Foreign Direct Investment by Small and Medium Sized Enterprises: The Theoretical Background

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ABSTRACT. This paper is an attempt to give a theoretical background to research on foreign direct investment by small and medium sized enterprises. Section 2 examines alternative theoretical approaches to SMEs investing abroad. Section 3 outlines the special issues which arise from SME foreign ventures and ends with an attempted synthesis of the theoretical approaches. In Section 4, a brief discussion of the nature of foreign direct investment by SMEs takes place. The paper ends with a short conclusion.

1. Definitional problems

It is apparent that definitions of "small firm" vary according to author and context. Definitions are not right or wrong, just more or less useful. Table I shows the definitions employed by the Wilson Committee and the UK 1981 Companies Act. On these definitions, the companies our British study (worldwide turnover less than £10 millions) are relatively large (Buckley *et al.*, 1988). However, when we examine the criteria used for instance in the Bolton Report based on "economic" criteria, then we are justified in terming our firms "smaller". The Bolton Report took as its criteria: (1) Market share, the characteristic of a small firm's share of the market is that it is not large enough to enable it to influence the prices or national quantities of goods sold to any significant extent, (2) Independence, which means that the owner has control of the business himself — this rules out small subsidiaries of large firms, (3) Personalized management, which implies that the owner actively participates in all aspects of the management of the business and in all major decision making processes with little devolution or delegation of authority. On these grounds the 43 firms analysed in the study

TABLE I
Definitions of small firms

A. Wilson committee 1978 (cmnd. 7503)

Manufacturing	200 employees or less
Retailing	Turnover 185 000 p.a. or less
Wholesale trades	Turnover 730 000 p.a. or less
Construction	25 employees or less
Mining & quarrying	25 employees or less
Motor trades	Turnover 365 000 p.a. or less
Misc. services	Turnover 185 000 p.a. or less
Road transport	5 vehicles or less
Catering	All excluding multiples and brewery managed public houses

B. 1981 Companies act

1. Medium-sized

A company may be classified as medium sized if, for the financial year and the one immediately preceding it, two out of the following three conditions apply:
(i) turnover did not exceed 5.75 m
(ii) balance sheet total did not exceed 2.8 m
(iii) average weekly number of employees did not exceed 250

2. Small

A company may be classified as small, if for the financial year and the one immediately preceding it, two of the following three conditions apply:
(i) turnover did not exceed 1.4 m
(ii) balance sheet total did not exceed 0.7 m
(iii) average weekly number of employed did not exceed 50

N.B. Balance sheet total means the total of all its assets without deduction of any liabilities.

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by Buckley *et al.* (1988) qualify for the epithet "smaller". Further, on the world scale they are in the tail of the size distribution of international firms. The criterion of £10 million turnover was chosen so as to exclude large multinationals but to leave a population such that a viable sample could be chosen.

Comparable definitions for other countries relate to the size of the economy. A study of US "midsized companies" defines midsized companies as those with sales between $25 million and $1 billion (Cavanagh and Clifford, 1983). An alternative US definition of a medium sized company is 15—50 million US dollars in sales (Fierheller, 1980). A study of strategic planning in small and medium sized companies in the Netherlands took lower limits of 50—75 employees, 3—10 million DF sales and 2—8 million DF in assets and higher limits of 300—500 employees, 25—100 million DF sales and 20—120 million DF assets (van Hoorn, 1979).

2. The analysis of foreign direct investment by small firms

There exists a variety of approaches to the analysis of small firm foreign direct investment. The economics of the firm's growth points to internal and external constraints on the growth of the firm. Questions about the size of firm may indeed be misplaced. Both the underutilised resources approach (Penrose, 1959) and the internalisation approach (Buckley and Casson, 1976; 1985) suggest that the size of firm is merely a point of time view of a dynamic process of growth and that it is the growth process which is critical. The export literature has seen the foreign expansion of firms as part of a generalised view of deepening international commitment, with foreign direct investment as a final stage in an evolutionary process beginning with the 'pre export phase'. A specific hypothesis on foreign investment behaviour in the early post war period, the "Gambler's Earnings Hypothesis" may be relevant to the explanation of the foreign operations of smaller firms. The corporate decision making approach exemplified by Yair Aharoni's *The Foreign Investment Decision Process* (1966) also represents a contribution to our understanding of decision making in first time foreign investors. Finally, the international business approach has been to attempt to define successful foreign operation and to relate this outcome to the subdecisions going into the investment decision. The following sections investigate these approaches in more detail.

2.1. *The economics of the firm's growth*

The economic theory of the multinational enterprise, drawing on industrial economics, international economics, the theory of finance and the economics of location has integrated and expanded concepts relevant to the growth of the firm (Buckley and Casson, 1976; 1985). Many of these concepts are relevant to the international expansion of smaller firms. (For a review of these concepts see Casson, 1983; and Buckley, 1983a, b).

The role of management is central in this process. The function of management is to adjust to change. The faster the rate of change, the higher the demand for management. Foreign direct investment is (or should be) a management intensive activity because of the risks involved in the move and because of the necessity to collect and, crucially, to channel information in order to support effective decisions. Smaller firms are constrained by a shortage of management time and consequently frequently take short cuts in decision making and information gathering which can be disastrous. However, the exercise of entrepreneurial ability is often difficult to rationalise from an observer's viewpoint. Individual managers endowed with foresight, flair, imagination (or luck) may be able to cut through the planning process and achieve success.

The availability of managerial skills and their successful absorption may be important constraints on the growth of the firm (Penrose, 1959). Further constraints arise from technological and contractual factors. The optimum scale of a production plant is a constraint on operations in an individual location, not on the size of firm because optimum scale plants can be replicated at different locations (Scherer *et al.*, 1975). The true constraints are coordination (via management) and contractual. The minimisation of transactions costs are a major explanation of firm size. The difficulties of diversification and expansion out of a given sector and product are well known (Teece, 1983), as are barriers to entry to new areas of growth (Bain, 1956). Smaller firms are vulnerable to product, market and technological changes because they are not diversified and are often one product, one market companies. Thus, although the state of technology may not be a constraint on firm size, changes in technology may curtail or reverse the growth of individual firms.

Organisational issues are also important in the growth of the firm. A balance must be achieved between hierarchical control and cooperation which suits the unique situation of the firm (Casson, 1983). This problem is highlighted, for example, by the difficult choice of chief executive of the newly created foreign subsidiary. This is bound up with the issues of exercising adequate control at a distance. Our findings (Buckley *et al.*, 1988) were that a British chief executive was chosen where hierarchical control was envisaged and a local national where a cooperative mode of operation was sought. Such a simplistic device did not, in many cases, succeed, but it illustrates a response to the organisational/management style problem which becomes more acute in international operations.

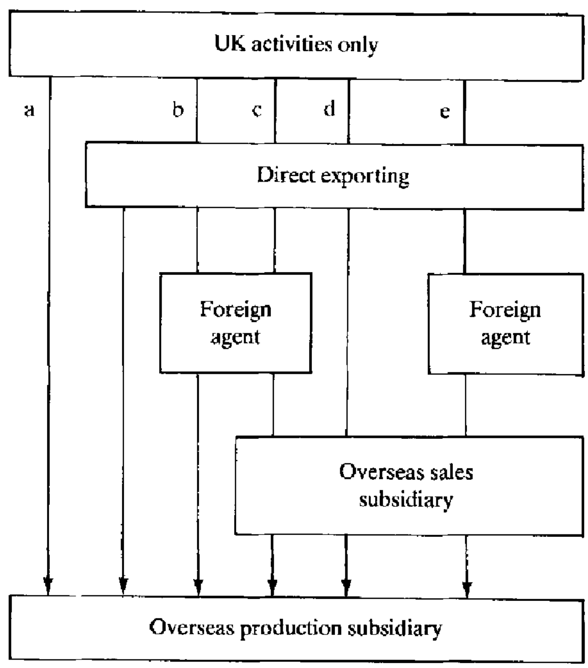
The availability of finance is often adduced to be a constraint on the expansion of small firms. Where external finance is not available, funds for expansion are limited to the profits generated by past investment. Beyond this, small firms must win the confidence of the market for funds. This confidence can be won by technological achievement, attempts at proof of future success, recruiting individuals who have the confidence of the market or astute political lobbying. In most cases financial constraints are secondary to managerial constraints. However the lack of funds for future investment in new products and processes (and for recruitment of managerial talent) is a constraint at particular points of time. As such, in a dynamic environment, they can be fatal by preventing the reduction of the vulnerability which besets smaller firms. A further corollary of lack of funds is that attempts to minimise outlays, e.g. on the acquisition of information, on salaries for key individuals and on product adaptation can be disastrous.

2.2. *The evolutionary approach: internationalisation*

The export literature has seen exporting as an innovative strategy and as a first step in internationalising, possibly a step which ends in failure. Thus exporting can be seen as launching a process of deepening international commitment, possibly leading to direct investment (For a full review of the literature, see Buckley, 1982).

This evolutionary approach is, to a degree, embodied in Figure 1. All but 7 of the 43 firms in the sample used by Buckley *et al.* (1988) had exported prior to making their first direct investment in a particular country. This deepening investment, and the success which goes with having a number of intermediate states (exports, agency, sales subsidiary) before a production subsidiary is capable of two explanations. The first is that each stage allows a learning process to take place. The second explanation is that the unsuccessful firm can drop out at any one of the intermediate states and thus never appears as a direct investor. In other words, looking back in time from a position where a direct investment is established, "failures" are weeded out (Buckley *et al.*, 1988).

The internationalisation approach has identified crucial interactions between internal and external pressures in the firm's development and,



N.B. Licensing may be an additional, or alternative, intermediate state.

Fig. 1. Routes to investment in production facilities overseas.

in particular, has highlighted the crucial role of management activity and awareness. All forms of international activity are management intensive, foreign investment particularly so. Information gathering, a crucial part of the feedback process, is particularly time intensive. The 1978 study shows the heavy costs of information gathering for a small firm with severe constraints on management time (Buckley *et al.*, 1988).

Information also plays a crucial role in reducing risk. One way of minimising the risks arising from foreignness is to invest in a country as similar as possible to the home country. This suggests an expansion strategy based on 'psychic distance', investing in psychically "nearby" countries first. The results of our study show that, often, psychic distance and physical distance are inversely correlated. It is unwise, however, to underestimate psychic distance between two ostensibly 'close' countries, as the 1978 study by Buckley *et al.* (1988) and those of British investment in Australia show (Buckley and Mathew, 1979; 1980; Mathew, 1979).

The switch from exporting to direct investment is a crucial decision. Models of the switch, based on the different costs involved in these methods of market servicing, have been put forward by Vernon (1966) and Hirsh (1976). The more complex model of Buckley and Casson (1981) specifies the optimal timing of the switch by reference to the costs of servicing the market, demand conditions in the market and host market growth. This decision emerges as highly complex and in a highly uncertain world, its correct execution demands a great deal of management judgement.

Alternative modes of technology transfer can be incorporated into this model by considering licensing as an alternative intermediate stage. This should not imply that licensing is merely a step towards a direct investment in all cases — it can be a viable, permanent and optimal choice under certain circumstances (Buckley and Davies, 1981).

2.3. *The "gambler's earnings" hypothesis*

The "gambler's earnings" hypothesis was put forward in the mid-1950s to explain an empirical phenomenon associated with foreign direct investment. This phenomenon was the large plough back of profits in foreign owned subsidiaries (notably in General Motors' Holden subsidiary in Australia). Consequently multinational firms were likened to gamblers who, beginning the game with a small stake (the initial investment, usually small) continually ploughed back their "winnings" (profits) into the game until a real "killing" was made. In foreign investment this meant that when a dividend repayment was eventually made to the parent firm, it was large in relation to the initial investment (Barlow and Wender, 1955; Penrose, 1956). Such behaviour poses adjustment problems for the host country because a large repayment can disrupt its balance of payments stability.

Underlying this behaviour are three features of interest. First, the subsidiary is assumed to be very largely independent of the parent. This may be because of distance (both physical and psychic), because of the need for local judgement or because of the lack of firm-wide policy coordination. Second, the differences in setting up a foreign rather than a domestic subsidiary are relevant. The rate of return on a foreign subsidiary needs to be higher in order to compensate for the greater risks. Moreover, foreign investment is often in the nature of an exploratory strategy in order to see if further foreign investment is desirable. Therefore, the risk averse firm is likely, initially at least to underinvest and to begin with a small stake. The small initial investment thus economises on the costs of investigation and organisation. Third, the process has a dynamic of its own. When the firm has a (small) successful foreign subsidiary, uncertainty is lower and the costs of search for further profit approximate to zero. The argument thus is that rather than scanning the world for further, possibly more profitable, opportunities, the firm will re-invest in its safe bet — the existing subsidiary. Thus, the investor will keep reinvesting long after this is justified by relative rates of return from other (unconsidered) alternatives. In other words, foreign investors are hypothesised to exhibit a bias in the allocation of investment funds toward existing, profitable subsidiaries. The "gambler's earnings" hypothesis is no longer a valid explanation of the behaviour of large, diversified multinational firms used to monitoring worldwide opportunities, managerially integrated and often highly centralised. However, the hypothesis may hold for small firms where the costs of information and coordination are high. For first-time foreign investors in particular, the costs of decision making may make such behaviour optimal. However, in the longer run, "gambler's earnings" behaviour results in missed opportunities, declining overall rates of return and lost gains from internationalisation. It may be a phase in the development of an international strategy before full international coordination is justified, but for the successful firm it must not be more than this.

2.4. *The corporate decision making approach*

The corporate decision making approach sees foreign direct investment (by small firms) as a managerial process. It is exemplified by Yair Aharoni's *The Foreign Investment Decision Process* (1966). In this approach, competition is insufficiently perfect to prevent there existing an area in which managers can exercise discretion and pursue their objective function. Consequently, the objectives of managers, which may involve the search for an easy life, or concern for the share price, or managerial rewards, can be sought. Also included in the approach are the costs of information, the limited decision horizons of managers, conflicts within the firm and uncertainty of outcomes.

Aharoni's study based on a survey of US investors and non-investors in Israel suggests a five stage process as typical of the foreign investment decision. It is a basic finding of Aharoni's work that a strong "initiating force" (Stage I) is necessary to propel an inert non-investor along the path towards a foreign direct investment. Such pressure may come from within the firm, an executive with an interest in such an investment perhaps, or from the environment, e.g. an outside proposal from a powerful source such as a client, distributor or government agency. Aharoni suggests that the existence of a profitable opportunity is not a sufficient stimulus, and the venture must have extra appeal. Given a sufficiently strong initiating force, Stage II is the investigation process. This is the beginning of the firm's search process. It is a biased search, however, carried out in a sequential way with built-in check points. If at one of these checks, a negative answer is found, the rest of the work is abandoned. Thus, the order of search is of crucial importance. The inexperienced foreign investor needs to know many factors in addition to those involved in its dramatic investment decisions. The phases of the search are: (1) general indicators, to establish the degree of risk, (2) on the spot indicators, and (3) presentation of a report. Before Stage III "the decision to invest" is reached, a process of building commitments in the firm takes place. The very fact of investigation is sufficient to create a commitment amongst the investigators, whence such a commitment diffuses throughout the decision makers. In Stage IV "reviews and negotiations" a bargaining situation occurs where powerful groups within the firm impose their wishes and attempts to reduce uncertainty (and outlay) are made.

The first few stages of Aharoni's model then represent a description of short-run decision making under uncertainty. The fifth stage "changes through repetition" adds a longer run element. In this stage, the firm changes organisationally so as to bring its foreign operation(s) within central control via, Aharoni suggests, an international division. The attitude to risk and uncertainty of foreign ventures alters radically, for the firm now finds them intrinsically little more risky than domestic ventures and the firm thus progresses to full international status.

2.5. *The international business approach: defining "success"*

In discussing the foreign investment behaviour of smaller firms it is difficult to avoid normative statements. The observer is tempted to discuss 'what ought to be done' rather than the decisions which have been made. It was to avoid this difficulty that the methodology of the Bradford study was designed (Buckley *et al.*, 1988). Briefly, the methodology is as follows. First, an attempt is made to define success. This is done by a 'success index' made up of measures of profitability, growth, managerial perception of success, synergy and an appraisal of the investment as a step towards full internationalisation. Second, each investment is then rated on a five point scale or "success index". Third, each subdecision is then evaluated on the basis of the outcome in terms of average success of those investments making that subdecision. On this basis, a best practice set of decisions can be defined. Fourth, the findings of the success index are tested against external factors which may have influenced the outcome. For instance, longevity of investment may positively influence the success rating. Indeed Lupo *et al.* (1978) showed that profitability of US multinationals in 1966 was strongly related to the ages of the subsidiary after controlling for the industry and country where the subsidiary was located. To eliminate such possibilities, the success rating is tested on these external factors which are shown not to be decisive. In view of this, the success index outcome is deemed to depend on managerial decision making. A variant of this model is also used in the companion volume (Buckley *et al.*, 1983) to evaluate the direct investments of smaller European firms into the UK.

A similar approach is used by Sikander Khan (1978) to evaluate export ventures. In classifying firms' export ventures, he uses (1) objective criteria; profit and sales penetration, (2) semi-objective criteria; the degree to which expectations are met compared to the actual outcome with respect to costs, export volume and profitability, (3) subjective criteria; the firms' assessment of the degree of success and failure concerning individual export markets. No attempt was made to combine or aggregate these criteria and Khan notes (p. 220) that the objective and subjective evaluations were not significantly different.

3. Special issues raised by small firm foreign investors

A crucial issue arising from the above discussion is the extent to which small firms are at all different in their foreign investment behaviour. There are several key areas in which small firms are different and these raise a set of important conceptual and strategic issues.

In comparison with larger firms, two critical shortages may affect smaller firms: capital and management time (Buckley, 1979). The lack of pull in the capital market may lead to less than optimal arrangements. Decisions taken in order to minimise capital outlay sometimes have negative consequences. One example is entering into joint venture arrangements where they bring in finance but subsequently prove to be a serious liability. In raising capital, the small firm faces a "Catch 22": how to raise finance without disclosing its competitive advantage secrets. Capital rationing can thus adversely affect small firms who therefore rely greatly on internally generated finance.

The shortage of skilled management in smaller firms is often a more serious liability. Small firms do not often have specialist executives to manage their international operations, nor do they possess a hierarchy of managers through which complex decisions can be sifted. Decision making is much more likely to be personalised involving *ad hoc*, short term reckoning based on individual perceptions and prejudice. Shortage of management time leads to the firm taking short cuts without proper evaluation of alternatives. Linked to management shortage are the problems of information costs, which (like any fixed costs) bear heavily on small firms. Attempts to avoid these costs, for instance by making no attempt to appraise a potential joint venture partner, can be disastrous. The horizons of small firms are limited by managerial capacity and there is little 'global scanning' for opportunities. Therefore, when an opportunity appears, it is often taken without proper evaluation. Given this problem, why does the firm not recruit management from outside the firm? An important point here is the crucial phase of growth from a family firm to a wider management controlled organisation (Casson, 1982). One issue is the desire to retain (family) control; the other is the difficulty in obtaining specialist knowledge of how to evaluate outsiders. Lack of these crucial skills constrains recruitment and makes endemic the burden on management. Consequently, small firms with inexperienced managers have an inevitable degree of naivety. They are politically naive because they lack the public relations skills, lobbying power and sheer economic muscle of larger firms. In the international sphere they lack knowledge of the local environment, the legal, social and political aspects of operating abroad.

Small firms face a high degree of risk in going international. It is likely that the proportion of resources committed to a single foreign direct investment will be greater in a small firm than a large one. Failure is more costly. It is arguable that owner-managers are greater risk takers than other types of decision makers.

The financial strategy of small firms also requires explanation. It is clear that the "Gambler's Earnings Hypothesis" shows up an important empirical phenomenon. An explanation is given by analogy with ploughing and harvesting. A period of ploughing may be set by the firm (say 5 or 7 years). In this time it is given a great deal of leeway. After that, it either generates a stream of income for the next project (the next ploughing) or it is sold off to obtain a return. The short horizon arises because of restricted capital and management time. Thus a target rate of return and payback period are discovered by trial and error.

It is important to distinguish two types of relationship between firm size and market size. In the first case we can envisage a small firm attempting to grow in a "big-firm" industry, i.e. an industry where optimal scale is large in relation to market size. Secondly, there are many industries with few economies of scale where many small firms exist. Industries requiring a wide range of specialist intermediate inputs, in particular, present a situation of a small firm in equilibrium with a small market. In such a situation, foreign direct investment can enable a small firm to service optimally a growing market (Buckley and Casson, 1981). This role of small firms to fill a market niche is a major advantage and has been noted for Third World multinationals who are seen as versatile users of flexible equipment (Wells, 1983). There is an argument that disinternalisation brought about by the need to decentralise in large companies and by the need for specialised services such as consultancies and oil industry services, makes this role loom larger on the world scale. However, in the first case, it is difficult for a small firm to grow in competition with large firms. In such situations, the vulnerability of small firms and the danger of becoming overstretched often lead to bankruptcy or selling out.

Synthesis

Several key points emerge from the theoretical literature. First is the importance of the relationship between firm and market. This is reflected in the crucial balance between firms size and market size. The growth of the firm by internalisation of markets is a key to understanding the velocity and direction of the growth of small and medium sized firms. The importance of market niches is also of great potential in explaining the industrial distribution and pattern of the foreign activities of SMEs.

Second, the importance of constraints on the international activities of SMEs emerges from the literature. Both internal and external constraints can be seen to influence growth patterns. Internal constraints are shortages of capital and management and informational constraints. The acquisition of greater resources is impeded by the necessity to retain (family) control and institutional difficulties of borrowing and raising finance (capitalising knowledge). External constraints arise from the market, from the dangers of takeover and from institutional restraints, both governmental and non-governmental.

Third, the role of uncertainty looms large in the decision making of SMEs. Partly, this can be offset by information acquisition, but this is costly and interacts with management shortages. Taking short cuts and inadequate evaluation of alternatives often result.

Fourth, the alternative forms of technology transfer must be evaluated. Licensing and other "new forms" (Buckley, 1983b; also Chapter 3 in Buckley and Casson, 1985; Buckley and Davies, 1981; Oman, 1984) of industrial cooperation must be considered as alternatives to foreign direct investment. It is notable that technology transfer by SMEs via licensing was also significant (White, 1983, pp. 272—3; and White and Campos, 1986, where of 32 cases of technology transfer to Argentina and Brazil, 14 were arms length technology agreements and 8 were minority foreign joint ventures, p. 82). Indeed, it has recently been hypothesised that smaller firms are likely to become important users of "new forms of international cooperation" such as licensing, joint ventures, turnkey operations and production sharing (Oman, 1984). Whilst such operations economise on capital outlay, they tend to be management-intensive and this may choke off the ability of small firms to enter into the more complex forms of such arrangements (Buckley, 1983). Licensing and joint ventures remain viable options, although the 1978 study (Buckley *et al.*, 1988) shows that the tolerance of small firms to joint venture arrangements can be low and that such arrangements can adversely affect success.

Fifth, the vulnerability of SMEs to technological, political, institutional and market changes must be stressed. Against this the flexibility of SMEs is often an important competitive advantage.

Sixth, the motives for foreign investment follow several patterns. (1) SMEs may be 'pulled' into foreign markets by larger firms, by government, e.g. tariff imposition, or other powerful influences. (2) They may be 'pushed' abroad by domestic conditions, e.g. a declining home market or avoidance of (foreign exchange) restrictions. (3) They may follow the classic motives of foreign direct investment — raw material or input control, market oriented or cost oriented. These forms of investment require very different types of analysis. Previous studies have shown that there are differences in predominant motives related to the nationality of SMEs. Ozawa (1985) found that many Japanese SMEs were investing in LDCs as offshore production platforms in order to export back to Japan whilst most Western European SMEs invest abroad in order to secure market access (Onida *et al.*, 1985, for Italy; Buckley *et al.*, 1988, for UK; Berger and Uhlman, 1984, for Germany; and Bertin, 1986, for France). See White and Campos (1986) for further elucidation. (4) SMEs are susceptible to 'spurious' investment based on inadequate evaluations of alternatives, over zealous actions in following up an approach from an external body or misinformation. (5) SMEs may invest abroad as a result of entrepreneurial foresight, which may or may not be rewarded.

Seventh, we should note that the large multinationals often have highly sector-specific expansion routes. This leaves market niches or "interstices" for SMEs to exploit. It is in these "small firm industries", not characterised by economies of scale where we should look for successful SMEs (see White and Campos, 1986).

Eighth, the international structure of industries should be examined. As well as industries populated by small firms, we can often observe a "fringe" of small firms in "large firm industries". This pattern should be investigated. Is it an historical legacy or a reaction to efficiency and optimum locational criteria?

The growth of the industry, too, is relevant. A cycle can be envisaged where in the early stages lots of small firms vie for position. As the industry matures, economies of scale become prevalent and dominance of the few ensues in an oligopolistic structure. Over time fragmentation takes place as new entry erodes the existing competitor's dominance. The role of SMEs over the life cycle of the industry needs to be examined.

Ninth, the location strategy of SMEs and multinationals is of great importance in determining the pattern of activity by both groups of foreign investors. Specifically, several forces are at work. (1) There are increasing returns to scale in many activities and this will affect location strategy and bias these activities towards large firm dominance. (2) The performance of many non-routine activities, such as research and development and marketing by modern firms, means that such activities will exercise a locational 'pull' on production. The inputs to these activities and the scale economies in their performance may dictate centralisation within the firm. (3) Many (multinational) firms operate in imperfect markets and cannot be considered as price takers. Consequently, large firms can often force down input or factor prices and will concentrate their activities in countries or regions intensive in these inputs. Such distortions will have important effects on the opportunities for SMEs to compete with or supply such monopolistic multinationals. (4) Avoidance of government intervention at home or in the host country will affect location. Biases towards low interference countries and to the use of transfer pricing will distort location of both SMEs and multinationals away from what would be, in the absence of government interference, least cost location. (5) Communications costs within the firm dictate the centralisation of high communication intensive activities and the decentralisation of routine, low communication cost activities. These influences on location must be evaluated for SMEs as there is a differential impact on the activities of integrated multinationals and more loosely organised SMEs.

4. The nature of foreign direct investment by small and medium sized enterprises

There are a number of suggestions in the literature as to the important factors in the existence of SMEs as direct investors. The range of industries and nature of production have been characterised in a number of studies.

Foreign investment by SMEs covers a wide range of industries. White (1983) characterises the operations as "highly specialised", covering one or two product lines, with short production runs, often serving the "contractual markets" given by other industries (p. 274). Typical industries include metal working, capital goods production, textiles and clothing, food, furniture, ceramic products and non-metallic products. These industries are well represented in the sample of UK outward investors which have been studied in detail (Buckley *et al.*, 1988).

UK smaller outward investors are largely engaged in the production of intermediate and component products and services for other firms. Thirty-six of the 43 investors studied made producer goods or services; only four were entirely engaged in consumer good production and four firms made both producer and consumer goods. A large proportion was engaged in the engineering and metal goods sectors (SIC orders VI, VII, VIII, IX, XI, XII) — fully 31 out of 43 (Buckley *et al.*, 1988, Table 2.2, p. 9).

Medium sized firms investing in the UK were also concentrated in these sectors (SIC VI, VII, VIII, IX, XI, XII) which accounted for 21 out of 35 production subsidiaries. Textiles also was well represented with 5 production subsidiaries. Again producer goods were dominant — 27 production subsidiaries made only producer goods; 2 made both, and only 6 were consumer goods specialists (Buckley *et al.*, 1983).

Smaller Japanese foreign investors cover a variety of labour intensive light manufacturing such as light metal articles, furniture, bags, footware, apparel, toys, plastic products, etc. It is expected that the 1980s will see many more smaller firm foreign investors in electrical machinery, non-electrical machinery and transport equipment as smaller suppliers and subcontractors follow large enterprises abroad (UNCTAD, 1984).

Foreign direct investors from less developed countries (many of them SMEs) were largely small scale manufacturers, with high adaptability to local conditions (including input availability) and flexible users of capital equipment. Local procurement, small scale manufacturing, special products and access to markets were picked out as competitive advantages of "Third World multinationals" (Wells, 1984). The existence of cross-national ethnic ties (e.g. overseas Chinese, expatriate Indian communities) should not be ignored.

These findings provide empirical support for the conjectures above supporting the hypothesis that balanced growth in "small firm industries" is conducive to success.

4.1. *The scale of UK SME foreign investment*

In the case of United Kingdom foreign investors, according to the latest survey conducted for 1981, an estimated 1500 enterprises had 9100 foreign affiliates. Two thirds of these foreign investors (i.e. 1000 firms) with net foreign assets less than 2 million accounted for 0.8% of the total net book value of UK foreign direct investment at the end of 1981 (British Business, 2nd March 1984) (see Figure 2). This is in sharp contrast to the 34 enterprises with net assets over 200 million and 1550 overseas affiliates which account for 55% of the total stock of British foreign investment.

When foreign investment in the UK is examined, it is found that about 3000 foreign countries had UK affiliates, three quarters (2150) of these had UK affiliates with a book value of less than 2 million, accounting in total for 2.4% of inward direct foreign investment in the UK (excluding oil, banking and insurance) (see Figure 3). In contrast, 21 foreign countries had assets valued at over 150 million in the UK, and account for one third of the total (British Business, 2nd March 1984). Inward investment was less concentrated than outward: the 100 largest inward investors account for 60% of total direct investment; the 100 largest outward investors account for 80% (again excluding oil, banking and insurance).

4.2. *The direction of UK foreign direct investment by SMEs*

The study by Buckley *et al.* (1988) examined first time foreign direct investors. None of these investments was in a middle income or developing country. However, the 52 firms (43 with foreign production subsidiaries and 9 with foreign sales subsidiaries) made a total of 39 further foreign investments — 33 production and 6 sales subsidiaries. Six production subsidiaries and two sales subsidiaries were in middle income and developing countries as Table II shows. This study also shows two marked shifts in overall UK foreign

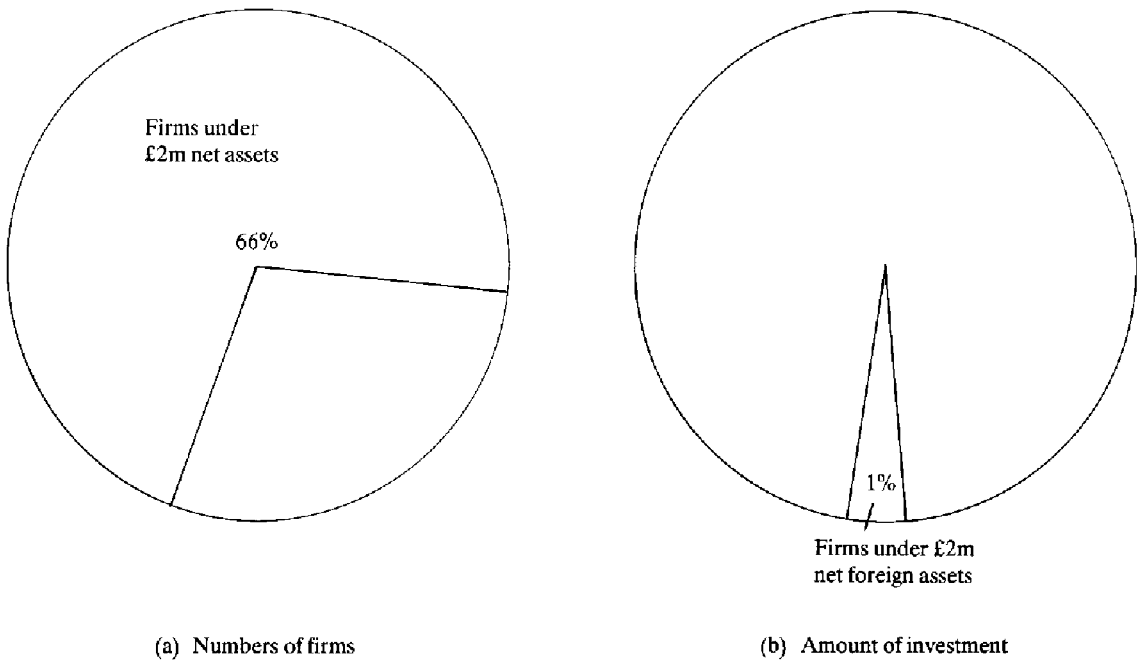


Fig. 2. UK foreign direct investment.

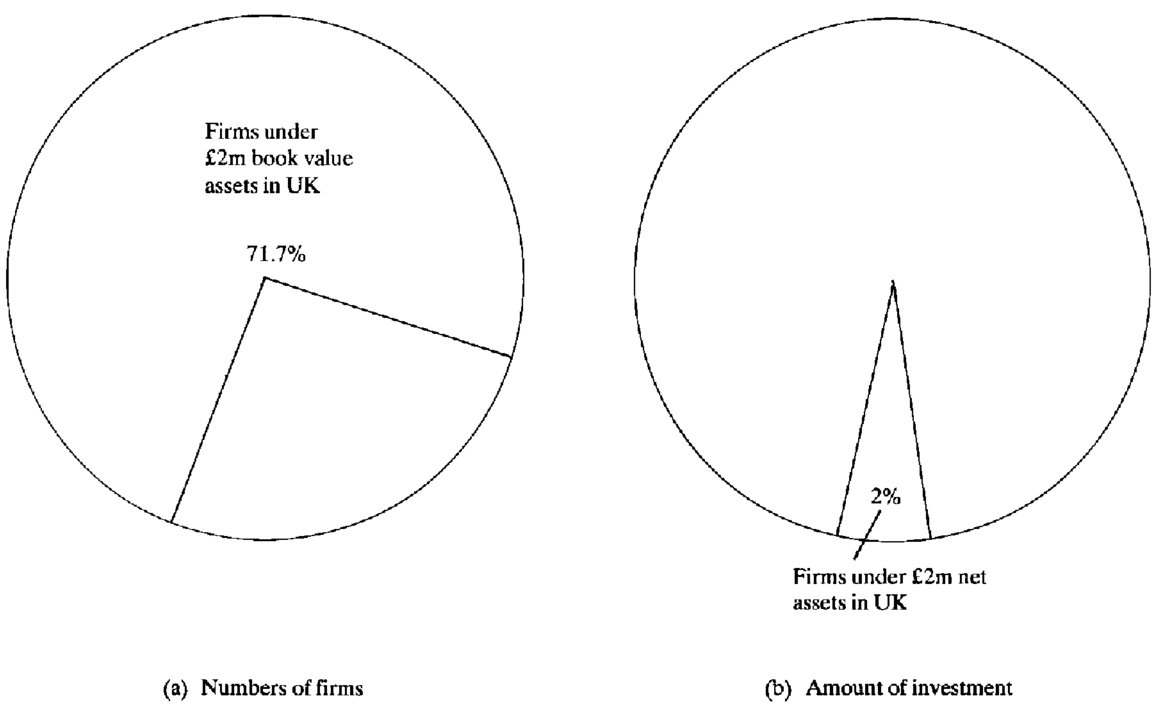


Fig. 3. Inward investment into UK.

TABLE II
Later foreign production and sales subsidiaries of the 52 UK smaller firms

Location	Foreign production subsidiaries	Foreign sales subsidiaries
Developed countries		
South Africa	5	1
Australia	4	—
Netherlands	4	—
France	3	1
USA	3	—
Canada	2	2
New Zealand	2	—
Ireland	2	—
Belgium	1	—
Norway	1	—
	27	4
Middle income and developing countries		
Mexico	1	1
India	1	—
Nigeria	1	—
Malta	1	—
Spain	1	—
Portugal	1	—
Bahamas	—	1
	6	2
TOTALS	33	6

* 43 with foreign production subsidiaries, 9 with foreign sales subsidiaries.
Source: Derived from the research reported by Buckley, Newbould and Thurwell (1988).

direct investment — one away from the old Empire and Commonwealth towards the countries of the European Communities dating from the late 1960s to late 1970s succeeded by a wave of investment to the USA. It appears, from very partial evidence that SMEs followed these general trends.

5. Conclusion

The problems facing SMEs in foreign direct investment are most acute for first time investors. Risks are perceived to be great and the firm has no international experience on which to draw. Many firms in the 1978 study had unsuccessful first foreign ventures but went on to undertake later successful foreign investments. Learning from mistakes is a vital part of business progress. However, the dice are stacked by the type of industry and environment faced by the firm. SMEs have a natural constituency in industries characterised by insignificant economies of scale and specialised demand. In such industries there is no "critical minimum scale" at which a firm can be expected to succeed in foreign direct investment. Attempts to move into areas of great potential demand where economies of scale are prevalent are fraught with danger and emphasise the vulnerability rather than the sensitivity of small firms.

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