Linking global firms to Local Small and Medium Enterprises

ATDF

Abstract

There are many types of business linkages and many different programmes to promote linkages between large and small companies. This paper focuses on two types of linkages, namely forward and backward linkages. Backward linkages refer to an arrangement where transnational corporations (TNCs) source parts, components, materials and services from small and medium sized enterprise (SME) suppliers in the host economy while forward linkages occur when a TNC provides inputs to another firm or industry.

This paper discusses the conditions necessary to enhance the competitiveness of SMEs and how business linkages between TNCs and SMEs can contribute to the competitiveness of both enterprises as well as to the growth and development of the host countries. Three case studies of successful linkage programmes in Africa and Asia are discussed. It also describes important elements in public-private sector partnerships.

Introduction

While it is generally accepted that SMEs are the backbone of the domestic economy, contributing to jobs and income and hence to poverty reduction, few governments in developing countries have framed policies to enhance their growth or survival. It is not difficult to find statements of commitment to private sector development, such as the recognition in the UK Commission for Africa report *Our Common Interest* that *"the public and private sectors need to work together to create a climate which unleashes the entrepreneurship of the peoples of Africa, generates employment and encourages individuals and firms, domestic and foreign, to invest."* However, coherent and well defined policies that have been developed in consultation with the private sector are generally absent.

For instance, some developing countries have been successful in attracting foreign direct investment (FDI) but not all have been able to ensure that FDI strengthens local enterprises. There is a lack of adequately skilled local human capital, absorptive capacity in local firms and/or incentives to stimulate the diffusion of technology to local firms. In such cases, FDI can add little value to local development and may result in a crowding out of access to finance, abusive transfer pricing that minimizes tax payments, foreign exchange instability, and labour and environmental problems.

These problems in part reflect the failure to combine policies to support SMEs with policies designed to attract FDI. Well-designed SME and FDI policies can ensure that FDI works for local enterprise development. This could be achieved by grounding FDI in local business linkages to facilitate access to finance, distribution and marketing channels and technology to local enterprises. The Government can use transnational corporations (TNCs) in their boarders to improve the capacity of local enterprises through business linkage programmes or supplier development programmes similar to those of Ireland, Malaysia and Singapore to name a few.

2. Global dynamics effect on linkages

The current dynamics of global production favour the creation of business linkages between TNCs and their suppliers. TNCs for the most part concentrate on their core operations and outsource others. The decision to source locally depends on the cost, quality, reliability and flexibility of local suppliers relative to suppliers abroad. It also may depend on national policies or WTO agreements such as the Trade-Related Investment Measures (TRIMs). TRIMs prohibits local content requirements, which specify that some amount of the value of the investor's production must be purchased from local sources or produced locally.

Normally, local sourcing should lower costs, allow for closer monitoring, and give greater flexibility in changing specifications and in developing new inputs.

In the case of the Asian tigers they did not have large natural resources or large internal markets but they had a competitive advantage in terms of the ability to provide special skills, infrastructure, and suppliers which could use technology efficiently and flexibly. Large companies not only look for efficient and flexible SME partners but they also use these partners to gain insights into fast moving technologies, close the gaps in their understanding or develop devices that may boost the long-term use of their products.

Many TNCs assert that there is a lack of suitable local SME partners which could meet their corporate standards or international product standards. For most local SMEs, "partnership readiness", a pre-requisite for mutually beneficial linkages with TNCs, often remains an elusive objective because SMEs lack information, experience, contacts and above all, the human and financial resources to implement the management and tech-

ATDF edited summary based on papers by Lorraine Ruffing, Senior Advisor, *WASME and Former Head of Enterprise Development Branch (UNCTAD*

Box 1: Key Features of TNC strategies that deepen linkages

- Investment driven by the search for strategic capabilities and assets rather than for cheap natural resources, low wages or protected local markets,
- Business models based on networking and inter-firm cooperation, and
- Decentralized corporate decision-making and empowered local management to authorize independent sourcing and new product development.

nology changes needed to do business with the TNCs. The vast majority of SMEs therefore remain de-linked from TNCs, missing these potential opportunities.

2.1 Facilitating partnerships

The challenge for developing countries is to ensure that such linkages occur and contribute to the growth and the competitiveness of SMEs and the development of the economy as a whole. Toward this end, a set of specific policies and programmes are required as well as the cooperation of various development actors in implementing them.

The strength of TNC-SME linkages and the ability of countries and individual enterprises to exploit them for technology upgrading vary greatly, depending on three factors:

⇒ The existence and efficiency of supporting public policies and measures that increase investment in domestic SMEs and facilitate both technical and managerial skill development;

⇒ TNC strategies which are conducive to local enterprise development; and

⇒ The existence of SMEs that have the potential to meet TNC standards within a short learning period.

Beyond the motives of a company to investing in a given developing country, many other aspects shape the corporate strategy and the TNC's willingness to develop linkages with local SMEs. These include the degree of technological sophistication of the TNC and the economies of scale attained, the length of time the TNC plans to operate in a host country, the geographic proximity and transaction costs between the TNC and its affiliates, the TNC's market position (such as whether it operates in price-sensitive markets or enjoys high innovation rents), and the trade policies of the host country, i.e. whether inputs can be easily imported.

2.2 Linkage and the corporate culture of TNCs

The TNC's willingness to develop linkages is also influenced by its corporate culture which, in turn, reflects cultural features of the TNC's home country. For example, several studies have shown that United States and European electronics and computer companies have used the Southeast Asian affiliates for specialized production in a global division of labour, therefore beginning a process of systematically upgrading the technology, improving quality control and diversifying managerial responsibilities for their subsidiaries. Japanese TNCs, on the other hand, have maintained higher value-added operations in Japan, while transferring only lower-end processes to their foreign affiliates (UNCTAD, 2000).

3 Corporate social responsibility

Governments can enlist the support of certain TNCs in building linkages because many profit-seeking TNCs are concerned with the issue of corporate social responsibility (CSR) largely because they are aware of the importance of their public and media profile. They understand that they need an implicit license to operate in the societies of their host and original countries. The social contract stipulates that with power and rights come certain responsibilities. Some TNCs interpret the concept of CSR in a broad sense, that is, they understand and accept obligations not only to shareholders but also to other stakeholders such as employees, suppliers, customers and even competitors, local communities and governments.

4. Case studies on promoting linkages between TNCs and SMEs

This section concentrates on backward linkages between large and small enterprises where the TNCs source parts, components, materials and services from SMEs and thus are more likely to have a profound development impact. The case studies were chosen with several criteria in mind:

⇒ They demonstrate [backward] linkages;

⇒ They are based on a profit-driven business strategy rather than philanthropic motives;

⇒ They are long-term and have already demonstrated positive development impacts;

⇒ They are sustainable in the future; and

⇒ They are replicable.

4.1 Linkages through enterprise development: The case of Zimele, South Africa

Zimele evolved out of Anglo American a global leader in mining and natural resources and De Beers Small Enterprise Initiative established in 1989. In 2000 a separate corporation was created called Zimele, which in Zulu/Xhosa means "to stand on one's own feet". Anglo American, recognized the potential for increasing efficiency through greater SME outsourcing. It created an investment fund of US$ 2.3 million, managed by its own Board and three permanent staff. Through Zimele, small specialist companies provide inputs into the operations of the MNC thus reducing Anglo's costs through competition.

Zimele's programme has three main goals:

1. To proactively seek out opportunities for black owned/managed SMEs to supply non-core services to Anglo Group companies;
2. To support SMEs more broadly, including those with links to Anglo American Group of companies, through the provision of finance, technical assistance, business planning services and the transfer of skills; and
3. To look for investment opportunities.

Zimele has two main areas of activity: procurement and business development services. The entire Zimele programme developed out of Anglo-American procurement opportunities. In procurement, Zimele identifies purchasing needs within the Anglo Group, and sources the needed goods and services from local SMEs. These SMEs have to be commercially and technically viable and meet quality standards, offer competitive prices and deliver on time. Zimele sets targets for local managers and lead contractors. It gives SMEs "bite size" tenders and provides prompt payment. For those SMEs wanting to take advantage of Anglo-American procurement opportunities, Zimele provides business development support services in terms of business skills, strategies and systems.

Zimele's objective is to promote the existence of stable, sustainable SMEs that make money. Zimele works with entrepreneurs with a passion for business that have been identified for a process of mentoring and nurturing using the "incubator" approach to transfer business skills and good business practice. Participating SMEs interface with all of Anglo's functional areas including top executives, line management, business development managers and networks and business intelligence. Most important are the business development officers (BDOs) within the Anglo Group who provide support. Through the BDOs Zimele can provide a range of support services including:

⇒ Access to Anglo procurement programmes;

⇒ Secretarial, accounting, legal and tax help;

⇒ Business skills and proposals;

⇒ Financial and administrative systems for proper control; and

⇒ Strategic planning and alliances.

In addition to seeking out specific opportunities for SMEs to supply Anglo American, the BDOs and Zimele core staff look for investment opportunities. Zimele provides finance through loans and taking a minority stake (20 percent) up to US $350,000 per company. The latter is quite important since Zimele acts as a partner/shareholder that shares the SME's risk. However, SME shareholders also must make their own capital commitment. Over time the capital dependency is reduced as Zimele looks for an exit strategy. As a shareholder, Zimele sits on the boards of the various SMEs and so can act as a force for good corporate governance as well as protect its investment.

Impacts

Through Zimele, Anglo American has "institutionalized" its approach to supplier development. Over the years this has enabled Anglo American to spawn or strengthen a number of successful SMEs. During 2004 Anglo American's divisions collectively spent $800 million on goods and services from SMEs ($440 million in 2003). Since its creation Zimele has invested in over 100 companies since 1989 and has exited from 70 of them. The survival rate for SME partners is 90 percent. This is significant since the average life of an SME in South Africa is six years.

Critical success factors

The success of Anglo American's Zimele model depends on the following critical elements:

⇒ Encouragement of long-term economic empowerment and wealth creation;

⇒ Development of sustainable, commercially viable businesses;

⇒ Investment in small businesses through equity and loans;

⇒ Minority stakes of up to 20 percent with clear exit strategy;

⇒ Focus on the creation of successful enterprises not on jobs; and

⇒ Sustainability and commercial viability as evaluation criteria.

What we see in this case study of Zimele is that Anglo-American developed this programme in the absence of specific policies requiring local inputs. At the same time, it was inspired by the black empowerment programme of the South African government, which requires corporations to set aside 1% of after-tax profit to help empower previously marginalized populations. As a result, Anglo-American had to take on many of the roles played by public and private partners, such as skills development and financing. It is a heavy burden for any company to "go it alone" but Anglo American has done it in a way that benefits both shareholders and stakeholders in the long run.

4.2 A win-win strategy: The case of Unilever Vietnam

Following successful negotiations with the Government and launch of operations in 1995, Unilever invested over US $100 million in refurbishing two existing plants and building two new ones. It also upgraded the facilities of nine main contract manufacturers and numerous suppliers, and created an extensive distribution network for its products. The contract manufacturers and suppliers needed special assistance to enable them meet the needs of Unilever. It should be remembered that Unilever was motivated to work with them in order to keep its operations slim, cost-effective and flexible. By increasing the capabilities of the local enterprises, Unilever knew that it would be increasing its own competitiveness.

To strengthen its local partners, Unilever used a step-by-step approach. Firstly, it carefully selected its partners; secondly, it treated the local enterprises as preferred business partners; and thirdly, it upgraded their technology through its Manufacturing Sustainability Improvement Programme.

Manufacturing Sustainability Improvement Programme

Unilever's Manufacturing Sustainability Improvement Programme focused on improving a number of key aspects such as plant hygiene and good housekeeping, management systems, equipment maintenance, processing, quality assurance and product safety, cost control, continuous improvement and security and confidentiality. Unilever provided the contract manufacturers with both training and access to technology in order to improve the above aspects.

Transfer of technology was achieved through the supply of world-class equipment, full-time hands-on technical support and supervision, access to Unilever's Innovation Centres and training in quality and hygiene, safety and productivity. Its experts taught the local enterprises what they needed in terms of modern plant and equipment, how much they needed to invest, and to invest only in what was needed to grow. Unilever provided in-house training since it did not have the benefit of a co-operatively managed training centre.

Unilever used a similar approach in training with its suppliers in audits to improve customer service, quality and safety. With both the contract manufacturers and suppliers, Unilever provided loan guarantees on the basis of the fact that a certain volume of sales was purchased by Unilever.

Besides its usual line of personal care products, Unilever also introduced new products based on local culture and tastes. One of its contract manufacturers had a unique product: Quoc Duong "Pha Quoc" fish sauce. The company had a prestigious source of raw materials — an abundance of good anchovies — and was experienced in processing them. It also possessed 90 percent brand recognition. Unilever Best Foods NV Ltd. invested $650,000 to build a bottling plant, expand Quoc Duong's fishing and fermentation capacity, and develop operational and management skills and protect its intellectual property against counterfeits.

Forward linkages

What Unilever accomplished in terms of *forward linkages* was also exceptional. A forward linkage is the outsourcing of the distribution of brand name products through local marketing outlets or distributors (Altenburg, 2000). Of course, Unilever was acting out of self-interest since the distribution network maintained and increased the demand needed to increase Unilever's turnover. Its distributors were its third leg after the contract manufacturers and suppliers, and key to its success as an enterprise. Unilever sold direct to its distributors — more than 350 of them. It trained them in the Unilever sales and distribution methodology as well as in cost and inventory management. It guaranteed them a volume of products to sell and it assisted them in reaching customers by giving vehicle loans and bank guarantees.

Impacts

During the linkage process, Unilever built up a healthy supply chain of growth-oriented contract manufacturers, suppliers and distributors. As a result, by 2001 contract manufacturers accounted for 48 percent of Unilever Vietnam's total production volume. Unilever was able to source 40 percent of its raw materials and 80 percent of its packaging from local enterprises. The enterprises in turn benefited in terms of increased turnover and employment. Unilever's employment policy to recruit, develop and retain local talent clearly benefited 7500 Vietnamese workers (of which 5500 were new jobs) in four plants and nine contract manufacturers.

Duy-Tan, a supplier of bottles, increased its total turnover from US $900,000 to US $6.67 million and employment from 160 to 664 between 1996 and 2002 through its association with Unilever. The transfer of technology to local enterprises enabled them to comply with international product quality standards and obtain ISO certifications. Since they were competitive in terms of costs and quality, they were also able to enter export markets and diversify their business partners and avoid total dependence on Unilever.

Unilever gained additional capacity with low capital investments, cost competitiveness and a nationwide distribution reach. It was able to pull ahead of its competitors because of local sourcing that gave it a price advantage.

Unilever's community programme initiative did not stray from its business model, but at the same time addressed the need for corporate social responsibility. It knew that it was a business, not a charity. However, the company was willing to share wealth with the local community for mutual benefit. It has invested more than 50 billion Vietnamese Dong (VND) in various social and community programmes over the last 10 years with a strong focus on health, hygiene and education programmes. For example, it has supported a programme to improve the health of 10 million children.

Critical success factors

There are at least 4 success factors identified:

1. Vision and commitment;
2. Commercial sense;
3. Utilizing local cultural traditions;
4. Investing for the long-term.

Unilever officials know that linkages are a part of normal business operations. They have a choice of sourcing internally or externally, in the host or home country. Their global sourcing strategy *committed* them to striking mutually beneficial partnerships with local enterprises if they made *commercial sense*. Unilever invested in a network of local contract manufacturers and suppliers and distributors over the *long term*. Their competitors had a more global and less local approach to the Vietnamese market and were less successful.

4.3 Public-private partnerships; the Case of Penang and Intel, Malaysia

In order to promote investment, exports and enterprise development, the government of the Penang region in Malaysia adopted a policy that put into place various institutions, infrastructure support and incentives. These included the Penang Development Corporation (PDC), one of the first examples of the concept of Free Trade Zones (FTZs), as a one-stop environment that facilitates interactions between potential investors and the local authorities and local business community. In addition, the Penang Skills Development Centre (PSDC) was developed to pools resources from the private sector, the government and academia to upgrade the skills of workers.

The Penang Government also placed great emphasis on ensuring good transportation facilities and links, utilities and other physical infrastructure for the business sector. Penang International Airport, the second largest in Malaysia, has been upgraded with improved facilities and a new air cargo complex. The Penang marine port is similarly a major regional hub with modern facilities for both international and coastal vessels. The national railway line to Kuala Lumpur, Singapore and Thailand also supports the Penang region. Adequate electric power is supplied via the National Grid System and the Penang Water Authority supplies water which meets WHO standards. Investments in information technology (IT) have made the telecommunications infrastructure and services in Penang one of the best and most modern in the region.

Furthermore, various attractive tax incentives were provided for approved projects, in order to ensure that start-up and operating costs are competitive. Both local and foreign enterprises benefit from tax holidays, investment tax allowances, and reinvestment allowances. It is important to note that the incentives are for TNCs and SMEs alike. There are special incentives for increasing local content, for hi-tech industries, for industrial buildings, and for research and development activities. There are a number of incentives for training and training facilities which are considered an investment.

Intel's approach

Intel arrived in Penang in 1972 looking for the following four qualities in potential suppliers: competitiveness, capability, stability and resourcefulness. TNCs such as Intel are in a strong position to choose their partners. They look for SMEs that can meet their corporate requirements as well as international standards on crucial production issues such as price, quality, delivery, health, labour and environmental standards.

SMEs, on the other hand, are less than "partnership" ready. It is unrealistic to think that in a world of giants, SMEs can become partnership ready without assistance. For this reason, Intel uses five criteria to select and nurture suppliers:

1. SME should be willing and capable of meeting Intel's requirements;
2. Intel provides training to SMEs that match its business needs;
3. Gradually allocate tasks or contracts based on the SME's abilities;
4. Continuous improvement of the capability of the SME through coaching;
5. Mature SMEs may become suppliers to Intel global production chain.

Many of these initiatives are undertaken in collaboration with external skill centres such as Penang Skills Development Centre (PSDC), Intel's Global Supplier Development Programme and the National Institute of Occupational Safety and Health for contractor safety certification training. It also shares its internal training courses and provides suppliers access to its innovation centres, engineers and assigns Intel staff to SMEs to share know-how.

Critical success factors

In distilling the "Penang experience" the following critical success factors emerge:

⇒ Long term commitment by both government and TNCs;

⇒ Targeted FDI strategy to attract TNCs with a positive corporate philosophy and willingness to delegate to local managers to develop linkages;

⇒ Establishment of public-private sector dialogue;

⇒ Formation of meso institutions, i.e. skill centers, such as PSDC;

⇒ Selective rather than indiscriminate support for SMEs;

⇒ Systematic supplier development programmes vs. less structured ones; and

⇒ Appropriate use of economic incentives.

Conclusion and recommendations

Business linkages are not the exclusive domain of the semiconductor industry. Backward linkages have been developed in many other sectors including mining, food and personal care products, textiles and automotive accessories. It is also possible to develop company programmes in the absence of the comprehensive public-private sector partnerships.

Advocates of business linkages should be clear in terms of what they are promoting — viable commercial ventures or acts of philanthropy. The number of discussions and initiatives promoting "partnerships" has covered a wide variety of relationships, and the distinction between commercial ventures and philanthropy has become blurred. Many philanthropic acts that have nothing to do with the TNC's business strategy are being promoted as partnerships and/or business linkages.

Providing health care, education or safe drinking water to local communities is not usually undertaken as a "commercial venture" although it might make sense in terms of corporate social responsibility. There are exceptions such as HIV/AIDS and malaria where the diseases are a threat to a large company's productivity. However, the company programmes are usually restricted to employees and their families and are not open to suppliers or the general community. Above all, most firms do provide health cover to their workers, in one form or another.

Giving general as opposed to selective support to SMEs in terms of setting up business centers or skill centers can make business sense if they are created and run cooperatively with other partners, using the principle of subsidiarity, and can enable both the TNCs' own suppliers as well as other SMEs to benefit. Promoters of such linkages should continually press for better enabling business environments. Administrative and regulatory burdens weigh more heavily on the SMEs than larger companies. This ensures that most SMEs remain in the informal sector, where they will find it difficult if not impossible to access partners, finance and global markets. In the case studies some of the participants in the linkage process function under very difficult circumstances.

The commitment and vision on the part of all stakeholders is best developed by public-private sector dialogue. Another reason why the Penang experience is unique is because few governments engage in regular and extensive public-private sector dialogue as in Penang. Here policies and programmes were developed in consultation to respond to public sector and private sector needs. When the Chief Minister called a meeting in the Penang Development Corporation, the local CEOs attended en masse.

All too often, there is a disconnect between the government's programmes for attracting FDI and for strengthening SMEs. These two policy areas need to be brought closer together through dialogue between investment promotion agencies and business service providers. The government must identify the economic sectors it wants to strengthen depending on where it might have a competitive advantage. It must then identify those TNCs with the right corporate strategy and track record in terms of supply chain management and direct its investment promotion programmes to them while at the same time strengthening its domestic enterprises. Of the examples described above, only in the case of Intel's activities in Penang did the government followed a targeted approach. In the other instances it was a case of working with whatever TNC was currently operating in the host country.

It is necessary to engage with local partners and/or institutions that work at a sectoral or regional level, known also as meso institutions, so that SMEs in the targeted economic sectors can be strengthened to participate in the linkage process. Otherwise, a very heavy burden rests on the TNCs as demonstrated in the case of Unilever to train and facilitate scale-up and quality enhancement. Meso-institutions can set up skills development, mentoring and coaching programmes in partnership with the business community and ensure that SMEs live up to commitments for continuous improvement. They can also ensure that the TNCs transfer skills, technologies, market information and other business contacts. The latter is important since the SME should not be dependent on just one TNC partner.

The meso-institutions should be run by a coalition of stakeholders and not solely by the government. If the private sector participates in management, the institutions will be successful in providing SMEs with what they need to do business with TNCs. Such partnerships relieve governments in developing countries of shouldering the entire financial and management burden of the meso institutions.

Economic incentives are sometimes necessary to scale up these best practices but they must be used sparingly by government in order to maintain fiscal stability. In the case of Penang, what the government gave up in corporate taxes, it made up in individual income taxes. In the absence of access to credit and equity, economic incentives can help SMEs maintain their cash flow so that they can invest in themselves. The effectiveness of the incentives should be evaluated to ensure that their benefits outweigh their costs. They must also comply with trade and investment rules. Since the Penang incentives were "horizontal" in nature, they complied with trade rules.

Developing countries that continue to ignore the necessity to support local enterprises through policies and programmes so that they are "partnership ready" will surely reap neither significant benefits from FDI nor will they increase their competitiveness in the global economy.

References

1. Altenburg, Tilman. (2000). Linkages and Spillovers between Transnational Corporations and Small and Medium-Sized Enterprises in Developing Countries-Opportunities and Policies, UNCTAD: Geneva.
2. Committee of Donor Agencies for Small Enterprise Development (2001). Business Development Services for Small Enterprises: Guiding Principles for Donor Interventions. World Bank: Washington, DC.
3. Erixon,Fredrik. (2005). Aid and Development: Will it Work This Time?, International Policy Network.
4. Evitar, Daphne. (2004). "Spend $150 billion per year to Cure World Poverty," New York Times Magazine 07.11.04.
5. Fitzgerald, Niall. (2005). "The business case for helping Africa," Financial Times, 0?/03/05, p.16
6. Hoffman, Kurt. (2005). "Lack of investment is the real tragedy in Africa," Financial Times, 10/06/05, p.11.
7. International Labour Organization (2004). A Fair Globalization: Creating Opportunities for All, Geneva.
8. Maitland, Alison. (2005). "A realistic framework for an ideal world," Financial Times, 18/05, p.10
9. UN Commission on Private Sector Development (2004). Unleashing Entrepreneurship: Making Business Work for the Poor, UN Development Programme, New York.
10. UNCTAD (2000). International Workshop on Technology Upgrading Through TNC-SME Linkages, Penang, Malaysia.
11. UNCTAD (2001). World Investment Report: Promoting linkages between foreign affiliates and domestic firms, Geneva.
12. UNCTAD (2003). Enhancing the contribution of the indigenous private sector to African development, Geneva.
13. United Nations Development Programme (2004). Partnerships for Small Enterprise Development, New York.
14. United Kingdom Commission for Africa (2005). Our Common Interest, London.
15. World Association for Small and Medium Enterprises (2004). Abuja Declaration: Promoting SMEs for Global Competitiveness, Nigeria.
16. World Bank (2005). Doing Business in 2005, Oxford University Press.