JESA INVESTMENT & MANAGEMENT CO. LTD.

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Obstacles to the internationalization of Italian companies

By Saro Capozzoli, Founder of JESA Investment Ltd

In this post-election atmosphere, regardless of the election results, I would like to stress the importance for Italy of a coherent strategy on the development of Italian companies in the markets abroad. In the current uncertain situation, characterized by a sharp drop in domestic consumption and traditional activities that make an economy grow, it becomes increasingly essential, to the very survival of our companies, their presence in foreign markets, even if only through export activities. Companies that are able to export and expand abroad, are in fact the only ones that, in this particular moment, are able to grow and hire new staff..

Several, however, are the obstacles to effective internationalization activities in Italy:

- The size issue, which makes it impossible to absorb the costs of exports, the exploitation of economies of scale and the diversification of the target markets;
- The problem of access to credit;
- Taxes, bureaucracy;
- Country risk related to the country where the company wants to work, export/internationalize itself;
- Lack of qualified human resources prepared to the expansion process.

The fragmentation of public initiatives by institutions and the consequent lack of resources to support them, do nothing but worsen this scenario. The lack of a unique flow of resources in support of long-term initiatives causes their dispersion. The companies are thus forced to operate by themselves, often with no idea of what they are doing, running the risk of landing in markets without real opportunities but just following the trends. For example, in Romania there are more than 28,000 Italian companies, even though this does not represent a market, while our presence is almost insignificant in more attractive markets, such as Vietnam, Turkey, Africa, not to mention China itself, where our French Germans competitors are already positioned, shutting the road and taking away market shares from our companies.

In order to be more effective, the presence of a commercial structure in the countries where a company exports allows the company to adapt quickly and more flexibly to changes that may occur in the various markets.

Politics, although having understood the need of exports to keep alive our industrial fabric, often proves not to be able to adopt valid and effective solutions, mainly due to the lack of an objective evaluation of the actual performance of our companies abroad. It's easy to make celebratory proclamations on the increase of exports, but this increase does not make any sense if an equal or greater decrease in revenues from sales originating in Italy occurs.

In this context, the instability and inefficiency that often characterize the responses of politics are also having a big influence; the fragmentation of bodies in charge of the promotion of our companies' activities abroad does nothing but make the entrepreneurs feel more and more left abandoned.

We hope that the new government will be able to give the right priority to this issue, trying to stop the "solo" of those regions who go abroad on their own and create, on the contrary, a single entity able to support the internationalization. This should be the priority for the next five years, if you do not want the desertification of our industrial base. Unfortunately, we are witnesses of this phenomenon: in the last few months on our desk piled up dozens cases of companies that are on the edge of bankruptcy due to the lack of internationalization. We must understand that we are already late in the conquest of increasingly important markets and that now strategies only

based on distributors/agents are no longer winning, but a presence through a commercial structure at least is needed, especially where the market is expanding like the Chinese one.
These days we are organizing a series of conferences on this subject, together with banks and industry associations in Italy, with a focus on the opportunities offered by emerging countries. During the events our managers located in China, Mongolia, Saudi Arabia and Chile will share their direct testimony and will be available to meet the entrepreneurs to share ideas and discuss in details every market's opportunities and issues. In the future editions of our Newsletter we will communicate the dates and the precise location.

*** * * ITALIAN VERSION * ****

In piena atmosfera post elezioni, indipendentemente dai risultati elettorali ormai noti a tutti, vorrei insistere sull'importanza per l'Italia di una strategia coerente sullo sviluppo delle aziende italiane verso i mercati esteri. Nella situazione incerta attuale del nostro Paese, caratterizzata dal un forte calo dei consumi interni e delle attività tradizionali che fanno crescere un'economia, diventa sempre più essenziale, per la sopravvivenza stessa delle nostre aziende, una loro presenza, anche solo attraverso attività di export, nei mercati stranieri. Le imprese che riescono ad esportare e ad espandersi all'estero, sono infatti le uniche che, nel particolare momento in cui ci troviamo, riescono a crescere, ad assumere.

Diversi però sono gli ostacoli in Italia ad un'efficace attività di internazionalizzazione:

- problema delle dimensioni, che rende impossibile l'assorbimento dei costi legati all'esportazione, lo sfruttamento di economie di scala e la diversificazione dei mercati target;
- problema dell'accesso al credito;
- tasse, burocrazia;
- rischio relativo al Paese dove si intende operare, esportare/internazionalizzarsi;
- carenza di risorse umane qualificate e preparate al processo di espansione.

La frammentarietà delle iniziative pubbliche a supporto da parte delle istituzioni e la conseguente scarsità di risorse per sostenerle non fanno altro che peggiorare questo scenario. La mancanza di un flusso unico di risorse a sostegno di iniziative di lungo termine, fa sì che esse vengano disperse. Le aziende sono quindi costrette a fare da sole, senza avere idea spesso di quello che vanno a fare, correndo il rischio di approdare in mercati senza reali opportunità ma solo seguendo le mode del momento. Ad esempio in Romania vi sono più di 28.000 aziende italiane, nonostante essa non rappresenti un mercato, mentre la nostra presenza è pressoché irrisoria in mercati più interessanti, come Vietnam, Turchia, Africa, senza parlare della stessa Cina, dove i nostri *competitors* francesi e tedeschi sono posizionati chiudendoci la strada, portandoci via quote di mercato.
Per poter essere più efficaci , la presenza di una struttura commerciale nei paesi in cui si esporta

permette all'impresa di adattarsi in maniera rapida e flessibile ai cambiamenti che possono avvenire nei vari mercati di riferimento.
La politica, nonostante abbia capito la necessità delle esportazioni per tenere in vita il nostro tessuto industriale, spesso ha dimostrato di non saper adottare delle soluzioni valide ed efficaci, soprattutto a causa della mancanza di una valutazione oggettiva della performance delle nostre aziende all'estero. Si fa presto a fare proclami celebrativi sull'aumento delle esportazioni, ma tale aumento non ha senso se ad esso corrisponde una pari o maggiore diminuzione del fatturato originato dalle vendite in Italia.

In questo quadro, pesano molto anche l'instabilità e spesso l'inefficienza che caratterizzano le risposte della politica, dove la frammentarietà degli organi atti alla promozione delle attività delle

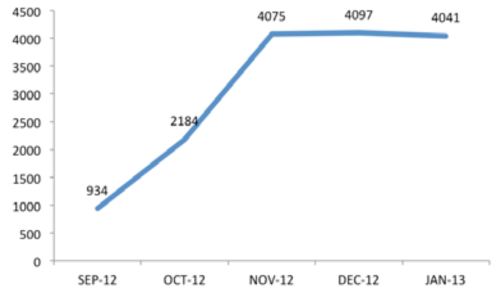
nostre imprese all'estero non fa altro che far sentire gli imprenditori sempre più abbandonati a loro stessi.

Speriamo che il nuovo governo riesca a dare la giusta priorità a questo tema, cercando di fermare i "solisti", come quelle Regioni che vanno all'estero da sole e di creare, al contrario, un'entità unica in grado di supportare l'internazionalizzazione. Questa deve essere la priorità dei prossimi 5 anni, se non si vuole la desertificazione del nostro tessuto industriale. Siamo purtroppo testimoni di questo fenomeno: negli ultimi mesi abbiamo visto passare dalla nostra scrivania decine di casi di aziende che proprio a causa della mancata internazionalizzazione si trovano al momento sull'orlo della bancarotta. Dobbiamo capire che siamo già in ritardo nella conquista di mercati sempre più importanti e che ormai le strategie basate solo su distributori/agenti non sono più vincenti, ma bisogna essere presenti con una propria struttura almeno commerciale, specialmente dove il mercato è in espansione come quello cinese.

In questi giorni stiamo organizzando una serie di conferenze su questo tema, in collaborazione con istituzioni bancarie e associazioni industriali in Italia, con focus sulle opportunità offerte dai Paesi emergenti. Durante gli eventi si susseguiranno le testimonianze dirette dei nostri manager localizzati in Cina, Mongolia, Arabia Saudita e Cile che saranno poi a disposizione ad incontrare gli imprenditori per condividere idee e discutere nel dettaglio le opportunità e le problematiche specifiche di ogni mercato. Nelle prossime edizioni vi comunicheremo le date e le location precise.

Is FIAT tradition of underperformance in China going to change?

Fiat Viaggio is the newest car produced by the joint venture between FIAT and Guangzhou Automobile Group Co Ltd. Launched in September 2012 only for the Chinese market(with a price that ranges between RMB 108,800 and RMB 158,800). Fiat sold in 2012 11,290 Viaggio, a result that is under the expectation of Fiat Group and Mr. Jack Chang, Managing Director of the GAC-Fiat joint venture, that had previously defined in 15,000 cars sold the sales goal of 2012 for Fiat Viaggio in China[1].



Sales Fiat Viaggio, 2012-2013

Looking at the numbers of China automotive market (19.3 million cars were sold in China in

2012), Fiat's figures remain low[2] and Fiat Viaggio ranks #192 among the top 304 models sold[3] and #21 in terms of sales among the new models launched in China in 2012 (below the Shanghai Englon SC3 and above Kia Soul), while other newcomers, such Hyundai Elantra Langdong and Kia K3, are delivering much higher figures (80,460 for Hyundai Elantra Langdong and 26,849 for Kia K3 that was launched one month after Fiat Viaggio).
Fiat's aims to sell 500,000 cars in China in 2015[4] but currently because of the high level of competition and low level of aggressiveness that characterizes the approach of Fiat in China, it is hard to believe that Fiat will be able to achieve this result.

Guangzhou Automobile Group Co Ltd the partner of Fiat in China is probably one of the strength of Fiat approach to China market, it is the sixth largest Chinese carmaker in 2012[5] and it has experienced other effective joint ventures with other foreign car manufacturers such as Toyota, Mitsubishi and Hyundai[6]. In January 2013 also Chrysler Group signed a preliminary agreement with Guangzhou Automobile Group to produce Jeep SUVs that will be sold in China[7] and in the next few years the two groups leaded by Sergio Marchionne expect to achieve with Guanzhou Automobile Group an annual production capacity of 344,000 vehicles.

In 2012 while Jeep, Chrysler and Fiat all together sold just over 60,000 cars[8], General Motors and Volkswagen AG sold more than 2.8 million cars each in China, accounting together for more than 29 percent of China's total Vehicle sales of 19.3 million.

Volkswagen was one of the earliest foreign carmakers, which made direct investment in China in 1985. VW came to the China market founding a joint venture Shanghai-VW, the first one in the China automotive market, with a contracted period of 25 years that was extended on April 12th 2002 for other 20 years. Afterwards VW founded another JV in 1991 with First Automotive Works Group Co and Audi AG joined the partnership in 1995[9]. The joint ventures of VW produce 12 Volkswagen's models, 4 Skoda's models and 4 Audi's models, ensuring a large supply to the Chinese market. VW's Shanghai plant produced cars that served as taxis, vehicles for government officials and for the transportation of the new emerging business elite.

Actually, VW has had nearly a monopoly in government and taxi sales for 20 years approximately. This market condition enabled VW to sell high volumes and thus harness economies of scale. The taxis became a permanent showroom for the brand, allowing VW to become well known and acquire credibility in China[10].
Audi entered into the China market in 1995 and its current success in the local market is due to several factors:

a. The brand image, its perception as a premium brand and the local production in 3 locations (Changchun, Beijing and Foshan)[11]. Due to a rising number of households with an average annual income above 250,000 RMB, Audi targeted a new premium segments in the price range below 300,000 RMB (e.g. Audi A3, Audi Q3)[12].
b. The strong dealers network created by VW Group, composed by 1,120 VW dealers, 230 Audi dealers and 240 Skoda dealers permitted to have a strong presence on the market. The VW strategy for the future is to create new production plants in the West (Urumqi) and in the South of China (Ningbo, Foshan)[13]. Furthermore within 2015 VW planned to widen the products portfolio reaching 94 models and an expansion of its own dealership network to 2,900 dealers with

1,900 VW dealers, 500 Audi dealers and 500 Skoda dealers[14].

General Motors entered the China automotive market through a 50%-50% joint venture with Shanghai Automotive Group in 1997. Since then, the market share has risen to a 10% of the total market, its strategy has been focused on passenger manufacturers, it has three plants in China with an overall annual production capacity of 450,000 vehicles. These results have been achieved by leveraging on the joint venture to acquire more production facilities then a foreign company would be usually entitled to; moreover, the dealer network is the largest among foreign companies in China, with 3500 stores in the end of 2012.The company has aggressively approached the market through a wide range of brands, such as the American Buick, Chevrolet, Cadillac and Opel, the Chinese Baojun, Wulin, Jiefan, and a complementary accessories production line with the interiors brand Genuine Parts and the spare parts brand ACdelco[15].

So what Fiat Group and Chrysler Group should do to gain market shares in China?

Being latecomers has reduced dramatically the span of opportunities both the groups leaded by Marchionne and also increase the level of investments that are necessary to recover the gap. To optimize the efforts, two key steps will be necessary:

a. The selection of a coherent portfolio of brands and models that will represent the base of the China strategy. This means that is necessary to choose if the groups need to focus on brands characterized by lower positioning image (Fiat) or brands that usually are associated with a higher status (Jeep, Alfa Romeo).
b. Investing to expand the dealer network, this investment will also help to improve the image and the brand awareness of the two groups in China.

Looking at the results of 2012 the Fiat Viaggio experiment doesn't seem so successful, but Fiat still needs to improve and expand its dealers network (just 150 dealers in 2012), so evaluating the results now could be misleading and superficial, but it is also true that for a brand like Fiat (traditionally characterized by high volumes and low unitary margins) achieving a high level of sales in China without institutional deals will be really challenging. So a bet on brands with a stronger perceived value and a higher unitary margin could have maybe higher probabilities of success and the choice of producing Jeep SUVs in China seems to represent the first step of Fiat Group and Chrisler Group in that direction, so why do not replicate a similar initiative for a brand like Alfa Romeo?.

Notes:

[1] Fiat Viaggio, www.carsitaly.net
[2] China automobile sales increase 7.12% in December 2012, www.caam.org.cn
[3] www.bestsellingcarsblog.com
[4] Fiat has ambition to sell 500,000 cars in China in 2015, www.inovev.com, Dec. 2012
[5] China Association of Automobile Manufacturers (CAAM), Jan. 2013
[6] Guangzhou Automobile Group Co., www.chinaautoweb.com
[7] Chrysler, Fiat reach accord to build Jeeps in China, Automotive news, Jan 2013
[8] Jeep to build 100,000 units a year in China, Automotive News, Jan 2013
[9] The investigation of Volkswagen's Entry Strategy in China's Car Market, XiaoFeng Wen, 2007
[10] VW in China, CEIBS, 2010
[11] Volkswagen Group China Presentation, Volkswagen, 2013
[12] Audi in China Presentation, Audi, 2012
[13] Significant growth of dealer networks planned, ChinaCarTimes, 2012
[14] VW to double dealer network in China, LeftLane, 2012
[15] GM to add 600 China Dealerships, www.online.wsj.com, 2012

A step back from transparency in China

Every A foreign investor who decides to enter the Chinese market for the first time often has to choose whether to do it on his own, through the establishment of a *Wholly Foreign Owned Enterprise* (WFOE) or through a partnership agreement with a local company.

With the latter choice, the investor must decide which type of alliance is the most appropriate to his business in China. This is a very critical decision since, according to the entry modality, various aspects change, including the ownership structure and the costs and risks of the operation.

According to the level of decision making power entrusted to the Chinese counterparty, four forms of partnership can be identified:

- Commercial partnership: no control on the partner's business from the foreign investor;
- Participation of minority: limited control;
- Joint-venture: shared/relative control;
- Acquisition: absolute control on the foreign subsidiary operations.

The importance of a due diligence analysis increases in parallel with the Chinese partner's ownership share. In case of a commercial partnership it can focus primarily on the financial and commercial parts, while, should an investor decide to enter into China through a joint-venture or an acquisition, it should be thoroughly conducted prior to any contractual agreement, considering the legal, financial and tax-related aspects of the potential target.

Before performing any type of evaluation it is essential to understand both the cultural mindset and the business strategies of the Chinese partner, to see whether a real interest alignment exists between the two parties or not.
The lack of such preliminary screening will almost surely generate problems among the prospective partners.

Moreover, investors have to conduct an as deep as possible examination of their potential partners, taking into account all the aspects that are relevant to the agreement, which can be summarized as follows:

- Review the company background and organization (e.g. corporate records, history, strategy and corporate culture);
- Financial status (e.g. historical results and of the current year, analysis of audited balance sheets);
- Technology (e.g. know how, computer facilities, hardware and software);
- Products (e.g. product development, research and development);
- Marketing and Sales (e.g. details on sales activities, recent market research and customer satisfaction studies);
- Legal (e.g. list of all litigation, claims or assessments, and judicial, administration, or regulatory proceedings pending or threatened);
- Insurance (e.g. insurance costs);
- Human Resources (e.g. management, employees, demographics)[1].

Among the most critical elements to be taken into account there are the estimation of the real tax burden to local authorities, the social security contribution which must still be paid, the regularity and completeness of all permits and the validity of real estate deeds.

Practically speaking, foreign companies often consult the data released by the '*State Administration for Industry & Commerce*' (SAIC) of the Republic of China, which is the competent authority in-charge of the supervision and regulation of the market and the application of related laws[2].

It should also be noted that no foreign law firm, even if authorized to work in China with representative offices, can obtain information from SAIC if not supported from a wholly Chinese law firm.
If someone wants to buy a stake-holding in a company owned by government agencies through an equity exchange, the relevant information on the target company can be found in the '*State-Owned Assets Supervision and Administration Commission*' (SASAC) database, where valuation reports are available.

The new laws regulating the SAIC promulgated by the Chinese Government in June 2012 have further restricted the access to companies data stored in this entity, making it virtually impossible to get hold of the information about the potential target company without any written consent of the target company[3].
This change in legislation has significantly reduced transparency and in addition it has allowed Chinese companies to hide relevant information making the task of due diligence even more complicated than in the past and increasing the risk for foreign investors/companies.

Moreover a due diligence performed after the completion of an agreement could be perceived by some potential Chinese partners as intrusive, or as a signal of a lack of trust.
For example, following the establishment of a joint-venture, the interest alignment with the other party is certainly lower and the transparency of the Chinese partner can greatly decrease, because after the completion of the contract there will fewer incentives to disclose information.
The due diligence process should therefore be always handled by a specialized company, with patience, sensitivity and correct timing, always before any type of contract is settled.
Should an investor need to carry out an analysis of a partner after the completion of an agreement, it becomes crucial to be advised from a specialized company, which will not simply perform a due diligence but an activity that can be defined as data intelligence, to be able to find all the necessary information.

Although some Chinese partners understand the need of transparency of foreign investors/companies and prove to be comfortable in disclosing information, the higher opacity generated by the new measures of the Chinese Government determined an increase of the entry barriers for foreign investors and a step back in terms of transparency.

It is therefore important to rely more on the experts present in the Chinese market who can offer a complete due diligence package covering not only the legal aspect but also focused on tax, financial and commercial issues.
Furthermore, these professionals represent a valid support to check the qualitative elements such as the Chinese partner's corporate culture, the interest alignment between the two parties and they can also play a relevant role in the case of miscellaneous internal problems among the partners.
Jesa is one of the few company in China that can offer a fully integrated range of services, and a due diligence package that can include tax, financial, strategic and commercial aspects.

Notes:

1 Due Diligence, An M & A Value Creation Approach, Wiley, William J. Gorges, HILGER Paul J., 2009.
2 www.saic.gov.cn
3 China Due Diligence Just Got a Lot More Difficult, China Hearsay, Stan Abrams, 4 June 2012.

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