beginning of this century. This is one of the main reasons why trade and service enterprises are not as many represented as production companies. According to the survey trade and service enterprises constitute for 17% and 20%. In contrast to the trading firms the share of German service firms in China has risen constantly over the last 10 years. Responsible for this development is, inter alia, the increasing standard of living and income of the Chinese population at least in the Eastern provinces that create demand for Western services.<sup>281</sup> The rising demand also attracts SMEs from Germany who see chances for untapped and evolving markets. Trading companies have disadvantages in China because of their business models. In most cases traders are resellers of products that they buy from other manufacturers and sell with an on-top margin. Therefore, trading companies often shift their businesses to

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<sup>281</sup> Brede/ Nerb (2004), p. 364f

products that are extraordinary in order to attract Chinese customers who cannot get the products elsewhere and willing to pay the price.<sup>282</sup>

Principally, the distribution of the three business types - production, trade and service - among the respondents of the panel reflects the overall distribution of the German business community in China quite accurately. According to the study “BusinessFocus China - Markteintritt” conducted by the German Industry & Commerce (Taicang) Co. Ltd. (GIC) German production firms in China disclose for 57% and sales and trade companies for the remaining 43%.<sup>283</sup>

The next chart in figure 37 deals with the relation of company size and the type of business. One could suspect that the small enterprises would be the ones to start business in the trade and service sectors due to the fact that establishing a production site would be difficult with the given low resources that they have.

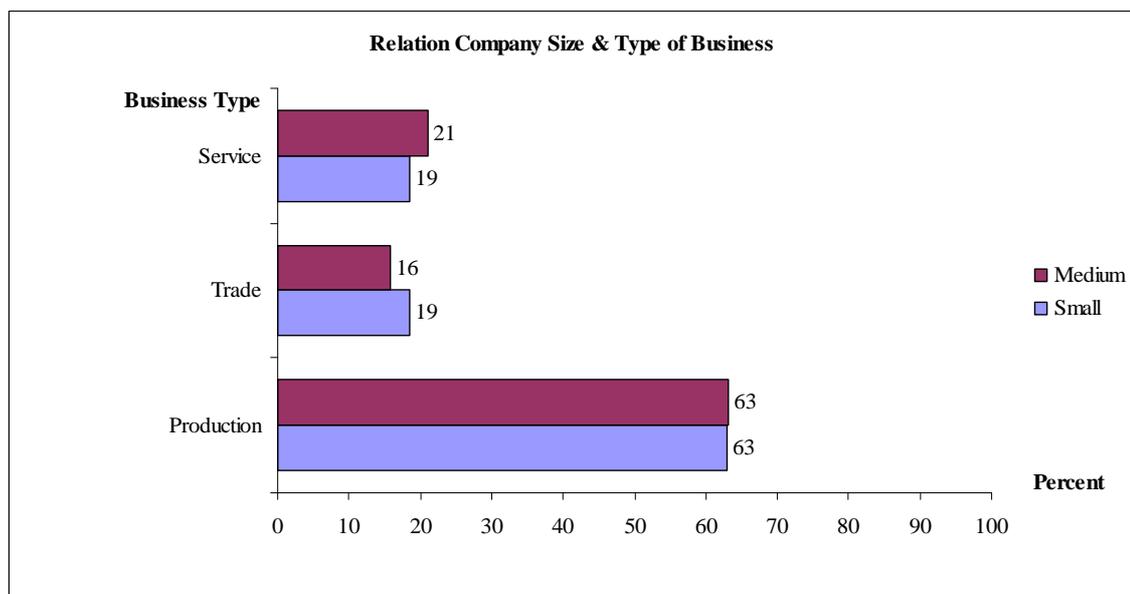


Figure 37: Relation of company size and the type of business

Figure 37 shows no evidence for this assumption. On the contrary, it displays that 63% of the small enterprises established a production facility in China despite of their low resources. This result is quite astonishing and would encourage other small German firms, interested in entering the Chinese market as a production company, provided that on-top of their presence those small production firms are also successful in China.

<sup>282</sup> Brede/ Nerb (2004), p. 370ff

<sup>283</sup> GIC (2008), p.34-38.

These questions will be answered and discussed chapter 6.3 which will deal with the evaluation of the current situation and business environment of German SMEs in China.

Apart from the surprising fact that 63% of the small firms engaged in production, the allocation of SMEs is almost identical in each of the three groups, and the following results displayed in the upcoming figures will also lead to statements about a homogenous distribution of small and medium sized enterprises.

Figure 38 shows the relation of the market entry date and the type of business. The findings of this relation validate statements which have previously been made. Before 2000 mainly production companies found their way to China. Trade and service-oriented SMEs rather established their businesses after 2000. As stated before, the share of service enterprises rose constantly in the last decades. The ratio between the 7% prior 2000 and 26% after 2000 can serve as evidence for this argument.

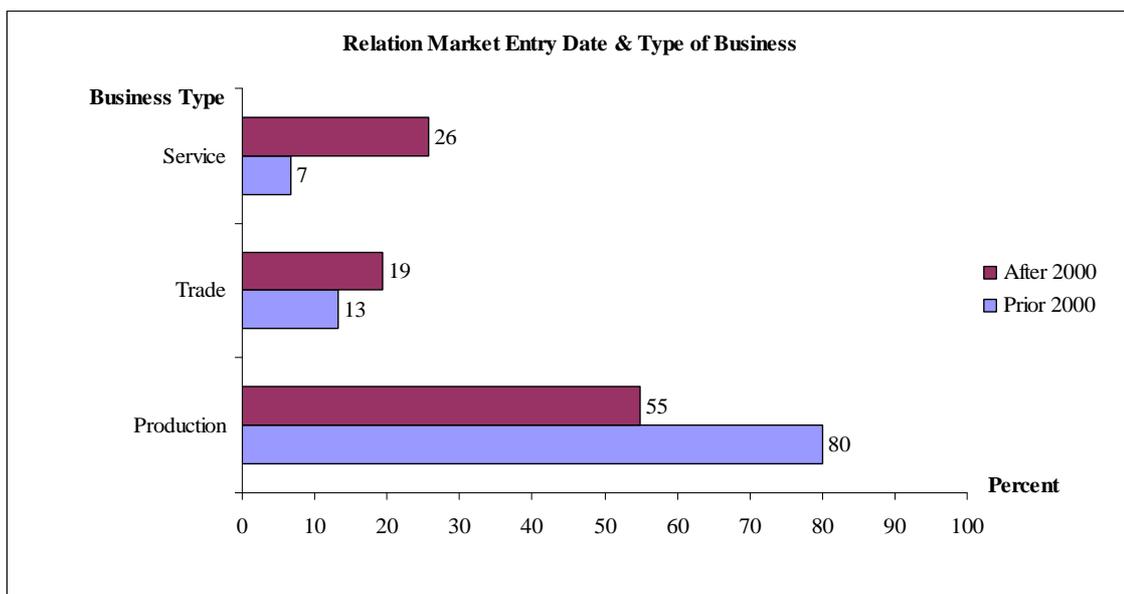


Figure 38: Relation of the market entry date and the type of business

In figure 39 the relation between the type of business and the area of business has been displayed. As expected, the production sector is primarily occupied with business industries like automotive, machine building and chemical, as well as food and textile, whereas the service sector plays a predominant role in pharmaceutical, energy, finance, IT and telecommunication. The trade sector is equally filled with representatives from all business industries.

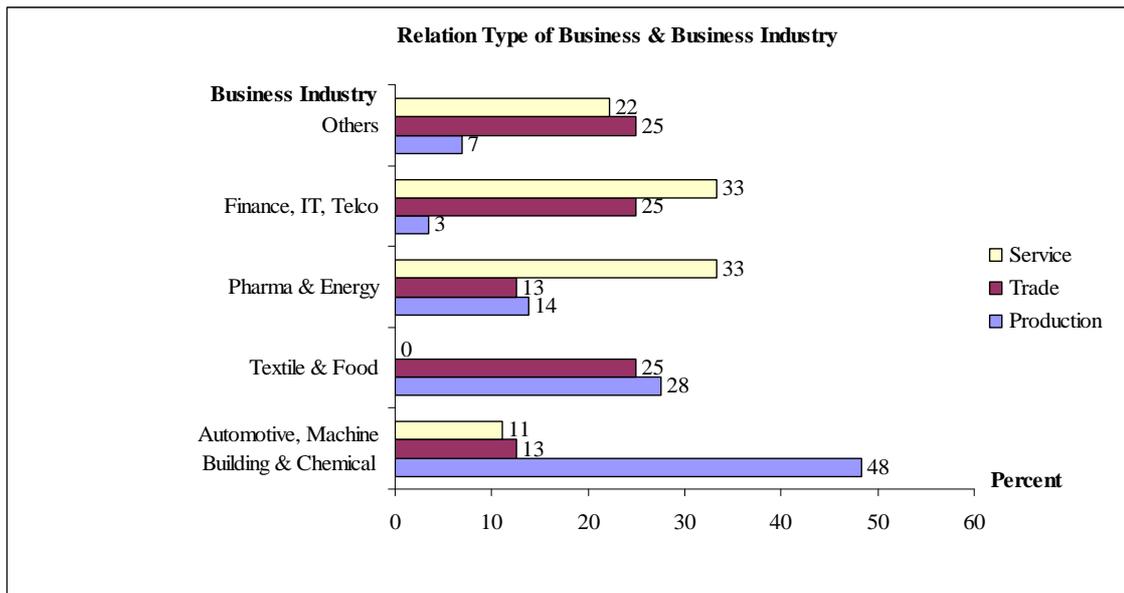


Figure 39: Relation of the type of business and the area of business

### 6.1.7 Form of operations in China

When a company is within the process of developing a strategy for expanding to a new market one of the most important decisions is to clarify the form of operations the company will adopt. In chapter 4 it has been pointed out that there are basically three options for direct investment to choose from. The first option is that the representative office (RO) that offers expansion at low cost and low risk with limitations to the extent that all goods have to be provided and all invoices can only be issued by the parent company. German ROs are often located in Beijing since those companies see the need for lobbying with the Chinese government.

The second option is the cooperation with a Chinese partner company, often in the form of a joint venture (JV). This solution mostly provides direct access to an existing customer and supplier network, but also implies the risk of less control over the overall China strategy. Due to no direct experiences with the Chinese customers and suppliers the opportunities for a successful development of the company in China are limited. In the past, establishing joint ventures was often the only way of setting up foreign invested enterprises in China since WFOEs were restricted or not allowed in many industries.

The third option is the wholly foreign owned enterprise (WFOE). The advantage of a WFOE is the total control over all operations, but it also brings the disadvantage that it entails the highest investment for expansion and therefore the highest risk.

According to a survey of the German Industry & Commerce in 2002 among the forms of penetration the number of representative offices represented 50% and the remaining 50% were split up between joint ventures and wholly foreign owned enterprises. In a follow up study in 2007, 73% of all German operations in China turned out to be enterprises (WFOE or JV). Accordingly, we can see that the trend clearly favors the WFOE. Most German companies do not only want to be represented in China, but also want to manufacture, sell their products, and provide their services.<sup>284</sup>

In the case of the present survey 35% of the respondents established their businesses as a representative office, 24% as a joint venture and 41% as a wholly foreign owned enterprise. Even though the respondents of the survey only represent the SME share of all the entire German community in China, it can be seen that the combined proportion of JV and WFOE is 65% which comes closely to a just mentioned percentage of 73%. Especially the 41% stake of WFOE demonstrates that the survey participants favor the option with the highest control and development potentialities which corresponds to the just described trend.

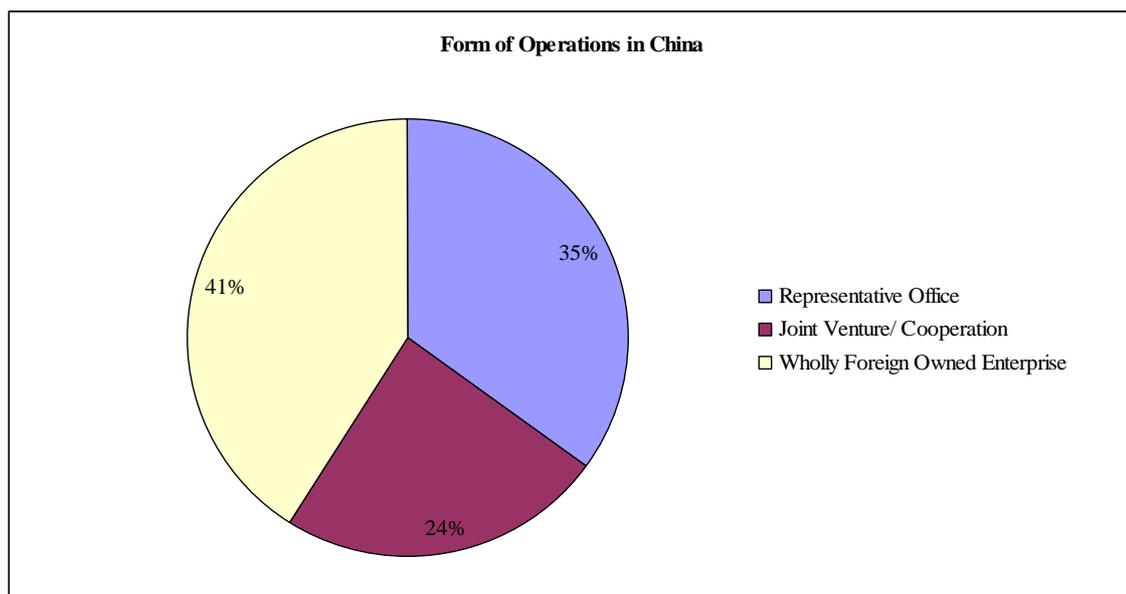


Figure 40: Form of SME operations in China: distribution in the sample

In order to get a clearer picture which form of operations the respondents chose at which point of market entry, the relation of these two characteristics has been calculated and displayed in figure 41. The distinction was determined by the market entry prior and after 2000.

Some of the just discussed arguments can be found in the results of this relationship. For example, the joint venture has not been a form of operations for companies expanding after 2000, whereas prior to 2000 47% of them chose this form. This reflects the argument that in the past German companies had only the option to cooperate when they wanted to sell their products or services directly on the Chinese market because the WFOE was forbidden in many cases. The low responses for the joint venture (13%) in the current period also reveal that firms that expanded after 2000 do not favour the co-operation since the disadvantages of this form of operations often prevail.

Equally interesting are the results for the representative office. Here, it can be seen that many of the German SMEs who settled in China after 2000 established an RO (48%) and that the percentage of firms with RO who came to China before 2000 is only 7%. It can be argued that SMEs who entered China after 2000 belong to the group of companies that followed the hype that took place in Germany to expand to China. These SMEs did not want to miss out the promised opportunities in China but only wanted to enter the Chinese market with a small investment of their resources in order to test the opportunities. In the case of failure the loss was smaller than with another form of operation. SMEs that made their way to China prior the year 2000 might have taken a more strategic and conscience decision to expand and therefore decided on another form of market entry that in their mind promised a more solid basis.

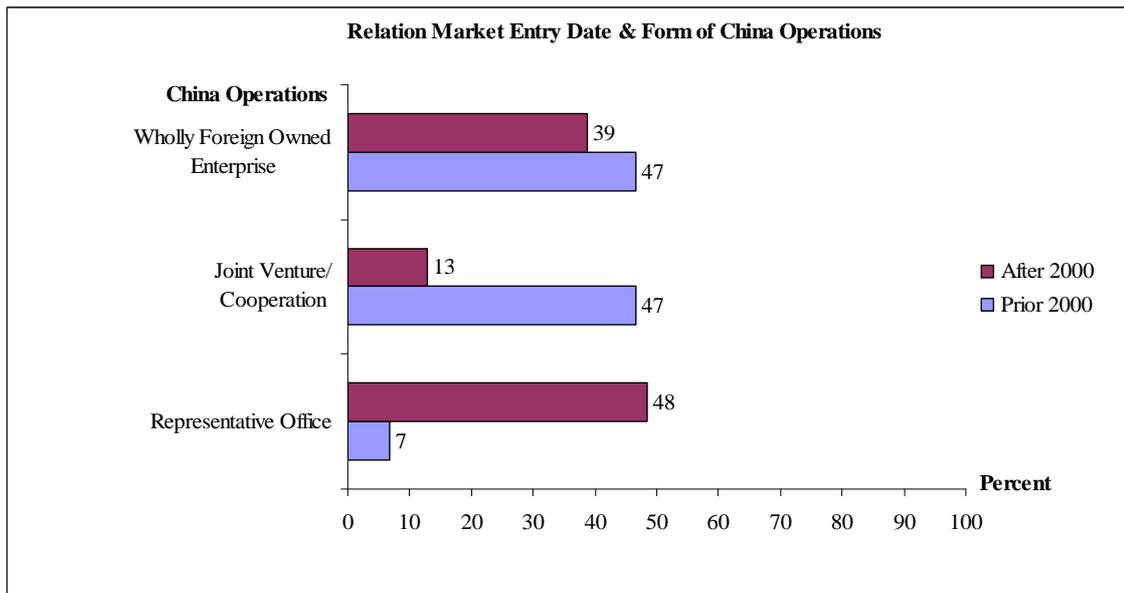


Figure 41: Relation between market entry date and form of operations

Even more light into the discussion is brought by figure 42 where company size is related to the form of operations. As argued earlier, small enterprises have a low amount of resources and, therefore, tend to establish their businesses in new countries in form of representative offices. The respondents of the survey prove this fact since 52% chose this form of operation in China. Furthermore, the above stated trend that firms today rather invest in a WFOE instead of a JV is also evidenced by the small companies' answers. 33% of them settled with a WFOE and only 15% with a JV.

Medium sized enterprises also demonstrate that the amount of resources often determines the form of operations. More than half of them chose the WFOE which incorporate the highest investments followed by the JV with 37%. This result can again be explained by the fact that in many cases medium sized firms entered the Chinese markets before it was possible for them to start individually as a WFOE. Only twinning with Chinese partners was allowed. The remaining 11% of the medium sized respondents work from their representative office. One indication here could be that those companies even though they have bigger resources started their China business and took the low risk and, hence, the low cost approach as a first step.

In the upcoming parts of the survey it will be illustrated how German firms evaluate their China expansion. The responses offer the opportunity to prove the above-made assumption.

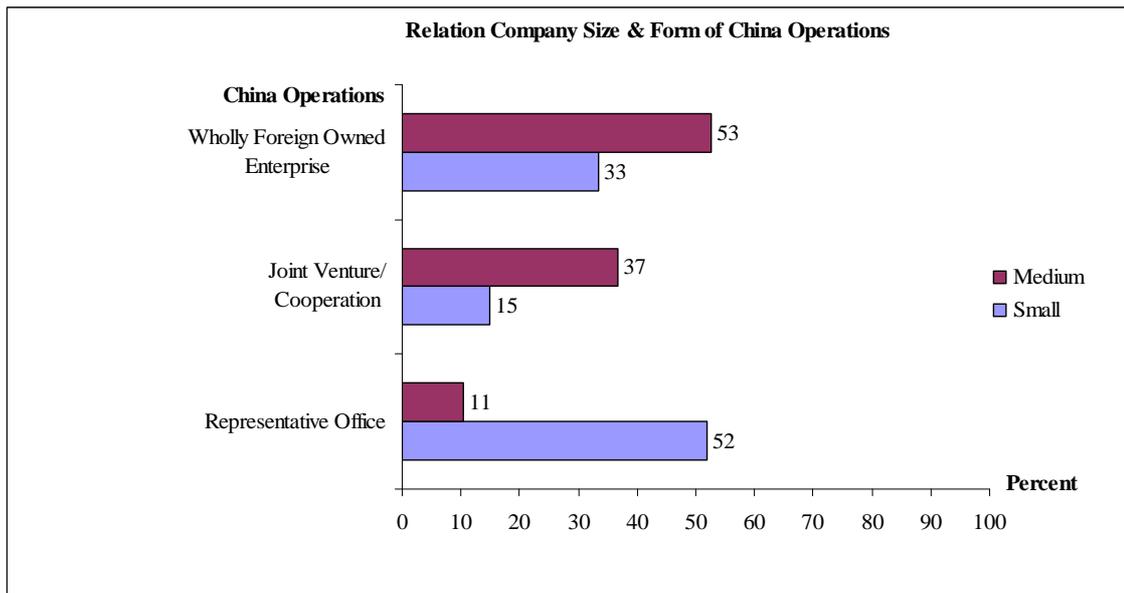


Figure 42: Relation of company size and form of operations

The last figure that deals with the form of operations in China, figure 43, shows the relation between the form of operation and the three business types: service, trade and production. Among the German SME respondents the service companies gave a relatively homogenous spread over the three forms of operations. Nevertheless, the most dominant form of settlement for services is the representative office with 44%. In most cases service companies only need an office where their employees adduce the company services. Therefore, the percentage of service firm operations with a WFOE in China is relatively low with 22%. In comparison to the RO there are not many advantages, except the company develops and expands its business in China and wants to interact directly with the China customers, for example in the form of issuing the invoices and cashing in the money. A representative office is not allowed to perform those actions and, therefore, always has to rely on the parent companies. A WFOE can act completely separated from the parent company. The 33% of service enterprises that chose the JV as a form of China operations underline the already stated argument that JV local partners quickly give access to their customer and supplier network. Service companies, of course, are less relying on local suppliers but are especially interested in the customer base of the partner to spread their service easily and become known in their branch in China.

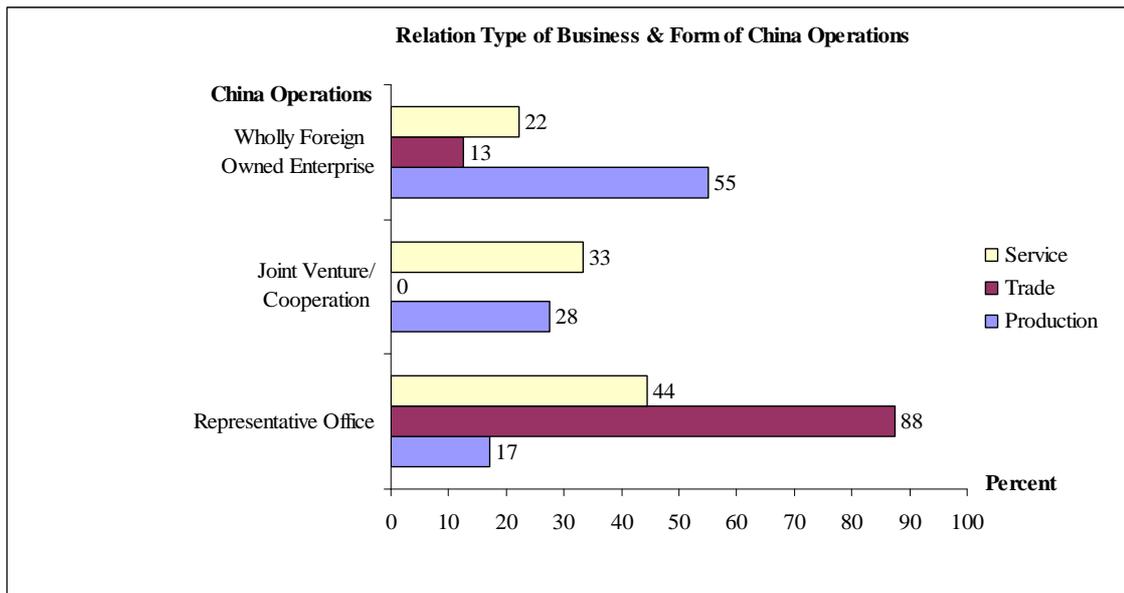


Figure 43: Relation between the type of business and the form of operations

Almost all trading companies within the survey basically operate with an RO (88%). This coincides with other surveys conducted by the GIC<sup>285</sup> and is not surprising since the business model of trading firms favours the RO.

As it has been illustrated earlier, production companies are the firms that expanded to China first. Therefore, they are the ones who have developed businesses in China that operate from their own WFOE. 55% of them decided on this form of operations. Obviously, it is the most convenient and sensible option for production enterprises since they want to have full control as manufacturers over their value chain and overall operations. 33% of the production companies settled for the JV as a form of operations. Again, these might be the ones who did not have the chance to expand to China otherwise. RO got only 17% of all responses from production companies within the survey. The RO is obviously not the best form of operations for a manufacturing company since normally the goal of German companies in China should be to start low-cost production in the host country rather than to produce in Germany and ship the goods to the Chinese markets. The RO can only be the first step into a new market for a production enterprise.

<sup>285</sup> GIC (2008); GIC (2009)

### 6.1.8 Reasons for choosing the form of operations in China

In previous chapter 6.1.7 the form of operations in China has been discussed and comprehensively related to the market entry date, the size and the business type of the German SMEs. The results have been rather intuitive. Nevertheless, some assumptions and arguments have been declared which will be verified to certain extent by the upcoming responses to the question: what were the reasons for choosing the form of operations in China.

Figure 44 summarizes the results of the German SME responses for each of the three forms of operations. Only the four most prominent answers were associated to each of them, similar answers have been summarized to one response.

As it has already been stated in the above arguments, the two reasons 'low risk approach' and 'low cost approach' are essentially important when thinking about the RO form of expansion. These two reasons are accompanied by the strategy that companies usually expand to a new country by choosing the RO. This strategy is not surprising since in many cases companies who enter the Chinese market have already expanded to another foreign country before. European countries around Germany are interesting targets for German SMEs because of their closeness.<sup>286</sup> When companies have already made the step into another country, they usually use the same paths again when this approach has been successful.<sup>287</sup> The last reason why German SMEs decided on the RO is that they followed a competitor's example. The strategy of several firms is to follow the market leaders. Those enterprises benchmark themselves to companies who they think have a successful strategy within their market and when those leaders expand their business into a new country the followers imitate their movements.<sup>288</sup> One can only hope that this strategy is not the only main motivation for expansion since the chances for failure is relatively high when companies are lacking their own strategy.

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<sup>286</sup> ENSR (2004), p. 15ff

<sup>287</sup> ENSR (2004), p. 35

<sup>288</sup> Brenner (1992), p. 73

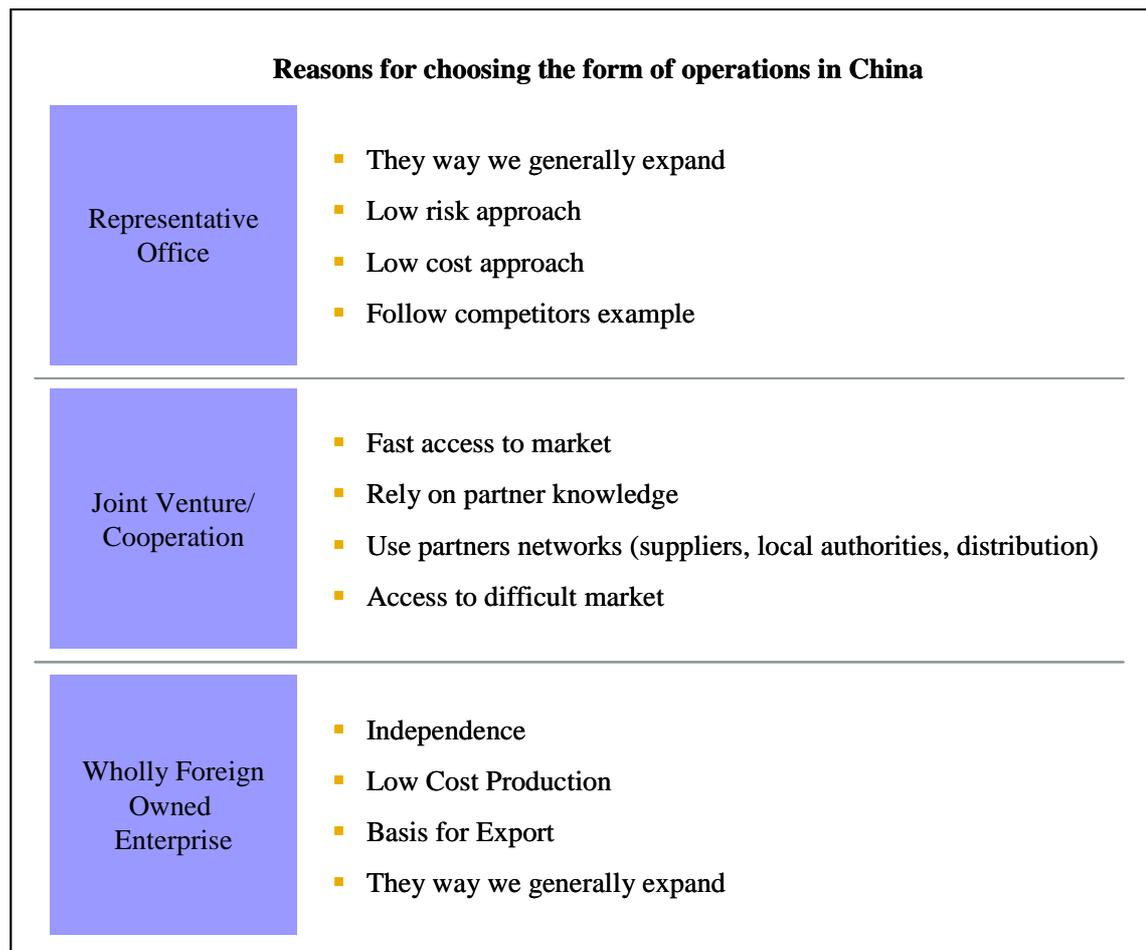


Figure 44: Reasons for choosing the form of operations in China

The four main reasons for choosing the JV as a form of operations in China have all been named before. Therefore, they are not explained again in detail. When a company thinks that its market in China is difficult and not easy and rather costly to access, the JV is an option to prevail over these difficulties. The JV partner offers fast access to the market with his existing sales network, knows how to interact with authorities and other business partners and is the competent partner in every business situation.

The last form of operation is the WFOE that has been chosen on the basis of already discussed reasons. The first reason is independence which is obviously important since dealing with a partner who comes from an entirely different cultural background and which cannot be properly assessed could create problems and difficulties that one does not have when he/ she runs the business alone. Moreover, often German SMEs think they have a competitive advantage over their Chinese competitors which is based on better technology or a more efficient value chain, etc. These SMEs do not want to reveal their knowledge to another business partner and, therefore, expand independently. The

GIC survey on market entry discusses the fact that even when German firms operate in their WFOE, their know-how has been transferred to their competitors. This might happen because Chinese workers who work for the German enterprise resign and switch to the competitors' company and reveal the secrets of the former employer. The survey further states that this proceeding has been done on purpose in several cases in order to gain the knowledge of the German firm.<sup>289</sup>

Another reason why the German SMEs favoured the WFOE is the low cost production. At first glance this argument does not seem clear since low cost production in China is not related to the WFOE, because low cost production is also possible in a JV or other forms of operation. However, what is meant by the German SMEs is that a WFOE gives them the legal entity to manufacture their goods and sole decisions to control costs.

The third reason that respondents stated in the survey is that a WFOE is the basis for export. The legal entity allows them to produce their goods and export them into neighbouring countries in Asia or to Germany and other markets where the mother SME is present.

The last reason for choosing the WFOE is that the German SMEs usually expand in that way. This argument has already been pointed out for the RO. The reasoning that was presented there is the same for the WFOE.

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<sup>289</sup> GIC (2008)

## 6.2 Expansion to China

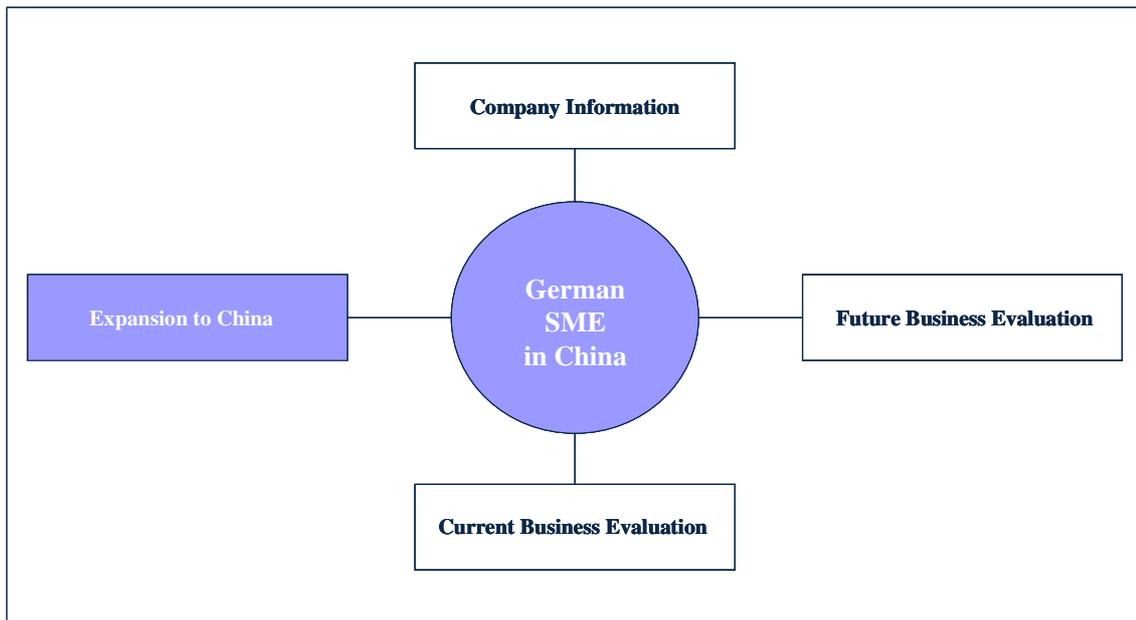


Figure 45: German SME in China – chapter two: expansion to China

Chapter 6.2 gives a detailed analysis of the motives for China expansion followed by an analysis of the strategy that German SMEs formulated. It will be examined how the SMEs evaluate their strategy retrospective and if and in which way they changed their initial strategy during the expansion process. Further on, the market entry preparation and coeval the satisfaction with the entry preparation will be mooted. The second topic will conclude with an illustration and discussion of the important internal and external success factors of China expansion for German SME.

### 6.2.1 Motives of SME for expansion to China

Chapter 4.1 has already given insights into the theoretical views in the literature about motives for expanding to new markets. These views will be enhanced by the responded motives of the SMEs in our survey.

By far, the most dominant motive for moving their business to China is the sheer market size (81%) as can be seen in figure 46. This does not come as a surprise since China is still deemed to be an untapped market with tremendous opportunities. Even though German SMEs often do not really know the market size of their particular market in China they believe that within a total customer market of 1.4 billion citizens their market for their products or services has to be big, too. On the other hand China is aspiring

and the Chinese markets constantly develop so the German SMEs want to have a slice of the pie at an early stage.

The sales market as top motivation becomes even more comprehensible when looking at the second motive that was stated by 65% of the respondents: the saturated home market. Unlike China most German branches have to face a saturated environment with declining sales and margins, fierce competition and not much room for development. In this case, internationalization often means survival for the companies involved.<sup>290</sup> China, in comparison to other Western but also to East European countries, offers a huge market potential at a reasonable investment, therefore in many cases China is the preferred country for expansion even though the SMEs are culturally closer to Eastern or Western Europe countries as well as from the distance.

In section 6.1.5 the reasons why the respondents decided on their particular location in China have been discussed. The most frequent response with 84% was to be close to business partner, e.g. suppliers and customers. The third motive for the German SME expansion to China is again related to customers and suppliers. 44% of the respondents state that either their customers or their suppliers expanded to China and they had to follow them on the one hand not to lose turnover and on the other hand not to lose partners within their existing and functioning value chain.

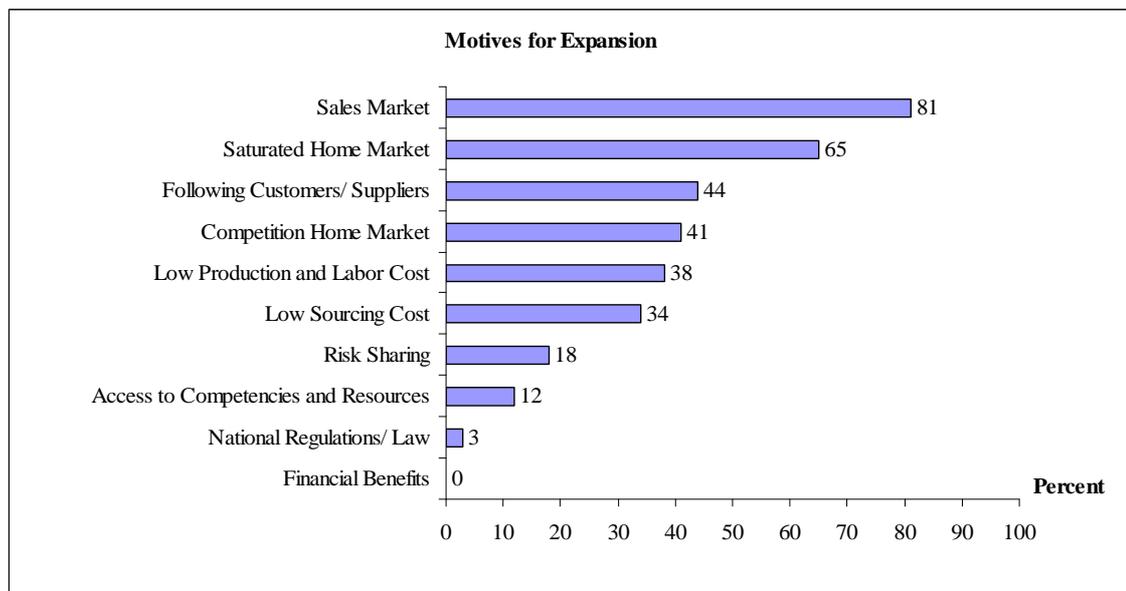


Figure 46: Motives of SME for expansion to China

<sup>290</sup> Sachse (2003), p. 83

The competition on the home markets is another strong motive for internationalization to China. In the case of the study, 41% of the respondents named this motive. Since most German SMEs operate in saturated markets, as seen above in figure 45, the battle for higher market share, turnover or better margins has been flared up long ago. Evasion from a situation with fierce competition and relocating to a country with a smoother business environment is often a reasonable mean to sustain turnover and margins.<sup>291</sup>

Low production and labor costs have been quoted as a motive for expansion as well. China's cost advantages are particularly appreciated by those German operations in China with a high local content share and/or a high export share. Surprisingly, only 38% of the participants of the survey gave this answer. Many German SMEs are under pressure to lower their cost structures in order to stay competitive. China offers these lower cost structures and, therefore, one could imagine that this motive would have been rated with a percentage closer to the 81% of the sales market motive.

The same can be said for the motive "low sourcing cost". Only 34% of the respondents declared this motive as an important reason for their internationalization. Other studies in this field display a higher percentage for the cost related motives.<sup>292</sup> The derogation could be explained by the fact that, apparently, sales-related reasons play a greater role than the cost-related reasons when it comes to motives for China expansion of the study participants.

Enterprises face changing environments that can harm their businesses, for example the change of regulations, fiercer competition, loss of suppliers or change in customers preferences. Therefore, the settlement in a new country introduces an opportunity for companies to diversify their business risk.<sup>293</sup> 18% of the study participants declared this driver as important for their decision making.

At least 12% see the importance of having access to new know-how and resources in China. In many cases, German firms are ahead of their Chinese opponents in terms of research and development, e.g. they have advanced products. Therefore, it is a belief of German enterprises that China does not really offer the chance to adopt or acquire new technologies or processes. In the case of the study the access to know-how is more related to the fact that German firms have the need to understand the Chinese way of

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<sup>291</sup> Anderie (2010), p. 32ff

<sup>292</sup> Mühlfeld (2004), p. 125

business and their working culture. In many circumstances German SMEs start with exporting their goods when they first get in touch with China. Unfortunately, they often face problems due to cultural differences. A subsidiary in China opens up chances to get closer to the market and Chinese business behavior. The motive to have access to resources can be explained by the need for low-cost workers or low-cost materials that can be occupied in China. It can also stand for the chance to have access to resources that are not available or only hard to get in Germany, e.g. special herbs which grow in China.

Even though Chinese law and regulations are far from being ideal for German SMEs they offer some benefits and amities that encourage German businesses to enter China, like low taxes for example. 3% of the respondents name this motive as important reason for their China expansion.

Surprisingly, none of the participants declared “financial benefits” as an important expansion driver. This motive has been included among the possible reasons because according to other studies<sup>294</sup> this factor has often been essential. The reason why it has not been essential in the given study could be that the majority of those studies focus on bigger medium sized and large German companies. Those firms like Siemens or Volkswagen, for example, have completely different approaches to internationalization. They keep close ties to political authorities and other important business players in the expansion country in order to prepare the ground for their large investments. In many cases those investments are backed up by financial benefits from the government or local authorities. One explanation could be the assumption that in the case of SMEs the amount of investments is so small in comparison to large firms that special financial benefits are generally not offered by Chinese authorities.<sup>295</sup>

## 6.2.2 Market strategy of SMEs in China

When a company is within the process of developing a strategy for expanding to a new market one of the most important decisions is to be clear what the form of market strategy the company will have.

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<sup>293</sup> Kretzberg (2008), p. 124ff

<sup>294</sup> GIC (2008)

<sup>295</sup> Even though this assumptions seems obvious the proof in literature could not been found for SME dealing with China. The European Network for SME Research (ENSR) acknowledges this fact for the expansion of West European companies into East European countries.

In the survey the participants were asked to choose among the following four types of strategy:

- Cost leadership
- Differentiation
- Niche
- Other

Figure 47 displays that only 4% of the respondents decided on the cost leadership strategy which is quite comprehensible since the SMEs settle within a market where local competitors already operate on low cost. Therefore, it is interesting to see which types of enterprises among the SMEs decided on this strategy. Figure 47 shows an overview which companies choose which kind of strategy. 13% of the trading companies and 3% of the production companies compete on a low cost strategy in China. No service firm decided on this strategy. The 13% trading companies show a lot of courage since these firms have business models where they resell products from other manufacturers. This means that the margin of the trader is put on top of the purchasing price of the manufacturer which creates a higher final price for the customers. Therefore, it is debatable whether those companies are able to survive with this type of strategy in China in the long run. Another reason for the 13% trading companies that chose low cost strategy might be that those traders import products to China which have never imported before and therefore the chances for a successful expansion to China could be good.

At this point it would be intriguing to get insights from those trading SMEs that entered with a cost leadership strategy and failed. Coevally, it would be interesting to hear from trading SMEs who were successful with this type of strategy. The 3% production firms that chose the cost leadership strategy have at least full control over their cost structures and can lower the costs within their value chain in order to be better than the Chinese competition.

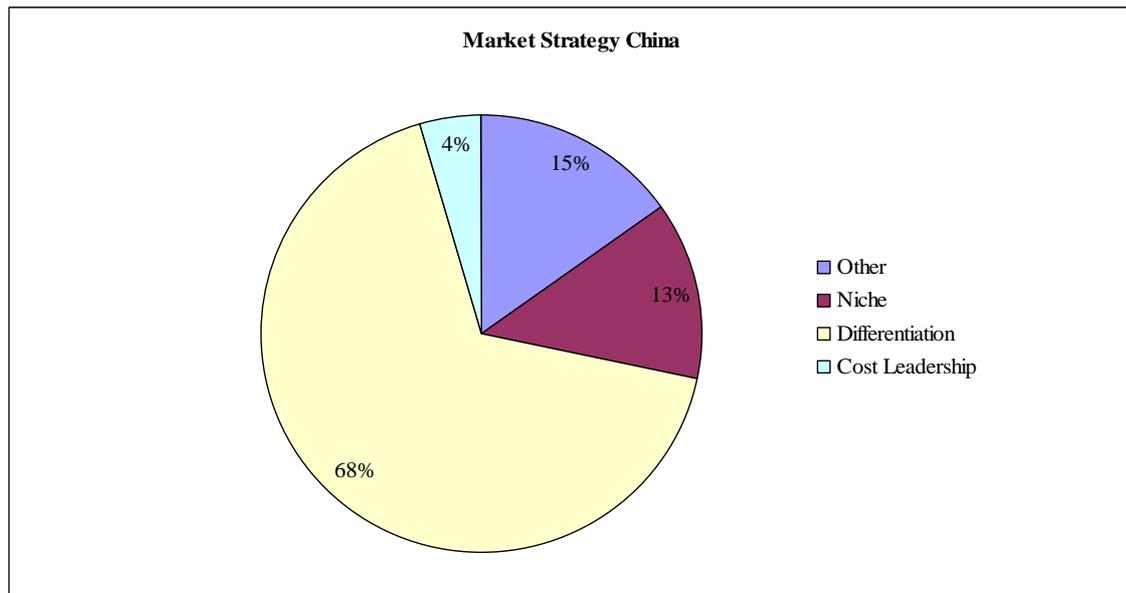


Figure 47: Market strategy of SME in China

The differentiation strategy is by far the most selected one by the participants of the survey. It is no wonder since the key competences of German firms are the advanced products and services that are based on progressive research and development and an efficient supply chain. In many branches most Chinese competitors currently catch up with the technological leadership of the German companies and partly they have already drawn level with them.<sup>296</sup> Nevertheless, the chances for forward-looking products and services are still very promising for German SMEs. Therefore, a total group of 68% determined the differentiation strategy for their entry into the Chinese markets.

The relation of type of business and market strategy illustrates that 76% of the production enterprises chose the differentiation strategy, whereas 56% of the service firms and 50% of the trading companies settled for this strategy. These results are not surprising and clearly display the dominance of the differentiation strategy among others. Especially the 76% share of production firms operating on differentiation indicate the great confidence of the German SMEs in their products.

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<sup>296</sup> Geulen (2001), p. 76ff

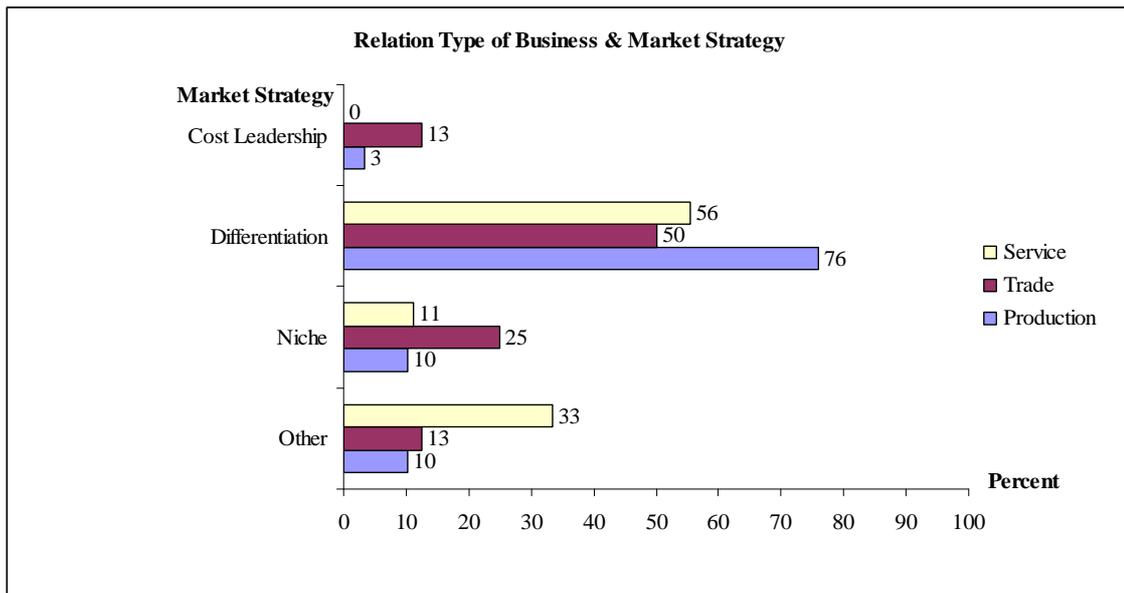


Figure 48: Relation of type of business and market strategy

The niche strategy is favored by 13% of the study participants. Due to their size SMEs in Germany already occupy niche markets in which they are able to compete with their products or services since they specialize themselves and put all energy and effort in one area of business or product. This specialization helps to keep costs low and to concentrate research and development on one specific sector to gain competitive advantages. In many times SMEs pick niche markets that are so small that bigger companies are not interested in since the prospective turnover is too low. Instead, this prospective turnover is enough for SMEs to run a successful business. Those SMEs that prolifically operate in niche markets in Germany pursue the same strategy when they expand to new markets.

Figure 48 shows that 25% of the trading companies decided on the niche strategy in China. It has been discussed before that it is debatable if trading SMEs are able to compete in the Chinese market because of their business model. The 25% trading companies operating in a niche market could give an answer to this discussion since in a niche area the customers are not as price sensitive as in “normal” markets because the supply is smaller and the options are fewer. Therefore, the customers are willing to pay a price premium for goods which they could not get otherwise. In this case the on-top margin that the trader puts on the price of his supplying manufacturer is no disadvantage for the trading companies.

11% of the service enterprises and 10% of the production companies favor the niche strategy in China as well. The niche strategy can definitely be advantageous for those

SMEs since the market participants are manageable due to clear and narrow business sectors. Competition is low which gives them time to get experience in the new business environment and to develop their businesses in China because especially in the first years, the newcomers make mistakes due to their lack of experience.

The fourth market strategy category that the respondents were able to choose was the “other” strategy. This category has been created for those German SMEs that were not sure about their China strategy or, in other words, it was created for those SMEs that might not have defined a solid or at least clear market strategy. Similarly, it could also be the case that those companies are not yet sure about their strategy and are in process of testing their products or services in all different strategic areas: high price – high quality, low price - reasonable quality, etc. in order to find out the best business sector for successful operations in China.

15% of the group of German SMEs picked this category and it will be interesting to see how those four groups evaluate their market strategy for China. This evaluation will follow in the upcoming section 6.2.3. Before we come to the evaluation it has to be noted that out of the service enterprises 33% selected “other” strategy. One reason could be that it is quite common that service companies are not sure which strategy they pursue since they mostly have a large variety of products which should be appealing to miscellaneous customer groups with different needs. On the other hand, only 13% of the trading and only 10% of the production companies voted for the “other” strategy. These low results demonstrate that those enterprises have a clear vision which strategy in China they should follow and that only some still have to find or develop their strategy or pursue another type of strategy that is different from the common types of strategy.

### **6.2.3 Evaluation of China strategy**

In this section the respondents were asked to evaluate their strategy for the Chinese market. The results give a picture of the current satisfaction and do not display what the German SMEs have actually done in order to get to the point where they stand today. Therefore, the next section 6.2.4 will outline how the strategy has been modified in the past.

The results shown in figure 49 are noticeably positive. More than 75% of the German SMEs that completed the survey state that they are satisfied with their own market strategy in China, even 26% claim that they are very satisfied. This extraordinary outcome

demonstrates that those German SMEs operate successfully in China; otherwise the companies would not be pleased with their current strategy. This high voting also reveals that those German SMEs have the resources and manpower to develop a sustainable and solid strategy. Other German SMEs interested in expanding to China should be encouraged regarding those statements and get into the process of migrating to China as well. Only 24% of the participants mentioned that they are not satisfied with their current strategy. Among those only 4% are very unsatisfied.

Another possible explanation for the very positive picture could be that only those SME decided to fill in the questionnaire that are satisfied with their own strategy. The “adverse selection” is surely there if we consider that companies that failed with their operation in China are already not in the business register, so they did not get the questionnaire.

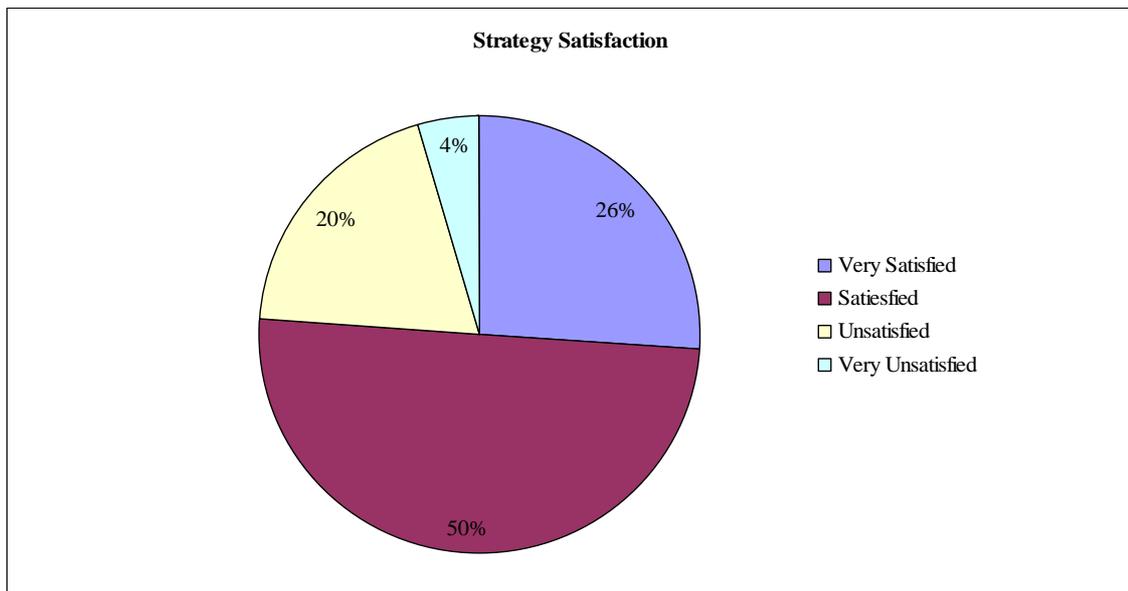


Figure 49: Self-evaluation of China Strategy

Figure 50 illustrates how the three types of businesses evaluate their market strategy. It can be concluded that the allocation among the four satisfaction estimations is almost the same and no business type really stands out. If at all, the group of production enterprises demonstrates an even more positive view on their strategy and the group of service corporations have a tendency to be a little more on the negative side. All in all, the results prove the rather positive evaluation of the strategies.

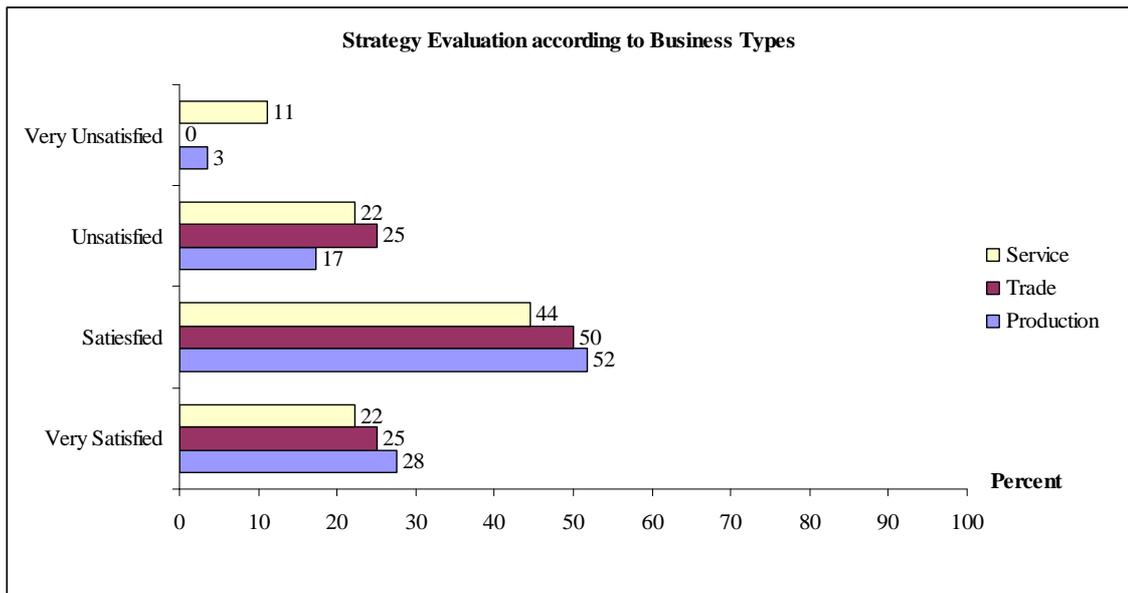


Figure 50: Strategy evaluation according to types of business

Figure 51 presents the results of the evaluation of the four strategic categories: cost leadership, differentiation, niche and other. 50% of the enterprises that chose the cost leadership strategy state that they are unsatisfied with this type of market strategy. This evaluation could support the above-made assumption that a strategy based on low cost is quite risky on the Chinese market where all competitors, especially the local Chinese competitors, compete on cost.

Furthermore, it is notable that firms operating with a niche strategy tend to rate their strategy as rather positively. None of those companies voted for “very unsatisfied”.

Interesting are the results for the “differentiation” and the “other” strategy. Even though both have the tendency to be more on the satisfied side there have been negative responses as well.

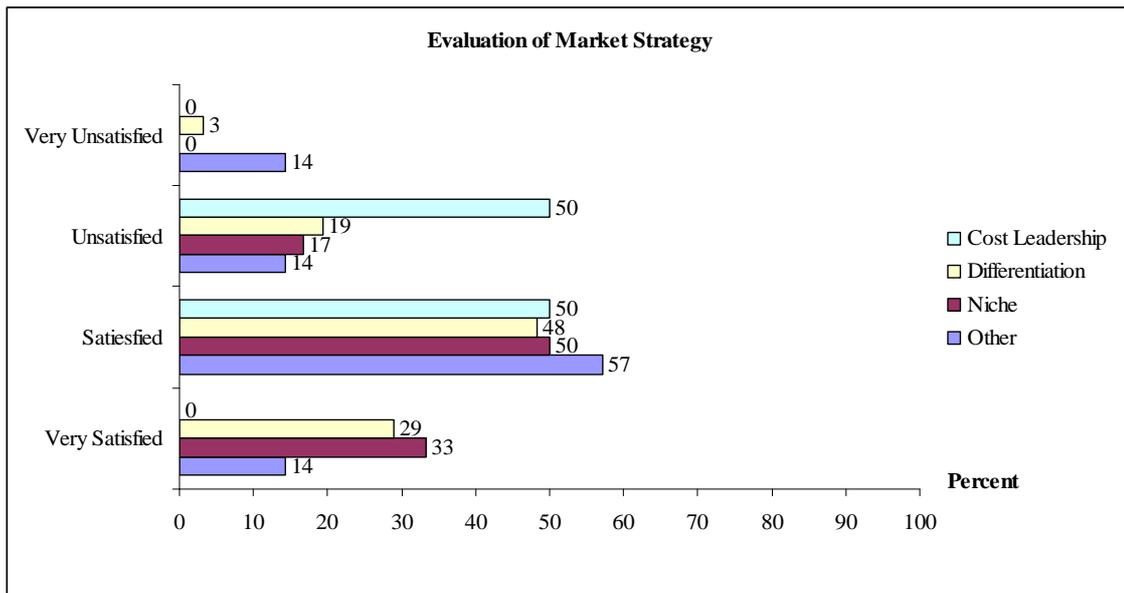


Figure 51: Self-evaluation of the market strategy

Both figures 50 and 51 demonstrate that it does not matter what type of business/ branch a company is in or which type of market strategy it pursues. No branch stands out among the others and no market strategy shows the mere potential to be successful in the Chinese market. Every area has its downsides.

And this is indeed a very good result since it makes clear that every company is able to develop a solid strategy for China no matter from which background it comes. Important is the preparation before expanding that incorporates the key competences of the enterprise and takes the new business environment in China into account. Questions regarding the entry preparation will be discussed in the section 6.2.5.

Before, in section 6.2.4 the focus of the study will lie on the strategy development of the German firms that settled in China. Here, changes in strategy in the past of the German SMEs will be examined.

#### 6.2.4 Strategy development of SME in China

Strategy is never set in stone. This means that successful strategies have to follow their environment and have to be adjusted accordingly.<sup>297</sup> When German SMEs operate on the German market this saying is definitely true. But when it comes to the Chinese market a new variable is added: the unknown and new market environment. The markets in

<sup>297</sup> Porter (1999)

Germany are basically familiar to the German SMEs. The business culture does not raise any issues and the behavior of the market players is more or less comprehensible. China is a totally different sphere where market players act unaccustomedly and the cultural differences are immense.<sup>298</sup>

Therefore, German SMEs have to take into account all those facts when developing their market strategy for China. It is obvious that in order to do that the SMEs have to acquire Chinese market knowledge, etc. This is not always the easiest which will later be pointed out in section 6.2.5 that will deal with market entry preparation. Nevertheless, no one can expect from an SME to develop “the ideal strategy” right from the start. Finding the best strategy that suits the company is an ongoing process that constantly incorporates the changing environment.<sup>299</sup>

Figure 52 illustrates the strategy development of the German SMEs that participated in the survey. Respondents were asked if they completely switched their initial strategy to a new one, if they had to carry out major or slight adjustments or if they undertook no changes at all. The answers give a clear picture that over 90% of the SMEs had to make at least small adjustments to their strategy. Only 9% stated that they still pursue their initial strategy with no changes. These 9% can, for example, be explained by the fact that the respondents just expanded to China and have not yet adjusted their strategy. Or they did not have to change their strategy because it has been developed so providently and estimations on the prospective markets have been solid.

From the point of view of the initial strategy a positive result is also reflected in the 61% related to the answer “slight adjustments”. This outcome exposes that basically the German SMEs of the survey have done a good job in preparing their initial strategy. As stated before, slight adjustments to a strategy is part of a normal process, which is needed to react to a changing business environment in order to stay ahead of competition.

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<sup>298</sup> Marohn (1995), Grimm (1998), p. 7-19

<sup>299</sup> Porter (1999)

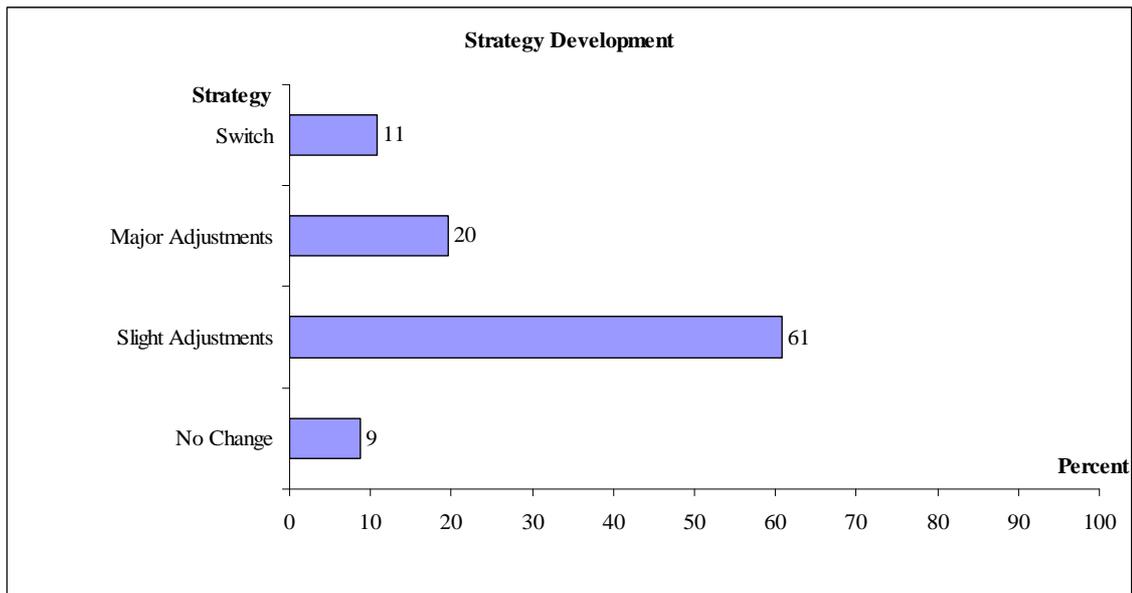


Figure 52: Strategy development of SMEs in China relative to the initial strategy

Major adjustments to the strategy have been carried out in 20% of the cases and even 11% of the respondents had to completely switch their strategy. Here, one third of the SME had to recognize that their initial strategy did not work for China and their particular markets. For the majority of German SMEs China is the first Asian country they internationalize to. Therefore, they have never experienced the different culture and business behavior before and false assumptions could have been made. The assumptions on customers and other market players were probably false or misleading. Sometimes it does not matter how good the preparation had been in Germany before they expanded, since the target country is different. The information that the SMEs gathered on the Chinese market have possibly been fragmentary and that is why the German SMEs were not able to develop a long-lasting strategy from the beginning and why they had to undergo the strategy change.

As a next step we analyze which types of businesses actually had to make adjustments to their China strategy and which not. The results displayed in figure 53 provide interesting insights. Production companies seem to have the most solid strategies right from the start. 10% made no changes and the majority with 69% only slightly adjusted their initial strategy. This could be attributed to the fact that the SME production corporations mainly transfer their successful business models from Germany to the new country since this is the most obvious and the easiest strategic option. Production companies often have a manageable portfolio of products which they can compare and benchmark with products from international and local competitors operating in China when devel-

oping their strategy for the new Chinese markets. In figure 48 it has been displayed that 76% of the production firms operate with a differentiation strategy in the Chinese markets which sets them and their products apart from the competition. In most instances working with a differentiation strategy refers to products which distinguish the German SMEs from their competition. This proceeding can be very successful and, as a result, the production companies do not have to or only slightly have to make adjustments to their market strategy in China. The same could similarly be true for the 10% production enterprises which operate on a niche strategy.

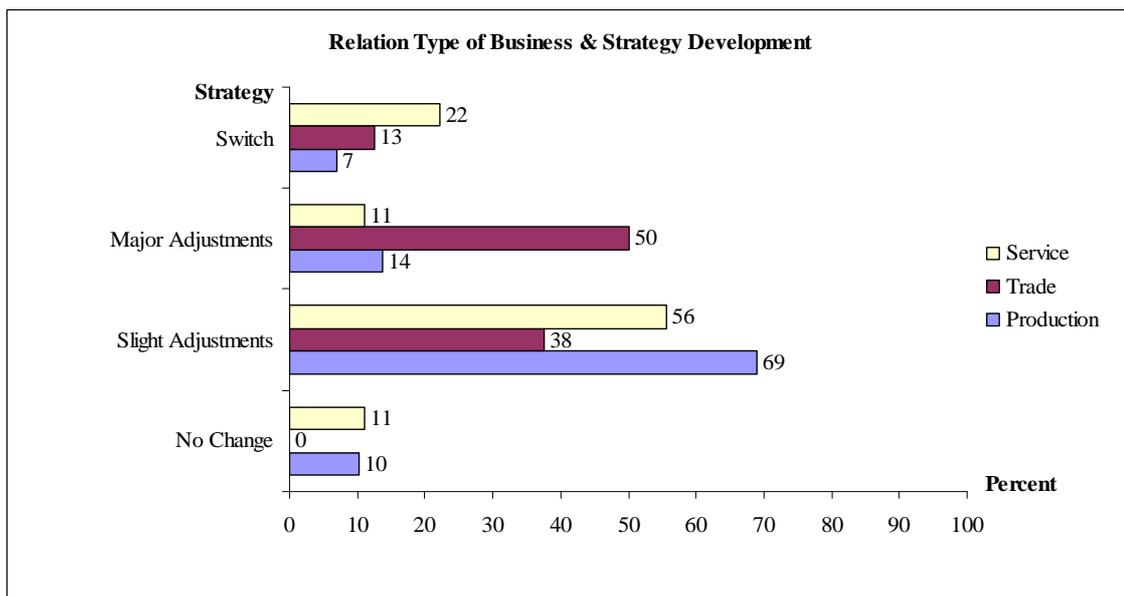


Figure 53: Relation type of business and strategy development

German small and medium sized service enterprises are rather new to the Chinese markets as it has been illustrated in paragraph 6.1.4. That is why many service firms did not experience alternating business environments in China that are present due to the rapid development of the Chinese industry and country in general. The short duration of their market presence could be one reason why there have not been big changes to the strategy of the German service SME. 11% of them did not have to modify their China approach and 56% of them only made slight adjustments. Another cause for the minimal modifications could be the same explanation just described with regards to the production companies in connection with their market strategies. Here, 67% of the service firms operate either with a differentiation or with a niche strategy. On the other hand it is worthy to remark that in contrast to the slight adjustments a large percentage of 22% of the service enterprises had to completely switch their China strategy and develop a totally new one.

Assumptions why the production SMEs had to face radical strategy change could be: cultural differences, unexpected market environment, insufficient market information or poor entry preparation. Those arguments hold for those 22% service firms that had to completely switch strategy and those 11% with major adjustments as well. Another specific reason regarding service companies could also be the circumstance that often new laws and regulations by Chinese authorities came into effect in the last years.<sup>300</sup>

When looking at the strategy development of the trading companies the picture becomes again different from the other two. All trading firms had to change their initial strategy after expanding to China, 38% made small adjustments, 50% had to redevelop their strategy to a great extent and even 13% had to completely switch their original approach. It can only be speculated why trading firms in particular had to deal with relatively significant changes. One assumption would be that a lot of trading firms had to exchange a greater number of products to meet the Chinese customers demand in proportion to their German portfolio. For them this proceeding could already feel like a major strategy change and so respondents might have decided on these answers in the survey.

Certainly, strategy is not only determined by the products that a company sells, other aspects like the entire marketing mix, the lead time or the after sales service play an important role, too. Due to the variety of dimensions that define the market strategy it cannot be clearly analyzed why a strategy change has taken place in a particular business sector or within a specific market strategy. Therefore, further research would be needed where, for example, another study could focus especially on the strategy of trading, service or production companies separately in order to gain more insights in those individual business areas.

### **6.2.5 Market entry preparation of German SME**

This section will deal with the market entry preparation of German SMEs in China. All study participants were asked to respond to the question: what did you do in order to prepare for your China expansion? 10 possible answers were predefined from which they could pick their choices. Figure 54 shows those answers in declining percentage order. Due to the fact that most German SMEs added their own preparation elements to the given 10 responses four additional replies were added.

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<sup>300</sup> Schlevogt (2000b)

The number one approach that 82% of the German SMEs followed was to get in touch with other German companies that already expanded to China in order to get insights and advice which steps to take to develop a successful market entry into China.

The second most frequent response has been to consult the German Chamber of Commerce. Here, the SMEs have two options: either they contact one of the eighty local Chamber of Commerce in Germany (DIHK) or they get in touch with the Delegation of German Industry and Commerce in China (GIC) that is represented in 4 Chinese cities: Beijing, Shanghai, Guangzhou, Hong Kong.<sup>301</sup> Apart from information and advice on branches and markets, the Chamber of Commerce conducts studies in various business areas to provide their members with practical insights. Especially when it comes to the topic of expanding to a foreign country the GIC in the particular state is the first contact for local information. In the case of the present study 80% of the German SMEs sent requests to the local or foreign Chamber of commerce.

The expansion to a new territory never accounts for daily business for an SME. Even if a firm has already internationalized to a number of foreign markets the settlement in every country is different again, especially when the cultural and business environment is as diverse as in China. Certainly, the basic approach can be transferred to the new strategy for China but the other market conditions need to be incorporated. Therefore, 76% of the German SMEs that participated in the survey assembled a team of employees to tackle the task of developing a China expansion strategy. This form of preparation has been the third most frequent response.

Nowadays, the internet is more and more essential. Today, enterprises that search for information first take a quick look on the internet to get a basic overview about the topic before making use of other information channels. This approach is cost-effective and expeditious. One would think that all German SMEs interested in expanding to China would consult the internet in various topics in order to get first market information on

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<sup>301</sup> All German companies registered in Germany, with the exception of handicraft businesses, the free professions and farms, are required by law to join one of the 80 German Chambers of Industry and Commerce. Thus, the Association of German Chamber of Industry and Commerce (DIHK), the umbrella organization, speaks for more than three million entrepreneurs. This gives the association considerable political influence. They represent the interests of their members in relation to the local, state and regional authorities and, through the DIHK, the Federal Government and the European Commission. They do not only perform public functions but also assist their members directly as counselors or mediators in business matters of local, regional and supra-regional importance. They are also involved at national level through the DIHK and internationally through the Delegations of German Industry and Commerce.

China. Certainly, this is the fact. Nevertheless, only 65% of the survey attendees stated that they used the internet as tools for their expansion preparation. This surprising result can only be explained by one circumstance: at the time when some of the German SMEs prepared their internationalization the internet had not yet been a source of valuable information or had not even been available. Looking back to figure 31, 33% of the survey participants entered the Chinese market before 2000. The internet reached its first real prominence in the late 90's. Still the availability of information was limited and the readiness to use the internet as a source of information was not very widespread at that time.

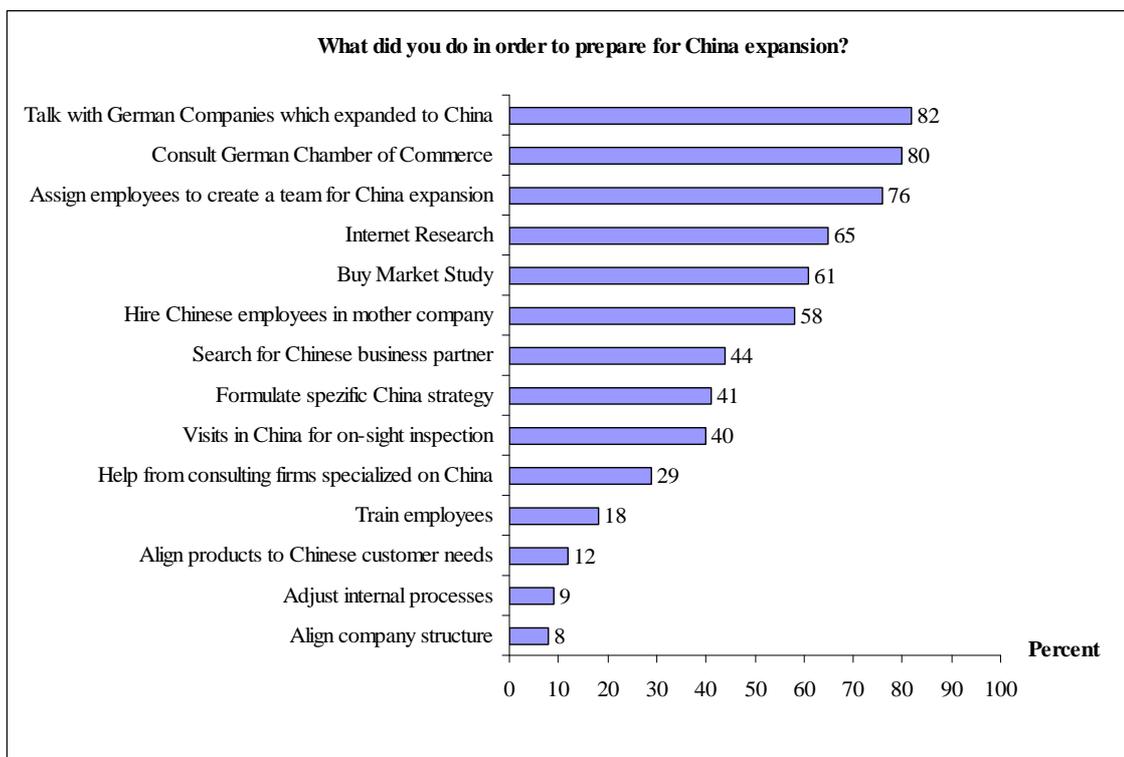


Figure 54: Expansion preparation of German SME

The “old way” of obtaining market information is to engage firms or institutions specializing in market research to conduct market studies and buy the results. Often this market information was already gathered in the past by those firms so that interested companies can easily purchase them. In comparison to broad internet information the market studies which are bought mostly offer the specific information a company is looking for, e.g. overview of market players in the woodworking industry in China. Therefore, this

“old style” of gaining access to market information can still be justified since tailored information is presented to the buyer. In the case of the present survey 61% of the SMEs bought market information for their entry preparation into the Chinese market.

Building a subsidiary in a foreign country often do not only entail to employ local staff in the new country but also in the home land. There are several reasons why also German SMEs hire Chinese employees in their parent company when expanding to China. One of the reasons is the future relationship between the parent and the affiliate. The affiliates do not work independently since in many ways they are still depending on support by the parent companies. Here, contact persons on both sides are needed in order to ensure the communication flows which are necessary to set up the new entity. German SMEs have quickly recognized that it is not sufficient to only deal with German staff. Ideally, Chinese employees are also included in the set up process on either side in order to incorporate Chinese knowledge, approaches and ideas as soon as possible. Moreover, it has been shown that after the establishment of the new entity the presence of Chinese both in China and Germany helps to build an understanding of business and culture in the daily operations among the diverse teams. 58% of the survey respondents share the view that mutual learning increases the momentum of the expansion process in order to achieve the objectives of successful establishment and further business development.

The next task that German SMEs did for their entry preparation goes into a similar direction as just discussed. 44% of them chose to look for Chinese partners who, of course, serve as an opportunity for the German SMEs to gain market knowledge or to have easier access to the striven markets.

Among all duties which have been named for entry preparation the upcoming one is most surprising. Solely 41% of the German SMEs declared that they formulated a specific market entry strategy for their China expansion. Naturally, one would assume that 100% of them would have taken the time to develop a specific strategy since the project entails significant changes to the companies which lead to considerable costs. This 41% could imply that the German SMEs act negligently because they do not prepare professionally their internationalization. However, it has been displayed above that this is not the case: they indeed prepare when they, for example, talk to other German enterprises that already expanded to China or they gather all necessary information, etc. What they do not do in several cases is to take this information and formulate a specific China

strategy. The mentality of German SMEs could be an answer for this kind of approach. SMEs act practically when it comes to implementation. They do not have the staff and the time to make detailed theoretical business strategies. The proceeding of SMEs is to get started once the important basic parameters are known and do not waste time with unnecessary envisioning of the future that cannot be predicted anyway.

The choice of location is an important success factor when it comes to the establishment of a new entity in China. Section 6.1.5 has already discussed the importance of this. Figure 54 indicates, 40% of the German SME survey respondents made the effort to visit China themselves and got first-hand information on the infrastructure, local business partners and authorities or friendly German companies. Even if this approach is costly for SMEs that have limited financial resources it helps to form a complete picture of the imminent project and reduces the chances for failures.

It has been professed that gathering information of the foreign market is essential for a successful expansion. 29% of the study respondents see the need to engage a consulting firm that is specialized in supporting an entry into new markets. In addition to market information in form of market studies consulting firms offer to develop the entire entry strategy or to provide valuable business contacts, which help to facilitate the ingress. There is no doubt that having a specialized consulting firm aside during the expansion eases the entire process. But on the other hand, this service is costly. The fact that SMEs have limited financial resources has already been stressed a lot. A company has to decide for itself if this investment pays off in the end because expensive errors could be prevented in the run-up.

The new market and business environment introduces new ways of thinking and behaviors to the existing employees. The staff in the parent company as well as the employees in the affiliate needs to be prepared for this new situation. 18% of the participants acknowledge this fact and train their people beforehand. Certainly, it would be better to see a higher percentage among the respondents in order to know that the employees were not caught flat-footed, but again the limitation in resources, respectively time could be reasons why the training of staff has only played an important role for 18% of the German SMEs.

The Chinese markets have a consumption behavior which can hardly be predicted by the German SMEs in the run-up of the expansion. The underlying goal when a company wants to sell its products on a new market is that the customers like what is offered.

Normally, one would assume that in this case the German enterprises align their products to the Chinese needs. Only 12% have in fact done that. The reverse conclusion is: 88% of the participated SME expanded to China without making any changes to their products or service. Either they are so confident that their German products or service also meet the needs of the Chinese customers or they first want to see if they can be successful with their products or services and only make adjustments if they do not go down well or perform well enough. Nevertheless, the low percentage of 12% in product alignment to Chinese needs has been unexpected.

The last two statements that were given by the respondents deal with the alignment of processes within the company (9%) and the alignment of the company structure (8%). Interestingly, similar to the alignment of the products or services to the Chinese needs for the most part the German SMEs tend to keep their processes and their company structure unaffected by the expansion to China. Again one assumption could be that these German SMEs think that their existing processes and company structures are sufficient to serve the Chinese market or that they first want to keep efforts and changes low whilst the company is still in its infancy and makes adjustments when they are actually necessary.

Now that all preparation activities have been discussed the next paragraphs will outline how the German SMEs evaluate their market entry preparation. The attendees could decide on poor, fair, good or excellent preparation. As it is human to rather not disclose that one has performed badly the evaluation might have the tendency to be too positive. Nonetheless, even if the results are slightly embellished, the underlying trend is meaningful. One trend that can be found in figure 55 is that 65% of the German SME respondents give good (54%) and excellent (11%) marks for their market entry preparation. This is a good signal since it shows that little resources or limited expansion experience do not prevent a successful preparation. Moreover, it displays that those entry preparation activities mooted above are adequate to set up the internationalization to China.

The remaining 35% are broken down into 33% who evaluate their preparation as “fair” and 2% that state that they are not satisfied (poor preparation) with their preliminary. The fact that 33% had a preparation that left room for improvements is generally not a negative result. An expansion process can still be successful even though the company has the feeling as if it could have done it even better, especially with hindsight. The

question there is how critical an enterprise sees its preparation activities. In section 7.2.3 it was asked to evaluate the China strategy. 24% of the German SMEs voted for unsatisfied (20%) and very unsatisfied (4%). The fact that 35% chose “fair” and “poor” preparation could be used as an explanation for the discontent with the overall China strategy. If the German SMEs already failed within the preparation process, the basis for a successful China strategy could be rather unstable.

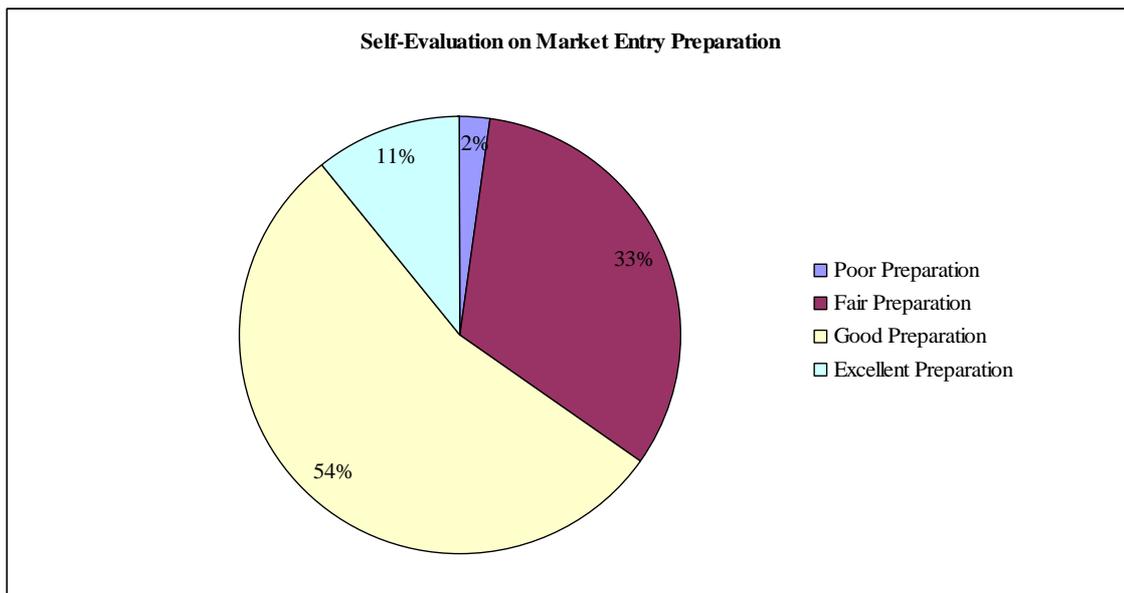


Figure 55: Self-evaluation of the market entry preparation

The last chart in section 6.2.5 is illustrated in figure 56. The idea behind this chart is to relate the market entry preparation to the strategy development. In other words, it should be displayed if there is, for example, a relation between poor preparation and the need to make adjustments to the strategy or in a reverse conclusion that an excellent preparation entails no changes or only minimal adjustments to the strategy. Indeed, both hypotheses can be found within the results: 67% of the participants that voted for poor market entry preparation had to completely switch to a new China strategy and the remaining 33% had to undergo major adjustments. On the other hand, 40% of those that had an excellent preparation could pursue it without any changes, only 40% had slight adjustments. Solely 20% encountered difficulties and made major changes to their strategies which shows that even an excellent preparation might sometimes not be enough because the new and incalculable business environment forces companies to move away from their initial plans. These consequences can also be true for those Ger-

man SMEs who had a “good preparation” but also had to take the necessary actions to make major changes to their strategy (16%) or even switch it completely (4%).

On the other hand, 60% of the SMEs that stated that they only had a “fair preparation” had good strategy performances: 4% did not have to change plans at all and 54% only had minimal modifications.

The bottom line is that the outcome shows that a solid preparation is not compulsory in order to pursue a successful expansion strategy, but the prospects look much better if the companies carry out their preparation assiduously.

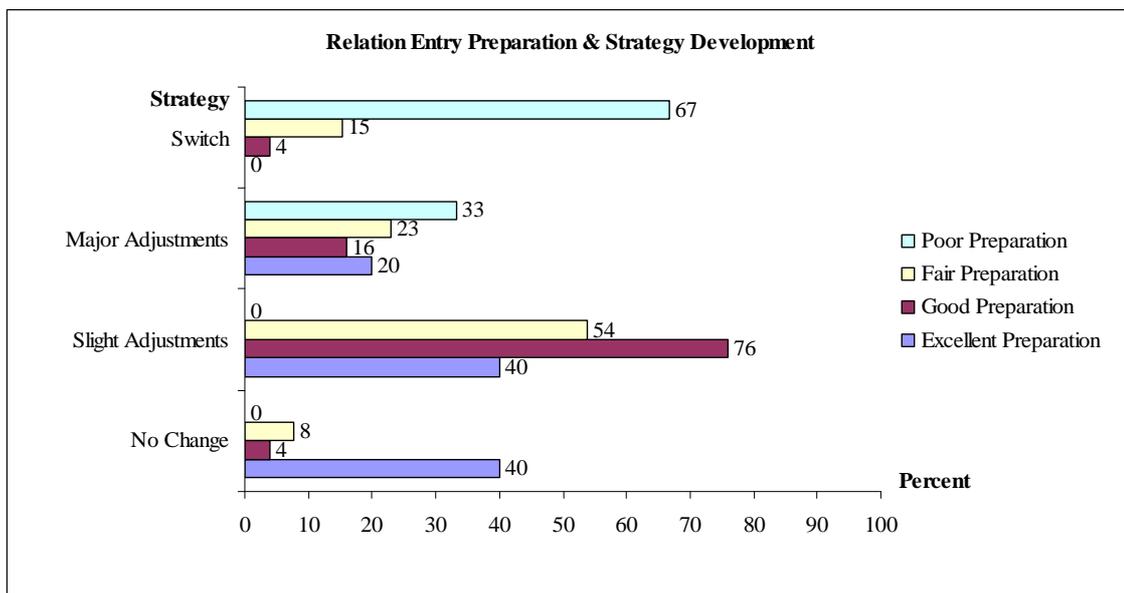


Figure 56: Relation of market entry preparation and strategy development

### 6.2.6 Internal success factors for China expansion

Section 5.2 has given an overview on the theoretical basis in literature on the internal success factors of companies who want to internationalize. The upcoming paragraphs will examine these internal success factors in the context of the German SMEs that expanded to China. They were questioned which factors they think are important to successfully enter the Chinese market. Ten possible answers were predefined but the participants were offered to further include internal factors when they saw the necessity. In addition to the ten given factors two more were eventually included in the results presented in figure 57 because several companies similarly named them.

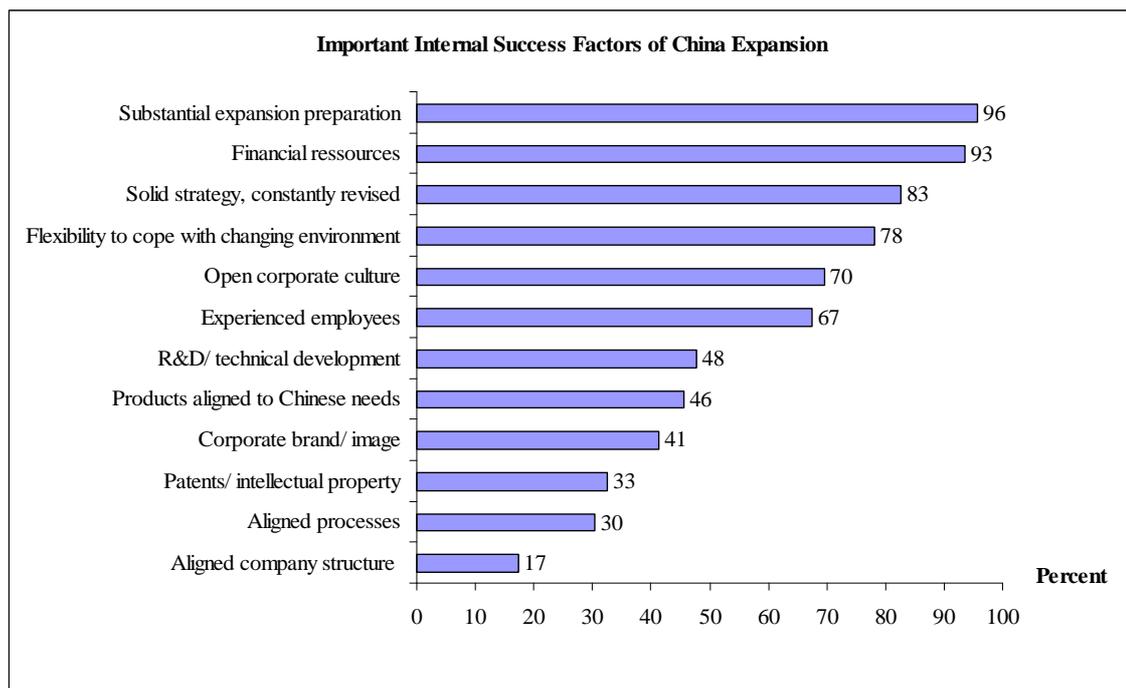


Figure 57: Important internal success factors of China expansion

The number one success factor that 96% of the German SMEs decided on was the substantial expansion preparation. All tasks necessary for a good preparation have just been discussed in the last section 6.2.5. The fact that almost all German SMEs picked this success factor shows that without a solid and comprehensive entry preparation a company can only hardly be triumphant even if all other internal factors look good.

The second most frequent response has been the need for financial resources. 93% of the SMEs picked the most obvious factor reflecting that expansion to a new country is costly. On the one hand, especially SMEs have very limited financial resources and, on the other hand, the companies have difficulties to assess how much money they have to invest in the internationalization process and concretely in which areas or steps. Therefore, the German SMEs have to precisely plan their expenditures in order not to run out of cash and compromise the settlement.

In the last section one surprising outcome has been that only 41% of the German SMEs declared that they formulated a specific market entry strategy for their China expansion. In contrast, when it comes to state internal success factors, 83% of the German SME declared that an important success factor is to have a solid strategy which is constantly revised. This raises the question of how such a discrepancy can happen. In life it can often be experienced that there is a difference between what people say that they should

do and what people in fact do. This behavior could be related to the above illustrated discrepancy as well. If the German SMEs are asked to name important internal success factors, the majority picks the solid strategy formulation, but when the companies actually design their internationalization processes the task is too demanding and the concrete strategy formulation is put aside.

Flexibility is the next buzzword that the German SMEs see among the important internal success factors for a successful market establishment in China. 78% of the SMEs think that flexibility is needed in order to cope with the constant changes in market environment. But flexibility is a broad notion which every company interprets differently. Therefore, it can stand for simple flexibility where an employee responds to customer wishes fast or for the high flexibility where entire processes and company structure are adjusted to meet the changes in environment. In this respect, it cannot clearly be evaluated what the respondents of the survey mean when they choose the answer “flexibility”.

The next internal factor voted by the participants is the “open corporate culture” with 70%. Similar to “flexibility” the “open corporate culture” can only hardly be evaluated since it expresses an idea that many companies like to identify with. Certainly, an open corporate culture is crucial when entering a new country with different business background and cultures. Especially in China business is done differently than in Germany and customers and other business partners have partly other needs than the existing clients and partners. The enterprise with an open corporate culture has to take this into account and has to welcome the unknown environment and adjust its behaviors accordingly. The majority of German SMEs in this study seems to have recognized this.

The success of a market entry strategy is to a large extent determined by the people that implement it. 67% of the German SMEs support this argument since they feel that experienced personnel is an important internal success factor for internationalization. Companies that employ key staff who has already planned expansion processes to other countries have an advantage because they went through each step before and bring in their experience which can protect companies from making fatal errors that are costly or harm the market settlement.

German SMEs are aware of the fact that they have to go a long way in China before they finally establish themselves in their particular market. Competition is giving them a

hard time and only the fittest with competitive advantages survive.<sup>302</sup> 48% of the respondents see the R&D, e.g. the technical development as a key internal success factor to create the competitive advantages. It has been declared earlier that 68% of the German SMEs chose the differentiation strategy as their market strategy for China. The differentiation approach only works with a well-functioning R&D that enables the companies to distinguish from their competitors and obtain competitive advantages.

46% of the study participants state that the alignment of the products to the wishes of the Chinese customers is an important internal success factor. This again opens up a discrepancy similar to the one just discussed where the internal factor has been the formulation of a solid market strategy. Here, a substantial percentage of the German SMEs announced that the products or service need to be aligned to the Chinese needs, but we learned from the previous section dealing with market entry preparation that only 12% indeed aligned their products for the Chinese markets. Again, there is a huge difference between what is believed to be the best actions to take and what is done in fact.

Well-known brands or a good image are attributes that help corporations in the interaction with market players in a new country: for example it is easier to call attention and attract customers. Equally, the positive image suggests a good business partner and therefore contracts are easier to find. Especially Chinese customers and market players in general have a distinct fixation about brands and corporate images. Companies that operate in the luxury segments like fashion or jewelry have high growth rates in China because the current trend is to show success in form of owning luxury brand products, e.g. Rolex, Chanel, Louis Vuitton, etc.. The same brand fixation is true for each branch in China where the Chinese know exactly who are the top players and brands on the market and use them as a benchmark.<sup>303</sup> Due to this reason one of the predefined answers for the German SMEs of the study has been the importance of corporate image or brand as internal success factor. 41% of them view this fact, too. They know that a well-known brand opens the way for an easier market establishment. Though the question remains if the SMEs actually operate with a high regarded brand or if they just wish that they would operate with a good brand in China. The question cannot exactly be answered. The truth is that SMEs are naturally not well-known global players due to their sheer company size and, therefore, in most cases do not have comparable images like

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<sup>302</sup> Seibold/ Ballhaus (2005), p. 36-38

<sup>303</sup> AHK (2007)

multinationals. Nevertheless, even among the SMEs are several enterprises which are market leaders in their particular markets and consequently well known in their branch.

One of the problems that all companies have to face that enter the Chinese markets is that the Asian and also the Chinese competitors undertake every effort to keep up with them in terms of technical progress, product design, quality or services. The only means is often to just copy the foreign products and introduce a similar product to the market. Moreover, as mentioned earlier Chinese culture believes that copying honors the person or company that has produced or manufactured the original product. Therefore, in many cases the Chinese do not see a violation of the foreign rights when they copy their products.<sup>304</sup> The only chance that foreign corporations have is to protect their ideas and products with patents. 33% of the German SMEs in the given study have the same view on this topic. Unfortunately, even patents are not sufficient to protect the intellectual property of the enterprises in several cases. Even though China has entered the WTO and committed itself to the trade rules and accepted that patent infringement has to be avenged, the reality shows that many Chinese firms still acquire ideas from foreign competitors and use them for their own products. Studies conducted by the GIC indicate that patent infringement slowly decreases, although German companies are still confronted with it.<sup>305</sup>

The last two internal success factors that were selected by the respondents deal with the alignment of processes within the company (30%) and the alignment of the company structure (17%). Interestingly, the same phenomenon occurs, which has been discussed earlier, that the wish to do something does not mean that the wish is actually implemented in reality. Concretely, 30% of the German SMEs believe that the alignment of the company processes is an important internal success factor for the expansion to China, but when looking back to their own results of market preparation it turns out that only 9% of the German SMEs have actually made some changes to their processes in order to meet the Chinese needs. Exactly the same situation can be spotted when looking at the alignment of the company structure. 17% of the German SMEs underline the importance but only 8% made the adjustments to their company structures. Perhaps this discrepancy can be experienced in many situations in life where the persons actually know about the importance of an action, but there are many circumstances that prevent

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<sup>304</sup> Zinzius (2000), p. 152

<sup>305</sup> GIC (2008)

the implementation, be that, for example lack of time, lack of motivation or lack of implementation know-how.

Therefore, it should be noted that this section clearly illustrates that the German SMEs often exactly know that in principle which internal factors determine a successful market approach but at the same time the section on market entry preparation has revealed that in many cases these actions have been omitted in the real implementation.

### 6.2.7 External success factors for China expansion

Having elaborated on the internal success factors for China expansion this section will discuss the important external success factors that have been emphasized by the German SMEs that participated in the study. The theoretical basis for this has been set in section 5.1. Just as before, ten possible answers were predefined but the participants were able to further include external factors when they saw the necessity. As a result, in addition to the ten given factors two more were eventually included in the responses presented in figure 58 because several companies similarly named them.

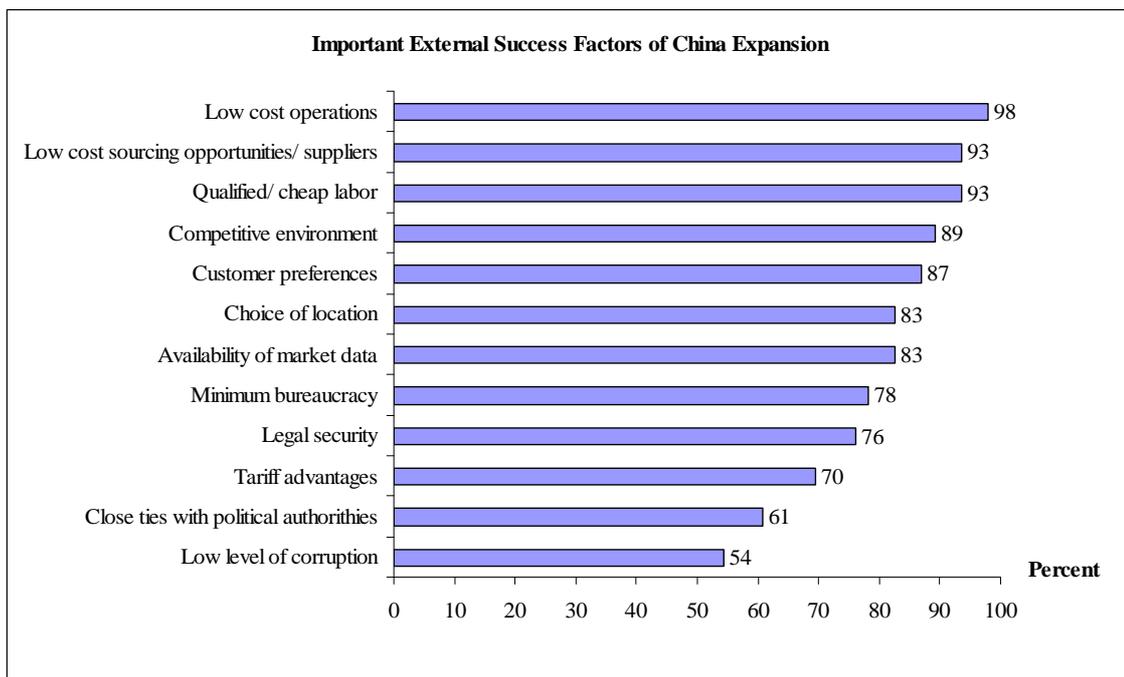


Figure 58: Important external success factors for China expansion

The number one success factor that 98% of the German SMEs decided on was the low-cost operations. The fact that almost all German SMEs picked this success factor shows that not only production enterprises look for low cost. The same is true for trading and

service firms who have the need to operate their value chain with minimal expenses in order to be competitive.

The second most frequent response is also related to low costs: low-cost sourcing opportunities. 93% of the SMEs picked this factor and it is comprehensible since the procurement of supplies accounts for a substantial share of the overall cost of the company.<sup>306</sup>

Not surprisingly, even the third important external success factor for German SMEs is related to costs. 93% voted for cheap and in some cases also qualified labor as a necessary component for business success in China. In this case cheap and qualified labor has not been separated since it was the aim to get insights on the importance of personnel in general.

Even though the majority of the German SMEs competes on differentiation or niche strategies in China the cost component as part of the whole package is always of great significance. Due to their strategies their products and services may be more expensive but the price sensibility of the Chinese customers does not allow a spread that is too far apart from the prices of the local Chinese companies.<sup>307</sup>

This argument gives a nice transition to the next external factor that has been selected by the German SMEs. 89% of them support the view that the competitive environment is a crucial factor for the well-being of the company in China. Later in the study the competitive environment will be further outlined in detail. Therefore, a deeper analysis why the SMEs chose this factor is not undertaken in this section. Principally, it can be noted that competition is always one of the most determining forces when looking at a business environment as also discussed in the theoretical section on external success factors.

Among the first four external success factors two can be found within the theory of the five forces by M.E. Porter, e.g. supplier power and rivalry among existing firms.<sup>308</sup> The force “determinants of buying power”, however is still missing from this list. Of course, the German SMEs do not disregard this force and therefore 87% of them opt for customer preferences. Naturally, it is essential to take into account the customer’s needs when entering a new country. The question that has to be answered is to what extend the

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<sup>306</sup> Baetge/ Kirsch/ Thiele (2011)

<sup>307</sup> Economist Corporate Network – industry report for KPMG (2004)

German SMEs actually react to these wishes. Earlier it has been revealed that even though the SMEs want to align their products and services, only 12% actually do that. These findings will be further examined in the upcoming chapters.

In section 6.1.5 the local presence of the German SMEs in China has been displayed and figure 35 has illustrated the reasons why the SMEs settled in their locations. Reasons like a stable business environment or to be close to business partners verify that the choice of location in fact is an external success factor for German SMEs in China. 83% of the respondents see it equally, as displayed in figure 58.

One driving factor in the section on preparations for entry to the market was to gain knowledge on the Chinese market. Therefore, German SMEs asked other German enterprises who were already operating in China, they consulted the German Chamber of Industry and Commerce, bought market studies or engaged with consulting firms specialized in the Chinese market. The result of 83% of SMEs who attach importance to the availability of market data verifies again the outcomes in the section market preparation.

With regards to the ideal location for settlement in China the SME respondents stated in section 6.1.5 that one of the most important factors is a stable business environment. One component that determines the not only stable but also well-functioning business environment is the bureaucracy. The processes within the local authorities that regulate the trade ought to be flexible and fast in order to support and not harm business operations. Already in Germany many SMEs complain about the bureaucracy that they face when doing business. Naturally, the topic of bureaucracy equally plays an important role in China. Especially since the procedures are new and unfamiliar and everything has to be executed in the Chinese language. 78% of the German SMEs see an important external success factor in local authorities that have minimized bureaucracy.

Another important component of a stable business environment is the legal security (voted by 76%) since the basis for a successful business development is an environment that is predictable so that the enterprises can comply their proceeding accordingly. Legal security signifies that rules and regulations have to be followed by the business partners and sanctions imposed if the standards are not observed. This applies particularly for patent infringement which will later be examined in the study more closely. The legal system is far more reliable in the Eastern provinces of China than in the Western

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<sup>308</sup> Porter (2008), p. 23-42

provinces where putatively arbitrary regulations dominates and, for example, local Chinese companies are privileged in comparison to foreign firms.<sup>309</sup>

Tariff advantages are externally important according to 70% of the SME participants. China has developed special economic zones that incorporate favorable tariffs which are not offered in the rest of China for companies located within. Minimized tariffs are another possibility for German SMEs to lower their cost structures.

It is a well-known fact that close ties with political authorities in China can help to hustle things along or to overcome possible problems. Nevertheless, it is difficult to reach the “right persons” and these will only be favorable if certain complaisance is given. The approach to enter the Chinese market together with a Chinese partner can help to smooth the way since ties to the Chinese authorities have already been established. Generally, it can be noted that bigger companies play the political keyboard in a much more professional manner than the small and medium sized enterprises. One reason for this is that these proceedings are cost-intensive which cannot be performed by SMEs and another reason is that Chinese authorities are especially flattered when big, well-known German corporations pay court to them. Nonetheless, 61% of the small and medium sized enterprises stated that the close ties are an important external success factor.

The last external success factor that was given by the respondents deals with the low level of corruption (54%). It is a fact that German firms have to face corruption when doing business in China. Naturally, it is beneficial if companies have less to do with these affairs but generally German SMEs also found their ways how to deal with corruption and sometime even use it for their own advantages. One example would be the accelerated handling of goods in customs to gain time advantages in order to ship the products faster to the customers.

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<sup>309</sup> Zinzius (2000), p. 152ff

## 6.3 Current business evaluation

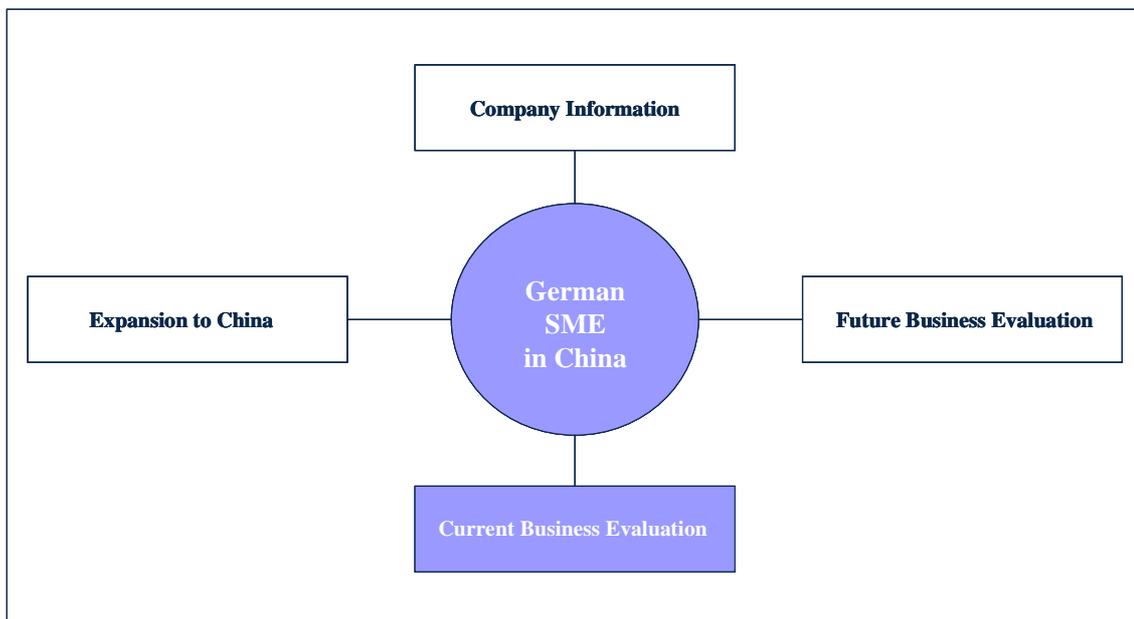


Figure 59: German SME in China – chapter three: current business evaluation

The upcoming chapter 6.3 will follow up with a detailed analysis of the current business situation of German SMEs in China. The SMEs were asked to evaluate the Chinese business behavior and Chinese personality traits, Chinese legal & public authorities, their own operations (internal value creation, costs of operation, etc.) and sales environment in China (opportunities, threats). The chapter will start with an evaluation of the overall China engagement.

### 6.3.1 Evaluation of current business situation in China

The general introduction of the evaluation of the present situation of German SMEs in China is done by figure 60. The participants were asked how they would evaluate their current general situation. The result is predominantly positive till very positive with over 80%. The question about the growth in China shows an identical result.

Due to the strong competition on the Chinese market it is known that a certain part of the German companies are not satisfied with their turnovers.<sup>310</sup> The answers of the study

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<sup>310</sup> GIC (2008)

mirror this partly. 43% are rather unsatisfied or very unsatisfied with their current turnovers.

The most positive result is with regards to the costs. 85% of the German SMEs are satisfied with the existing cost structures. Due to the positive cost structures it is understandable that the profit margin is also considered positively by 74%.

Furthermore, the resident SMEs also consider the Chinese customers as well as the suppliers as positively, except 40% who are not satisfied.

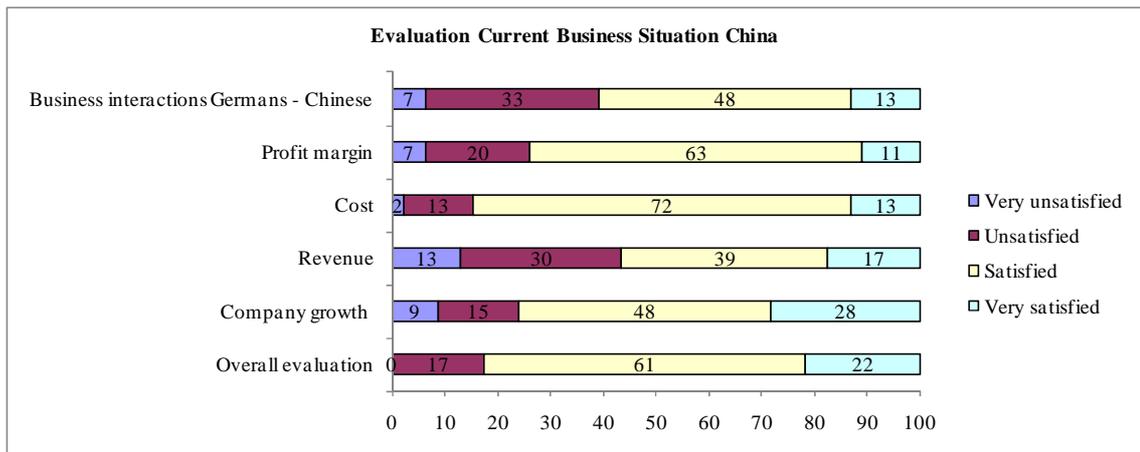


Figure 60: Evaluation Current Business Situation China

With special regards to the world crisis, which is still present in many countries<sup>311</sup>, a very positive estimation of the present situation surprises. An explanation for this could be that China also recovered very fast from the crisis as Germany did.<sup>312</sup>

It remains to be seen how the asked companies evaluate the identical criteria for future. This analysis will be depicted in chapter 6.4.

### 6.3.2 Evaluation of legal and public authorities in China

In the previous chapters on external success factors for China expansion the survey participants declared a minimum of bureaucracy, legal security, close ties with the local authorities and a low level of corruption to be significant.

<sup>311</sup> Goldman Sachs (2011), Grant (2011)

<sup>312</sup> Orth (2010), Economics NewsPaper (2011)

Therefore, a follow up question was asked where the German SMEs had to evaluate those four external success factors in their current business environment. The estimations show a diverse picture with a tendency to be more on the unsatisfied side.

Especially when looking at the evaluation of the bureaucracy 72% of the SMEs state that they are unsatisfied with the way the authorities handle their obligations. Even 11% of them are very unsatisfied which gives rise to the suspicion that those enterprises face severe restrictions which slow down their businesses. Only 17% of the German SMEs are satisfied with the Chinese bureaucracy that demonstrates that there are also Chinese administrations who work efficiently even though those are still the minority.

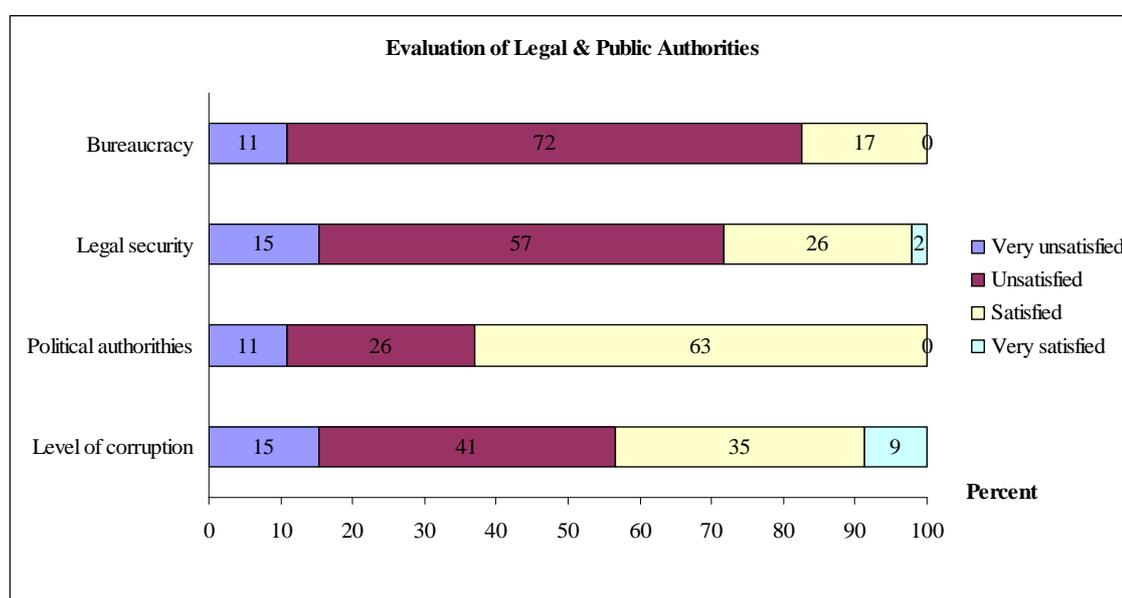


Figure 61: Evaluation of legal and public authorities in China

The legal security only performs slightly better than the bureaucracy. But still the results of 57% unsatisfied and 15% very unsatisfied participants show a real negative picture. This might be attributed to the fact that either the German SMEs already have to deal with situations where they are being wronged and the justice system in China does not help them or they have the feeling that many elements of business practice have not yet been defined well enough so that in many cases German SMEs have to work in grey zones that could lead to unintentional misbehavior.<sup>313</sup> 26% of the respondents are satisfied and 2% are very satisfied with the legal security in their business environment. It is

<sup>313</sup> Schwantes (1999), p. 47f, also see the “Guide Catalogue of Industries for Foreign Direct Investment” issued by the Chinese State Commission in the year 1995

possible that those firms never had any contact with the justice system and therefore voted in this way. It can also be the case that there have been points of contact but the outcomes has been in favor for the German SMEs and that is why the positive evaluation was achieved.

Among those four external success factors the political authorities are the only field where the German SMEs are rather satisfied with. 63% gave this positive signal. Only 26% were unsatisfied and 11% very unsatisfied with the political authorities. This positive outcome indicates that generally the German SMEs get along with their local administrations and that the differences between Germany and China in terms of the political system are for the greater part of no negative consequences for the business.

Looking at the outcome of the evaluation of the level of corruption diverse opinions are displayed. 56% (15% very unsatisfied and 41% unsatisfied) of the SMEs are disaffected with the level of corruption and the remaining 44% (35% satisfied and 9% very satisfied) are pleased. The responses point out that more than half of the German SMEs have to suffer from corruption but have to accept the fact that they have to follow the game in order to keep their businesses running smoothly. The other half also accepts the corruption, makes the best out of it and uses it to gain advantages or has not yet experienced corruption and therefore voted positively on that question.

All in all, it can be noted that in addition to the rather unsatisfied voting it is remarkable that German SMEs rarely decided to choose “very satisfied” in their evaluations which underlines the need of German firms that the Chinese legal and public authorities improve their processes, their reliability and their transparency in the future. In this context, chapter 6.4 will discuss how the German SMEs evaluate their future business environment in China where again the question was asked if the German SMEs assume that the legal and public authorities develop to the positive side or if they stay in the status quo.

### **6.3.3 Evaluation of own operations in China**

In contrast to the rather negative evaluation of the Chinese legal and public authorities the evaluation of the current operations in China shows a thoroughly positive picture. The first topic deals with the choice of location. Chapter 6.1.5 has already given an overview where the German SMEs are located. The results of the survey now illustrate that the majority of German firms is satisfied (43%) or even very satisfied (26%) with

their choice of location. Only 31% see deficits in their working environment, 22% are unsatisfied and 9% are very unsatisfied. An interesting follow up question for further research with regards to this would be how many German SMEs actually changed their first location in China to a more favourable one and which factors led to the decision.

The efficiency of internal workflows in China needed to be evaluated, too. The responses emphasize that at the most SMEs the internal workflows do not run to the full satisfaction. Generally, 76% are not satisfied (56% unsatisfied, 20% very unsatisfied) and only the remaining 24% are satisfied (20% satisfied and 4% very satisfied). As an explanation German companies often declare that they have major difficulties to implement the German workflows based on German process thinking into the existing Chinese patterns of working. Chinese employees have a different understanding of workflows because they have learned and experienced it otherwise in their past when working with Chinese firms. Therefore, the German enterprises have to teach and train their workers/ employees in order to create a more efficient internal workflow. In paragraph 5.2 that has dealt with internal success factors of German SMEs in China companies like Siemens or Bosch gave an example how they cope with the training and education of their employees.

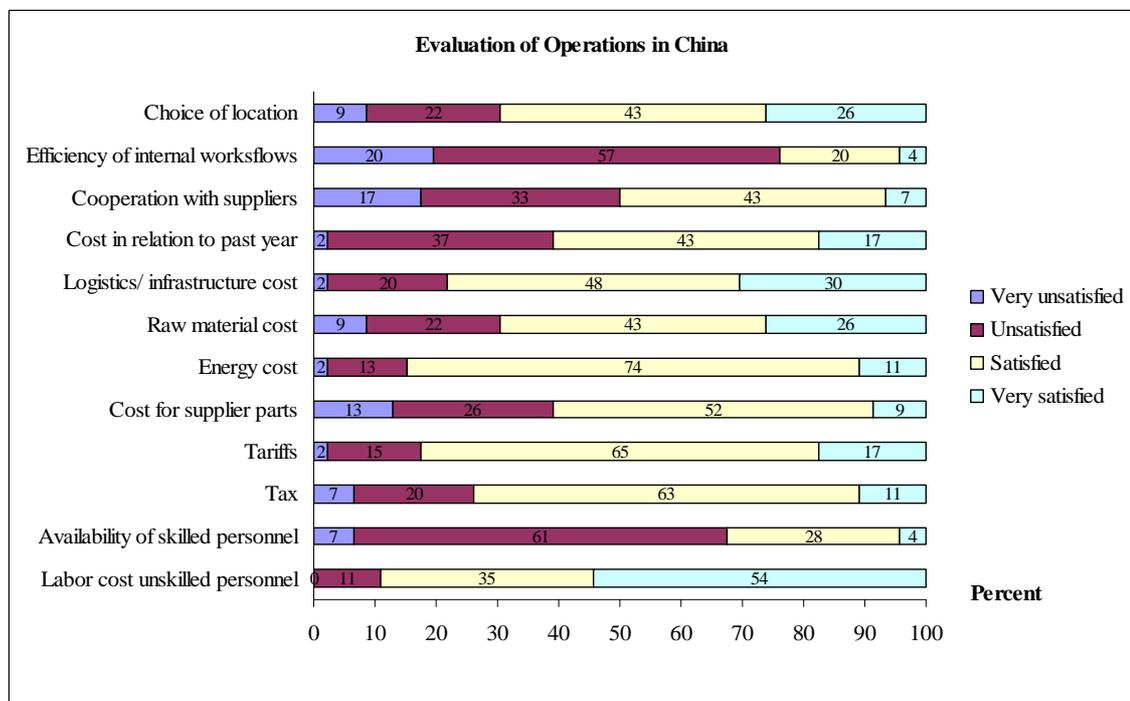


Figure 62: Evaluation of own operations in China

The cooperation with local suppliers determines significantly the success of the middle-sized companies in China. 50% of the companies state that they have built up good till very good relation to Chinese suppliers and that the cooperation is successful. The other 50% show a negative picture. It is worth mentioning that 17% of the German companies are very unsatisfied with the present cooperation partners. The main problems according to *Müller-Stewens* and *Lechner* are communication, efficiency and non-constant quality<sup>314</sup>.

The low costs in China are the main reason for German companies to settle in China. It was asked to what extent costs have developed compared to the previous year. The majority of the German middle-sized companies (60%) are satisfied up to very satisfied. However, 37% of the interviewed said that they view themselves faced with increasing costs. The increasing costs are until now primarily problematic in the Eastern provinces. In the Western regions, which are economically backward, the costs have not changed compared to the previous year. However, the costs in the Eastern provinces are still so low that a set branch is still competitive. Nevertheless, there is a tendency among German companies to operate future investments in the more Western regions.

In the following, individual important positions for German companies are analyzed in detail. The logistic and infrastructure costs are evaluated positively by the majority. Almost one third of the interviewed is very content. This can be explained by the fact that the costs of the shipment of products are still very low. On the other hand this is additionally facilitated and optimized by recent large investments in infrastructure. Besides, the costs of raw material are still acceptable. Only 31% state that they are not content with the increasing costs. By far the most positive evaluation of the costs refers to the energy costs that are still very low compared internationally. The last cost position concerns the costs of supply products. More than 60% of the participants pay favorable prices. It is interesting that 13% state that they are not very content with regards to the supply costs. A study conducted by the German Chamber of Commerce, China gives more insights to this. Hence, German medium-sized companies are not flexible concerning the choice of the supplier. It takes too long to agree with the existing suppliers instead of looking for new cooperation partners.<sup>315</sup>

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<sup>314</sup> Müller-Stewens/ Lechner (2002)

<sup>315</sup> GIC (2008)

Trade barriers in the form of tariff restrictions, import and export quotas can be an obstacle for German companies in China. On the one hand, this affects the import of German semi-finished goods, but also the export of products made in China. The present study shows a positive picture. The medium-sized companies have successfully come to terms with the existing restrictions and have adjusted their import and export insofar as the processes are only affected minimally or that arising costs are compensated. Only 17% of the firms state that the present tariffs have a negative effect on their daily business.

Especially in Germany, taxes are a factor that companies complain about. The operating profit is taxed with 46%. The Chinese municipality and construction tax as well as the education tax is calculated from the basis of the business tax, the value added tax and the consumption tax. Additionally, for these types of taxes varying tax rates appear. In contrast to the common tax rate of 3% in the education sector, the tax rate of the municipality and construction tax varies between 1, 5 and 7%. Referring to that, the tax rate in urban regions is 7%, in counties 5% and in other regions 1%.<sup>316</sup> Due to the regionally varying tax rate in China, there is no common tax rate for German medium-sized companies. Nevertheless, the tax burden is by far lower than in Germany. Analogue to other cost positions there is also a very positive result. 63% of the companies state that they are content with the taxes and another 11% are very content. The rest of 27% are hence not very satisfied with their tax burden. Again with reference to the above-mentioned study, companies are not content with the existing cost structures and hence relocate their investments to the more Western provinces.

The last evaluation within the operations was the personnel sector. The question to what extent German companies can rely on qualified Chinese employees, the majority answered quite negatively. 78% are not content with the personnel due to the fact that a large number of employees is very willing to work but often not qualified enough for the often high-technological development of German medium-sized companies. In contrast, German companies that are ready to work with unqualified employees are in a real El Dorado of choices. As a result, also in the more elaborated regions of China, the wages for this sort of workers are still very low. Hence, 54% of the companies state that they are very content with the costs for the unqualified workers. Another 35% agree with this statement.

### 6.3.4 Evaluation of China sales environment

In chapter 6.2.1 the motives to do business in China have been illustrated in detail. The main reason was the enormous potential of the Chinese market as sales for German products. Hence, it was important to question German companies for their estimation of the Chinese market and the competitive surrounding.

First it was asked how far the Chinese customer evaluates quality or to what extent quality is an important criterion. The answers show that the Chinese customer is very quality-oriented. Only 30% stated that their customers do not appreciate the products' quality.

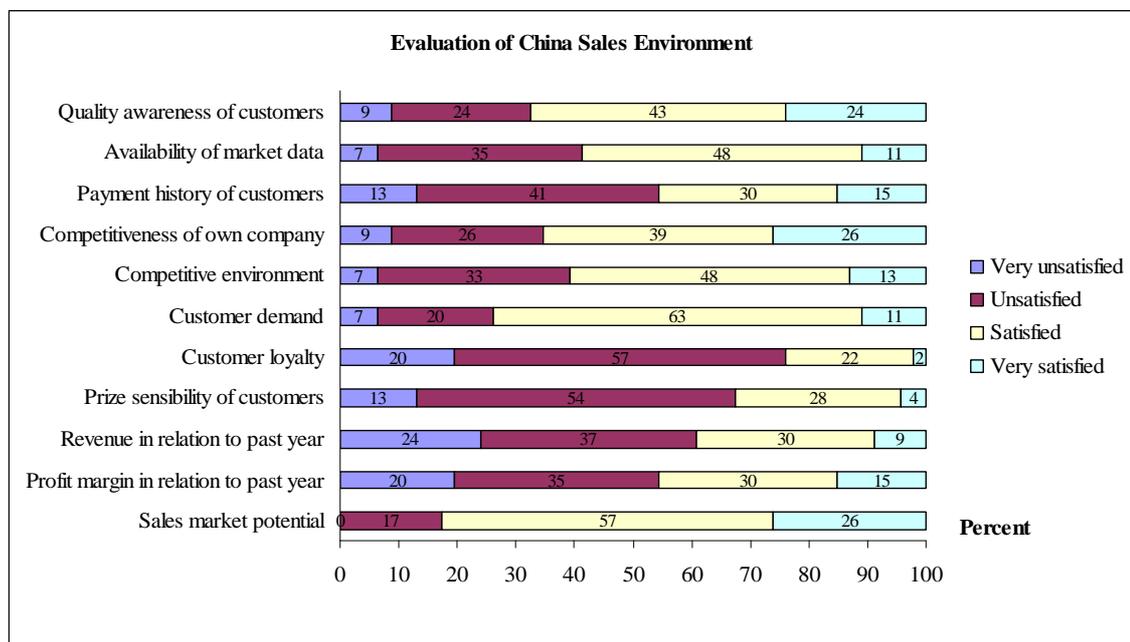


Figure 63: Evaluation of China sales environment

Due to the fact that the Chinese sales market is very big, it is necessary for German companies to acquire market data in order to develop a reasonable strategy to cultivate the market. It was especially difficult in the past to acquire relevant market data. Due to globalization and the accession to the WTO China has opened more and more and German SME have received data that until then were only accessible to Chinese state companies. Another favorable factor is the allocation of international market research companies that conduct independent researches in China. Therefore, 59% stated that they are content with the accessibility of market data.

<sup>316</sup> See 18<sup>th</sup> resolution of the People's Party of China on taxes for domestic and foreign firms

A criterion that characterizes a good customer is the payment on time. The companies were asked whether their Chinese customers pay their bills. The interviewed do not give an explicit picture. 50% are confident up to very unsatisfied. The reasons for the bad payment morale are manifold and cannot be classified clearly. It would be interesting to conduct a further study or a comparison of the payment morale between German and Chinese customers. German studies show that the German customers' payment morale has worsened within the last years so that it is possible the mixed Chinese payment morale is no exception.

The main goal of a market entry for German companies is to establish and to assert themselves on the market. It can happen that the competitor is confronted with unknown local Chinese companies as a result of a not very intensive preparation. This can be explained by the fact that Chinese companies have not had to make an appearance internationally due to the large domestic sales market. Nevertheless, German medium-sized companies evaluate their competitiveness as positive. 39% state that they are confident and 26% are very confident. A reason for this could be the often technical superiority of German products.<sup>317</sup>

One of the most important questions that a company has to face when expanding into a new market is the one for the competition environment. Certainly, one has to differentiate among the product and service. However, the German companies consider this rather positive with 61%.

Another important point is the demand for the product or services of the German SMEs. Although the Chinese market possesses a huge potential it cannot be taken for granted that the products that are offered in Germany or in the Western countries are automatically demanded in China. However, the German companies register a good demand for their products or services with 74%. Nevertheless, the result about the loyalty of Chinese customers towards German products turned out rather negative. Only 24% made positive experiences. The main part faces itself with disloyal customers who put less emphasis on long-term partnerships than on short-term cost reductions through cheaper products of the competition.

This leads to the next question asking about the price sensibility of Chinese customers. The results are also seen negatively by the German SME since 54% of them state that

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<sup>317</sup> Kretzberg (2008)

the customers react sensitively to price changes. 13% deal with Chinese customers who change the product on the basis of even small price changes.

After having analyzed the customer, the competition and the market, it is now very important to outline whether German medium-sized companies are able to generate turnovers in China. At the beginning of the study it was shown that all interviewed companies generated turnovers in China. They were then asked whether they are content. Interestingly, the positive sales expectation does not cohere with the turnover contentment. Over 60% did not achieve the planned goals and have to be content with lower turnovers.

The profit development is even more important. Companies that are founded on a foreign market are usually randomly in the profit zone in the short term. Hence, the question concerning the contentment with the profit is very important. In contrast to the turnover development, the profit development is better. Only 55% state that they did not reach the profit expectations.

To conclude, the participants were questioned about their expectations of the sales potential and sales environment. Despite the negative experiences, the majority of the companies (83%) defined the Chinese market as very lucrative and promising.

### **6.3.5 Evaluation of importance of sales instruments in China**

The next sub point will deal with the experiences of the German medium-sized companies in China in terms of how they promote their products. The most important element is the visit of fairs or exhibitions. According to figure 64, 93% see there a very important promotion instrument in China. Due to the size and opaqueness of the Chinese market, they favor topical fairs that make sure that potential customers are present so that the costs are reasonable compared to the promotion success (acquisition of new customers). Besides, fairs offer the possibility to inform about the local competition.

In China, as in all countries, interpersonal relations with customers are of special importance. For this reason, almost all German medium-sized companies implemented a sales team mostly consisting of local Chinese people who know the sector. Additionally they can interact easier with the customers on the spot due to the knowledge of language and business behavior. 83% of the interviewed regard Chinese sales representatives as important.

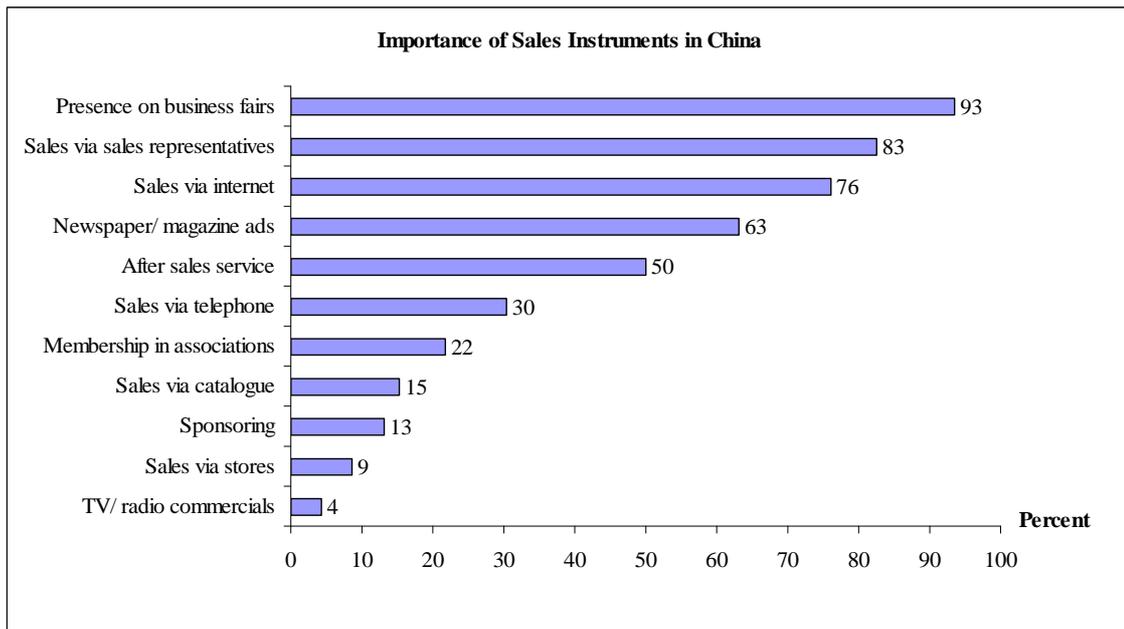


Figure 64: Evaluation of importance of sales instruments in China

Although especially in China the interpersonal relations between trade parties are a common topic, the anonymous internet cannot be thought away out from daily working routines anymore. Especially young Chinese use the internet in order to establish business relations due to the simplicity of the internet. It is mainly used for short-term sales and not for long-term business relations. German companies that can distribute their products via the internet are hence offering them on website in the Chinese language where Chinese customers can order their products. Apart from that, the German Chamber of Commerce in China states that many German companies located in China have a website in Chinese or English language in order to inform local Chinese customers about their company, products and service. 76% of these companies state that the online presence helps to boost their sales.<sup>318</sup>

Although the internet as sales instruments has implied a dominating role, many German companies still use the traditional possibility to promote their products via print media. Due to the fact that the specialized media, like specific magazines related to one topic for example, has not established yet, as in Germany, the announcement in local newspaper is still chosen. The extraordinary high percentage of 63% shows that this traditional medium is still good for promoting products.

<sup>318</sup> GIC (2008)

The fact that in the past German companies had problems to justify the added value of their products over the sales service has changed completely today. Today the Chinese are aware of the fact that is not only important to buy a product in the short term, but to maintain the durability by means of negotiating the service contracts with the individual company.

Not only the durability of the bought product is important, but also the basic service, for example in form of an installation service or telephone hotline, gives the product an added value that is appreciated more and more by the Chinese. Hence, German service packages that offer an added value are done well. According to the study 50% do this.

At least 30% of the participants view the distribution of information via telephone as an effective instrument for the promotion success in China. There are two ways that have been established in China. The first one is the promotion via the own call center with own Chinese telephone agents. The second one is the telephone promotion via external call centers.

Basically it is difficult for German companies to find the right customers for their products. Similarly to trade fairs where a high number of companies of the same sectors are presented, trade associations are of particular value here. Regular meetings on an association basis offer the possibility to exchange information and contact to potential clients. 20% of the interviewed use this instrument to enhance business contacts and sales.

Another traditional form of promotion is the delivery of flyers, brochures and catalogues where companies can present themselves and their products. 15% of the interviewed use this possibility of marketing in China.

13 % of the interviewed expect a better image by means of local sponsoring and the acquisition of new customers. 9% have opened their own sales shops in China and a low percentage of 4% make use of television and radio advertising in order to draw attention to their company and their products.

The present point showed variants that were used by German medium-sized companies in order to establish the promotion. Further analysis would be interesting concerning the success measurement of the promotion instruments of the German medium-sized companies in China in order to present best practice strategies to freshmen or already established companies.

### **6.3.6 Evaluation of Chinese business behaviour and Chinese personality traits**

The following chapter will deal with the assessment of the Chinese working attitude and operating methods from the perspective of the SMEs in China.

The different operating methods of Chinese and Germans are often discussed in the literature as well as in economic life. Consequently, one of the first questions in this chapter was whether the German SMEs are satisfied with the operating methods of the Chinese. Surprisingly, more than 60% were satisfied till very satisfied with the way how Chinese companies co-operated with them. Only 39% were unsatisfied with the Chinese way to make business. The positive result proves that different operating methods do not automatically lead to problems but, on the contrary, shows that German SMEs have adapted very well to the Chinese operating methods.

The second question in this chapter was whether the Germans are satisfied with the Chinese working attitude. This involves the working attitude of the own Chinese employees as well as of the Chinese suppliers and customers. Even though the result does not turn out so positively, at least 50% evaluate their partners positively. The other 50% consider them rather negatively. This cannot be ascribed to the working zeal which is described as very high by German companies. Furthermore, in many cases this is due to an unsatisfying education, a lack of understanding of the work processes by virtue of deficient communication, a miscomprehension between the German SMEs on site with the Chinese partners or employees based on a different cultural background.

The next questions aimed at the communicative competence of the Chinese with view to the capability of expressing oneself either in English or, even better, in German. Again the contentment balances each other with almost 50%. Certainly, one has to consider the sector in which the German company is operating in China in order to assess to what extent the employers are able to speak the foreign language. Hence, employers of the manufacturing sector often have only undergone a minimal education; they work for less than 5 Euros a day and, hence, can only communicate in the Chinese language.

One characteristic that is regarded negatively is the capability to see the bigger picture, so that, for example, an employee can see other points of intersection beyond his work area or can solve problems from an interdisciplinary perspective. This characteristic is slightly or not well developed due to the Chinese education and training. In many cases the Chinese education system is based on imitation. This means that working steps are

shown to the Chinese employees in order to let them imitate these one-to-one. In their Chinese surrounding it is not wished to acquire skills that are beyond their original work. Hence, 78% of the SMEs criticize the Chinese capability to see the bigger picture and only 22% are satisfied with that.

The next question was whether the Chinese are hard-working employees. More than half of the study participants answered that they are satisfied. This assessment coheres with many other studies<sup>319</sup> that have described the Chinese principally as very diligent.

The assessment of the Chinese creativity is similar to the assessment of 'to see the bigger picture'. 63% of the questioned would likely to have employees that are more creative. Only 37% are content with the creativity. German companies in the GIC survey in 2008 state that they learned that creativity has been promoted in universities and schools since the last decade due to the fact that China is aware of the fact that they have to generate their growth and prosperity by means of their own innovations and creativeness in the future. This involves creative thinking in order to promote research and development with the aim to produce products that can compete successfully on the world market.<sup>320</sup>

The next aspect of the survey was the Chinese openness towards the Western culture which mainly shows a positive picture. More than 60% state that they have the impression that the Chinese are interested in the Western culture or the Western way of negotiating during interactions.

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<sup>319</sup> Deutsche Bank Research (2004)

<sup>320</sup> GIC (2008)

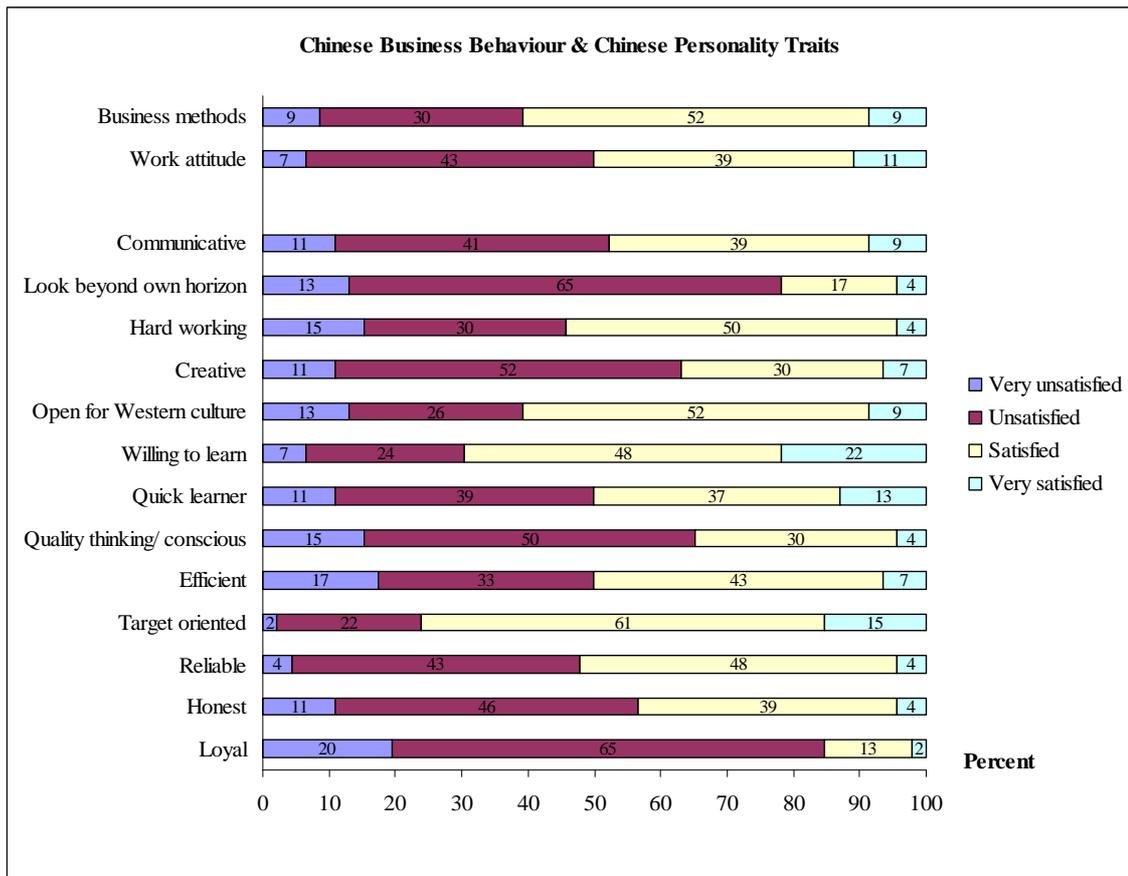


Figure 65: Evaluation of Chinese business behaviour and Chinese personality traits

One of the most positive assessments resulted in the question about the willingness to learn. 22% of the companies are very content with the employees or the customers and suppliers. Further 48% are satisfied. This is proved by other studies<sup>321</sup> that show that Chinese are eager to acquire knowledge of technical skills as well as Western work processes. However, the other side of the coin is that in many cases the Chinese employees use this knowledge after a short time for themselves be it for other Chinese employers who profit from this knowledge or in form of an own company that develops a product that competes with that of the original German employer. The last question in this chapter supports this finding because it is about loyalty. We could anticipate the outcome: 85% of the questioned German SMEs consider the Chinese employees or suppliers and customers as disloyal.

It has been stated that the Chinese are very eager to learn. Referring to that, another question is whether the Chinese can be considered as 'fast learners'. Exactly half of the

<sup>321</sup> Deutsche Bank Research (2004)

questioned are happy about those Chinese who wish for new contents and who can understand and use them after a short time. However, the other 50% are set in a working environment in which they are not content with the time that an employee, a customer or a supplier needs to acquire new things.

Principally, German products stand for quality. Therefore, it is more than understandable that German companies operating in China stand on qualitative work as they are used to in Germany. The next question is aimed at this aspect. 50% of the interviewed are not content, further 15% are even unsatisfied with the quality conscientiousness of the Chinese employees. By implication this means that the qualitative work or processing of products does not yet play an equally important role as in Germany.

The answers to the question concerning the efficiency are similar to those related to the qualitative characteristics of Chinese people and show a divided picture. 17% are very unsatisfied with the efficiency of the employees or suppliers. On the other hand 7% are very satisfied with the efficiency in their working environment. In general, one half is content and the other one is not.

With regards to the goal orientation, 76% of the SMEs are content with the Chinese. Interestingly this is by far the best assessment in the point on Chinese working methods and personal characteristics. Considering the reliability and the honesty, the Chinese are considered far more negatively. Referring to the reliability the assessment is balanced, but when it comes to honesty, the results are more negative.

## 6.4 Future business evaluation

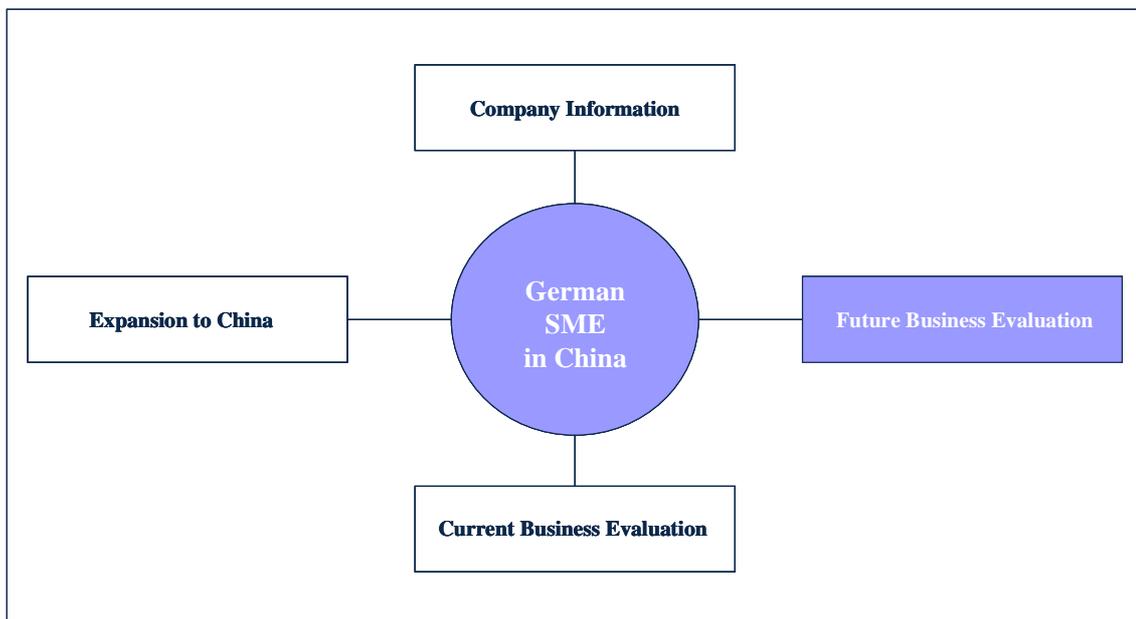


Figure 66: German SME in China: chapter four: future business evaluation

After having depicted and evaluated the current situation of German SMEs in China, the upcoming part will now deal with the assessment of the future.

The focus will first be put on the future economic and working environment in China. Furthermore, the legal and public authorities will be evaluated followed by the assessment of how concrete work processes will be like in the future. This point will finally evaluate the future of the Chinese operational environment or of the Chinese market for German products or services.

In all four sub-points the interviewed were asked to decide for one of the three future variations: either the situation will be worse than today or there will be no change or there will be a positive development.

This future contemplation is very exciting since there has been an increase of news release that claims that German SMEs would withdraw their engagement in China and would again produce their products in Germany or Europe. The stated reasons for this 'withdrawal' are manifold. However, one reason stands out, namely 'variations in quality in manufacturing'. On the one hand, this can be ascribed to varying qualities of products by suppliers in China. On the other hand this is also due to the badly clocked production processes and the Chinese employees. Referring to the latter, this is due to the

fact that the employees are not well trained, but also do not internalize the high-quality standards of the production. Another aspect is that it is said that former cost advantages in comparison to Germany do not exist anymore, for example the cost for the employees, logistic and energy have risen, and hence Germany becomes more competitive considering the costs.<sup>322</sup>

Insofar it remains to be seen if the present study also reflects these future contemplations.

#### **6.4.1 Evaluation of future business environment in China**

The following paragraph will depict the future expectations in more detail. The first question was how German companies saw the future cooperation with the Chinese. 54% of the interviewed companies see an enhancement of the relation and 43% do not see any change. Only 2% expect a deterioration of the interpersonal relations. This estimation coheres with the results of other studies<sup>323</sup> that have also shown that Chinese and the Germans are more and more approaching each other and that the reciprocal understanding for each other increases.

One of the important signals for a successful operating on a market is the figure of the profit margin. Only 30% of the respondents state that they expect an improvement of their own profit margin in the future. 35% think that they will operate with an identical or similar profit margin and the other 25% even expect deterioration.

One reason for the latter could be the fear of increasing operational costs in China, which is supported by 33% of the interviewed. 54% see equal costs and only 13% consider a better cost situation for the future.

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<sup>322</sup> NZZ (2011); Spiegel online (2008)

<sup>323</sup> GIC (2009)

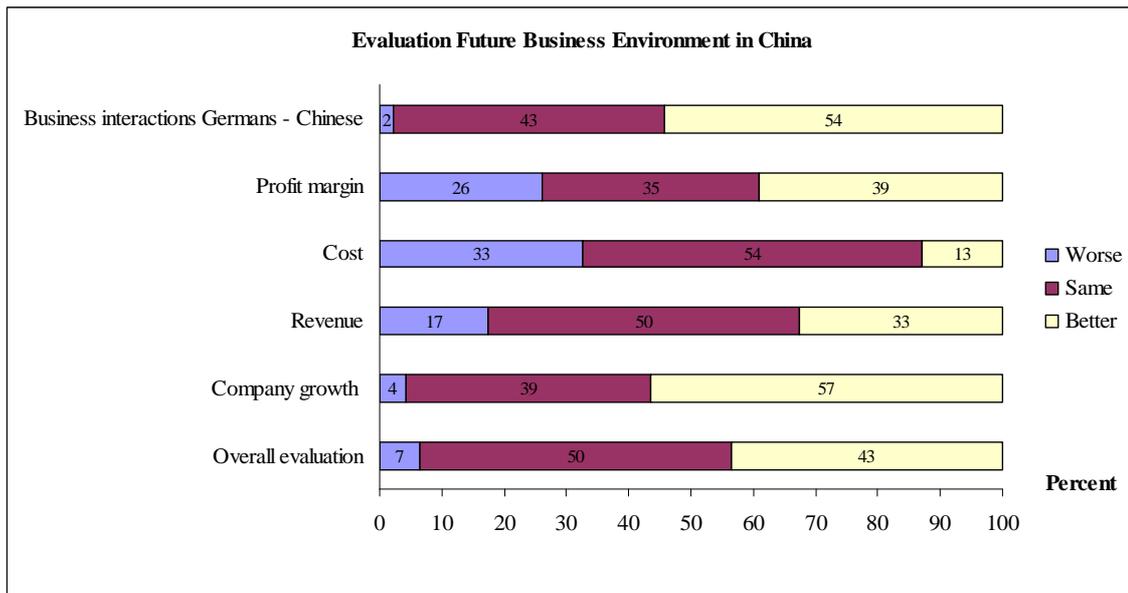


Figure 67: Evaluation of future business environment in China

With view to the sales situation, the study participants see a better future scenario. 33% are of the opinion that the sales situation will improve in the future. Half of the interviewed do not see any change and 17% think that their sales will decrease in the future.

The success of a company can often be measured by its growth. Hence, when assessing the future business environment, the question was asked to what extent German SMEs assume that they will grow with their company. The answers were mostly positive. 57% see a growth potential for their company, 39% think that they maintain in size and the remaining 4% proceed from a declining company size.

The last question deals with the overall evaluation of the business environment in China. The morale is quite positive. 43% think that they will improve their business in China. Further 50% state that their situation will not principally change, which does not mean that the situation is not already very good. Only a small part of 7% presumes that the general situation will develop negatively for their company.

#### 6.4.2 Evaluation of legal and public authorities (future)

The following paragraph will deal with the future estimation of the legal and public environment. In chapter 6.3.2 the German SMEs have already had to assess their current situation. It could be shown that the SMEs are rather unsatisfied with the legal systems in China, whereas the interviewed are content with the local public authorities.

Hence, it is interesting to see that the German SMEs presume a similar situation considering the bureaucracy in China for the future (67%). 11% of the interviewed believe in a deterioration of the situation and 22% think that they are confronted with less bureaucracy in China in the future.

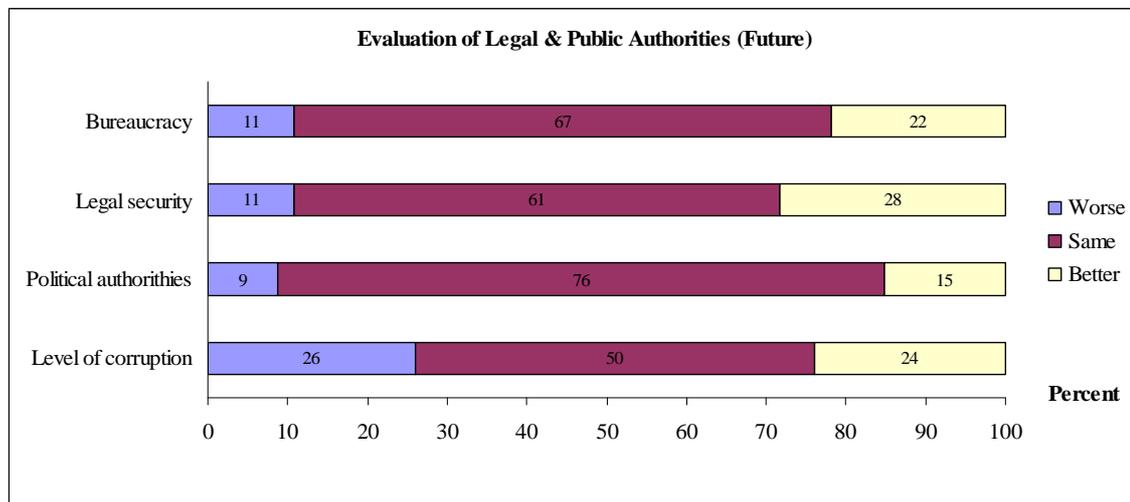


Figure 68: Evaluation of legal and public authorities (future)

A similar estimation can also be seen with view to the legal security. 28% think that they will benefit from a better legal security. 61% of the SMEs presume that they will not be any changes and the remaining 11% think that the legal security will further on deteriorate for German companies.

Since a main part of the German companies have been content with the political organs in China, they also assume that they will no further change in the future. 15% expect a better situation and the remaining 9% a worse one.

The German SMEs can deal with the current level of corruption quite well, so that 50% say that this situation stays similar as now, 24% are of the opinion that the level of corruption will decrease and the remaining 26% presume that the corruption will increase in the future.

### 6.4.3 Evaluation of operations (future)

In chapter 6.3.3 the assessment of the current operations in China was depicted. Apart from the aspects efficiency and availability of the skilled personnel, the feedback was all in all relatively positive.

Hence it is interesting that regarding the future expectations the picture of what we get is the opposite what we got for current operations. Looking at the estimation considering the future efficiency of internal working processes, it is apparent that the majority of 70% think that this will change positively. The remaining 30% assume that the situation will not change. Thus there are no participants that expect the internal working processes less efficient in the future.

Also when it comes to the estimation of the future cooperation with suppliers it looks rather positively. 41% of the SMEs see the opportunity for a better cooperation, 54% regard this unchanged and only 4% assume deterioration.

Looking at the assessment of the future costs, we can see a relatively high percentage of companies that see an increase of costs. The focus of the questions was set on logistics and infrastructure, the costs for raw material and energy as well as the costs for suppliers. As already hinted at, more than half of the SMEs see a deterioration of the cost situation. Roughly 40% think that the cost situation will not change significantly and around 15% are of the opinion that further cost cutting can be expected.

Regarding the current tariffs, the participating companies are satisfied; so that 65% state that they do not expect any changes, 24% are even convinced of positive signals and 11% assume that the Chinese authorities will induce aggravating tariffs for the import of goods.

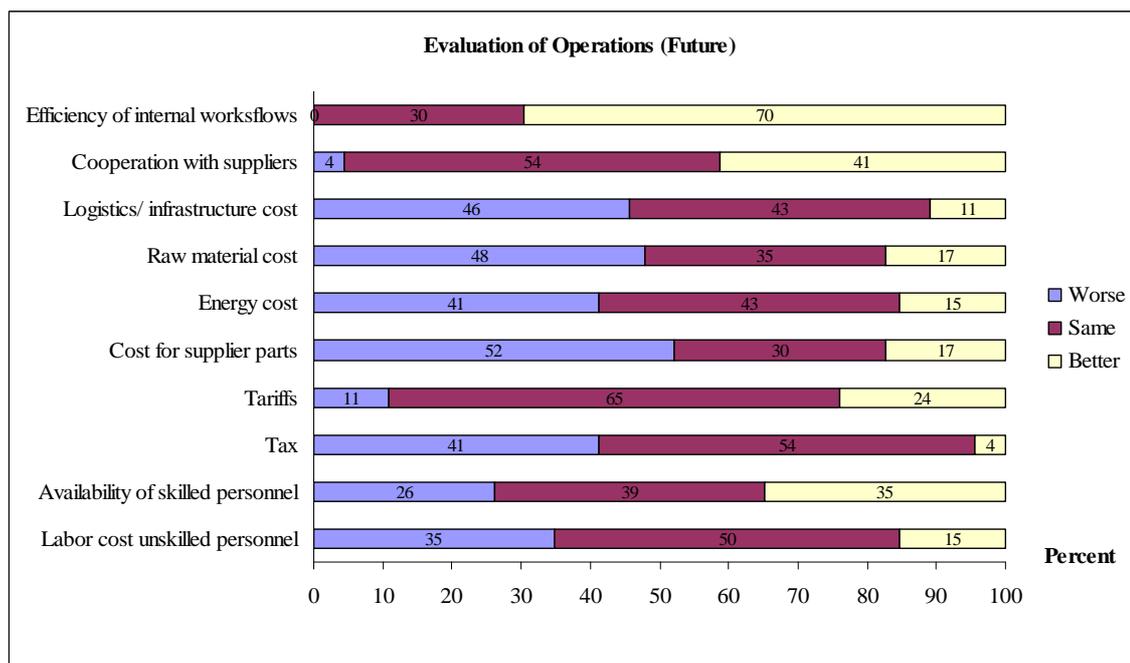


Figure 69: Evaluation of operations (future)

The current assessment showed a positive picture of the current tax rates for foreign companies. Nevertheless, 41% of the respondents state that the tax rates will change to their disadvantages. Further 54% think that there will be hardly or no changes and the remaining 4% hope for tax cuts. These tax cuts can be explained by the fact that those companies want to resettle regionally which will result in tax cuts. A resettlement of the company from a region like Shanghai, for example, to a more western province goes along with cost cuts for all cost positions, including tax rates. Eventually, this procedure cannot be observed frequently with SMEs operating in China<sup>324</sup>.

The possibility to employ qualified Chinese people was rated rather critically by German companies. A rather different situation is assumed for the future. 35% see an enhanced situation in the future and rely on the education offensive of the Chinese government. 39% of the companies assume that it will be unchanged difficult to gain qualified working forces. The remaining 26% answered this question with a negative assessment.

Contrary to the above, the assessment of the availability of unskilled employees was rather positive for the current situation. Nevertheless, this changes considering future prospects. Hence, 35% of the respondents say that it will be more difficult to access unskilled personnel. On the contrary, 50% think that it will be further on easy to access unskilled personnel and 15% think that the situation for employers will be even more positive.

#### **6.4.4 Evaluation of China sales environment (future)**

In chapter 6.3.4 the current assessment of the Chinese market and the competition environment was questioned. Despite the fact that German SMEs regard customer loyalty and price sensibility in China rather negatively from their point of view, the general picture was indeed positive.

The upcoming point will describe the forecast for the Chinese market environment and will show to what extent the competition environment will change for German companies.

In the past German companies bemoaned that Chinese customers could not realize the difference in quality between their and the domestic products. In 6.3.4 it has been

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<sup>324</sup> GIC (2009)

shown that the Chinese have developed a quality awareness implying that high-quality products often have a higher value, durability and an advanced function they can benefit from in their business<sup>325</sup>. Hence, 50% of the Germans see an increasing awareness of quality products for the future. 46% assume that the awareness remains as it is and the remaining 4% see deterioration.

The access to market data of the Chinese market was rather difficult in the past due to restrictions set up by the regime. However, it can be observed that the number of market research companies have increased in the recent past and foreign companies have used these possibilities. Thus, German SMEs state that they are content with the market data. 65% predict an improvement considering the access of market data in the future. The remaining part thinks that the situation will not change.

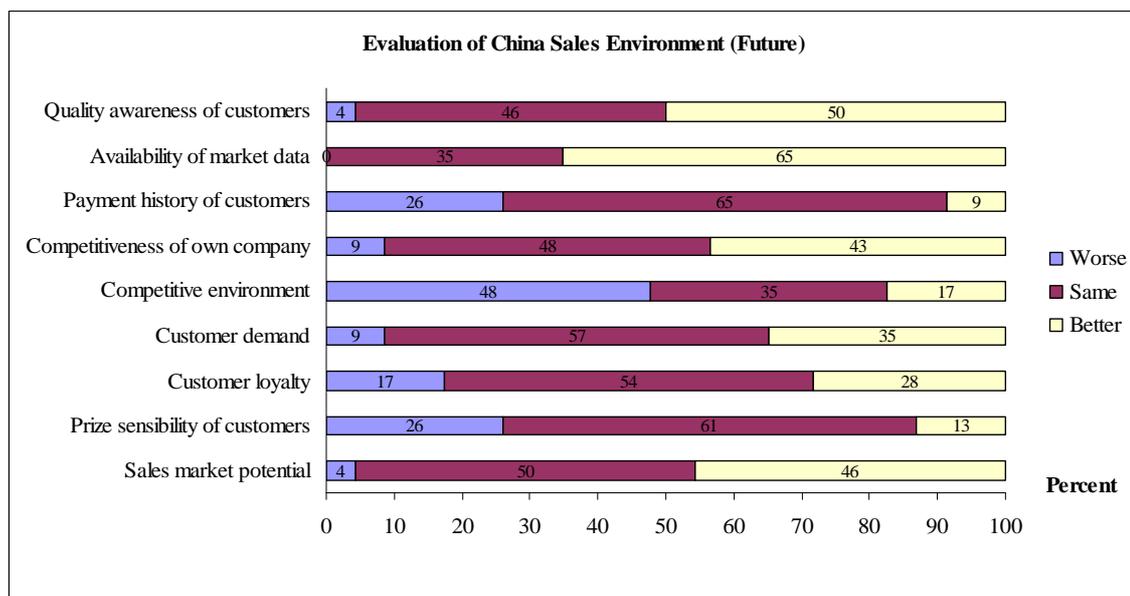


Figure 70: Evaluation of China sales environment (future)

The current paying morale of the Chinese customers split the opinion of the interviewed SMEs. 50% declare that they are content with the paying morale; the other 50% are unsatisfied. Interestingly, the assessment shows that 26% fear that the willingness to pay the bills will further deteriorate. 65% do not expect any changes and only 9% foresee an improvement.

<sup>325</sup> Geulen (2001), p. 157ff

The assessment of the current competitiveness was already regarded positively. For the future many of the SMEs (43%) think they are capable of further establishing their current positive competitive position. 48% think that the competitiveness remains at the established level and only 9% declare that they will lose their position with respect to their competitors.

The current competition environment was rated as sufficient by more than half of the study participants. In the future 50% see accentuation of the competition, 35% expect unchanged conditions and according to the remaining 17% there will be improvement.

The current demand for products and services was mainly rated positively by German SMEs. Thus, the future prospects are regarded highly positive. 57% expect an unchanged demand and even 35% view an increasing demand. Only 9% think that there will be a negative development with respect to their market environment.

With view to customer loyalty, the questioned presented throughout a negative picture of their Chinese customers. More than half of them fear that this remains in the future. Only an optimistic third hopes to find ways and means to tie down their Chinese customers. 17% predict that the customers will be more volatile.

One reason for the lacking customer loyalty may be the price sensibility of the Chinese. At present the majority of the study participants are unsatisfied in this respect. 61% state that this situation will not change. Only 13% foresee an improvement and 26% see a further increase of the price sensibility.

Finally, the last question aimed at the general evaluation of the future of the Chinese market. The German SMEs are already satisfied with the current view on the situation. Thus, 50% think that this positive development will remain in the future. 46% predict an even more promising market environment in coming years. Only 4% presume that the market conditions will deteriorate.

## **6.5 Summary of key findings**

The study aimed at providing a better understanding of the German SME expansion process to China, an evaluation of both their current operations in China and a forecast of their future within the Chinese market.

The first section characterized the German SMEs operating in China with regard to qualitative and quantitative measures: annual turnover, parent company, number of em-

ployees, business industry, date of market entry, local presence in China, branch, form of operation and reasons for choosing the form of operations. The individual criteria showed gradually a very heterogeneous group of the respondents that presented an overall insight in the German SMEs in China. Especially with respect to the choice of the current market cultivation strategies depicted in 6.1.7 it can be shown that the SMEs had the resources to establish a subsidiary in China. 43% of the participating companies decided for this form of foreign market cultivation. The reasons why the companies have especially chosen this form are comparable with the reasons that have been theoretically outlined in chapter 4.2. On the one hand, the low risk approach and the low cost approach for the representative office had priority and on the other hand the independence and complete control considering realization of foreign strategies played a role to establish a WFOE.

The second section has illustrated the expansion process of German SME to China. Herein, the motives for China expansion have been discussed followed by an analysis of the strategy that German SME formulated. Questions have been analyzed with respect to how the SMEs evaluate their strategy retrospectively and if and to what extent they changed their initial strategy during the expansion process. Further on, the market entry preparation and coeval the satisfaction with the entry preparation was mooted. The second section concluded with an illustration and discussion of the important internal and external success factors of China expansion for German SMEs. The motivation of German SMEs coheres with the motives for international expansion as described in chapter 4.1.1. The results of the market strategies did not come as a surprise either. Due to the fact that German SMEs often produce high-quality as well as high-technology products it was to be expected that the main part of the study participants have chosen the segmentation strategy. Fortunately, the respondents stated that they had kept to this strategy in the course of further market cultivation. Meanwhile with respect to the preparation for the engagement in China it was significant that German companies relied on other companies, which had already been settled in China, and asked for advice. The preparation via internet also gains importance. With view to the internal as well as external success factors for an engagement in China the same elements and arguments can be found as illustrated in chapter 5. Among the internal factors, a substantial expansion preparation and a good financial nest egg were two of the important factors. Among the external factors, it was basically the low costs and the market potential.

The third section dealt with the current business situation of German SMEs in China. The SMEs were asked to evaluate their overall China engagement, the Chinese business behavior and Chinese personality traits, Chinese legal & public authorities, their own operations (internal value creation, costs of operation, etc.) and sales environment in China (opportunities, threats). Against expectations the results were very positive apart from some negative statements with respect to legal and public authorities based on some problems with the current bureaucracy. With view to the evaluation of the operations, some negative points were mentioned with respect to the availability of qualified working force or the inefficient workflows that can seldom be compared with the precise procedures in Germany. Regarding the sales environment, the market potential and the customer demand these characteristics stood out as highly favorable. The loyalty and the price sensibility of customers were rated negatively. The replies to the questions about the forms of how German SMEs process the market from the point of view of production turned out exciting. The German SMEs had positive experience with visiting branch-specific fairs, the employment of sales consultants who know the Chinese language and the cultural requirements and, hence, can optimally care for the customers. Rather bad experience had been made by establishing own commercial shops or placing ads via radio or television. With view to the German and Chinese cooperation, including the own employees and the Chinese suppliers, the results were mixed. Learning something new and working goal-oriented were underlined as positive characteristics. Though, it was also said that the Chinese do not have high quality awareness, they are disloyal and are people who seldom see the bigger picture.

The fourths section gave an overview of the future prospects of German SMEs in China. The SMEs were requested to evaluate identical business areas (Chinese legal & public authorities, own operations and sales environment in China) as in the third section but this time to formulate their expectations for the future. Contrary to the latest press reports, which claim that German SMEs terminate their China engagement and come back to Germany, the interviewed companies estimate the future prospects rather positively.

True to the motto 'everything that is good today, will be a bit better in the future'. Thus, it can be that the companies that turn their back on China did not participate in this study. Right at the beginning it has been drawn the attention to the aspect that the results of this study might be too positive since the companies that were not successful in China and terminated their engagement in China before the start of the survey could not be questioned since they were not captured anymore by the German Company Directory. One possibility for future research would be to get an earlier edition of the German Company Directory, compare it with the current one and find firms which became disillusioned by China and get their views on the same questions.

## 7 Conclusion

The aim of this dissertation was to especially look at German SMEs and to outline and analyze how they organized their expansion to China, how they evaluate their current situation in China and how their economic situation will change in the future.

Thus, the underlying questions are:

- Why and how do German SMEs business in China?
- How do they handle their current situation?
- How do SMEs view their future in China?

Chapter 2 to 5 served as the basis for the analysis of the questions that were to be discussed in the empirical study in chapter 6.

Chapter 2 has described the position and importance of the SMEs for the German economy. Chapter 3 has then outlined China as a land of unlimited business opportunities. It was depicted how China has developed in the last 30 years and the impact that political, social and legal conditions have had on China's rise towards an economic power. Furthermore, it has been shown what kind of benefits have been drawn from these framework conditions and how the economic interactions, for example in form of imports and exports, and inward investments have developed. The depiction, which has included many decades of the past, has illustrated that German companies have not got interested in China as a result of the worldwide globalization. Instead, China had already been an important economic partner for German companies already in the past decades and the Germans have established their engagement gradually.

Chapter 4 has dealt with the international expansion of companies. The first part has discussed the motives for an international expansion that can be cost-, market- or competition-oriented. With regards to German SMEs it can be detected that the market-oriented motives were and are of higher importance for the internationalization to China than e.g. the cost-oriented ones against expectations considering the low cost structure in China. The next part has outlined the special characteristics or framework conditions for SMEs with special consideration of the resource facilities (capital, know-how, human capital) that are brought in by SMEs in international expansions. Chapter 4.2 has dealt with forms of market entry mechanisms. The forms of foreign market cultivation,

such as export, joint venture or subsidiaries, have been described in detail as well as their individual advantages and disadvantages. Finally, the forms that have been chosen by German SMEs have been depicted. It has been shown that the literature does not offer a basis for answering the question that what form is optimal since there does not exist a patent solution due to the diversity of the SMEs. Hence, the market entry strategies that were chosen by the German SMEs and how they have developed could not be simply outlined. According to other studies it can only be assumed that, due to limited resources in comparison to large business, the SMEs choose market entry strategies that are resource-efficient and that the engagement is extended gradually, subject to successful operating, with a view to establishing their own subsidiary.

Chapter 5 has described in detail the factors that are necessary for the success abroad. Chapter 5.1 has first focused on external success factors followed by the internal ones in chapter 5.2. In conclusion it can be stated that the keys to success in a foreign country have been on the one hand an in-depth research on the market, the customers, the location, the competition, etc. On the other hand is an in-depth evaluation of the internal resources of the firm such as capital, know-how, experience or human capital is similarly crucial in order to develop a successful market entry strategy.

Within the scope of the empirical study presented in chapter 6, the topics that have been outlined in the previous chapters 2 to 5 have been taken up again. Finally, chapter 6.5 has summarized the most important results of the study.

The underlying questions have been discussed and answered in detail within the scope of the study. Why and how do German SMEs go to China? How do they handle the current situation? How do they see their future in China?

The initially formulated aims of this paper have been achieved

1. The answers to the questions are supposed to serve as information and help for SMEs that in view of the increasingly changing market conditions in China are looking for ways how they can also internationalize successfully in China or extend their competition position.
2. The literature base on the topic of German SME expansion to China needed to be broadened/ extended with practical findings coming from firms which successfully entered the Chinese market and prevail within.

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Despite the good results of the study it has to be pointed out that the study participants have mostly had a successful development in China and, hence, the findings tend to be too positive. Beyond doubt, companies that had to leave the market unsuccessfully due to their own faults or adverse conditions would influence the interpretation negatively.

Even though it is rather difficult to find those companies and furthermore to convince them to share their experience in a survey, those results would be of high significance to depict the overall picture of German expansion to China more realistically and more completely.

# Appendix

## A.1 Questionnaire

### Survey on the expansion of German SME to China

Thank you for participating in the survey. It will take not more than 20 minutes to complete the questionnaire.  
All data is collected anonymously.

#### A: Company information

<p><b>1 Turnover</b> (choose one answer)</p>	<p>0-25 Mio. <input type="checkbox"/></p> <p>25-50 Mio. <input type="checkbox"/></p> <p>50-100 Mio. <input type="checkbox"/></p> <p>100-250 Mio. <input type="checkbox"/></p>
<p><b>2 No. of employees</b> (choose one answer)</p>	<p>0-49 <input type="checkbox"/></p> <p>50-249 <input type="checkbox"/></p> <p>250-499 <input type="checkbox"/></p> <p>500-1.000 <input type="checkbox"/></p>
<p><b>2 Business industry</b> (choose one answer)</p>	<p>Automotive, Machine Building, Chemical <input type="checkbox"/></p> <p>Finance, IT, Telecommunication <input type="checkbox"/></p> <p>Textile, Food <input type="checkbox"/></p> <p>Pharmaceuticals, Energy <input type="checkbox"/></p> <p>Other <input type="checkbox"/></p>
<p><b>4 Date of market entry</b> (choose one answer)</p>	<p>Prior 2000 <input type="checkbox"/></p> <p>After 2000 <input type="checkbox"/></p>
<p><b>5 Local presence in China</b> (choose one answer)</p>	<p>Liaoning <input type="checkbox"/></p> <p>Beijing <input type="checkbox"/></p> <p>Tianjing <input type="checkbox"/></p> <p>Shandong <input type="checkbox"/></p> <p>Jiangsu <input type="checkbox"/></p> <p>Shanghai <input type="checkbox"/></p> <p>Hubei <input type="checkbox"/></p> <p>Sichuan <input type="checkbox"/></p> <p>Zhejiang <input type="checkbox"/></p> <p>Fujian <input type="checkbox"/></p> <p>Guangdong <input type="checkbox"/></p>
<p><b>6 Reasons for choosing the locations in China</b> (multiple answers possible)</p>	<p>Access to good infrastructure <input type="checkbox"/></p> <p>Skilled work force <input type="checkbox"/></p> <p>Low cost supply (people, raw materials, energy, ..) <input type="checkbox"/></p> <p>Stable business environment (regulations, bureaucracy, ..) <input type="checkbox"/></p> <p>Low tax and other public dues <input type="checkbox"/></p> <p>Climate <input type="checkbox"/></p> <p>To be close to business partners (suppliers, customers) <input type="checkbox"/></p> <p>Other German companies around <input type="checkbox"/></p> <p>Other <input type="checkbox"/></p>
<p><b>7 Type of business</b> (choose one answer)</p>	<p>Trade <input type="checkbox"/></p> <p>Production <input type="checkbox"/></p> <p>Service <input type="checkbox"/></p> <p>Other <input type="checkbox"/></p>
<p><b>8 Form of operations</b> (choose one answer)</p>	<p>Representative Office <input type="checkbox"/></p> <p>Joint Venture/ Cooperation <input type="checkbox"/></p> <p>Wholly Foreign Owned Enterprise <input type="checkbox"/></p>
<p><b>9 Reasons for choosing the form of operation</b></p>	<p>Representative Office <input type="checkbox"/></p> <p>Joint Venture/ Cooperation <input type="checkbox"/></p> <p>Wholly Foreign Owned Enterprise <input type="checkbox"/></p>

**B: Expansion process**

**1 Motives for expansion**  
(multiple answers possible)

Low production and labour cost	
Low sourcing cost	
National regulations/ law	
Sales market	
Saturated home market	
Following customers/ suppliers	
Risk sharing	
Competition home market	
Access to competencies and resources	
Financial benefits	
Other	

**2 Market strategy China**  
(choose one answer)

Niche	
Differentiation	
Cost leadership	
Other	

**3 Strategy satisfaction**  
(choose one answer)

Very satisfied	
Satisfied	
Unsatisfied	
Very unsatisfied	

**4 Strategy development**  
(choose one answer)

Switch	
Major adjustments	
Slight adjustments	
No change	

**5 Preparation for China expansion**  
(multiple answers possible)

Internet Research	
Buy market study	
Consult German Chamber of Commerce	
Talk to German companies which expanded to China	
Search for Chinese business partners	
Assign employees to create an expansion project team	
Formulate strategy for China expansion	
Visit China for on-sight inspections	
Align products to needs of Chinese customers	
Adjust internal processes	
Other	

**6 Self-evaluation on markt entry preparation**  
(choose one answer)

Poor preparation	
Fair preparation	
Good preparation	
Excellent preparation	

**7 Internal success factors for expansion**  
(multiple answers possible)

Financial resources	
Experienced employees	
Open corporate culture	
Solid strategy, constantly revised	
Aligned processes	
Products aligned to Chinese customers needs	
R&D, technical development	
Patents/ intellectual property	
Flexibility to cope with changing environment	
Substantial expansion preparation	
Other	

**8 External success factors for expansion**  
(multiple answers possible)

Qualified/ cheap labour	
Choice of location	
Minimum bureaucracy	
Low cost operations	
Competitive environment	
Customer preferences	
Availability of market data	
Low cost sourcing opportunities/ suppliers	
Legal security	
Close ties with local authorities	
Other	

**C: Current business evaluation**

**1 Evaluation current business situation**  
(choose one answer)

	Very unsatisfied	Unsatisfied	Satisfied	Very satisfied
Business interactions German - Chinese				
Profit margin				
Cost				
Revenue				
Company growth				
Overall evaluation				

**2 Evaluation legal & public authorities**  
(choose one answer)

Bureaucracy				
Legal security				
Public authorities				
Level of corruption				

**3 Evaluation operations in China**  
(choose one answer)

Choice of location				
Efficiency of internal workflows				
Cooperation with suppliers				
Cost in relation to past year				
Logistics/ infrastructure cost				
Raw material cost				
Energy cost				
Cost for supplier parts				
Tariffs				
Tax				

Availability of skilled personnel				
Cost for unskilled personnel				

**4 Evaluation of China sales environment**  
(choose one answer)

Quality awareness of customers				
Availability of market data				
Payment history of customers				
Competitiveness of own company				
Competitive environment				
Customer demand				
Customer loyalty				
Price sensibility of customers				
Revenue in relation to past year				
Profit margin in relation to past year				
Sales market potential				

**5 Importance of sales instruments**  
(multiple answers possible)

Sponsoring	
Sales via sales representative	
Sales via catalogue	
Newspaper/ magazine ads	
Membership in associations	
TV/ radio commercials	
Sales via stores	
After sales service	
Presence on business fairs	
Sales via internet	
Other	

**6 Chinese business behaviour & personality**  
(choose one answer)

	Very unsatisfied	Unsatisfied	Satisfied	Very satisfied
Business methods				
Work attitude				
Communicative				
Look beyond own horizon				
Hard working				
Creative				
Open for Western culture				
Willing to learn				
Quick learner				
Quality thinking/ conscient				
Efficient				
Target oriented				
Reliable				
Honest				
Loyal				

**D: Future business evaluation**

**1 Evaluation future business situation**

(choose one answer)

	Worse	Same	Better
Business interactions German - Chinese			
Profit margin			
Cost			
Revenue			
Company growth			
Overall evaluation			

**2 Evaluation legal & public authorities (future)**

(choose one answer)

Bureaucracy			
Legal security			
Public authorities			
Level of corruption			

**3 Evaluation operations in China (future)**

(choose one answer)

Efficiency of internal workflows			
Cooperation with suppliers			
Logistics/ infrastructure cost			
Raw material cost			
Energy cost			
Cost for supplier parts			
Tariffs			
Tax			
Availability of skilled personnel			
Cost for unskilled personnel			

**4 Evaluation of China sales environment (future)**

(choose one answer)

Quality awareness of customers			
Availability of market data			
Payment history of customers			
Competitiveness of own company			
Competitive environment			
Customer demand			
Customer loyalty			
Price sensibility of customers			
Sales market potential			

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## Declaration

I hereby declare that I have prepared this work independently. No other sources or tools were used besides those that were explicitly stated within the paper. Ideas and thoughts from other authors have been marked explicitly.

Ahlen, 17.06.2012

Place, Date

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Signature