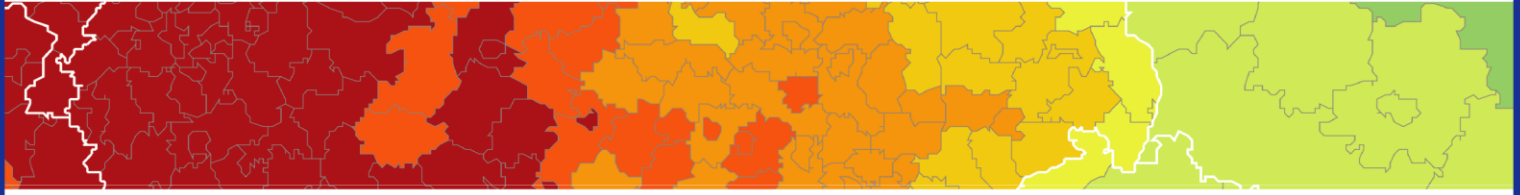


Inspire policy making by territorial evidence



# The World in Europe, global FDI flows towards Europe

## FDI by European SMEs

Applied Research

**Main Report**

March 2018

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The World in Europe,  
global FDI flows towards Europe

FDI by European SMEs



## Scope and introduction to the study

This report is part of the study, *The World in Europe, global FDI flows towards Europe*. The study casts new light on three topics related to the integration of Europe in the world economy:

1. Extra-European FDI towards Europe
2. Intra-European FDI
3. FDI by European SMEs

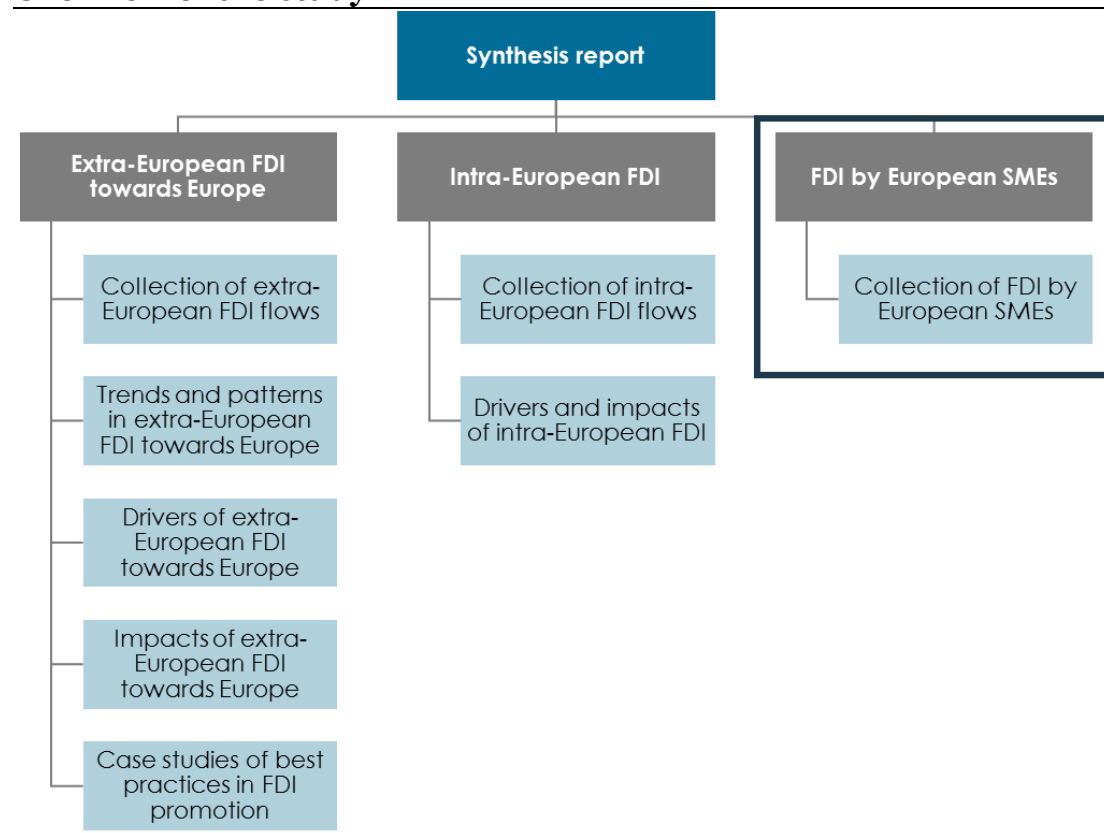
Key conclusions and recommendations related to each of these questions can be found in three stand-alone reports. Each report is supported by a number of scientific reports that contain detailed methodological descriptions and results. The insights gained from the study are summarised in a synthesis report that cuts across the three topics.

This stand-alone report analyses FDI by European small and medium-sized enterprises (SMEs). The insights gained in this part of the study will be used to develop tailor-made policy recommendations that can help spur European SMEs carry out cross-border investments. An overview of the assembly of the database, background tables and additional discussions can be found in the accompanying scientific report, *Collection of FDI by European SMEs*.

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### Overview of the study

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The present analysis on FDI by European SMEs addresses the following key policy questions:

- What are the patterns of SME FDI flows at the national and regional levels?
- How do the patterns of SME FDI flows compare to the patterns for all enterprises?
- What is the breakdown by economic sector for SME FDI?
- What are the characteristics of the internationalisation process of SMEs through FDI?

For the analysis, we divide the firms into three size groups: Micro enterprises, SMEs and large firms. We define an SME in the following way:

**Definition of an SME:** *We compute the average number of employees, average operating revenue and average total assets for each firm across the years 2013-2015, when the information is available. We then define an SME as a firm which has*

- *Staff headcount (number of employees) between 10 and 250 or*
- *Turnover (operating revenue) between EUR 2 and 50 million or*
- *Balance sheet total (total assets) between EUR 2 and 43 million.*

In **Chapter 2**, we explain how outward FDI can help SMEs grow, and we describe the trends and patterns in FDI by European SMEs. The analysis is based on a unique database of FDI by European SMEs that has been developed as part of this study. In **Chapter 2**, we analyse the destination of outward FDI by European SMEs, where we distinguish between intra-European FDI and extra-European FDI. In **Chapter 3**, we analyse the origin of outward FDI by European SMEs at both the national and regional level. We use the following categories to analyse groups of regions with similar characteristics:

- The **rural-urban typology** from Eurostat

*Rural regions:* Regions where the population in rural grid cells accounts for 50% or more of the total population.

*Intermediate regions:* Regions where the population in rural grid cells accounts for a share between 20% and 50% of the total population.

*Urban regions:* Regions where the population in rural grid cells accounts for less than 20% of the total population.

- The **metropolitan typology** from Eurostat

*Capital metropolitan regions:* Regions that host the capital city.

*Other metropolitan regions:* A single or a combination of NUTS3 regions, which cover agglomerations of at least 250,000 inhabitants across a city and its commuting zones.

*Non-metropolitan regions:* All other regions.

- The **level of economic development**

*More developed regions:* Regions where the average GDP per capita over the period 2010-2013 was more than 90 per cent of the EU28 average.

*Transition regions:* Regions where the average GDP per capita over the period 2010-2013 was between 75 per cent and 90 per cent of the EU28 average.

*Less developed regions:* Regions where the average GDP per capita over the period 2010-2013 was less than 75 per cent of the EU28 average.

In **Chapter 5**, we outline the internationalisation patterns of European SMEs through outward FDI, and we construct an indicator of the FDI performance of SMEs in individual European countries. The indicator is comparable to the one used to measure the internationalisation of a country's SMEs through trade in goods and services computed by "SME Performance Review". We also analyse how European SMEs benefit from productivity spillovers from foreign companies located in the same region.





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## Abbreviations

EC	European Commission
ESPON	European Territorial Observatory Network
EU	European Union
FDI	Foreign Direct Investment
FT database	fDi Markets database offered by the Financial Times
M&A	Mergers and acquisitions
NUTS	Nomenclature of Territorial Units for Statistics



# 1 Executive summary

Small and medium sized enterprises (SMEs) are highly important for the European economy for two main reasons. *First*, they constitute around 7 per cent of all firms in the EU and account for 37 per cent of the total employment. This equals 1.6 million firms and more than 50 million employees.<sup>1</sup> Around 36 per cent of value added (more than EUR 2,500 bn.) in the EU in 2016 were accounted for by SMEs. *Second*, SMEs hold a growth potential in Europe – the growth in value added for European SMEs was 3.8 per cent in 2014 and 5.7 per cent in 2015, illustrating the importance of SMEs for European economic growth.<sup>2</sup>

This report is part of the study *The World in Europe, global FDI flows towards Europe*, and the overall objective of this part of the study is to analyse the FDI patterns of European SMEs. The insights gained in this report can be used to develop tailor-made policy recommendations that can improve the framework conditions for European SMEs that undertake FDI projects both within and outside Europe. The final conclusions and recommendations from the study are summarised in this executive summary.

This analysis differs slightly from previous reports in the study by being highly explorative. *First*, we have built a unique database, in which we have merged data on FDI projects undertaken by European firms, with data containing firm-level information on the investing companies. This allows us to identify FDI projects undertaken by European SMEs.<sup>3</sup> *Secondly*, we have constructed a new SME FDI indicator at the country level, which provides information on the degree of internationalisation of SMEs across European countries. The present analysis is a first step in analysing the investment patterns of European SMEs, but more research is required to further the understanding of the location decisions of SMEs and the trends in undertaking FDI projects.

## Destination and origin of FDI by SMEs

SMEs account for 30 per cent of the total number of FDI projects by European investors. These investments are carried out both within and outside of Europe. 50 per cent of the projects undertaken by European SMEs are located in an EU country, 5 per cent are located in a candidate or EFTA country, while the remaining 45 per cent of projects are located in other countries. FDI projects outside Europe mostly go to North America (14 per cent), China and Hong Kong (5 per cent) and Southeast Asia (4 per cent).

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<sup>1</sup> The numbers are estimates for 2016 and are taken from the SBA Fact Sheet for the European Union.

<sup>2</sup> Numbers are taken from European Commission (2016) “Annual report on European SMEs 2015/2016 – SME recovery continues”.

<sup>3</sup> Additional discussions on the construction of the database can be found in the accompanying scientific report, *Collection of FDI by European SMEs*.

In order to detect patterns in the origin of SME FDI flows across territorial groups of regions in Europe, we use the following categories to analyse groups of regions with similar characteristics:

- The **rural-urban typology** from Eurostat

*Rural regions:* Regions where the population in rural grid cells accounts for 50% or more of the total population.

*Intermediate regions:* Regions where the population in rural grid cells accounts for a share between 20% and 50% of the total population.

*Urban regions:* Regions where the population in rural grid cells accounts for less than 20% of the total population.

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- The **level of economic development**

*More developed regions:* Regions where the average GDP per capita over the period 2010-2013 was more than 90 per cent of the EU28 average.

*Transition regions:* Regions where the average GDP per capita over the period 2010-2013 was between 75 per cent and 90 per cent of the EU28 average.

*Less developed regions:* Regions where the average GDP per capita over the period 2010-2013 was less than 75 per cent of the EU28 average.

We find that SMEs in capital city metropolitan regions, as well as in urban and more developed regions, account for the majority of FDI investments by European SMEs, even when taking the economic size of these regions into account. Capital metropolitan regions, thus for example account for 23 per cent of European GDP, but is the origin of 63 per cent of the value of outward FDI by European SMEs. London, Brussels, Paris and Madrid are the regions from which the largest value of FDI by European SMEs originate.

## **Comparison with the overall FDI pattern**

Compared to FDI undertaken by enterprises of all sizes, the investment patterns of SMEs diverge in mainly two dimensions. *First*, a relatively larger share of SME FDI projects are in the service sector. Thus, while SMEs account for 29 per cent of all FDI projects, they account for 32 per cent of FDI projects in the service sector. *Second*, the average deal size of the projects by SMEs is smaller than the average deal size of projects in general, as large European firms have undertaken large investment projects. The average deal size for a project by an SME is

thus EUR 50 million, while it is EUR 121 million for large firms. This is explained by the size of the firms. The fact that SMEs, on average, undertake smaller FDI projects than larger firms, implies that they are more sensitive to increases in the fixed costs of undertaking the FDI project. Hence, initiatives to reduce the fixed costs of undertaking FDI projects are likely to benefit SMEs disproportionately.

We show that M&A deals are on average larger than greenfield projects, with an average deal size of EUR 92 million for M&A deals compared to an average project size of EUR 31 million for greenfield investments for SMEs. This is lower than the corresponding figures for all firms, where the average deal sizes are EUR 158 million and EUR 42 million for M&A deals and greenfield projects, respectively.

### **Internationalisation of SMEs through FDI**

More than one third of the European SME investors undertake more than one investment. SMEs that invest in multiple FDI projects are more likely to make their first investment within the EU. For SMEs in the EU countries, other EU countries are the destination in a little under half of all recurrent projects. This implies that recurrent SME investors from the EU keep investing within the EU.

SME investors from the candidate and EFTA countries gradually reduce their share of investments within the EU, the more projects they carry out. SMEs from these countries undertake close to two thirds of their first projects within the EU. However, this number is reduced to close to one third for subsequent projects.

EU SMEs undertaking multiple FDI projects continually increase the size of the projects within the EU, while the projects outside of the EU remain at a constant level. Most likely, this is due to the standardised rules within the EU.<sup>4</sup> The fact that SMEs tend to continually increase the size of their projects within the EU, as they invest in multiple projects, suggests that SMEs can utilise the experience they gain from one project to the next. This reduces the risk of investing, allowing the SMEs to continue to increase the size of the projects.

While most SMEs from the EU that invest multiple times either invest exclusively within the EU or outside of the EU, several EU SMEs also carry out investments both within and outside of the EU. Of these, around half make their first investment within the EU, while the other half undertake their first FDI project outside of the EU.

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<sup>4</sup> Standards guide the practice of all firms including SMEs and there are three European Standard Organisations. In the report "The future of European Standardisation", the European Parliament stresses that SMEs are not adequately involved in the standardisation system and therefore do not sufficiently exploit the benefits derived from standardisation. The Small Business Standards (SBS) is a European organisation with the goal of defending and representing SMEs in the standardisation process. In 2010, two of the European Standard Organisations released the guide "Guidance for writing standards taking into account micro, small and medium-sized enterprises (SMEs) needs", with the focus of keeping the needs of SMEs in mind when designing European standards. More than 1000 European standards are adopted annually. This increased the similarity of doing business across European countries, lowering the costs for SMEs of undertaking FDI projects, even if the potential is not yet fully realised.

In order for SMEs to undertake investments abroad, they need to be productive enough to overcome the fixed costs of setting up an affiliate in a different country and to compete successfully against incumbents in that market. One way in which SMEs can improve their productivity is through engaging with foreign investors in their home market. Foreign firms hold technical, operational and managerial knowledge that local firms can tap into and improve their productivity, via so-called *productivity spillovers*. We find that European firms of all sizes, on average, benefit from productivity spillovers arising from European inward FDI, but that SMEs and smaller firms do so especially. As European SMEs become more productive, they are also in a better position to undertake outward FDI. Inward FDI may thus help facilitate outward FDI by European SMEs and other firms.

### **More can be done to reduce the costs and obstacles to SMEs of FDI**

Many small companies in the EU struggle to internationalise their business and take advantage of the open trade framework in place. Only 25 per cent of EU-based SMEs export at all and an even smaller portion export beyond the EU. This study finds that even fewer SMEs succeed in investing across borders. The Commission already has in place a range of initiatives aimed to help European businesses face competition, access foreign markets and find new business partners abroad.<sup>5</sup> As a part of this study, we highlight policy initiatives which could support European SME FDI.

- **Improve the integration of SMEs with foreign firms.** The closer the collaboration between European SMEs and foreign firms, the larger the potential for productivity spillovers. Strengthening inter-firm collaboration could be done by e.g. strengthening the business network across regions.<sup>6</sup> This is particularly important in rural, non-metropolitan and less developed regions, and SMEs in these regions may also benefit from sharing experiences with SMEs that have been successful in investing abroad.
- **Bring down fixed costs of investing abroad.** Within the EU, increased standardisation of rules and regulation regarding FDI is a way to bring down fixed costs. Outside the EU, targeted support programmes like the “Step in Japan” by the EU-Japan Centre could be set-up in more selected countries to provide legal and accounting services and to help the SME finding qualified labour and local partners. Naturally, it should be ensured that the programmes do not displace private sector enterprises or violate state aid agreements.
- **Ease capital constraints.** SMEs are severely affected by capital constraints, particularly in times of economic crisis, which reduces their potential for engaging in FDI. Capital constraints for SMEs could, for example be eased by market-based financing as

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<sup>5</sup> See, for example, the descriptions of the European standardisation system and the access to markets information available at [https://ec.europa.eu/growth/smes/access-to-markets\\_en](https://ec.europa.eu/growth/smes/access-to-markets_en).

<sup>6</sup> The importance of inter-firm collaboration for SMEs was also highlighted in the 2014 *Study on Business Networks* from DG Grow at the European Commission. The study investigated emerging forms of inter-firm collaboration.



suggested by the OECD (2015). New lending to SMEs declined in nine out of 16 EU countries in 2016, cf. OECD (2018). However, the same report shows that the use of financing instruments other than bank debt generally increased<sup>7</sup> and that the operating environment for SMEs improved in 2016.

## **Suggestions for further research**

For the purpose of this analysis, we have constructed a unique database containing both M&A deals and greenfield projects for European SMEs. Multiple questions still remain, for which further research is needed. These include:

- A highly important extension to the current study is to analyse the connection between undertaking FDI projects and international trade by European SMEs. Do the SMEs first export and subsequently undertake FDI projects? If this is the case, do they undertake the FDI project in the same regions as they export to? Or do the SMEs in some cases need a physical presence in order to export to some countries? If this is the case, the fixed costs of undertaking FDI projects become fixed costs associated with exporting. A third way an SME can internationalise is through licensing.<sup>8</sup> How does this internationalisation channel relate to FDI and trade? Do SMEs use licensing as a first step of internationalisation to investigate if there is a market for their products?
- Do SMEs improve their economic performance following an FDI project? Do they increase their number of employees, revenue, profit, etc.? Further research into this could expand our knowledge of the SMEs' growth patterns using FDI as a means of expansion.
- What characterises recurrent SME investors? Is it possible to identify similarities across SMEs just before they undertake their first FDI projects? How do they differ from SMEs which will only make their first FDI investment after five years?
- What characterises regions that host many SME FDI investors? A case study could be carried out with the goal of identifying initiatives in the best performing regions that are transferable to other regions.
- What is the relationship between inward and outward FDI at a regional level? Can SMEs learn to undertake FDI from foreign firms in their home regions?
- How did the financial crisis affect the internationalisation of SMEs through FDI? This could be studied by constructing the FDI indicator for the years 2003-2010.

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<sup>7</sup> Other financing instruments include leasing and hire purchases.

<sup>8</sup> With licensing we refer to situations in which a firm licences its name to a person in another country. This person then has the responsibility of producing and selling the firm's goods or services in the other country.

## 2 Trends and patterns of SME FDI flows

In this chapter, we analyse the general trends and patterns of FDI projects undertaken by European SMEs. We do so by studying the evolution in the number and average value of FDI projects across time. In addition, we analyse the distributions of SME FDI projects across sector and types of FDI, and compare with the equivalent distributions of FDI projects by European firms of all sizes.

SMEs are highly important for the European economy for two main reasons. *First*, they constitute around 7 per cent of all firms in EU and account for 37 per cent of the total employment. This equals 1.6 million firms and more than 50 million employees.<sup>9</sup> Around 36 per cent of value added (more than EUR 2,500 bn.) in the EU in 2016 were accounted for by SMEs. *Second*, SMEs hold a growth potential in Europe – the growth in value added for European SMEs was 3.8 per cent in 2014 and 5.7 per cent in 2015, illustrating the importance of SMEs for European economic growth.<sup>10</sup> SMEs are the industry leaders and innovators of tomorrow and their significant growth rates are important numbers in a region plagued by relatively low growth prospects.

Consequently, a lot of attention and money are directed towards helping SMEs thrive. This is the case both on a European and a national level.<sup>11</sup> The support for SMEs covers inter alia reducing the costs and time required to start a company, reducing resource consuming regulation and increasing access to finance.<sup>12</sup>

### 2.1 How FDI can help SMEs grow

European SMEs can realise their growth potential in a range of ways. They might expand internally, increase exports or expand abroad. This report focuses on the latter growth channel, by identifying the patterns of expanding through FDI. The analysis covers both greenfield investments and mergers & acquisitions (M&As).

Investing abroad via either M&As or greenfield investments can help SMEs access new markets. SMEs can thus for example set up production in the US to serve the US market with lower costs of transportation, than required if they had to serve the market via exports from Europe. FDI can also help SMEs to increase their efficiency, or gain access to specific production factors, by locating their production in low-cost locations, or in locations where the

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<sup>9</sup> The numbers are estimates for 2016 and are taken from the *SBA Fact Sheet for the European Union*.

<sup>10</sup> Numbers are taken from *Annual report on European SMEs 2015/2016 – SME recovery continues*.

<sup>11</sup> The Small Business Act (SBA) is the main framework for EU policies regarding SMEs. Its main foci are promoting entrepreneurship, lessen the regulatory burdens and increase the access to finance and to foreign markets and internationalisation.

<sup>12</sup> An example of a directive targeted at protecting particularly European SMEs is the Late Payment Directive which was implemented into national law by 2013. The objective is to protect SMEs against late payments and thereby improve their competitiveness. Close to 80 per cent of European enterprises had encountered late payments within the previous three years, and it is expected that SMEs are overrepresented in this figure, European Commission (2015).

required production factors are easily available. This is both the case for European SMEs constructing or purchasing a factory in a low wage country to increase their cost competitiveness or an SME setting up or purchasing an R&D department in a region with relative abundance of skilled personnel. FDI may also help SMEs access and grow through new technology. This is most likely to occur via M&As, as SMEs can benefit from the acquisition of other enterprises through the purchase of essential technological advancements.

In order for the European SMEs to realise their growth potential, it is important to understand their behaviour as foreign direct investors.

## **2.2 SME FDI flows across time**

The analysis of the SME FDI flows covers the period 2003-2015 and thus includes both the overheated pre-crisis years, the financial crisis and the following recovery period. During these shifting times, the most significant problems for SMEs have changed. In 2011, 15 per cent of SMEs in the EU reported that credit constraints were the most important problem for their enterprise.<sup>13</sup> By 2016 this had fallen to 9 per cent, although there are large differences across countries. In Greece and Cyprus, 24 per cent of SMEs report access to finance to be the most pressing issue.

The analysis is based on a unique database covering FDI projects by European SMEs over the period 2003-2015, which has been especially constructed for this analysis.<sup>14</sup> The database covers both M&A deals and greenfield projects. In order to identify which projects were undertaken by SMEs, this information has been matched with firm-level information on the investing companies.

In the beginning of the sample period, European SMEs undertook relatively few investments, but the average deal size was relatively large, cf. Figure 1. In the pre-crisis years and during the financial crisis the number of FDI projects has been increasing (except from 2008 to 2009) and the projects have become smaller in terms of average deal size.<sup>15</sup> This could indicate that the barriers to direct investments abroad are being broken down. When an enterprise invests abroad it is associated with fixed costs of undertaking the investment. These costs include both the monetary and time costs associated with undertaking the investment, as well as the risk associated with the project, which needs to be covered by the return on it. The higher the risk associated with a given investment, the higher the costs. This implies that the costs of undertaking an FDI project are higher, the higher the uncertainty of the foreign relationship and the more complicated the bureaucracy surrounding the regulation. The latter increases the costs of undertaking an FDI project by increasing the time and money required in preparation

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<sup>13</sup> This is taken from the survey information provided in European Commission (2016).

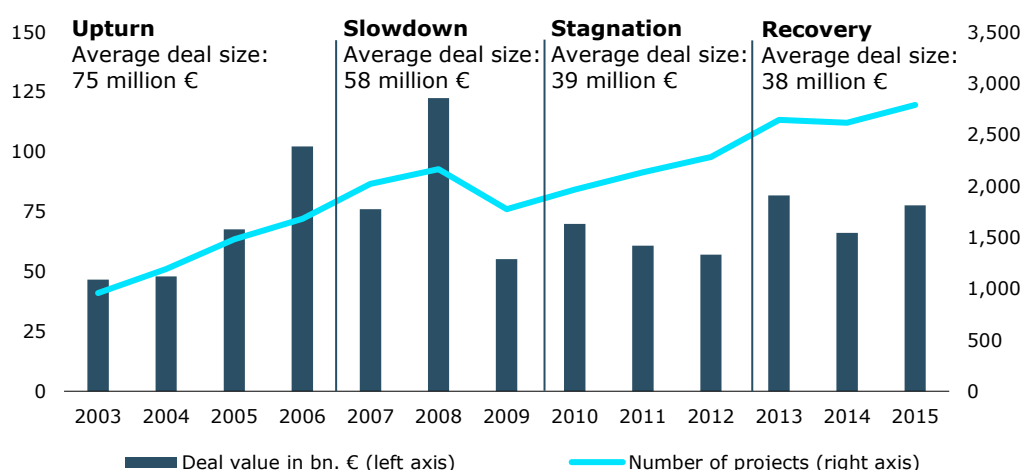
<sup>14</sup> Additional details on the construction of the database can be found in the scientific report, *Collection of FDI by European SMEs*.

<sup>15</sup> We have no reason to expect that this trend could be due to an underlying data issue, e.g. that the coverage of SME investments has improved over time.

of the investment. The initial costs of undertaking an FDI project are fixed as it is a one-time cost incurred by the SME to assess its possibilities and understand the regulation surrounding the planned FDI project. Hence, independently of the size of the project, the firm has to spend time understanding the rules and regulations and on assessing the risks and benefits of the project.

The larger the fixed costs of undertaking the FDI project, the larger the projects must be in order to generate a profit. Therefore, the decrease in the average deal size of the projects across time can be seen as an indication that the fixed costs are decreasing, allowing smaller projects to be profitable. During this period Europe was severely affected by the financial crisis, which may also have reduced the size of the projects, due to higher risks and limited access to finance for SMEs in many European countries. The severe impact of the crisis on the European market, may also have pushed some SMEs to look for better market opportunities outside of their home market, and may thus have been a push factor for smaller FDI projects.

**Figure 1 European SME FDI flows by number and value, 2003-2015**



Note: The figure depicts the aggregate SME FDI flows from Europe in number of projects and values across the period 2003-2015 towards both European and non-European destinations.

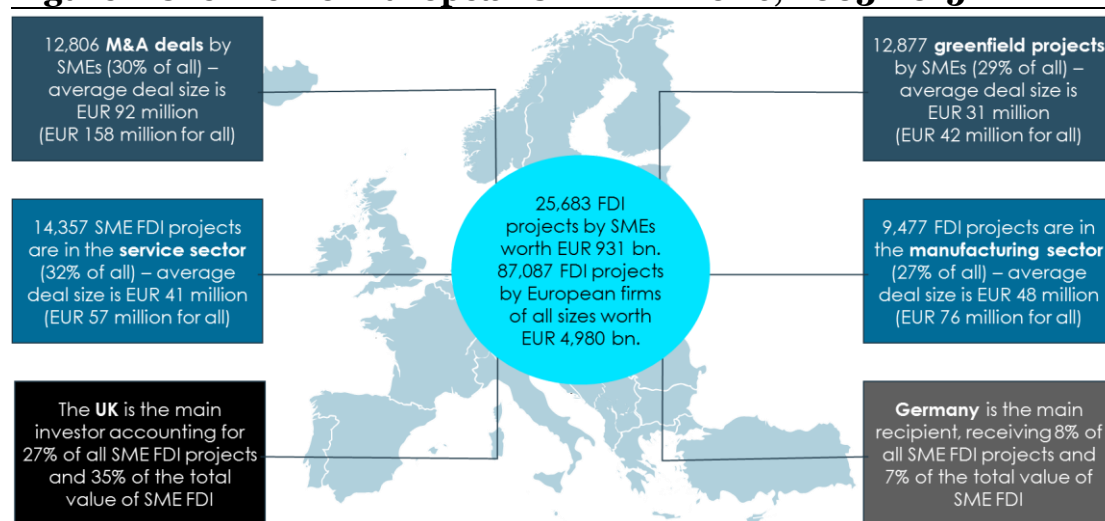
Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

Following the crisis, the aggregate deal value rose to a higher level in the recovery period from 2013-2015 compared to the previous four years. However, as the number of projects also increased rapidly, the average deal size fell slightly compared to previously.

### 2.3 Characteristics of European SME FDI

In total, there were 25,683 FDI projects undertaken by European SMEs over the period 2003-2015. This is close to 30 per cent of the total 87,087 FDI projects by European enterprises in the same period, cf. Figure 2. The total deal value of the SME FDI is more than 900 bn. EUR, which is around 19 per cent of the total value. From these figures it is apparent that SMEs are highly important for the aggregate FDI patterns, highlighting the relevance of analysing the FDI patterns of these firms.

**Figure 2 Overview of European SME FDI flows, 2003-2015**



Note: The average deal sizes are calculated using only the projects with a reported deal value. Each investment is classified as either services, manufacturing or other, where other includes i.a. agriculture, mining, quarrying and construction.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

We categorise every investment according to its sector and type. We find that 12,806 projects by European SMEs are M&A deals, while the remaining 12,877 are greenfield projects. For both types of FDI projects, this is close to 30 per cent of the total number of FDI projects undertaken by all European enterprises. Hence, SMEs are not over or underrepresented in either of the two FDI types relative to all firms. The M&A deals are on average larger than greenfield projects, with an average deal size of EUR 92 million for M&A deals compared to an average project size of EUR 31 million for greenfield investments. This is lower than the corresponding figures for all firms, where the average deal sizes are EUR 158 million and EUR 42 million for M&A deals and greenfield projects, respectively.

The United Kingdom dominates as the source country for SME FDI, cf. Figure 2. UK SMEs account for 27 per cent of the number of all the projects by European SMEs and 35 per cent of the total value of these projects. This approximately corresponds to the combined value of FDI projects by SMEs from France, Belgium, the Netherlands, Germany and Scandinavia and highlights the significance of the United Kingdom as the origin of European FDI by SMEs. The main destination is Germany which receives 8 per cent of the total number of European SME FDI projects.<sup>16</sup>

<sup>16</sup> In the comparison of shares of projects and values of the origin and destination countries, recall that the origin countries only include the European countries, while the destination countries include the entire world.

There is a larger share of SME FDI projects in the service sector than in manufacturing. In the period 2003-2015, 14,357 FDI projects undertaken by SMEs were in the service sector and 9,477 in the manufacturing sector. Relative to all European FDI projects undertaken in that period, SMEs thus account for 32 per cent of all service sector FDI projects and 27 per cent of all manufacturing sector FDI projects, cf. Table 1. SME FDI projects in the manufacturing sector (average deal size of EUR 48 million) are slightly larger than those in the service sector (average deal size of EUR 41 million). The same pattern, however, exists for all firms, where the average deal size in the manufacturing sector is EUR 76 million and EUR 57 million in the service sector.

One of the reasons, why SMEs account for a relatively larger share of FDI projects in the service sector, than in the manufacturing sector, may be that the service sector is generally less capital intensive than the manufacturing sector. This reduces the costs and makes it easier for smaller firms to undertake FDI projects in this sector. This is consistent with micro firms also accounting for a relatively larger share of service projects than manufacturing projects, while the opposite is true for large firms.<sup>17</sup>

In addition, the average deal size increases in firm size, implying that larger firms undertake larger FDI projects, cf. the last column of Table 1. The average deal size for an FDI project undertaken by an SME is EUR 50 million while the corresponding number for large firms is more than twice the size.<sup>18</sup>

**Table 1 Number and average deal size across firm sizes, 2003-2015**

	Share of all firms	Share of all FDI projects	Share of FDI projects across sectors			Average deal size (in EUR million)
			Services	Manufacturing	Other	
Micro	93%	26%	29%	21%	25%	45
SME	6%	29%	32%	27%	27%	50
Large	1%	45%	39%	52%	49%	121

Note: The shares of all firms reported in column one are taken from the Small Business Act (SBA) Fact Sheets and cover the EU. Each investment is classified as either services, manufacturing or other, where other includes i.a. agriculture, mining, quarrying and construction.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

<sup>17</sup> An additional explanation may be that there is a higher share of SMEs in the service sector (53 per cent) compared to large firms (47 per cent) (own calculations based on data from Eurostat for 2014).

<sup>18</sup> The average deal size of EUR 45 million for micro enterprises seems relatively high. In the construction of the dataset, we used the consolidated data at the firm level to identify firm sizes. This reduces the risk that subsidiary companies in the dataset are treated as part of a larger group instead of being recorded as micro enterprises. As consolidated data are not always available, this risk is not fully eliminated. Also, small holding companies that are not part of a larger group are recorded as micro enterprises, which may increase the average deal size. This concern is largest for micro enterprises where data is most limited.

## **2.4 Concluding remarks**

In this chapter we showed that the number of SME FDI projects has been increasing every year from 2003 to 2015 (except for the years 2008 to 2009). The aggregate deal value, on the other hand, has not reached the pre-crisis level. Hence, the average deal value has decreased across time. This indicates that the barriers to undertake FDI projects have been lowered during the period 2003-2015, allowing smaller projects to be carried out. Further, we showed that SMEs are slightly overrepresented in FDI projects in the service sector.

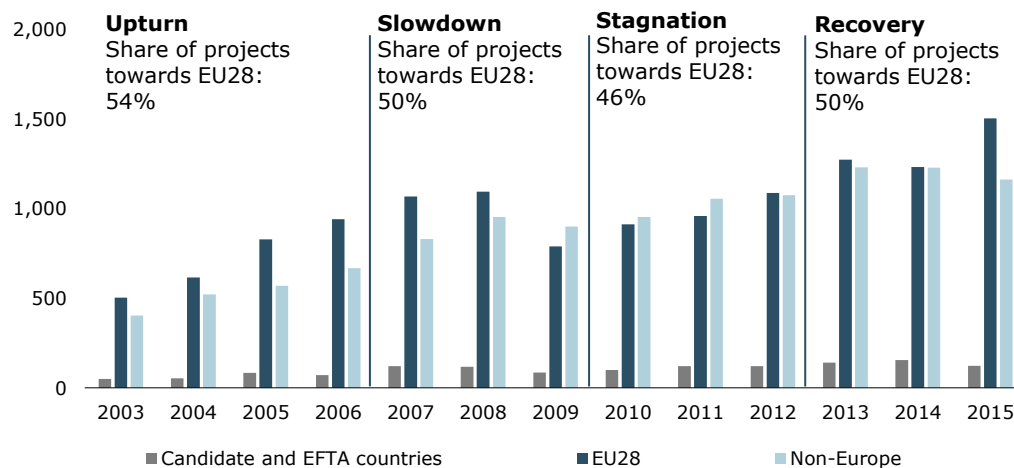
### 3 Destination of SME FDI flows

In this chapter, we analyse the destination of SME FDI. We do this across multiple dimensions. *First*, we investigate the change in destinations across time. *Second*, we analyse the destination of European SME FDI flows across Europe. *Finally*, we conduct the same analysis on world regions.

The destination of FDI is an important dimension in analysing the patterns of SME FDI initiatives. The destination patterns of SME FDI may indicate where investment barriers are high and where they are low, and the choice of destination may therefore reveal information about the latent barriers that SMEs face when undertaking FDI projects. This section analyses where investments are made and the differences arising due to the type of FDI.

The EU is the destination for around half of the SME FDI projects during the period 2003-2015, cf. Figure 3. Following the financial crisis, in a period of stagnation from 2010 to 2012, the relative importance of the EU as the destination of FDI by European SMEs fell from 50 per cent to 46 per cent. This highlights the negative effects of first the financial crisis and afterwards the European debt crisis on the European economies. Greece, for example, was the destination for 26 projects in both the period 2003-2008 and 2009-2015, however, the average deal size of the projects fell significantly from EUR 63 million to EUR 37 million. The crisis not only affected the SMEs in Greece and their ability to undertake FDI projects abroad, but also the size of the projects invested in Greece by SMEs from other European countries.

**Figure 3 Number of European SME FDI projects by destination, 2003-2015**



Note: The figure shows the number of M&A deals and greenfield projects undertaken by European SMEs across three broad destination categories.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases



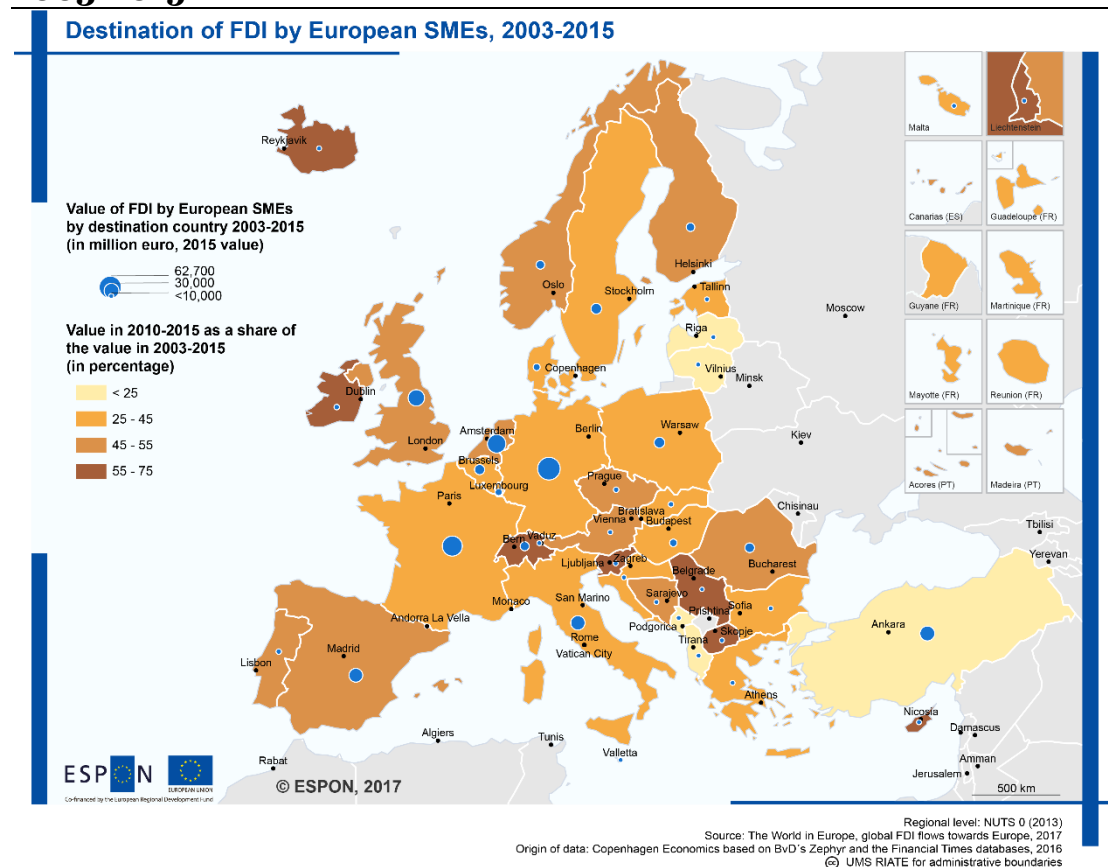
In the most recent years, the share of projects undertaken within the EU has increased again. Particularly, the last year indicates that the incentives to invest within the EU have improved, with the largest number of SME FDI projects during the whole period taking place within the EU.

### 3.1 Destination of SME FDI flows across European countries

European countries were the destination for the majority of the SME FDI projects undertaken in the period 2003-2015, cf. Figure 3.

Germany is the most important destination in Europe, receiving SME FDI projects worth more than EUR 60 bn. in the period 2003-2015, cf. Map 1. Following Germany are France (EUR 51 bn.), the Netherlands (EUR 43 billion) and the United Kingdom (EUR 35 billion). This implies that SMEs are investing slightly differently from European enterprises in general, as the United Kingdom is the main destination for intra-European FDI in general.<sup>19</sup>

**Map 1 Destination of European SME FDI flows across Europe, 2003-2015**



Note: The FDI values cover both greenfield investment and M&As. Not all M&As listed in the database have a deal value recorded. Of the 12,806 M&A deals recorded, 5,737 have a deal value and are included in this figure.

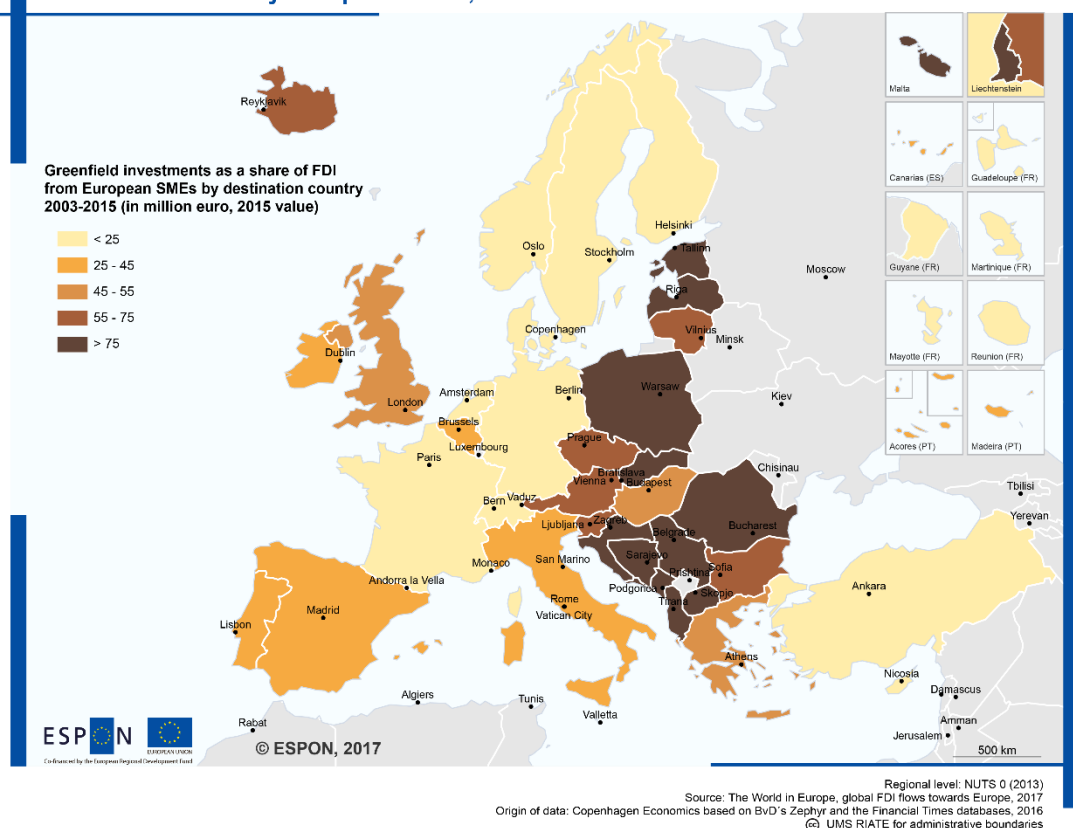
Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

<sup>19</sup> See the main report, *Intra-European FDI*, for more information on intra-European FDI.

The European countries differ substantially in the type of FDI they receive from European SMEs, cf. Map 2. There is a clear tendency for FDI projects undertaken in the new Member States and the candidate countries to be greenfield projects, whereas the old Member States and the EFTA countries receive a larger fraction of M&A deals. For example, 88 per cent of the value of SME FDI towards Poland are greenfield projects, whereas the corresponding number is 19 per cent for Switzerland. This follows the pattern from both the extra- and intra-European analyses, and it appears that SMEs are not different from other investors in this respect.

## Map 2 Destination of SME greenfield projects, 2003-2015

### Destination of FDI by European SMEs, 2003-2015: Greenfield investments



Note: The FDI values cover both greenfield investment and M&As. Not all M&As listed in the database have a deal value recorded. Of the 12,806 M&A deals recorded, 5,737 have a deal value and are included in this figure.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

### 3.2 Destination of SME FDI across world regions

We now analyse the destination of European SMEs globally and compare with the investment patterns of all firms. The EU is the single largest destination for FDI by European SMEs accounting for 50 per cent of the projects and 39 per cent of the deal value, cf. Table 2. Other large destinations are North America (14 per cent of the projects), China and Hong Kong (5 per cent of the projects) and Southeast Asia (4 per cent of the projects).

The deal size varies substantially across the various regions. The average deal size is generally lower for regions which are closer to Europe, either geographically or culturally. This indicates that there are lower fixed costs associated with investing in these countries, allowing smaller projects to be profitable. Asia is an exception, with the average deal size of projects in China and Hong Kong, India and Southeast Asia being lower than the average for projects in the EU. This can potentially be explained by systematic differences in the types of FDI across countries, where the Asian countries are predominantly the destination of greenfield projects and e.g. the US is the destination for a large share of M&A deals.

**Table 2 Destination of SME FDI across world regions, 2003-2015**

Destination region	Share of total deal value by SMEs	Share of total number of projects by SMEs	Average deal size by SMEs (in EUR million)
<b>Europe</b>	<b>46%</b>	<b>56%</b>	<b>47</b>
EU28	39%	50%	45
Candidate and EFTA countries	6%	5%	65
Europe (not elsewhere included)	1%	1%	43
<b>The Americas</b>	<b>28%</b>	<b>19%</b>	<b>68</b>
North America	19%	14%	62
Latin America (excl. Brazil and Mexico)	4%	2%	93
Brazil	3%	2%	83
Mexico	1%	1%	63
<b>Asia</b>	<b>17%</b>	<b>17%</b>	<b>42</b>
China and Hong Kong	5%	5%	38
Southeast Asia	4%	4%	39
Russia	3%	3%	52
India	2%	3%	34
Japan	2%	1%	56
Asia (not elsewhere included)	1%	1%	45
South Korea	1%	1%	60
<b>Other</b>	<b>8%</b>	<b>8%</b>	<b>44</b>
Africa	4%	3%	61
Middle East	3%	3%	40
Australia, New Zealand and Oceania	2%	3%	29

Note: The table shows the share of total FDI projects by European SMEs towards a given region. The last column shows the average deal size by SMEs across the world destination regions.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

Comparing the global investment patterns of SMEs to those of all firm sizes, the first thing to note is that the average deal sizes across almost all regions are larger for all firms than for SMEs, cf. Table 3.<sup>20</sup>

<sup>20</sup> All firms include both SMEs, micro and large enterprises. The inclusion of micro enterprises explains why the average deal size for South Korea is higher for SMEs than for all firms.

The distribution of both the deal value and the number of projects are similar for SMEs and all firms, when comparing columns 2 and 3 of Table 2 and Table 3. This implies that SMEs do not differ substantially from other firms regarding the destination of their FDI projects across broadly defined world regions.

**Table 3 Destination of total FDI across world regions, 2003-2015**

Destination region	Share of total deal value by all firms	Share of total number of projects by all firms	Average deal size by all firms (in EUR million)
<b>Europe</b>	<b>44%</b>	<b>53%</b>	<b>72</b>
EU28	39%	46%	73
Candidate and EFTA countries	4%	5%	72
Europe (not elsewhere included)	1%	1%	51
<b>The Americas</b>	<b>31%</b>	<b>20%</b>	<b>116</b>
North America	22%	14%	121
Latin America (excl. Brazil and Mexico)	5%	3%	120
Brazil	3%	2%	99
Mexico	1%	1%	83
<b>Asia</b>	<b>17%</b>	<b>19%</b>	<b>60</b>
China and Hong Kong	5%	6%	54
Russia	5%	3%	112
India	3%	3%	52
Southeast Asia	2%	4%	41
Japan	1%	1%	58
Asia (not elsewhere included)	1%	1%	54
South Korea	1%	1%	58
<b>Other</b>	<b>8%</b>	<b>9%</b>	<b>65</b>
Africa	4%	4%	90
Middle East	2%	3%	52
Australia, New Zealand and Oceania	1%	2%	44

Note: The table shows the share of total FDI projects by European firms of all sizes towards a given region. The last column shows the average deal size by these firms across the world destination regions.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

### 3.3 Concluding remarks

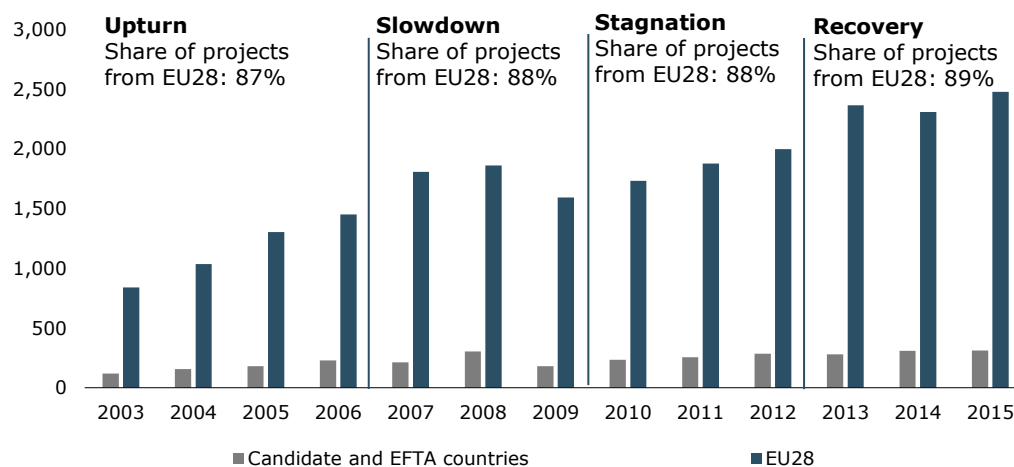
In this chapter, we showed that Europe and particularly the EU is the most important destination of European SME FDI. The EU was the destination for 50 per cent of the projects undertaken during the period 2003-2015. Within Europe, Germany was the main destination, accounting for SME FDI worth EUR 60 billion. Furthermore, the largest destination regions of European SME FDI outside Europe were North America (14 per cent of the projects undertaken by European SMEs) and China and Hong Kong (5 per cent).

## 4 Origin of SME FDI flows

In this chapter, we analyse the detailed patterns of origin countries and regions of European SME FDI. We do this by first analysing the patterns across time, before investigating the origins at a country level. In addition, we analyse the origin of European SME FDI at the NUTS3 level. All NUTS3 regions are classified into various groups, which allows us to study the distribution of SME FDI across territorial groups of regions.

The share of European SME FDI projects that originates from the EU is constant across the period 2003-2015 at close to 90 per cent, cf. Figure 4. This implies that the evolution in number of SME FDI projects across time are almost identical for projects undertaken by EU SMEs on one hand and those undertaken by SMEs from the candidate and EFTA countries on the other. In addition, the figure highlights the importance of the EU countries as origin countries for SME FDI, whereas the candidate and EFTA countries only constitute a relatively small fraction of the total number of FDI projects.

**Figure 4 Number of European SME FDI projects by origin, 2003-2015**



Note: The figure shows the number of M&A deals and greenfield projects undertaken by European SMEs. The numbers in the four periods report the share of the projects which are undertaken by a firm in EU28.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

Comparing four separate origin regions within Europe to their respective economic size implies that the old Member States and the EFTA countries are overrepresented, cf. Table 4. The old Member States (or EU15) account for 78 per cent of European GDP, but for 84 per cent of the value of SME FDI outflows and 89 per cent of the number of SME FDI projects. The EFTA countries account for 4 per cent of European GDP, but for 12 per cent of the total value of SME FDI flows.

In contrast, the new Member States (or EU13) and the candidate countries in combination account for 19 per cent of European GDP, but are only the origin countries of 2 per cent of the number of SME FDI projects and 5 per cent of the value of SME FDI outflows.

**Table 4 GDP and SME FDI by country of origin, 2003-2015**

	Share of European GDP	Share of SME FDI outflows by value	Share of SME FDI outflows by number of projects
EU15 (old member states)	77.6%	83,7%	88,6%
EU13 (new member states)	11.5%	4,4%	1,6%
Candidate countries	7.1%	0,1%	0,1%
Non-EU (EFTA) countries	3.8%	11,7%	9,7%

Note: The EU15 comprises the following 15 countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the UK. The EU13 includes Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia. The candidate countries are Albania, the former Yugoslav Republic of Macedonia (FYRoM), Montenegro, Serbia and Turkey. The non-EU countries include Iceland, Liechtenstein, Norway and Switzerland.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

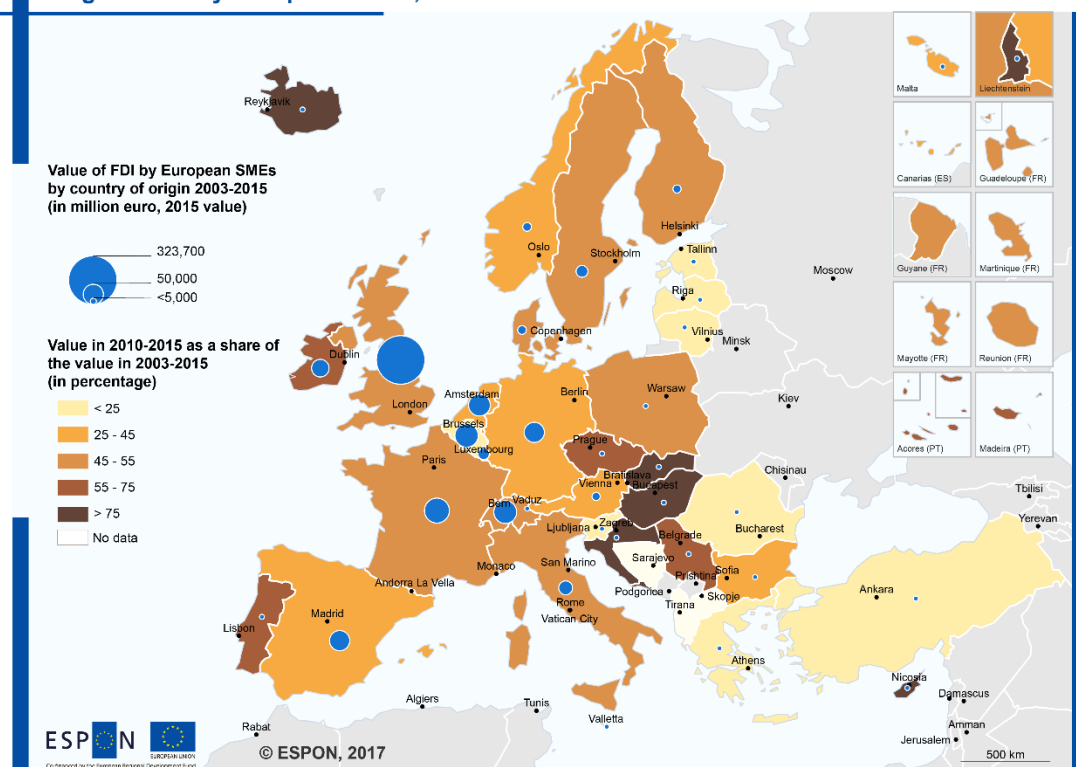
The fact that the EU13 account for a much smaller share of the number of projects than the share of the value of FDI outflows, implies that the average projects from these countries are larger than projects from elsewhere in Europe. This indicates that there are larger fixed costs associated with undertaking an FDI project for SMEs in these countries than for SMEs in the EU15, since only larger projects appear to be viable.

#### 4.1 Origin of SME FDI flows across European countries

The United Kingdom is by far the dominating country of origin of SME FDI, cf. Map 3. The United Kingdom accounts for 35 per cent of the total value of SME FDI, worth more than EUR 320 bn. The second largest source country is France, which accounts for 9 per cent of total SME FDI (around 87 bn. EUR). Approximately 50 per cent of the SME FDI originating from both the UK and France has taken place before 2010, while the other half has been undertaken in 2010 and after. This pattern holds for the majority of large origin countries, with the exceptions of Belgium and the Netherlands, where 85 and 72 per cent of the SME FDI have taken place before 2010, respectively. Both these countries have thus become less important as origin countries of SME FDI in the second half of the analysed period. Other countries have experienced an increase in their SME FDI across time. 65 per cent of Irish SME FDI thus took place in 2010 or after. The same is the case for the Czech Republic (58 per cent), Iceland (75 per cent), Portugal (62 per cent), Cyprus (83 per cent) and a few additional countries predominantly from the EU13.

## Map 3 Origin of European SME FDI flows, 2003-2015

### Origin of FDI by European SMEs, 2003-2015



Note: The FDI values cover both greenfield investment and M&As. Not all M&As listed in the database have a deal value recorded. Of the 12,806 M&A deals recorded, 5,737 have a deal value and are included in this figure.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

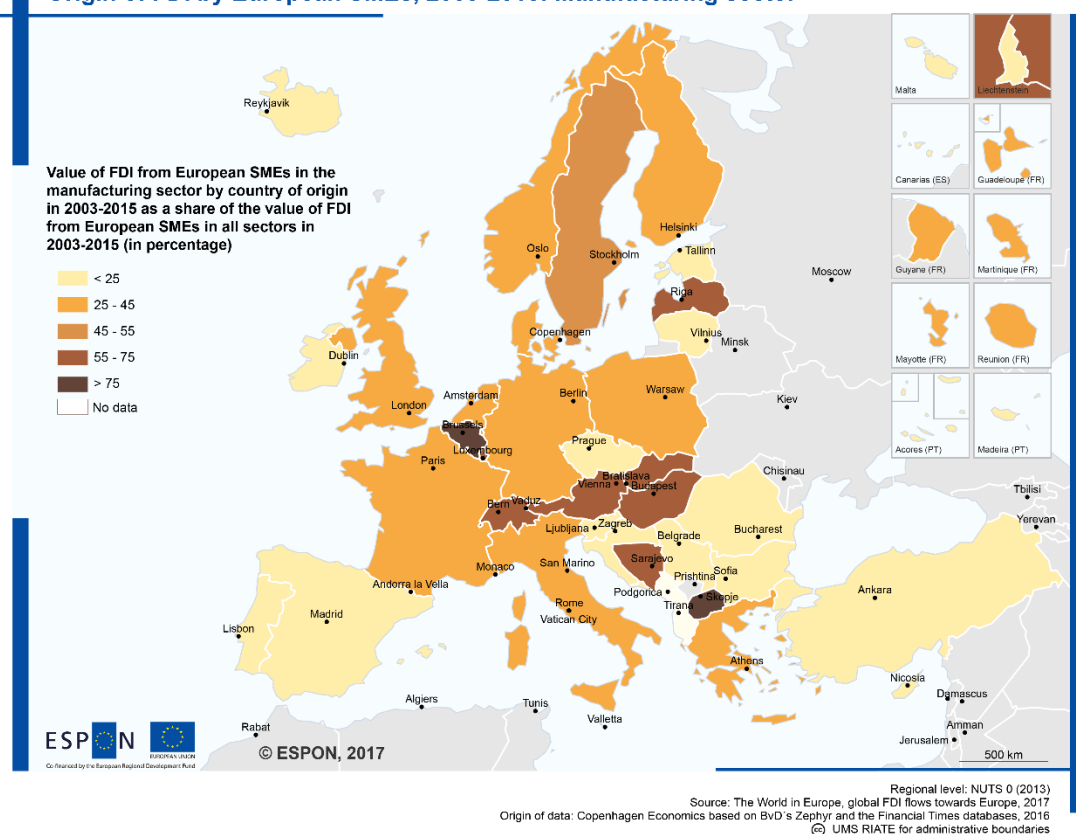
SMEs in the old Member States undertake a relatively large share of projects within the manufacturing sector, while SMEs from the new Member States primarily undertake FDI projects in the service sector, cf. Map 4.<sup>21</sup> In the main report *Intra-European FDI*, it was found that the share of FDI *inflows* in the manufacturing sector generally was higher for projects undertaken in the new Member States. Combining the findings on inward and outward FDI in the manufacturing sector indicates that there are large net flows of SME FDI in the manufacturing sector from the old to the new Member States.

There is likely to be a tendency for SME FDI to be concentrated in regions and sectors where firms of all sizes carry out many investments. Such synergies and interrelations could be explored further.

<sup>21</sup> The map shows diversions from this pattern. For example, more than 50 per cent of the value of SME FDI from the two new Member States Slovakia and Hungary are in the manufacturing sector. Conversely, for the old Member States Spain, Portugal and Ireland, the value of SME FDI in the manufacturing sector accounts for less than 25 per cent.

## Map 4 Share of SME FDI in the manufacturing sector, 2003-2015

### Origin of FDI by European SMEs, 2003-2015: Manufacturing sector



Note: The sector classification follows Table 4 in the scientific report, *Trends and patterns in extra-European FDI inflows towards Europe*

Source: ESPON FDI (2018) based on data from BvD's Zephyr and FT databases

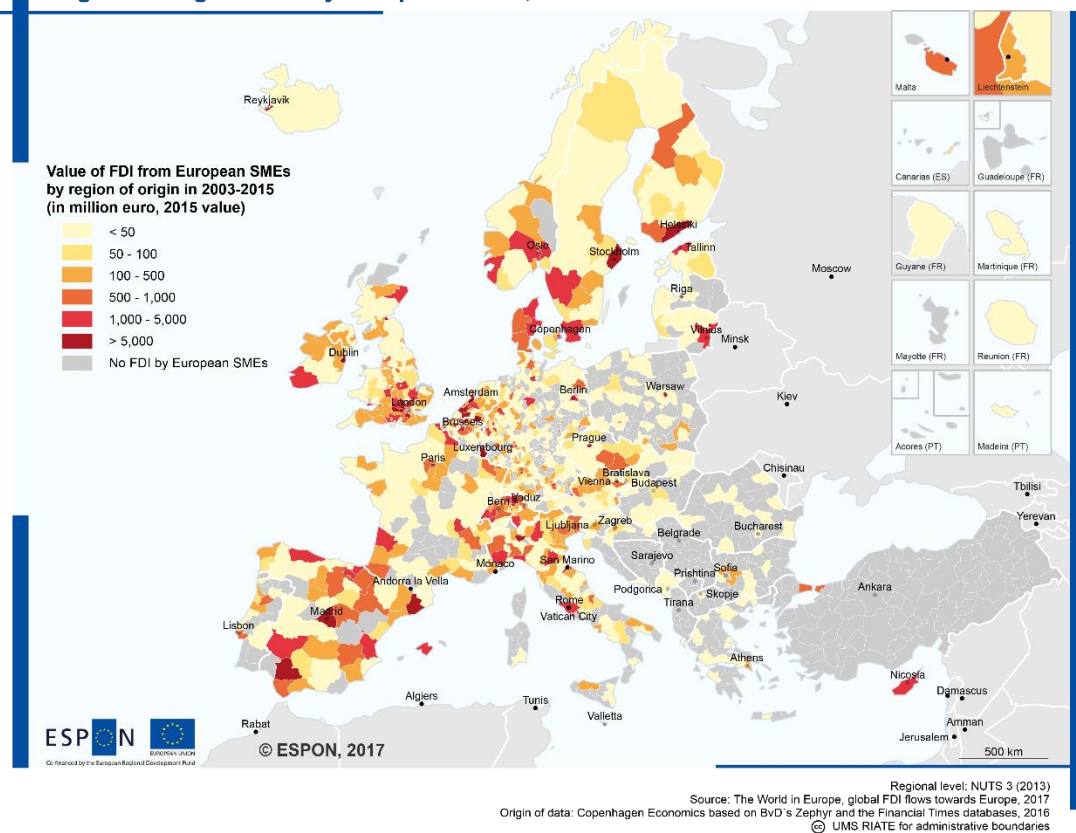
## 4.2 Origin of SME FDI flows across European regions

“Westminster” in London is the largest NUTS 3 origin region for FDI by European SMEs and account for 1,742 FDI projects worth close to EUR 150 bn., cf. Map 5. Another London region (“Camden and City of London”) is also among the top five largest origin regions, accounting for EUR 50 bn. of SME FDI. The remaining regions in top five include “Arr. de Bruxelles-Capitale” with EUR 68 bn., “Paris” with EUR 47 bn. and “Madrid” with EUR 26 bn.



## Map 5 Origin of European SME FDI flows across regions, 2003-2015

Region of origin of FDI by European SMEs, 2003-2015



Note: The FDI values cover both greenfield investment and M&As. Not all M&As listed in the database have a deal value recorded. Of the 12,806 M&A deals recorded, 5,737 have a deal value and are included in this figure. In addition, 388 projects have not been associated with a NUTS3 code. These are excluded from this figure.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

### 4.3 Origin of SME FDI flows across territorial groups of regions

In order to detect patterns in the origin of SME FDI flows across territorial groups of regions in Europe, we classify all regions into groups based on three different groupings. *First*, we use the Eurostat typology to identify rural, intermediate and urban regions. *Second*, we use the Eurostat typology to identify capital metropolitan and other metropolitan regions, and we classify the remaining regions as non-metropolitan regions. *Third*, we classify the regions according to their level of development as follows: Less developed regions have a GDP per capita lower than 75 per cent of the EU28 average, transition regions have a GDP per capita between 75 per cent and 80 per cent of the EU28 average, and more developed regions have a GDP per capita above 90 per cent of the EU28 average.<sup>22</sup>

<sup>22</sup> More details of these classifications can be found in the scientific report, *Impacts of extra-European FDI towards Europe*.

The top-five NUTS3 regions in terms of origin of SME FDI are all capital cities, which shows the importance of SMEs in capital regions in terms of undertaking SME FDI projects. This dimension is investigated further in Table 5, from which it follows that even though capital regions only make up 23 per cent of European GDP, they are the origin regions for 50 per cent of the SME FDI projects and account for 63 per cent of the total value of SME FDI projects. Other metropolitan regions make up 44 per cent of European GDP, but account for only 28 per cent of the FDI projects by European SMEs and 22 per cent of the value. This implies that non-metropolitan regions account for the remaining 22 per cent of the projects and 15 per cent of the value even though 33 per cent of European GDP is generated in these regions. Capital regions are thus highly important as the origin regions of SME FDI, which could be due to the high degree of internationalisation of these regions.

The domination of capital city regions as origins of SME FDI, further translates into urban and more developed regions being overrepresented as origin regions relative to their GDP, cf. Table 5. Comparing these findings to those in the main report *Intra-European FDI* it follows that capital, urban and more developed regions are even more overrepresented as origins than as destinations for intra-European investments. As destinations, capital city metropolitan regions accounted for 42 per cent of intra-European FDI projects (50 per cent of the value), which is lower than the share of SME FDI these regions account for as origin regions.

In addition, SMEs located in rural, non-metropolitan and less developed regions might be negatively affected to a larger degree by the tightened credit constraints following the financial and debt crises. Greece is an example of how the crisis and the binding credit constraint have limited SMEs' possibility of investing abroad. In the pre-crisis period 2003-2008, Greek SMEs undertook 94 FDI projects at an average deal size of EUR 16 million, compared to only 30 FDI projects in the period 2009-2015. In addition to the significant reduction in the number of projects, the average deal size more than halved in the latter period to EUR 7 million.

**Table 5 Origin of SME FDI across territorial groups of regions, 2003-2015**

	Share of European GDP 2003-2014	Share of SME FDI flows by value, 2003-2015	Share of SME FDI flows by number of projects, 2003-2015
Urban regions	54.6%	78.5%	67.5%
Intermediate regions	32.7%	17.1%	25.9%
Rural regions	12.6%	4.4%	6.6%
Capital city metropolitan regions	22.6%	63.1%	50.1%
Other metropolitan regions	44.2%	21.7%	27.6%
Non-metropolitan regions	33.2%	15.1%	22.2%
More developed regions	73.1%	94.4%	90.7%
Transition regions	14.5%	4.3%	6.1%
Less developed regions	12.4%	1.3%	3.2%
Regions next to capital city regions	8.6%	4.0%	8.2%
Regions along national land borders	18.0%	15.8%	20.7%
Other regions	73.4%	80.2%	71.1%

Note: The figures on share of European GDP do not include Iceland, Liechtenstein and Switzerland.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

M&A deals accounted for close to 50 per cent of the total number of FDI projects by European SMEs during 2003-2015. M&A deals are, to a larger extent than greenfield projects, undertaken by SMEs in more developed, urban and capital regions, cf. Table 6. For example, 60 per cent of M&A deals originate from capital city metropolitan regions, while the corresponding number is 41 per cent for greenfield projects.

SMEs from capital city regions also account for the largest share of FDI projects in the service sector (59 per cent), but a relatively small share of FDI projects in manufacturing (36 per cent). The number of manufacturing FDI projects by European SMEs are in fact distributed almost equally across the three metropolitan regional types. Likewise, the origin of SME FDI in the manufacturing sector is less biased towards urban and more developed regions than the number of projects in the service sector, cf. Table 6.

**Table 6 Distribution of the number of SME FDI projects across types, sectors and territorial groups of origin regions, 2003-2015**

Share of:	Total FDI	Type of FDI		Sector		
		M&As	Greenfield	Services	Manuf.	Other
Urban regions	67.5%	71.7%	63.8%	74.6%	57.2%	72.4%
Intermediate regions	25.9%	22.9%	28.5%	21.3%	33.1%	19.1%
Rural regions	6.6%	5.4%	7.7%	4.1%	9.7%	8.5%
Capital city metropolitan regions	50.1%	59.9%	40.6%	58.5%	36.0%	57.8%
Other metropolitan regions	27.6%	22.3%	32.9%	25.0%	32.6%	22.8%
Non-metropolitan regions	22.2%	17.9%	26.5%	16.5%	31.4%	19.4%
More developed regions	90.7%	92.7%	88.7%	93.2%	87.1%	89.6%
Transition regions	6.1%	4.4%	7.8%	4.5%	8.5%	6.8%
Less developed regions	3.2%	2.9%	3.4%	2.3%	4.4%	3.6%
Regions next to capital city regions	8.2%	7.7%	8.7%	6.9%	10.7%	5.4%
Regions along national land borders	20.7%	20.0%	21.3%	17.7%	26.4%	14.4%
Other regions	71.1%	72.3%	70.0%	75.4%	62.9%	80.2%

Note: Each investment is classified as either services, manufacturing or other, where other includes i.a. agriculture, mining, quarrying and construction.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

#### 4.4 Concluding remarks

In this chapter, we showed that the United Kingdom was the main origin of European SME FDI, accounting for projects worth EUR 320 bn. When analysing the sectoral split of SME FDI, we showed that the old Member States undertook a relatively large share of projects within the manufacturing sector. Further, on a NUTS3 regional level, we found that capital city metropolitan regions are the most important as origin regions, with London, Brussels, Paris and Madrid being the most important NUTS3 origin regions. The importance of capital city metropolitan regions was particularly pronounced for M&A deals and within the service sector.

## 5 The internationalisation patterns of European SMEs

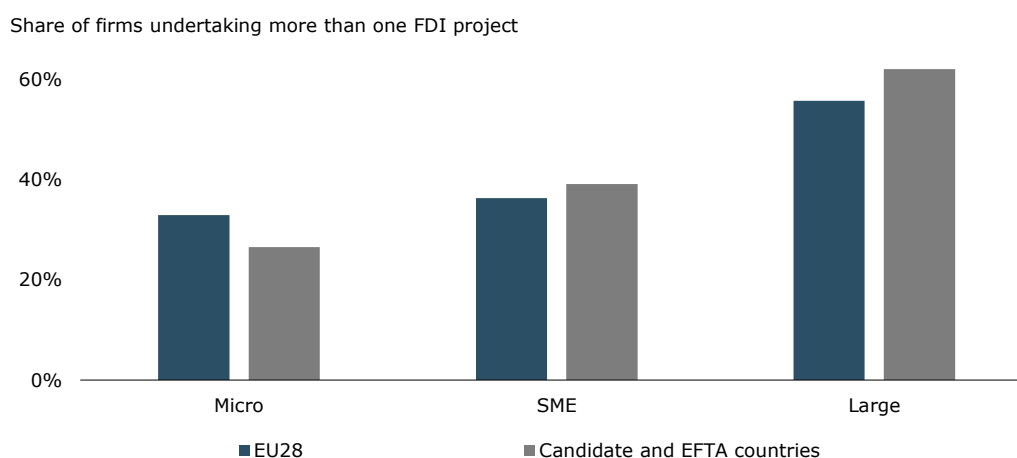
In this chapter, we analyse the internationalisation patterns of European SMEs. We do this by studying the changes in destination and average deal size across investments by recurrent SME investors, i.e. SMEs undertaking multiple FDI projects. Further, we analyse whether the SMEs use FDI projects within the Single Market as a stepping stone to investing abroad. We identify each unique SME investor, track their FDI projects and analyse the destination patterns of these across time.

Around 40 per cent of the SME investors undertake multiple FDI projects, cf. Figure 5. The figure shows that the larger a firm is, the more likely it is to undertake multiple FDI projects. One third of micro enterprise investors in the EU undertake several FDI projects. The same is true for 36 per cent and 56 per cent of SME and large enterprise investors in the EU, respectively. The pattern is the same for investors in the candidate and EFTA countries, albeit it is slightly more pronounced in these countries.

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**Figure 5 Share of European firms undertaking multiple FDI projects, 2003-2015**

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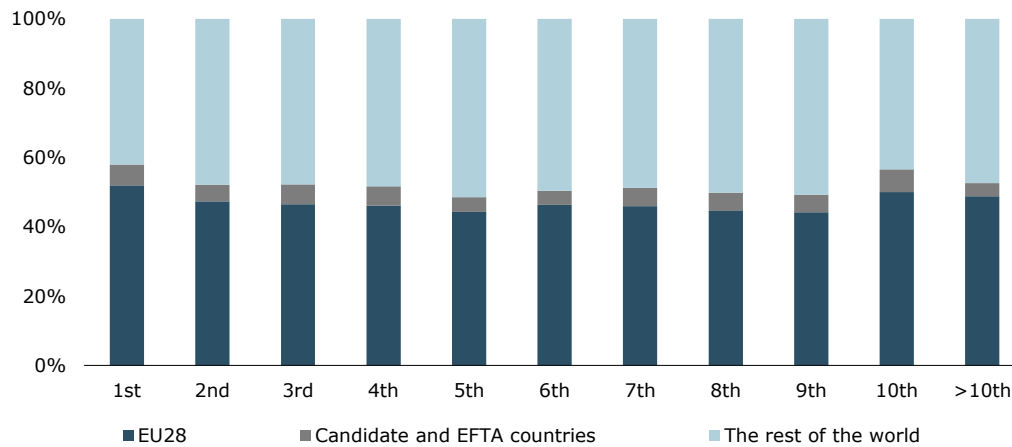
Note: There are 28,572 unique firms in our sample. Of these, 25,816 are firms in the EU28 and the remaining 2,756 firms are from the candidate and EFTA countries. The figure shows the number of unique firms making multiple FDI investments divided by the total number of unique firms. The results on the candidate and EFTA countries are highly affected by Switzerland, which account for close to two thirds of the unique firms in this group of countries.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

### 5.1 Destination of recurrent European SME investors

52 per cent of the first projects undertaken by SMEs from the EU countries are within the EU. This drops slightly to around 47 per cent for subsequent FDI projects by EU SMEs cf. Figure 6. The fact that SMEs from the EU to a large extent keep investing in other countries in the EU can be an indication of the low investment barriers that exists within the EU due to the free movement of capital within the Single Market.

**Figure 6 Destination of FDI by recurrent SME investors originating from the EU, 2003-2015**

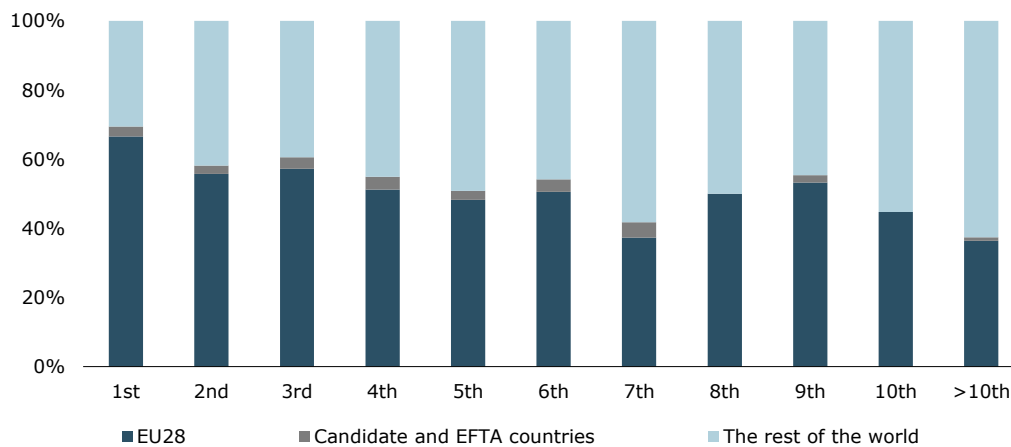


Note: The figure shows the destination of FDI projects by firms in the EU28 across the number of investments by each unique firm. Hence, just over half of the 1<sup>st</sup> investments by each unique firm is done within the EU28. The figure excludes 1,599 investments by 381 firms as they took place at the same time in different regions.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

Firms in the candidate and EFTA countries are less inclined to keep investing in the EU, and SMEs in these countries, which undertake several FDI projects are gradually shifting their investments away from the EU to the rest of the world, cf. Figure 7. However, the first FDI project, which the SMEs from the candidate and EFTA countries undertake, is within the EU in 67 per cent of the cases. This is higher than the equivalent 52 per cent for SME investors from the EU. The incentive to invest within the EU for SMEs from non-EU countries, may initially be especially large, as this gives these firms better access to the large EU market. However, when access has been made, firms in the candidate and EFTA countries might start investing elsewhere to obtain access to other markets. The underlying motivation for investing within the EU may thus differ between EU SME investors and equivalent investors in the candidate and EFTA countries.

**Figure 7 Destination of FDI by recurrent SME investors originating from the candidate and EFTA countries, 2003-2015**



Note: The figure shows the destination of FDI projects by firms in the candidate and EFTA countries across the number of investments by each unique firm. The figure excludes 1,599 investments by 381 firms as they took place at the same time in different regions.

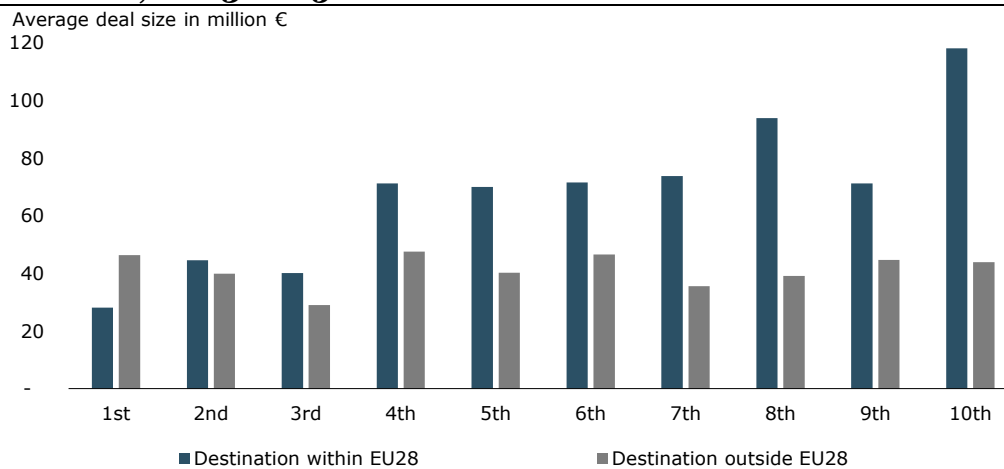
Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

## 5.2 Deal sizes for recurrent SME investors

The FDI projects undertaken by SMEs from the EU Member States are increasing in average value when the destination is within the EU, cf. Figure 8. This is not the case for investments by EU SMEs in destinations outside of the EU.

The first investment is smaller in size if the destination is within the EU, cf. Figure 8. This is in line with the EU providing better opportunities to invest in another member state lowering the fixed costs of investing. When these fixed costs are low, it can be profitable for firms to undertake smaller projects. This indicates that the low barriers to invest within the EU make smaller projects profitable and that there is a degree of learning from investing within the EU. This creates certainty for the SMEs, making them more confident with every consecutive FDI project, allowing them to continually increase the deal size.

**Figure 8 Average deal size for European SME projects across destination, 2003-2015**



Note: The figure shows the average deal size of FDI projects by firms in the EU28 across destination. The figure excludes 1,599 investments by 381 firms as they took place at the same time in different regions.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

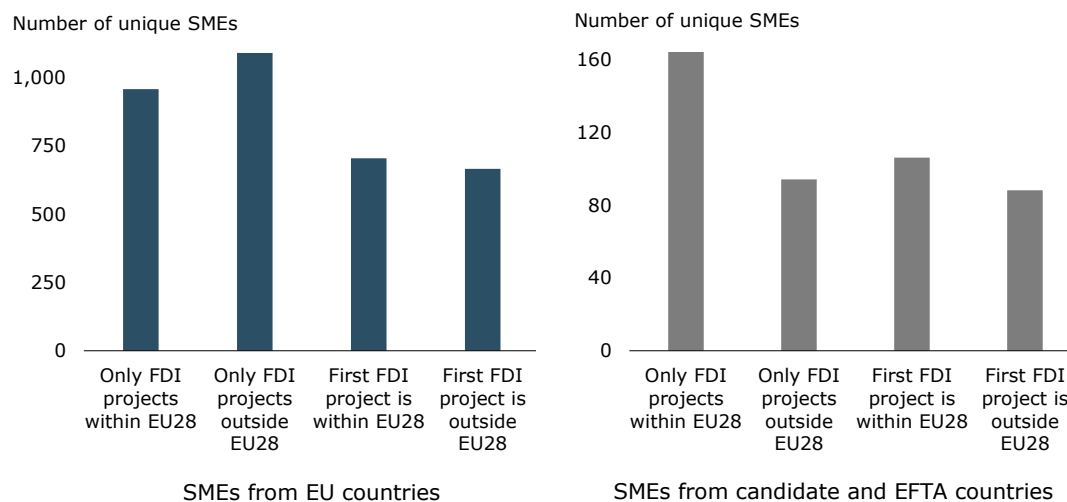
When undertaking FDI projects outside of the EU, the regulation differs across countries. This means that the SMEs to a smaller extent can utilise the experience from one project to the next, when undertaking FDI projects in different countries.

### 5.3 Destination of the first FDI project by European SMEs

Recurrent SME investors from the EU in most cases either undertake all their FDI projects within the EU or outside of the EU, cf. the first panel of Figure 9. The figure shows the investment patterns of SMEs that undertake more than one FDI project. 958 unique SMEs from the EU make all their FDI projects in another EU country, while 1,090 SMEs make all their FDI projects outside the EU. Of the 1,370 unique SMEs that undertake FDI projects both within and outside the EU, 704 make the first project within the EU. This implies that close to half of these SMEs make their first investment outside of the EU. Hence, there is no clear indication that the SMEs in the EU make investments within the internal market as a stepping stone towards making an FDI investment outside the EU. However, this can be explained by trade and FDI being substitutes in terms of entering a foreign market. As trade costs are low within the EU, the incentive to undertake an FDI project is reduced as the SME can serve the foreign market through exports. At the same time, the incentive to undertake FDI projects outside of the EU is higher as the trade costs are higher, due to both tariffs and non-tariff barriers to trade, e.g. distance and cultural differences.



**Figure 9 Investment pattern of European SMEs, 2003-2015**



Note: The figure shows the investment patterns of European SMEs making more than one investment. The SMEs are split into four mutually exclusive and collectively exhaustive bins depending on their investment patterns. The figure excludes 1,599 investments by 381 firms as they took place at the same time in different regions. The figure only includes SMEs which undertake more than one FDI project in the period 2003-2015.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

Similar patterns exist for the candidate and EFTA countries with the exception that relatively few unique SMEs from these countries only invest outside of the EU, cf. the second panel of Figure 9. The difference in investment patterns between SMEs from the EU countries and those from the candidate and EFTA countries may be due to a number of factors. Some investors from the candidate and EFTA countries may thus for example invest in the EU to gain better access to the Single Market. Trade in goods and services and FDI are not always perfect substitutes. In some service sectors a physical presence is necessary to do business in the other country or region. This is also the case for the candidate and EFTA countries in accessing the Single Market, even though they already face low trade barriers with the EU countries.

#### 5.4 The integration of SMEs in the world economy

We construct a country-level indicator specifying the integration of the country's SMEs in the world economy measured in terms of FDI investments.

For each country, the SME FDI indicator is calculated as the number of SME investors over the total number of SMEs, using three-year moving averages of both measures

$$Indicator = \frac{Number\ of\ SME\ investors}{Number\ of\ SMEs}$$

This is a comparable measure to the trade internationalisation indicator by the "SME Performance Review", which, among other things, reports the share of SMEs that export. The trade indicator is used to assess how internationally integrated the SMEs are across European countries.

The three countries with the highest SME FDI indicator in the period 2013-2015 are Luxembourg, Cyprus and the United Kingdom, cf. Map 6. The high values of the indicator variable for Luxembourg and Cyprus could potentially be due to the two countries having multiple holding companies.

Other countries with a high SME FDI indicator are the Nordics, with both Sweden, Finland and Denmark in the top-seven. Hungary, Romania and Bulgaria are the three EU countries with the lowest indicator value.<sup>23</sup>

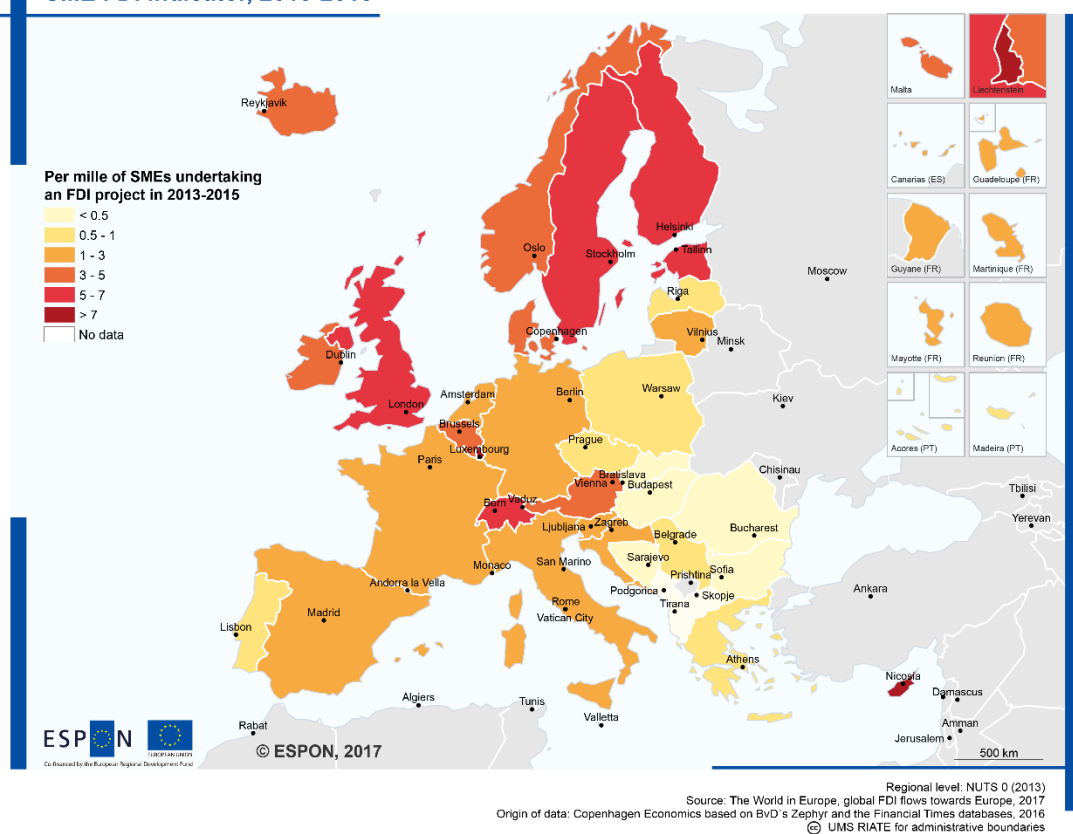
The indicator variable is a simple, but powerful measure of how well a country's SMEs are integrated into the world economy. It complements the existing trade indicator, by providing insight into another dimension of the internationalisation of SMEs. The FDI indicator is thus a proxy of how cheap or easy it is for SMEs across countries to invest abroad. The indicator can help policy makers monitor changes in the share of SMEs undertaking investments abroad and thus assess whether there is a need for further initiatives to help its SMEs expand and grow through FDI. For SMEs to grow, it is important that the conditions for these firms are optimal. This will benefit both the European SMEs and economies in general.

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<sup>23</sup> In the scientific report, *FDI flows by European SMEs*, the indicator is discussed further and is specified across multiple time periods.

## Map 6 The SME FDI indicator, 2013-2015

SME FDI indicator, 2013-2015



Note: The SME FDI indicator 2013-2015 is calculated as the number of unique SME investors between 2013 and 2015 divided by the number of SMEs in the country in the same period. A firm is defined as an SME in the period 2013-2015 using the definition reported in the preface of this report and in the scientific report *Collection of FDI by European SMEs*. In addition, the scientific report includes a table with values of the indicator across both time and countries.

Source: ESPON FDI (2018) based on data from BvD's Zephyr and Financial Times' fDi Markets databases

### 5.5 Inward FDI as a facilitator or outward FDI

In order for SMEs to undertake investments abroad, they need to be productive enough to overcome the fixed costs of setting up an affiliate in a different country, and to compete successfully against incumbents in that market.

One way in which SMEs can improve their productivity is through engaging with foreign investors in their home market.<sup>24</sup> As discussed in the report *Extra-European FDI towards Europe*, foreign firms hold technical, operational and managerial knowledge that local firms can tap into and improve their productivity, via so-called *productivity spillover effects*. These can

<sup>24</sup> Naturally, there are many potential ways an SME can improve its productivity. An important one is through leadership development within the SME. Quality leaders are instrumental in identifying opportunities and understanding the value of enhancing productivity. However, this aspect of productivity improvement is not addressed in the present study.

accrue to local firms within the same industry (intra-industry spillovers) or to local firms in other industries (inter-industry spillovers).

Productivity spillovers to local firms within the same industry can occur via e.g. knowledge transfers and increased competition, while productivity spillovers to local firms in other industries can also occur via vertical (buyer-supplier) linkages with foreign owned firms. Knowledge transfers can arise via e.g. labour movements, when former employees of foreign owned companies move to new jobs in local companies, and bring with them the knowledge and experience they have built up in their previous employment and which can help increase the productivity of the local company. In contrast productivity spillovers arising from e.g. increased competition may be both positive and negative. On the one hand, increased competition from foreign firms, may force local firms to become more productive in order to stay in the market. On the other hand, if a large foreign firm takes over significant market shares from local firms, this can push up the average cost of production for the local firms. This occurs because the local firms' fixed costs of production will be spread across fewer units when their market shares are reduced (Aitken and Harrison, 1999). Via dis-economies of scale, their productivity may therefore be reduced.

Similarly, spillovers arising via buyer-supplier linkages between foreign and local firms can be both positive and negative. Positive productivity spillovers may arise via e.g. direct interaction between foreign firms and their local suppliers, as it is in the self-interest of foreign firms to engage directly with their local suppliers in order to raise the quality of their products (Javorcik, 2004). When large multinational companies enter a region and purchase their inputs locally, they also increase the size of the market for local suppliers. A larger market may allow some of the existing suppliers to benefit from economies of scale, attract new suppliers and spur competition (Markusen and Venables, 1997). However, if the foreign firms purchase most of their inputs outside of the region, and at the same time crowd out local competitors, who purchase their inputs from within the region, they may cause the productivity of local suppliers to fall. This occurs as the fall in demand facing local suppliers can cause their unit costs to increase, as the fixed cost of production will be spread across a smaller volume of production (Markusen and Venables, 1997). See the report *Extra-European FDI towards Europe* for a detailed discussion of all spillover channels.

Spillovers can accrue to local firms of all sizes but impacts may differ between small and large firms. On the one hand, one may expect the largest productivity spillovers to accrue to large local firms, as these may have a larger *absorption capacity* (i.e. ability to absorb the new knowledge or technology spilling over from foreign firms) than smaller firms.<sup>25</sup> On the other hand, larger firms may also be more likely to be in direct competition with foreign owned firms

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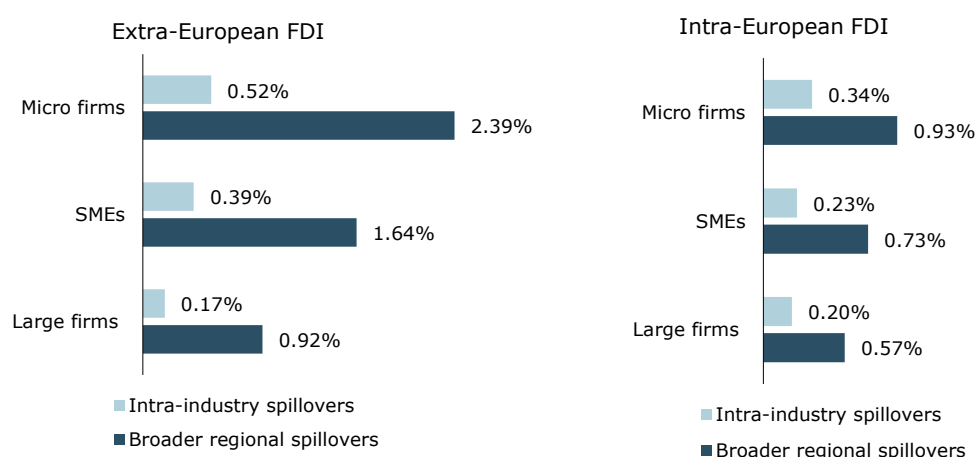
<sup>25</sup> As noted by Damijan et al. (2014) firm size seems to have a positive influence on domestically owned firms' absorption capacity.

and any negative productivity impacts arising via this channels may thus be especially large for larger local firms. At the same time, while smaller local firms may have a smaller absorption capacity than larger firms, these may be the firms that have the most to learn from foreign firms and may thus have the largest scope for benefitting from knowledge spillovers.

As discussed in the report *Extra-European FDI towards Europe*, we have analysed productivity spillovers arising from inward FDI to Europe from outside of Europe (extra-European FDI) as well as from inside of Europe (intra-European FDI), based on detailed firm-level data. In general we find that local firms of all sizes benefit from productivity spillovers, but that smaller local firms (i.e. micro firms and SMEs) benefit the most, cf. Figure 16. This is true for both extra-European and intra-European FDI, although the largest productivity spillovers are found to accrue from extra-European FDI.

As mentioned, one reason why smaller local firms tend to benefit the most from productivity spillovers, may be that these are the firms that have the most to learn, so that the potential for knowledge spillovers may be especially large. Local firms benefit from spillovers arising from FDI *within* their own industry and region (intra-industry spillovers) as well as from FDI in *other* industries within their own regions (broader regional productivity spillovers). Broader regional spillovers tend, however, to be largest, underlining the importance of buyer-supplier linkages between foreign and local firms. The is true for SMEs, as well as for micro firms and larger firms.

**Figure 10 Productivity spillovers from inward FDI to local European firms of different sizes**



Note: The figure to the left shows the average percentage increase in labour productivity for SMEs and other firms, associated with a one percentage point increase in the employment share of non-European owned firms within a given industry and region in Europe. The figure to the right shows the equivalent spillovers arising from European owned firms (e.g. intra-European FDI). See the scientific report, *Impacts of extra-European FDI towards Europe*, for details on the estimation methodology and results.

Source: ESPON FDI (2018) based on data from the Amadeus database

These findings thus show that European SMEs benefit from inward European FDI. As they become more productive they also become better able to cover the fixed costs of undertaking

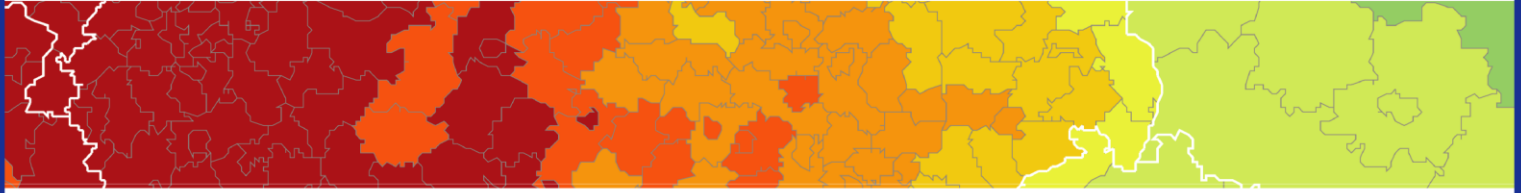
an FDI project and competing successfully against incumbents in foreign markets. Hence, this is a very interesting channel through which inward FDI can stimulate outward FDI. This furthermore implies that regions that are successful in attracting FDI projects might also, as a result, become successful as origin regions of SME FDI.

## **5.6 Concluding remarks**

In this chapter, we showed that SMEs are more likely to undertake multiple FDI projects than micro enterprises, but less so than large firms. Around 40 per cent of SME investors were recurrent investors undertaking more than one FDI project. We showed that recurrent SME investors from the EU kept undertaking FDI projects within the EU at approximately the same rate. On the other hand, recurrent SME investors from the candidate and EFTA countries lowered their share of projects within the EU for subsequent FDI projects. In addition, we showed that recurrent SME FDI investors from the EU increased the deal size of the projects within the EU, but not outside of the EU. In addition, we constructed an SME FDI indicator variable specifying the integration of SMEs in the world economy, and showed that Luxembourg, Cyprus and the United Kingdom had the largest share of all SMEs undertaking FDI projects. Finally, we showed that European SMEs, and indeed other European firms, can benefit from inward FDI to European regions, via so-called productivity spillovers. As European SMEs become more productive, they are also in a better position to undertake outward FDI. Inward FDI may thus help facilitate outward FDI by European SMEs and other firms.

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