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OPPORTUNITIES AND THREATS ANALYSIS FOR EUROPEAN BORN GLOBAL COMPANIES ON THE CHINESE MARKET

Introduction

China is the fastest developing economy in the world. Its vast and dynamic market gives many opportunities for foreign investors. Many multinational corporations enter the Chinese market after having developed in their domestic markets, some of them having had years of experience there. However, new type of firms, called born globals, do not need to develop in their home market first – they go global immediately after their founding. This new way of doing business is getting more and more popular, because foreign markets provide demand for specialized niche products. Large economies, like the Chinese one, provide huge demand and therefore many opportunities for international investors and exporters. However, it seems even more difficult to internationalize a venture directly from Europe to China due to cultural, economic and political differences. This can be challenging for born global firms because of their limited international experience and lack of human and financial resources.

The purpose of this paper is to analyze potential opportunities and threats for European born global companies entering Chinese markets. The first section of the article presents literature overview on the born global phenomenon. The second section characterizes the Chinese market and gives an overview of the current issues of cooperation between the European Union market and China. The last section evaluates opportunities and threats involved in rapid internationalization from Europe to China.

Born global firms – theoretical background

In the last decades many scholars have pointed out an increasing number of small and medium enterprises (SMEs) which start acting internationally immediately after their emergence.[1] Those companies do not follow traditional internationalization theories, most often represented by the Uppsala model[2] which claims that firms first develop in their domestic markets, establish a solid home base and go international in later stages of their life cycle.[3] Different studies have named those firms: *born globals*[4], *international new ventures*[5], *born internationals*[6] or *instant internationals*.[7] The amount of new terms can be explained by the fact that the generally accepted theories of international business fail to explain the existence of such companies.[8]

Literature study provides us with several conceptual frameworks concerning born global firms. Oviatt and McDougall developed a theory which explains why such companies emerge.[9] Their theoretical approach describes four necessary elements for explaining the existence of new international ventures: (1) organizational formation through internationalization of some transactions; (2) strong reliance on alternative governance structures to access resources; (3) establishment

[1] Alex Rialp, Josep Rialp, David Urbano, Yancy Vaillant, "The Born-Global Phenomenon: A Comparative Case Study Research", *Journal of International Entrepreneurship*, Vol. 3, Iss. 2, June 2005, p. 133.

[2] Jan Johanson, Jan-Erik Vahlne, "The Mechanisms of Internationalisation", *International Marketing Review*, Vol. 7, No. 4, 1990.

[3] Elena Pawęta, "The Determinants of Born Global Companies Emergence in Central European Countries", *Entrepreneurial Business and Economics Review*, Vol. 1, No. 2, 2013, p. 42.

[4] Michael Rennie, "Global Competitiveness: Born Global", *The McKinsey Quarterly*, No. 4, 1993; Gary Knight, S. Tamer Cavusgil, "The Born Global Firm: A Challenge to Traditional Internationalization Theory", [in:] *Advances in International Marketing,* S. Tamer Cavusgil and Tage Madsen (eds.), 1996.

[5] Benjamin M. Oviatt, Patricia P. McDougall, "Toward a Theory of International New Ventures", *Journal of International Business Studies*, Vol. 25, No. 1, 1994.

[6] Sumit K. Kundu, Jerome A. Katz, "Born-international SMEs: Bi-level Impacts of Resources and Intentions", *Small Business Economics*, Vol. 20, 2003.

[7] Ian Fillis, "Small Firm Internationalisation: An Investigative Survey and Future Research Directions", *Management Decision*, Vol. 39, Iss. 9, 2001.

[8] Patricia P. McDougall, Scott Shane and Benjamin M. Oviatt, "Explaining the Formation of International New Ventures: The Limits of Theories From International Business Research," *Journal of Business Venturing*, Vol. 9, Iss. 6, 1994.

[9] Oviatt and McDougall, "Toward a Theory…", p. 45.

of foreign location advantages; and (4) control over unique resources. Additionally, this model provides four types of international new ventures according to the number of countries involved and the level of coordination of value chain activities: export/import start-ups, multinational traders, geographically-focused start-ups, and global start-ups. Another model of born global firms, established by Madsen and Servais,[10] claims that the future development of such companies is influenced by the characteristics of the environment, of the organization and of the entrepreneur himself.

As the born global phenomenon is a relatively new concept in literature, every author uses their own definitions, focusing on criteria such as share of foreign sales, the period of time before starting international activity or the number of export markets. Knight and Cavusgil define born globals as firms which have 25 % share of foreign sales and start international activity 2 years after starting the company.[11] On the other hand, Luostarinen and Gabrielsson propose that born global's share of foreign sales should be not less than 50% and they do not define the time period before starting international activity – firms can go international immediately after their emergence.[12] Gabrielsson et al. provides an explanation for such differences among definitions. Definitions of born global companies suggesting smaller foreign market share usually come from Australian or American researchers who base their assumptions on the large countries reality, which results in low export rates. European perspective, however, requires modified definition, because any start-up with a specialized product from a small country could meet these requirements.[13] That causes differences in European and American approaches towards the definition of born globals.

There are several factors determining whether a company will become a born global. Those factors can be divided into three categories – entrepreneur-related reasons, organizational reasons and external factors.

Factors influencing the propensity to become a born global company.[14]

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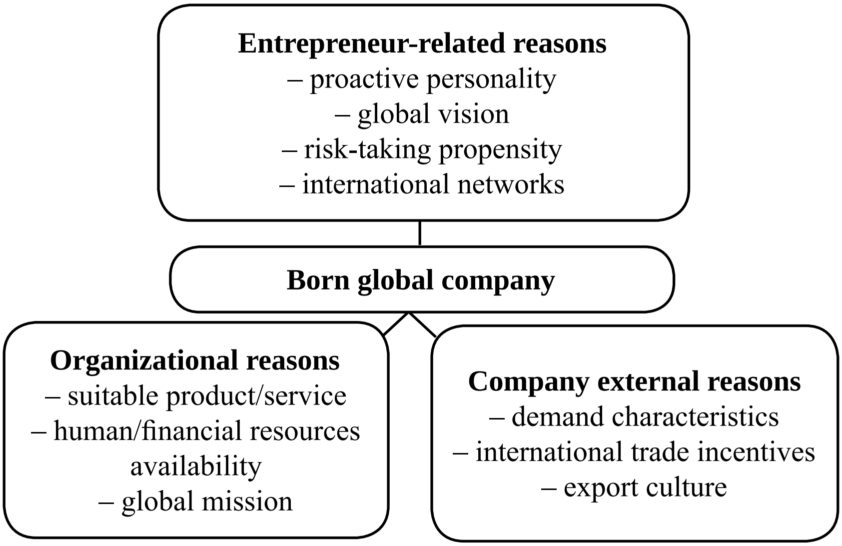
[10] Tage K. Madsen, Per Servais, "The Internationalization of Born Global Firms – an Evolutionary Process", *International Business Review*, Vol. 6, Iss. 6, 1997, p. 581.

[11] Knight & Cavusgil, "The Born Global Firm…".

[12] Reijo Luostarinen, Mika Gabrielsson, " Globalization and Marketing Strategies of Born Globals in SMOPECs", *Thunderbird International Business Review*, Vol. 48, Iss. 6, November/December 2006.

[13] Mika Gabrielsson, V H Manek Kirpalani, Pavlos Dimitratos, Carl Arthur Solberg and Antonella Zucchella, "Born Globals: Propositions to Help Advance the Theory", *International Business Review*, Vol. 17, No. 4, 2008, p. 387.

[14] Zahra Shaker A., George Gerarde, "International Entrepreneurship, The Current Status of the Field and Future Research Agenda", [in:] *Strategic entrepreneurship: Creating a New Mindset*, M.A. Hitt, R.D. Ireland, S.M. Camp, D.L. Sexton (eds.), Blackwell Publishers, Oxford, 2002.



External factors influencing born globals' emergence can be connected with sectoral, regional or national export culture, specific demand characteristics or foreign trade facilitators.[15] Born globals often emerge from small economies where low domestic demand and active international demand foster international entrepreneurship. Other external factors include the emergence of global value chains and global networks, and the growth of knowledge and enterprise clusters where open innovation and public-private research and development cooperation are supported.[16]

Organizational reasons can include: a company's mission to become internationally active, human and financial resources availability as well as employees' skills and commitment to do business internationally. An innovative niche product can push a firm to start acting globally. Young firms may produce such specialized products or components that domestic demand proves insufficient. Such firms start selling in the international markets because of a small size of their domestic market.[17]

Entrepreneurial reasons play a significant role in the internationalization decision. Entrepreneurs who start global businesses are proactive, they possess certain international experience and personal network of contacts, their entrepreneurial mindset allows them to identify specific opportunities on international markets.

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[15] *Ibidem*.

[16] Eurofound, "Born global: The potential of job creation in new international business", Publications Office of the European Union, 2012, Luxembourg: http://www.eurofound.europa.eu/publications/htmlfiles/ef1265.htm [accessed 15.09.2014].

[17] Elena Pawęta, "Born Global Companies: New Market Opportunities for International Entrepreneurs", *Forward*, No. 13, November 2013, p. 6.

Born globals are usually small or medium-sized companies, offering specialized niche products or services, or innovative technological solutions. According to the traditional internationalization scheme, companies first expand into countries with the least psychic distance.[18] However, born global firms do not limit themselves to certain geographical areas or cultural specifications, as they act globally from the moment of their emergence. This article focuses on opportunities and threats of acting on the Chinese market. It is one of the most challenging markets for European born global companies due to cultural, sociological and economical differences.

Chinese market characteristics. Opportunities for born global firms

China is the world's second largest economy by nominal GDP. Its economy has been growing rapidly, with a GDP growth rate of 14.2% in 2007, which has declined to 7,7% in 2013, but is still almost four times higher than the GDP growth rate in the United States.[19] It is a rapidly developing economy, being described as a nation functioning under modern Chinese capitalism. China has somehow evolved into a functional conglomeration of state and/or worker owned businesses where even privately owned enterprises and any combination of all of these are recognized. Central planning and collective ownership are no longer in total control of decision making and production. The demand of the marketplace plays a big role in the economic process.[20]

Currently, the Chinese economy is in a gradual slowdown. A weaker global economic environment and tighter domestic policies slowed the GDP growth. Interestingly, an important factor for the high GDP growth dynamics throughout the last decades and changes in its structure is the attraction of the foreign capital by means of foreign direct investments (FDI).[21] In 2013 China attracted a record 117.6 billion USD in FDI.[22]

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[18] Jan Johanson, Finn Wiedersheim-Paul, "The Internationalization of the Firm – Four Swedish Cases", *Journal of Management Studies*, Vol. 12, Iss.3, October 1975.

[19] The World Bank data on GDP growth: http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG [accessed 05.10.2014].

[20] R. Sabatini, "China: Its Historical Progression Toward an Open Market Economy", [in:] *Business interaction in local economies*, Maciej Kozłowski, Andrzej Kacprzyk (eds.), Wilkes, Vol. 2, 2006.

[21] J. Michalczyk, "Chiny – trudny partner w regionie Azji i Pacyfiku" („China – Hard Partner in Asian Pacific Region), [in:] *Azja – Pacyfik. Obraz gospodarczy regionu*, B. Drelich-Skulska (ed.), Wrocław 2007.

[22] Reuters: http://www.reuters.com/article/2014/01/16/us-china-economy-fdi-idUSBREA0F0EI20140116 [accessed 15.10.2014].

Amount of foreign direct investments to China according to the countries with larger amount of FDI in the years 2010–2014 (in billion USD)[23]

Country	2010	2011	2012	2013	I–IX 2014
Hong Kong	67,47	77,01	71,28	78,30	61,64
Singapore	5,65	6,32	6,53	7,32	4,52
Japan	4,24	6,34	7,38	7,06	3,39
Taiwan Province	6,70	6,72	6,18	5,24	3,94
USA	4,05	2,99	3,13	3,35	2,17
Republic of Korea	2,69	2,55	3,06	3,05	3,23
Germany	0,933	1,13	1,47	2,09	1,32
Holland	0,952	0,76	1,14	1,28	0,47
U.K.	1,64	-	1,03	1,03	1,01
France	1,23	0,80	-	0,76	0,51

Geographical structure of Chinese FDI shows a connection with the Asia-Pacific region. The main investors originate from Hong Kong, Singapore and Japan. However, the data shows increasing direct investments inflow from Europe – investment from the European Union increased by 18.1 percent year-on-year in 2013 to 7.2 billion USD.[24]

Unfortunately for European firms, the Chinese government is interested mostly in attracting Chinese capital from countries like Taiwan, Hong Kong and Macau, which are associated with the so-called Greater China.[25] Therefore, China uses trade-distorting measures to shield their domestic markets from international competition, for example, compulsory joint ventures, technology transfer and access to cheap land and loans from state-owned banks.[26] Thus, European SMEs may experience protectionism even in specific business behaviors or unspoken rules in the Chinese market which increase risks of investing into this market in the beginning. However, born global entrepreneurs are characterized by a certain amount of international experience and a network of personal contacts, which makes risks less significant for this type of firms.

Opening Chinese economy for the foreign capital increased the amount of international enterprises and that caused the emergence of special economic zones playing significant role in attracting investments to China. They function along the coastal area as modern industrial centers, where investors can gain different benefits, for example tax incentives. China has adopted preferential income tax policies for foreign firms. The income tax rate is 15 percent in the economic zones, hi-tech

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[23] www.fdi.gov.cn [accessed 05.10.2014].

[24] *Ibidem*.

[25] Bogdan Góralczyk, Zdzisław Góralczyk, „Chiny na arenie międzynarodowej" („China on the International Scene"), *Azja-Pacyfik*, Nr 4, 2001, p. 21–22.

[26] The Economist: http://www.economist.com/news/special-report/21587381-protectionism-can-take-many-forms-not-all-them-obvious-hidden-persuaders [accessed 05.11.2014].

industrial zones and economic and technological development zones. Corporate income tax is 24 percent in coastal areas and provincial capital cities.[27] Foreign firms have the following tax reduction and exemption policy: (1) income tax exemption for the first two years after generating profits; (2) reduction in income tax by half in the following three years.

Additionally, the Foreign Income Tax Law in China offers the following incentives for foreign firms: (1) the law does not distinguish capital gains from ordinary income; both are taxed in the same way; (2) if a foreign firm is engaged in certain industries like agriculture, forestry or animal husbandry, or is established in a remote and economically undeveloped area, the income tax can be reduced between 15 and 30 percent following the initial five-year tax exemption and reduction; (3) if a foreign firm is engaged in the construction of energy, seaport or transportation projects with a life expectancy greater than 15 years of operation, it is exempt from income tax in the first five years commencing from the first profit-making year, and its tax liability is reduced by 50 percent from the sixth through the tenth year.[28] Tax incentives can be very attractive for international investors. The challenges of tax incentives implementation will be discussed in the following section of the article.

One of the most important opportunities provided by the Chinese market is the emerging middle class which means a totally new huge consumer market. The research provided by McKinsey & Company suggests that the continued middle class expansion will be powered by labor-market and policy initiatives that push wages up, financial reforms that stimulate employment and income growth, and the rising role of private enterprise, which should encourage productivity and help more income accrue to households. If McKinsey's projections come true, by 2022 more than 75 percent of China's urban consumers will earn 9000 USD to 34000 USD per year.[29] The growth of the China's middle class will create new market opportunities for both domestic and international companies. Younger generation of the Chinese middle-class is not satisfied with standardized products for mass consumers and become more picky in their tastes. Therefore, there will be plenty of opportunities for companies with specific niche products matching the changing needs of the new generation of consumers.

The fact that the Chinese workforce cost is relatively small can help direct investors reduce costs. However, there are some parts of the society that have high earnings and can afford to consume luxury goods. The results of a survey released by Peking University show a wide gap between the nation's top earners and those

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[27] Marc Massoud , J. Taylor, "Foreign Direct Investment and Tax Incentives: The Case of China", [in:] *Business Integration in a Global Economy*, M. Roszkowski and A. Kacprzyk (eds.), University of Lodz Press, 2006, p. 31.

[28] *Ibidem*, p. 32.

[29] McKinsey Quarterly: http://www.mckinsey.com/insights/consumer_and_retail/mapping_chinas_middle_class [accessed 02.11.2014].

at the bottom, and a vast difference between earners in the top-tier coastal cities and those in interior provinces. The survey found that in 2012, the households in the top 5 percent income bracket earned 23 percent of China's total household income. The households in the lowest 5 percent accounted for just 0, 1 percent of the total income.[30] The coastal areas are the richest and the further from the Pacific, the lower income per family. This shows market potential for European products and services aimed at rich customers located in the Eastern part of China.

Logistics infrastructure in China fosters exports and investments from abroad. Starting from 2013, the train service between Chengdu, China and Łódź, Poland started operating. This train is considered to be a Silk Road of a new generation. Its capacities are over 8000 tons in total weight of goods, it has shorter delivery time (14 days) than by sea freight and lower costs.[31] Apart from that, China offers advanced road infrastructure, high-speed rail, modern airports and sea ports, which gives small European companies an opportunity to enter the market easier.

China is in general a very attractive target market for European born global firms – it is large, fast growing, with increasing consumer middle class and modern infrastructure. Unfortunately, there are also some threats of rapid internationalization on the Chinese market, and that will be discussed in the following part.

Threats of rapid internationalization in the Chinese market

The main reasons for increasing direct investments into the Chinese economy are: favorable policy of the government, cheap workforce supply, improvement in workforce qualifications, increasing purchase power and liberalization of foreign economic relations.[32] Entrepreneurs acting in China admit that in spite of the market attractiveness, it can be quite challenging to start exporting to this market. Entering the Chinese market can be very hard, time-consuming and very costly. Barriers to enter it are caused by the cultural, language and legal differences. Among the main threats of doing business in China now are: rising costs, slowing market growth, increasing competition, HR problems, dumping, protectionism and legal issues (including intellectual property rights (IPR), corruption, lack of transparency, certification and technical norms requirements).

As it was mentioned above, Chinese economy is currently experiencing a slowdown with the GDP growth rate decline to 7.7% in 2013. Moreover, recent report by the Organization for Economic Co-Operation and Development predicted

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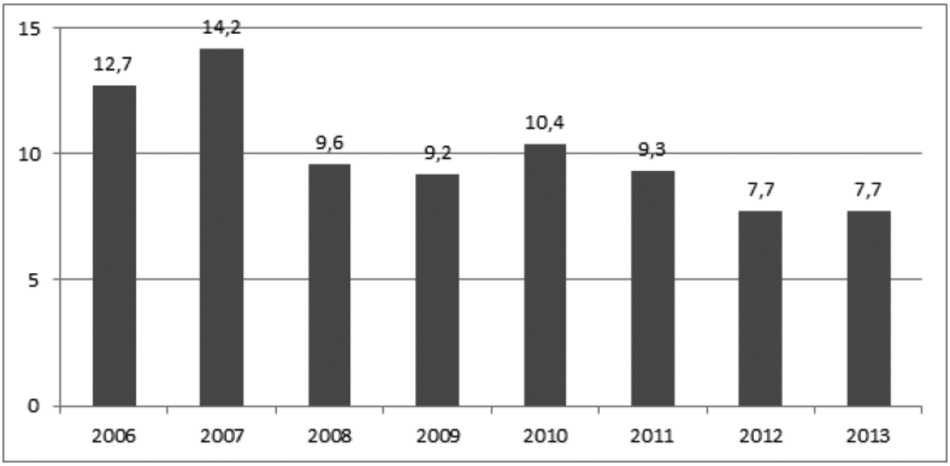
[30] New York Times: http://www.nytimes.com/2013/07/20/world/asia/survey-in-china-shows-wide-income-gap.html?_r=0 [accessed 02.11.2014].

[31] http://www.shippingonline.cn/news/newsContent.asp?id=26119 [accessed 03.11.2014].

[32] Edward Haliżak, *Zmiana Układu Sił USA-Chiny a Transformacja Porządku Międzynarodowego (Change in USA-China Forces and Transformation of the International Order)*, Żurawia Papers, Zeszyt 7, Warszawa 2005, p. 66.

that by 2015 it is going to drop to 7.3%.[33] The GDP growth trend in China throughout the last 8 years is presented below. The annual percentage growth rate of GDP at market prices is calculated based on constant local currency.

Annual percentage growth rate of GDP in China in the years 2006–2013[34]



For multinational corporations this trend can be a significant threat, as the economy slowdown lowers the possibility of achieving their strategic targets on the Chinese market. However, born global companies seem not to be affected by the overall economic state, as they operate on specific niche markets which might develop faster than GDP.

Tax incentives for international investors offered by the Chinese government were discussed in the previous section. The problematic issue about tax incentives is difficulty and costs of managing them effectively. The administration of incentive programs is complicated and therefore has to be effective in order to cover the cost of implementing them. Knowledge and experience in the Chinese market or international connections with Chinese partners are required in order to manage administrative issues, as there have been corruption cases in administering such governmental programs.[35] Therefore, tax incentives may help firms go international, but the effectiveness of such incentives depends much on the born global firm activity and on its motivation for starting business abroad.

Intellectual property protection has been one of the main threats on the Chinese market for a long time. Currently, legal regulations concerning intellectual property protection in China are working and risks can be minimized by making

[33] OECD report: http://www.oecd.org/eco/outlook/Interim-Assessment-Handout-Sep-2014.pdf [accessed 08.11.2014].

[34] The World Bank data: www.data.worldbank.org [accessed 02.11.2014].

[35] Massoud & Taylor, "Foreign Direct Investment…", p. 32.

careful plans during the start-up phase.[36] The "Inside Track: China" report shows several practical strategies that foreign companies can use to protect their intellectual property rights. They are: early intellectual property registration, taking measures to prevent internal breaches, carefully choosing business associates, using contracts whenever possible, cultivating useful relationships with authorities and cooperating with competitors who can also become victims of IP violations.

Chinese government protectionism measures make it harder for foreign companies to operate on this market. However, such measures as labelling regulations and customs processes are targeted mostly at big multinational companies from automotive, pharmaceutical and other industries. The constantly changing legal environment and corruption issues increase uncertainty on the market. The Chinese market is characterized by penetration of politics into the business world, where many local firms and institutions are connected to the party.

One of the main threats of the Chinese market currently is the danger of an upcoming financial crisis. Economists expect a real estate market crisis in China, as currently one might observe a big fall in house prices which was caused by oversupply of houses.[37] If the worst scenario comes true and the Chinese real estate market collapses, there will be a decrease in the demand for exported goods as the value of yuan will drop and exported goods will grow in price.

Conducting business activity in China requires constant observation of the market and of the changing legal procedures. There is evidence that 48% of foreign businesses, including leading multinational corporations, fail and withdraw from the China market within two years after establishing operations there. Among the main reasons for the withdrawal from the market are: employee theft or intellectual property theft, failure to localize products and services to suit the domestic market, failure to seek local advice, underestimating local competition, insufficient or improper market research, inability to communicate with the local market in culturally appropriate and sensitive ways.[38] Such a high failure rate illustrates the level of risks of doing business in China. However, in the modern globalized world if an international entrepreneur wants to succeed, they cannot ignore the Chinese market, as otherwise they will give competitors an opportunity to succeed.

Conclusion

Born global firms conduct their business activities globally. Entrepreneurs with global mindset start operating internationally from the beginning of the existence

[36] Inside track: China: http://m.hsbc.de/mobil/downloads/marktfuehrer/InsideTrackChina.pdf [accessed 18.10.2014].

[37] Dhara Ranasinghe, "China Real Estate: A Buble Bursting?", CNBC.com: http://www.cnbc.com/id/101945949# [accessed 25.10.2014].

[38] Weber Shandwick, http://www.webershandwick.com.au/8-reasons-why-multinational-corporations-fail-and-withdraw-from-the-chinese-market [accessed 02.11.2014].

of their company. Such activity itself seems to be quite challenging. Starting operations on the Chinese market without prior experience and sufficient knowledge seems to be even more risky. This market is characterized by a 48% failure rate of foreign businesses, and that illustrates how high the risks of doing business there are. The main threats of the Chinese market are: rising costs, slowing market growth, increasing competition, protectionism and legal issues (including IPR, corruption, lack of transparency, certification and technical norms requirements). However, China provides many opportunities for foreign investors and exporters. It is a very attractive market for European born global firms – it is large, still fast growing, with increasing consumer middle class and modern infrastructure.

The Chinese market is challenging for all types of companies – for multinational companies as well as for small born global firms. The advantage of born globals is that protectionism issues are targeted at huge international corporations rather than at small firms. Chinese economy slowdown is a significant threat for multinational corporations, while born global firms are not affected by it due to specific niche markets they operate in. Therefore, international new ventures have an opportunity to be competitive on the Chinese market.

Abstract

Companies which do not follow traditional internationalization path, but start international activities immediately after their founding, are called born global companies in the international literature. This relatively new type of international entrepreneurship can be challenging due to limited international experience and lack of resources. It seems even more difficult to internationalize a venture directly from Europe to the Chinese market. The purpose of the paper is to analyze potential opportunities and threats for European born globals entering the Chinese market. The study shows that the main opportunities provided by the Chinese market are: its size, rapid growth (which is, however, slowing down), increasing consumer middle class, modern infrastructure, cheap workforce supply, improvement in workforce qualifications and political stability. Unfortunately, there are also some threats of rapid internationalization in the Chinese market which are caused by cultural, social and political differences. The main threats of the Chinese market are: rising costs, slowing market growth, increasing competition, HR problems, dumping, protectionism and legal issues (including intellectual property rights, corruption, lack of transparency, certification and requirements concerning technical norms).

Key words: internationalization, born global, China, international entrepreneurship, opportunities, threats