Firms' Decisions on the Location of Economic Activity – A Survey

A Report for the New Zealand Treasury

Final Report

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Contents

The observations and views expressed in this report are drawn from the authors' interpretation of interviews with representatives of a number of firms and organisations. The views and conclusions in the Lessons and Policy Implications section are the authors' alone and are not necessarily shared by the Treasury.

1 Introduction

Context

- Concerns about 'hollowing out' are widespread in the business community and among politicians. These concerns, while differing in detail, are all based on a view that the loss of economic activity from New Zealand is unacceptably high and likely to be damaging to New Zealand's current and future growth prospects.

- However, very little formal work has been undertaken on hollowing out in the New Zealand context. As a result the public policy community lacks clarity on the issue, and there is little consensus on how to reduce the loss of activity from New Zealand or mitigate the impacts of that loss.

- This report aims to contribute to an improved understanding of hollowing out in New Zealand.

Objective

- Treasury has sought the assistance of Firecone and Zusammen in undertaking a survey-based research project on the drivers of hollowing out. The objective of the work is to improve the government's understanding of:

    - why firms shift activity offshore
    - the costs and benefits identified by export-oriented firms remaining in New Zealand around moving some or all of their activity offshore
    - the views held by the owners and management of firms about any characteristics of the New Zealand

economy and/or public and economic policy settings that would influence locational decisions by New Zealand firms.

Methodology

- It should be emphasised that this was a small-scale project. We have interviewed a total of 15 firms. All were selected on the basis that they earn a relatively high proportion of their total revenue from exports or offshore operations. However, they vary significantly in terms of their total size, stage in their development cycle, and sectoral focus. There are therefore clear risks in generalising the results of our work too strongly.

- We would also note that given its survey-based nature, our work is primarily 'reflective'. With the exception of the Policy Implications section, the report does not attempt to filter or interpret the messages we received from the firms interviewed. Instead our objective was to help policy makers better understand firms' perspectives on the reasons for, and impacts of, the relocation of activity offshore.

- As a result this work should be seen as providing only 'one piece of the puzzle'. Further work will be needed before the government can gain a clear understanding of the levels and patterns of hollowing out occurring in New Zealand, its drivers and impacts, and the potential for policy changes to reduce the level of hollowing out or its impacts.

Report Structure

- Our report is structured as follows.

    - Section 2 provides a brief introduction to hollowing out: how the term should be interpreted; what anecdotal evidence there is that hollowing is occurring in New Zealand; and why hollowing out matters.

  - Section 3 provides a stylised overview of the internationalisation process, explaining the steps that firms go through to move away from a primarily domestic focus and the implications of that process for the location of components of their value chain.

  - Section 4 discusses the different forces that keep activity in New Zealand, or pull it away, in more detail.

  - Section 5 summarises the forces affecting the location of activity in New Zealand in the form of a strengths, weaknesses, opportunities and threats (SWOT) analysis.

  - Section 6 sets out our assessment of the key lessons to take from this work, and suggests some areas for further policy analysis or development.

- A list of the people and firms interviewed is attached as an appendix.

Confidentiality

- Our interviews were undertaken on the basis that any firm-specific information provided would be treated as confidential.

- In writing this report we have included a number of practical examples to support our findings. However, in keeping with the assurances given to interviewees, we have avoided mentioning specific firms when providing examples or quotes. Where it was necessary to give details of the firm involved to make an example meaningful, we have been careful to keep that information relatively generic.

2 Hollowing Out – An Overview

Definition – What Does 'Hollowing Out' Mean?

- The term 'hollowing out' is not always used internationally to refer to the same set of economic phenomena. However, it is typically used quite consistently in New Zealand to refer to:
  - high and growing levels of foreign control of New Zealand-based businesses (i.e. a majority shareholding by a single overseas company)
  - the relocation of the bulk of companies' operations to another country
  - the relocation of key components of firms' operations – such as head office, R&D, or exporting functions – to another country
  - high and growing numbers of firms delisting from the New Zealand share market and re-listing on another bourse, such as the ASX.
- These events are likely to have both immediate and longer term impacts. In assessing the impacts of hollowing out, it is important that any longer term impacts on New Zealand's growth levels and development patterns are taken into account.
- For the remainder of this report we use the term 'hollowing out' in this way: to refer to the loss of New Zealand control of companies; the re-location of entire companies, or a number of their key functions, to other countries; and the shifting of firms' stock market listing to another country's bourse. When referring to the impacts of hollowing out, we include both short- and long-term impacts.

Evidence that Hollowing Out in New Zealand Is Unusually Significant

- To date no comprehensive empirical studies have been undertaken which assess whether the loss of economic activity from New Zealand is unusual in terms of its size or nature.[1] However, in our view there is strong anecdotal evidence to suggest that high levels of hollowing out are occurring.
    - By international standards New Zealand has a small number of successful large firms.
    - A majority of New Zealand's largest 200 firms are foreign owned.
    - Most of those large foreign-owned firms are focussed on serving the domestic market and undertake little or no export-oriented activity. As wholly owned subsidiaries of foreign companies, they are unlikely to ever internationalise in the future (e.g. TelstraClear is highly unlikely to expand internationally out of New Zealand, Telstra will do so from Australia).
    - Many of New Zealand's large foreign-owned companies also appear to be run increasingly tightly from head offices overseas, especially Australia.
    - A significant number of our moderate-sized but strongly growing export-oriented firms (large firms 'in waiting') move abroad at relatively early stages in their development.
    - A significant number of New Zealand firms have shifted their head offices offshore over the last 10 years.

[1] However, we understand that some government-led studies are currently underway.

- An even greater number of New Zealand firms have delisted from the NZSX in the last 10 years.
- Most FDI inflows have been in the form of buying existing businesses, rather than establishing new ones.
- New Zealand's stock market has a very low capitalisation by international standards and is one of the few bourses to have shrunk over the last 15 years.
- The emigration of New Zealand residents is very high by OECD standards (although in actuality it is only the net flows of migrants to Australia which are clearly above OECD norms).

Why Hollowing Out Matters

- Economic activity is becoming increasingly 'footloose' internationally. The forces of globalisation are increasing the extent to which economic activity, and the factors of production underpinning it, move between and within countries to maximise the profits of the firms involved. There is a growing trend towards globally distributed value chains, with the outsourcing of those components of the chain not central to organisations' value propositions. The development of the firms we spoke to mirrors these international trends; all have located at least some of their operations offshore.

- All firms with significant international sales need to locate at least some of their operations offshore, especially in the areas of manufacturing and sales and distribution. It would therefore not be practical, nor in New Zealand's interests, to attempt to prevent all individual instances of relocation of economic activity.

- But this fact does not negate the importance of the levels and nature of economic flows into and out of an economy. A country's per capita income level is determined first and foremost by the value of the goods and services produced within its boundaries.[2] The relocation of activity can become problematic where the New Zealand economy is not attracting replacement activities of a sufficient quality or in the necessary volumes.

- To increase incomes, New Zealand must therefore increase the value of economic activity undertaken here and embodied in our exports. It is therefore strongly in New Zealand's interests to focus on the net levels and quality of the business activity that occurs here. The loss of any particular business, or component of its value chain, from New Zealand will not necessarily be negative. But a sustained net reduction in the overall level of high skill, and therefore high value-added, activity undertaken in New Zealand would almost certainly be harmful.

- New Zealand economic policy therefore needs to address the following core questions.

    - How effective is New Zealand at retaining economic activity?

    - How strong are the attractors for specific types of activities?

    - How strong is new start-up activity and what is the quality of these ventures?

    - Can New Zealand grow and retain truly global organisations?

[2] The extent to which that economic activity is owned by New Zealanders also matters, but to a smaller degree. The gap between GDP and GNP in New Zealand, at around 5%, is high by international standards. But it is low in absolute terms and demonstrates that New Zealanders capture a significant portion of the value generated by foreign-owned businesses that have parts of their operations located in New Zealand.

3 Internationalisation Process – Stylised Overview

Introduction

- The internationalisation experiences of the firms interviewed differ markedly. These differences appear to have been driven by the firms' different development histories, market structures and product features and because business development is inherently a stochastic process.

- However, a number of broad recurring themes arose during the interviews, particularly in the stages and experiences firms go through as they expand the size of their offshore sales and operations.

- In this section of the report we have drawn together those common experiences to form two 'stylised' internationalisation stories for a typical New Zealand company. Our purpose in providing these stylised stories is to familiarise the reader with the key steps New Zealand firms appear to go through as they internationalise, and thereby provide context for the next section's more detailed discussion of the forces firms identified as influencing their decisions on where to locate components of their value chain.

- In this overview we have drawn a distinction between *traditional* and *emerging* internationalisation processes. The 'traditional' story reflects the history we heard most often. It relates to firms that started with an almost entirely domestic focus and began to internationalise only after having developed a relatively strong domestic presence. The 'emerging' story came from a smaller number of relatively new companies, which had a strong focus on foreign sales from their inception.

Traditional Story

Initial reasons to locate in New Zealand

- Those firms fitting the traditional story started their operations in New Zealand for no reason other than that their founders lived here. There was no evidence to suggest that they explicitly chose New Zealand because it was a 'good place to start a business of this type'.

- Most explicitly addressed the question of where best to locate only at a later stage in the company's life cycle when the business's needs were better understood and location constraints had become more apparent (see below).[3]

Establishment with vertically integrated operations and a strong domestic focus

- The companies initially established themselves as vertically integrated organisations, with an owner-manager structure and a strong focus on servicing the New Zealand market. In many cases they were established without explicit internationalisation objectives.

[3] It should be noted that given the design of our survey methodology there is a risk that our sample is biased away from New Zealanders who relocated offshore because 'there is a better place to start a business'. This effect should not be underestimated, given the large number of New Zealander passport holders living abroad.

Initial motivations to locate activities offshore

- Those firms fitting the traditional story began pursuing offshore sales in order to increase their growth prospects. This typically reflected the fact that they had exploited the local market to the maximum extent practical, or was a response to greater domestic competition from foreign suppliers.

- The decision to seek offshore sales typically prompted a far more careful analysis of where best to locate the different components of their value chain. (See figure 1 below for a stylised description of the key components of a firm's value chain)

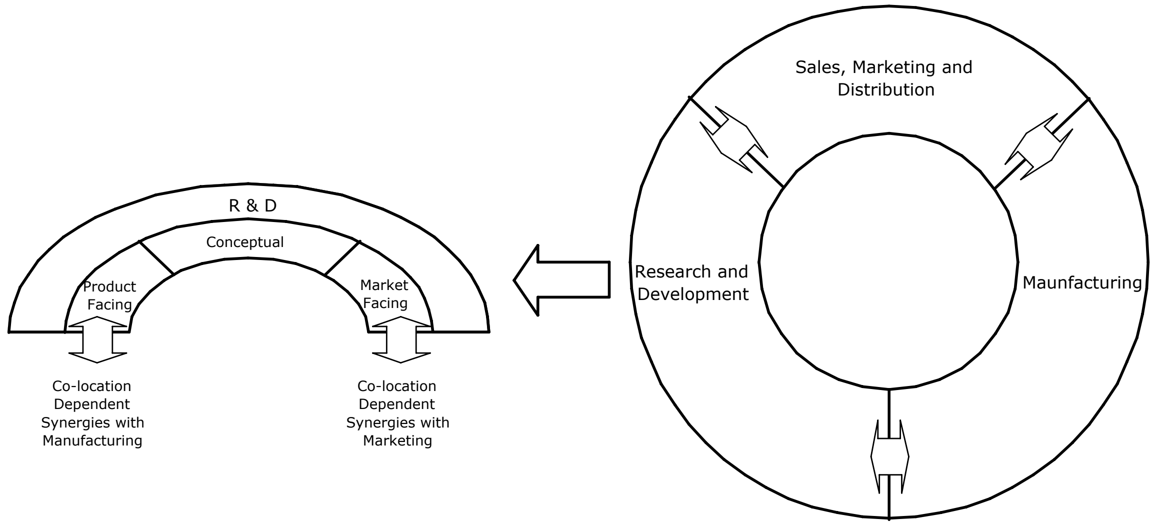
- Manufacturing was often the first component of the value chain shifted offshore. The initial motivation for this was typically to secure lower costs, which were seen as important for successfully competing in the newly targeted overseas markets. However, almost all firms reported other important benefits, including higher quality manufacturing capabilities, an ability to manage greater complexity, and supply chain advantages.

- Sales and marketing activities were also often relocated in order to be 'closer to market'. This allowed stronger in-market relationships, improved tacit knowledge exchange and greater familiarity with the market.

  'Australians only like dealing with Australians, Americans only like dealing with Americans.[4]

[4] Throughout the report we insert unattributed quotes from interviewees in this format to illustrate various points.

Figure 1 – Key Components of a Firm's Value Chain



Initial 'stickiness' of some activities

- Firms' R&D activities and overall management functions typically proved 'stickier' than others – that is, remained in New Zealand for longer.

- The stickiness of these functions came from their reliance on the New Zealand-based founders, and/or a small number of key technical staff with a long history with the company, who frequently insisted on remaining in New Zealand for family and lifestyle reasons.

Magnet effect of relocated activities

- Once a company has begun relocating key components of its supply chain offshore, a self-reinforcing process often begins, with the relocated components acting as 'magnets' of attraction for components remaining in New Zealand.

- These forces of attraction reflect the synergies that typically arise from locating the different parts of a firm's value chain with each other, and/or closer to key markets.

- Companies reported benefits from co-locating sales and marketing activities closer to their manufacturing activity and to customers. This helps to reduce transport costs and to better incorporate customers' needs into product design. Similarly, companies saw benefits from placing their R&D activities closer to their manufacturing activity and to their large markets. This helped to ensure better management of the roll-out of new products, and a better understanding by R&D staff of their customers' needs.[5]

- Foreign ownership also often proved to be a strong magnet for relocating key elements of a company's operations offshore.

  'In the vast majority of deals offshore, venture capitalists making a strategic investment will actively encourage New Zealand businesses to relocate.'

[5] The interviews did not focus on identifying the attributes where these pull effects are likely to be greatest. Our sense is that the manufacturing 'pull' for product-facing R&D can to be strongest where product or manufacturing is complex and highly innovative. The sales and marketing 'pull' for market-facing R&D might be strongest where customer preferences change frequently and need to be anticipated.

'The act of relocating can instantly add value through cost savings, relaxed volume constraints, improved quality and service, and an investor base which has a better understanding of potential value.'

- In addition to these 'magnet' effects, the very process of relocating one piece of a company's value chain appears to increase the likelihood of others following.
    - Success with managing the logistics of having one part of the chain offshore provides the necessary confidence to take other more strategic parts of the business offshore.
    - Some countries are seeking to attract a greater share of the economic activity arising from the firms that currently locate (low-value) parts of their business there. China, for example, is managing to a strategy of using low cost manufacturing to attract more valued activities as the country improves its capability and capacity and reduces perceptions of risk.
- Moreover, there is suggestion that the stickiness of core New Zealand-based activities, such as research and development, can sometimes wear off. This occurs for a number of reasons including staff turnover, growing realisation of the importance of co-location synergies, and improving offshore capability.
- We would stress that the existence of these 'magnet' effects does not mean that internationally focussed firms will always ultimately be lost from New Zealand. Activity will remain in New Zealand where the benefits from keeping them here are greater than the magnet forces. But in the absence of clear reasons for firms to retain aspects of their operations in New Zealand, the magnet effects mean that the ongoing gradual loss of activity is likely.

The trigger of 'growing to the next level'

- As noted, the initial decision to attempt to develop offshore sales often triggers a firm to assess the location of the various parts of its value chain more carefully.

- Internationalisation then typically follows a step-wise rather than incremental process triggering a series of reassessments about location. Most of the firms reported facing critical stages in their internationalisation process where relatively large and risky changes were required to grow 'to the next level', often involving decisions to relocate key parts of the firm's value chain.

- This commonly occurred when New Zealand firms felt the need to develop offshore strategic partners in order to speed up their growth into large offshore markets. This often led to hollowing out through joint ventures, licensing and dilution of ownership.

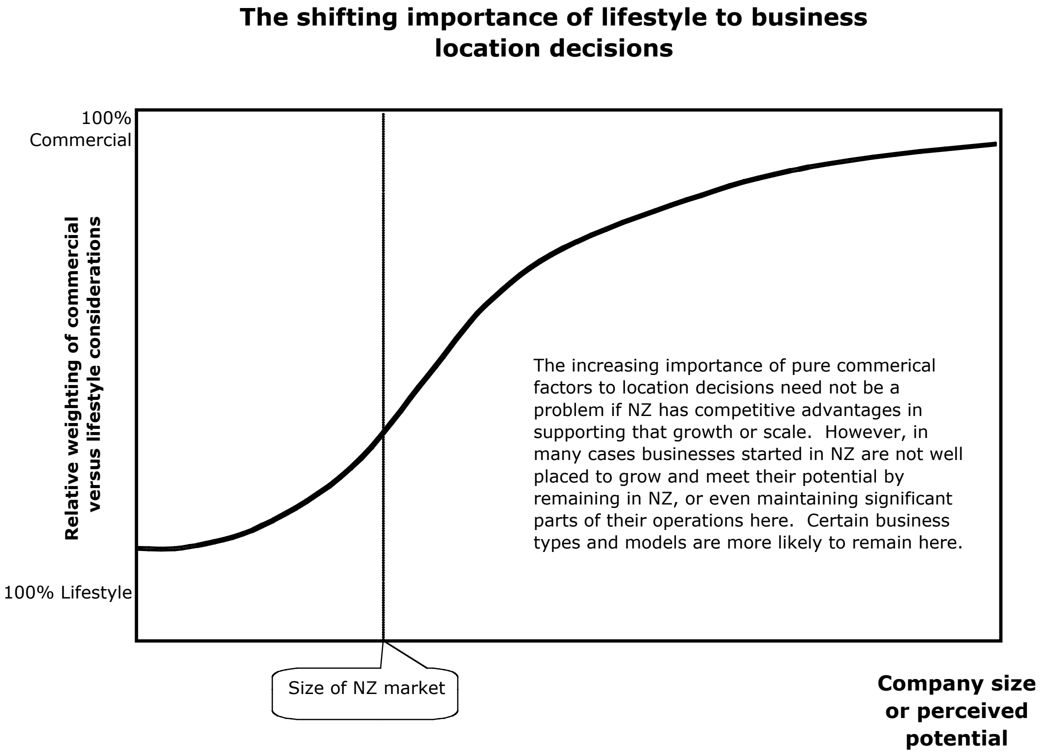
- The need for greater capability and capacity can also result in decisions to relocate to larger, more scalable and sophisticated economies. The current owners' limited appetite for risk and the desire to capture some of the value they have already created often result in a sale to overseas parties at this stage.

- Growth itself can also act as a trigger. As firms grow there is an increasing likelihood that the location of elements of the business will be reviewed. The criteria used become increasingly commercial as the firm grows, with the initial 'lifestyle' considerations becoming less and less important. This is due in part to the reducing influence of any single individual, notably a founder or owner, on the firm and therefore on the nature of the implicit cost–benefit analysis used.

  'We are an owner-managed firm and we locate here because we like the lifestyle. However, there are costs in terms of accessing markets and logistic issues.'

- This relationship between company size and the relative weighting given to different factors when considering location decisions is illustrated in Figure 2 below.

Figure 2



Emerging Story

- As noted, most of the firms interviewed reflected the traditional internationalisation process outlined in the previous section. However, a smaller number of relatively new companies, which had a strong focus on foreign sales from their inception, followed a slightly different process. This stylised 'emerging' internationalisation story is outlined here.

Going global from the outset

- Many of the newer firms in our sample were established with explicit aims of going global. New Zealand was never expected to be their primary market during their growth path, and in some cases was by-passed altogether.

- Again, New Zealand is selected as the place of business for lifestyle and reasons of national pride.

  'I started this company because I want to grow a large international company based in New Zealand.'

- The owners and managers of these firms often appear to be 'recycled' from companies that have internationalised previously. As such, they have an improved understanding of what it means to build a truly international business from New Zealand.

A different business model

- Explicit internationalisation goals from inception have led companies to develop differently from the traditional way outlined above.

- Rather than starting in New Zealand and being relocated at a later date, certain parts of the value chains of these companies are distributed globally from the outset. These firms most often place significant elements of manufacturing and sales and marketing offshore more or less immediately. The research and development, sales management and head office functions are again cited as elements more likely to be located in New Zealand.

- While these owners are often running their businesses from New Zealand for lifestyle reasons, they are very commercial about where best to locate activities so as to maximise commercial benefits. The founders are selecting opportunities and structuring businesses with explicit reference to the strengths and weaknesses of New Zealand as a place to manage and conduct business.

- One interviewee outlined a business model specifically designed for New Zealand, in which the New Zealand-based firm undertakes the inception, coordination and integration roles, with the manufacturing and R&D contracted out. While not talking specifically about a 'New Zealand business model', many of the firms interviewed seemed to be taking a similar approach, with the bulk of their operations undertaken offshore.

- Some examples of the business models we observed are outlined below. While there are no formal names for these, we have attempted to categorise and name them, drawing on the language used by the interviewees.

The product model

- The founders of companies pursuing the product model see a trade sale as the best means of capturing the value of their idea or concept.

- From the outset their intention is not to build a large company, but rather to build the product/brand and demonstrate market acceptance, so that the product will be an attractive acquisition for global corporations. This model minimises the consequences of some of New Zealand's weaknesses, such as limited scale or the high cost of supporting markets, by selling to a better-placed party before these issues become a major problem.

- Examples include the sales of 42 Below to Bacardi and Aftermail to Quest.

The product development model

- Companies pursuing the product development model aim to build a technology platform which can be repackaged and reused across a range of products servicing large markets. These companies are globally distributed from the outset. They focus on the research and development part of the value chain and excellence in managing distributed value chains.

- Manufacturing is largely outsourced, though some companies are looking for New Zealand manufacturing to support product prototyping. The company will often try to own or control sales and marketing. Head office activities may be located anywhere in the world.

- Many of these companies consider themselves to be global companies, and have explicitly rebranded themselves as such and not 'New Zealand exporters'.

- There is some evidence that parts of the New Zealand-based research and development functions of these companies are at risk. We heard on a number of occasions how the market-facing and product- or manufacturing-facing aspects of R&D are often best placed where the market or manufacturing is. This leaves the relatively small 'conceptual' R&D functions in New Zealand, and there was some questioning of whether it made sense for these to remain here. There is an expectation that these parts will come under increasing pressure as Asian economies develop more sophisticated innovation systems.

- Examples of this model include Vectek, Navman, Rakon and NextWindow.

The acquisition model

- A number of larger New Zealand companies with a strong product or sector knowledge have been extending their global reach through the acquisition of companies operating in similar markets offshore. In most cases the management of those firms is retained, and they continue to operate relatively independently from the parent head office in New Zealand.

- Fletcher Building is a good example of this model.

The large New Zealand company model

- Companies pursuing this model are looking to grow a large company with a significant component of the operation and added value occurring in New Zealand.

- One example is the 'software as a service' model where product development can take place in New Zealand and installation and support is not enterprise specific, e.g. Application Service Provider model. This model has yet to be validated in New Zealand, but companies such as Xero are pursuing it and recently raised $15m in an IPO.

Why New Zealand?

- A notable feature of these models is that they are more independent in location than specific to New Zealand. They reflect a subset of business activities which can be undertaken anywhere in the world with the requisite infrastructure, skilled labour, access to capital, and political stability.

- This approach has allowed these firms to mitigate some of the negative impacts of operating an international business from New Zealand. But at the same time it has loosened their ties to New Zealand, making it relatively easy to relocate to another country in the future.

'Whilst we have accepted the inevitability of some activity leaving our shore, we have yet to provide a compelling reason for the other parts to stay here.'

4 Retention, Dispersion and Attraction Forces

- This section provides a more detailed description and discussion of the factors firms identified as influencing decisions on where to locate economic activity. Retention forces – those helping to keep activity here – are discussed first, followed by dispersion and then attraction forces.

Retention Forces

History / inertia

- The most common reason companies gave for being located in New Zealand is that this is where they were established. When asked, the interviewees often stated that it would probably be more sensible for them to be located somewhere else.

- But they also emphasised that it takes time and effort to relocate a firm's operations or share market listing. Once established here, they would make the effort to shift activity away only where there was a compelling reason for doing so. The importance of this inertia effect should not be underestimated.

Lifestyle / national pride

- Another important reason for being based in New Zealand is that this is where the owners, managers and other key staff wanted to live. This desire to live here reflected a mix of lifestyle and national pride.

  'We are determined to remain New Zealand owned and operated.'

- Key staff wanting to continue living in New Zealand were often members of the senior management team or board. For the smaller businesses, groups of experienced researchers or product developers were also often critical to the ongoing success of the company, and strongly tied to New Zealand.

Access to key people and skills

- None of the companies cited the quality of New Zealand's workforce in general as being a reason to keep operations here. The importance of key staff in keeping activity in New Zealand therefore diminishes as firms grow. Larger firms become less reliant on such individuals and more able to find and attract suitable replacements for key positions. With one exception, access to key staff and skills was therefore not a significant driver for the larger firms interviewed.

  'As key New Zealand staff retire or resign they are likely to be replaced in Australia.'

- However, a number of the companies interviewed emphasised that key staff often remain in New Zealand when the companies they established or worked in shift offshore, and are then 'recycled' into new business ventures. For example, a significant number interviewed had engaged ex-Navman staff and management. Similarly, the trade sale of Aftermail has enabled the founders to establish Xero.

- This recycling of people and capital has helped to reduce the impact of firms shifting offshore and has the potential to improve New Zealand's internationalisation capability in the future.

- While general skill shortages were not cited to any great degree during the interviews, the absence of a 'critical mass' of people with specific industry or technology skills was identified as a consideration when reviewing existing location choices. Deeper and more specialised foreign labour markets, where these skills are more likely to be readily replaced, were deemed to mitigate operational risks.

High levels of New Zealand ownership

- High levels of New Zealand ownership were sometimes seen as a factor keeping the business located in New Zealand. For one company, the cornerstone shareholdings held by New Zealand-based directors and senior managers meant that a shift offshore was very unlikely. For another, high levels of general New Zealand ownership through the NZX made a shift of the registered head office unlikely, despite New Zealand providing only around 10% of the company's overall revenue.

Cost savings

- While New Zealand is seen as a high cost location for manufacturing, it was seen as being a relatively low cost location to hire professional staff, such as designers, product developers and accountants. However, there was some evidence that New Zealand's cost advantage in this area is at risk of being undercut by the more successful developing nations, such as Thailand and China, which have increasingly skilled workforces.

Dispersion Forces

Development of strategic relationships

- Most firms stressed the importance of developing key strategic relationships with overseas companies in order to increase their growth prospects. These strategic relationships provided:
  - access to sales, marketing and distribution channels
  - credibility
  - capital

- access to a larger customer base.

- These strategic relationships were achieved through a number of channels:

    - simple repeat business
    - more formal joint ventures
    - selling a stake of the New Zealand business to the international third party
    - the New Zealand business buying, or taking a stake in, the international company.

- Where a foreign ownership stake in the New Zealand company was involved, the interviewees mostly reported that the capital itself was secondary, and that it was the strategic benefits that led them to pursue the arrangement.

  'We recently raised significant extra capital from two US-based investors which significantly reduced level of New Zealand ownership of business (despite all existing shareholders also contributing extra finance). The US investors provided improved networks and credibility for future fund raising taking our product to market.'

- New Zealand venture capitalists were generally viewed as failing to provide the same level and quality of strategic benefits as offshore investors. Growing New Zealand firms are often seeking strategic or 'smart' capital which can be leveraged. Offshore VCs were generally considered to offer more in this regard, including specialist industry and market knowledge and relationships, access to 'deep-pockets' to fund subsequent phases of growth, entry to synergistic innovation systems (e.g. a portfolio of firms with common ownership and other linkages) and the credibility of being funded by a top-tier global VC firm. Firms also saw differences in the motivations and requirements of domestic investors compared with foreign strategic investors.

  'The New Zealand venture capitalist just don't have the capability.'

'New Zealand investors want a quick payback with virtually guaranteed returns. American venture capitalists want us to re-invest in growing the company.'

Specialisation and economies of scale

- All the firms interviewed outsourced their manufacturing to at least some degree, and most used international providers (especially in Asia). The foreign manufacturers were seen to provide:
    - lower costs
    - higher quality (*'Neither India or China are cost driven choices. They are flexible, efficient, and offer unsurpassed quality and ability to deal with complexity.'*)
    - specialist skills (*'There was no suitable capability in New Zealand.'*)
    - greater flexibility to scale productions levels up and down with little notice. (*'While large by New Zealand standards, our production volumes are a small component of the [offshore manufacturer's] output. This allowed us to grow our production capacity very quickly, and means we can scale it back when our order book is reduced.'*)

- However, the majority of the companies began their manufacturing in New Zealand, while the product development process was being completed and volumes remained low. A number felt that, while New Zealand was unlikely to ever be a sensible place to base bulk manufacturing, it was important that the economy retained sufficient manufacturing capability and capacity to allow product development and niche manufacturing to continue to occur here.

Management of critical relationships

- As they grew, all the companies said they faced the need to place at least some staff offshore in order to better manage critical relationships.

  - Offshore sales and technical staff are sometimes needed to ensure prompt customer service.
  - Cornerstone investors require regular and easy access to firm management.
  - Companies listed on overseas bourses, such as the ASX, need to maintain strong contacts with market analysts and fund managers.
  - Considerable effort is required to manage joint venture-type arrangements.

- These forces tended to grow in line with the size and complexity of each company's offshore activities. In some instances this seemed to lead inexorably to a shift in the centre of gravity from New Zealand to the company's larger markets.

  'It is simply not credible to manage an international business of this type from New Zealand.'

- The majority of the larger companies interviewed saw no need to shift their operations away from New Zealand entirely. However, they did expect to need to continue to grow the size and number of their offshore divisions.

  'We are quite comfortable that we can continue to operate from New Zealand for the indefinite future.'

  'We believe that we can become a global business from our base in New Zealand.'

Proximity to customers

- As revenues from New Zealand sales were outstripped by those from key overseas markets, a number of companies faced pressure to locate parts of their operations in, or closer to, those markets.
  - Cheaper to base production close to customers
    - One company initially shipped all of their internationally manufactured product through New Zealand before sending it to market. But it now transports the product directly to the end markets from the country of manufacture.
  - Market knowledge
    - A number of companies felt that product development could not be undertaken effectively from New Zealand, given the need to 'know the customer' and the unfamiliarity of New Zealand staff with overseas customers' requirements and expectations.
  - Credibility and branding
    - One of the larger companies has steadily shifted its operational management to Australia in order to be closer to its single largest customer base. Another company is being pressured by offshore owners to locate operations in its major market (i.e. USA), though management is more inclined toward co-locating with suppliers and manufacturers (i.e. Asia).
  - Sales and technical support
    - Fast and effective post-sales support often requires teams to be located much closer to key customer bases.

Proximity to other components of the company's value chain

- In addition to placing activity closer to their key markets, most of the companies saw benefits from placing parts of their operations closer to other components that had already been shifted offshore.

    - Placing R&D teams closer to manufacturing: all companies expressed a strong need to ensure good communication between their R&D teams and manufacturers in order to allow lessons from the manufacturing team to be fed back into product design and new designs to be manufactured correctly. This was typically felt to be most acute in the early stages of a new product's development. However, some companies saw ongoing benefits from co-locating their R&D and manufacturing activities.

      'We have an engineer who thinks it would be better to undertake the development work in [the country were manufacturing occurs]. He is probably right that this would lead to better outcomes.'

    - Placing sales, marketing and distribution teams closer to manufacturing: sales and marketing teams need to be able to communicate quickly and effectively with the manufacturer in order to rectify any problems that arise.

    - Placing sales, marketing and distribution teams closer to R&D: through proximity to customers, sales and marketing teams often gain useful knowledge about how a product could be improved.

Business environment

- Interviewees' perceptions of the importance of New Zealand's macroeconomic environment were mixed. A number, especially the larger companies, felt that New Zealand's macroeconomic and policy environment was a significant disadvantage.

'New Zealand is not a friendly place to manufacture in.'

- However, others felt that New Zealand's business environment was broadly equivalent to the other, mostly OECD, countries that they were likely to be based in if they were not here.

- Exchange rate levels and volatility: all the firms interviewed expressed concerns about the New Zealand dollar's present strength and levels of volatility. Most of the firms interviewed enjoyed a degree of 'natural hedging' against exchange rate fluctuations, given the level of activity, especially manufacturing, undertaken offshore. However, recent high exchange rate levels have still had a significant impact:

  'We are trying to roll out 20-30 stores per annum at the moment. Exchange rate fluctuations can lead to swings of $4m or so in costs.'

  'It is unacceptable that such a high proportion of our revenue volatility is driven by exchange rate effects which we cannot control or manage.'

- Tax rates: only a minority of the companies expressed concerns about New Zealand tax rates. But those that did felt it was a significant factor, and pointed out that New Zealand increasingly needs to compete against Asian countries rather than other OECD ones.

  'In a global market place you simply don't locate where the taxes are 33% without some pretty compelling reasons'. The company concerned saw its two most likely alternative locations as:
    - *Singapore: a 20% tax rate with large grants to relocate (and possible tax holidays)*
    - *Hong Kong: 8% tax rate.*

- Imputation credits: one firm raised a concern that any tax it paid in overseas jurisdictions did not earn imputation credits in New Zealand.

'Our offshore operations are effectively part of our export business. But we are penalised for structuring our business this way.'

- Other issues: a number of companies also raised concerns about:
    - the quality of New Zealand's road, rail and port infrastructure
    - the level and poor quality of local government regulation, and the operation of the RMA
    - the impact of New Zealand's upcoming climate change policies.

Owning / controlling channels to market

- Several firms felt that there were benefits in their owning and controlling their sales, marketing and distribution channels. This allowed them to capture a greater proportion of potential revenue stream and ensure better responsiveness to customers. This required acquiring an existing overseas business or using key New Zealand staff to establish those offshore operations.

Foreign control

- High levels of foreign ownership, especially when held by one or two key investors, appear to reduce the 'inertia' effect discussed in the retention forces section. Foreign owners tended to reverse the burden of proof around location, asking 'what compelling reasons are there to stay?' rather than 'what compelling reasons are there to leave?'

- One of the potential benefits offered by cornerstone foreign shareholders was the ability to help shift a New Zealand firm's centre of gravity to a larger offshore market, thereby increasing its growth prospects and value.

Flow-on effect of previous decisions / tipping point

- The business models used by companies to allow them to successfully internationalise from New Zealand have in many cases resulted in the components remaining here becoming less 'sticky', and in some cases have taken the companies involved close to a 'tipping point' beyond which there would no longer be any logical reason to keep the remaining activity here.

- Subject to the key people being willing to move, a number of the companies felt that they could relocate to another country with the appropriate infrastructure and institutions relatively easily. This has left them more vulnerable to the other dispersion forces discussed above, such as changes in ownership or adverse macroeconomic conditions in New Zealand.

Attraction Forces

No compelling reasons to base operations in New Zealand

- All the firms interviewed felt that, given their history, there were forces acting to keep aspects of their operations here. However, none of the companies were able to identify any forces that would attract internationally oriented activity to New Zealand. While they choose to stay here for now, they would not have chosen to move here had they been established somewhere else.

- A number expressed a strong view that the government had failed to focus on developing a compelling reason for firms to base their operations in New Zealand. They contrasted the New Zealand approach with countries such as Thailand and China which are looking to attract, in the companies' views successfully, key firms in key sectors.

- A number also felt that New Zealand could do better at promoting the New Zealand lifestyle to a targeted group of entrepreneurs, innovators and managers with internationalisation experience.

Loss of Ownership

Lack of exit opportunities

- A number of the owner-operators interviewed identified the difficulty of developing an effective 'exit strategy'. After the firm had reached a certain stage they wanted to reduce their risk and realise some of the fruits of their labour, but found it hard to do so in New Zealand:

- At least three of the companies interviewed have their owners at a crossroad – do they sell and monetise their wealth, or do they 'risk the firm' one more time?

- In order to maximise their return within acceptable risk, owners often sell relatively early, and often in a trade sale to a larger offshore company.

'While some companies may appear to sell out too early, the decision to exit needs to be considered in terms of the risk profile the owners face.'

Weak venture capital market

- Several companies saw New Zealand's venture capital market as weak, lacking the specialist skills and international networks needed to maximise a firm's potential. This left some companies without any potential New Zealand-based VC partners.

Cultural expectations

- A number of the interviewees expressed the view that during internationalisation New Zealand entrepreneurs often sell their businesses relatively early for cultural reasons.

- That partly reflected the view that New Zealanders feel that they have been as successful as they want to be once they can afford the 'bach, BMW and house'. However, a number also felt that most New Zealand entrepreneurs became nervous when they considered taking their company further down the internationalisation path than their peers had done in the past. In other words, New Zealand lacks a strong history of entrepreneurs retaining control of their company past a critical size, and that this dissuaded others from attempting to do so.

- However, some interviewees felt that this was changing, and there was a growing confidence among a key group of businessmen that it was possible to successfully build a large international company from New Zealand.

5 Summary of Retention, Dispersion and Attraction Forces

Strengths and Weaknesses of New Zealand as a Place to Locate Business Activity

- In this section we summarise the forces influencing firms' decisions on where to locate economic activity. Drawing on the opinions expressed in our interviews, we list New Zealand's strengths and weaknesses as a place to locate business activity, and the likely opportunities and threats arising from them.

- The issues which we believe New Zealand has some degree of control over are discussed further in the Lessons and Policy Implications section that follows.

Strengths

- The following are key strengths of New Zealand as a place to do business as identified by the firms interviewed.

  - *Natural 'stickiness' in elements of the agriculture and forestry sectors*
    - New Zealand has obvious competitive advantages in the agriculture, forestry and fishing sectors due to our significant natural resources.

  - *Proud Kiwis wanting to have New Zealand-based businesses*
    - A number of the businessmen we spoke to are clearly proud of being New Zealanders and want to grow large and successful internationally focussed firms that remain based here.

- *Demand for the New Zealand lifestyle*
  - A large number of the interviewees strongly want to keep living in New Zealand.

- *A growing number of business people with capital and internationalisation skills*
  - There is a growing pool of New Zealanders with hands-on experience in growing global firms. Many of them have been 'recycled' from firms such as Navman, and a number have considerable capital to reinvest.

Weaknesses

- The following are key weaknesses identified by interviewees.

  - *Difficulties managing mission-critical relationships*
    - Firms need to maintain strong relationships with customers, suppliers, investors, and strategic partners. Those key stakeholders are often located a significant distance from New Zealand and operate in different time zones.

  - *The need to build strategic partnerships leading to weaker ties to New Zealand*
    - It is difficult for firms to grow internationally solely through unassisted organic means. Internationalising firms therefore often seek out strategic partnerships through inviting a foreign firm to take a cornerstone shareholding or by entering into licensing arrangements with a large overseas firm. While effective at helping the firm to internationalise, these arrangements often result in increased pressures to shift activity away from New Zealand.

  - *No compelling cost structure*
    - With the exception of professional staff, New Zealand is a relatively expensive place to locate

economic activity.

- *Few compelling quality, skill or strategic benefits*
    - Other than to access New Zealand's natural resources, firms see few compelling benefits from locating activity here.

- *Unfavourable macroeconomic climate*
    - New Zealand is perceived as having high interest rates and a high and volatile exchange rate. In other areas, such as tax rates, New Zealand does not offer any strong advantage.

Opportunities

- The following are key opportunities the interviewees saw for New Zealand to improve its attractiveness as a place to do business.

    - *Greater use of a 'New Zealand business model' geared towards internationalisation*
        - As a growing number of new firms successfully internationalise through use of a business model suited to New Zealand, others are likely to emulate and follow.

    - *Increasing 'stickiness' by becoming 'everything to somebody'*
        - Government policies could be used to create more compelling advantages for targeted types of firms or sectors to locate business activity in New Zealand.

    - *Capability and capacity improvement through recycling people and capital*
        - There is potential to further develop the pool of New Zealand business people with strong internationalisation skills, as a growing number of firms expand their offshore operations and key staff

continue to be recycled throughout the economy.

- *Improved value capture during the company/product life cycle*
  - There is potential for New Zealand firms to become smarter about capturing a greater share of the potential value of their businesses, such as through improved exit strategies and negotiation of better licensing arrangements.

- *Management and marketing of the New Zealand lifestyle to improve attraction and retention*
  - There is potential for the government to use the benefits of the New Zealand lifestyle more effectively as a way of attracting and retaining key businesses and business people.

- *Undertaking explicit competitor country analysis*
  - The effectiveness of government policies could be improved by developing a more strategic understanding of the relative strengths and weaknesses of New Zealand as a place to do business.

- *Further development of New Zealand capital markets*
  - There is potential for New Zealand to capture a greater proportion of the value of the businesses established here through strengthening the coverage and strategic capability of our capital markets.

Threats

- The following are key threats that firms identified.

  - *'Low cost' competitors increasingly managing quality and complexity better than New Zealand*
    - The international competitive environment is not static; countries such as China and Thailand are working to attract more highly skilled activity, and in many instances are succeeding.

- *Relocated elements of the value chain acting as magnets*
  - New Zealand firms with significant overseas sales will always need to place some parts of their value chains overseas. This will in turn typically result in increased pressure to relocate the components that were initially retained in New Zealand.

- *Insufficient pipeline of new activity to offset losses*
  - The ongoing loss of some economic activity from the New Zealand economy is inevitable. It is therefore vital that sufficient new firms of suitable quality are created. The 'pipeline' of new and emerging firms may not prove adequate.

- *Continuing perception of a difficult macroeconomic environment*
  - There is a risk that New Zealand will gain a reputation as having an unfavourable macroeconomic climate.

- *Reaching a tipping point*
  - The loss of activity from New Zealand has negative effects on those firms which remain. There is a risk that this could lead to a downward spiral, with greater numbers of firms leaving New Zealand over time.

Table 1 – Summary of SWOT Analysis: New Zealand as a Location for Economic Activity

Strengths	**Weaknesses**
o Natural 'stickiness' in elements of the agriculture and forestry sectors. o Proud Kiwis wanting to have NZ based businesses. o Retention due to demand for the NZ lifestyle by strategically important owners and employees. o Growing (recycled) group with capital and internationalisation skills.	o Difficulties managing 'mission critical' relationships due to distance and infrastructure (i.e. with customers, suppliers, and investors). o Strategic foreign ownership / licensing often the most efficient means to build relationships and speed to market. o No compelling cost structure, other than cost of professional staff. o Macro uncertainty and associated risk premium. o Absence of a credible government / business partnership.
Opportunities	**Threats**
o Rise of the 'NZ business model' geared towards internationalisation of NZ based companies. o Create 'stickiness' by becoming 'everything to somebody'. o Capability and capacity improvement through recycling people and capital. o Improved value capture during the company / product lifecycle (i.e. explicit planning for exit, licensing). o Manage and market the NZ lifestyle to improve attraction and retention. o Explicit competitor country analysis when developing policy to improve attractiveness of NZ as a place to do business. o Further development of depth, completeness and strategic capability of NZ capital markets.	o 'Low cost' competitors manage quality and complexity better than NZ, and continue to improve at pace. o Relocated elements of the value chain act as magnets, due to synergies, for other parts of the chain still located in NZ. o The pipeline of new activity isn't sufficient to offset 'hollowing out' losses. o Continuation of poor infrastructure, required to support the NZ business model, relative to competitors. o Continuing perception of the NZ 'risk premium' (i.e. high and volatile exchange rate and high interest rates). o Tipping point – inability to justify locating any aspect of the business in NZ, due to absence of positive reasons to do so.

6 Lessons and Policy Implications

- In this last section of the report we set out the key lessons we consider should be taken from our interviews and suggest a number of areas where further policy effort could be considered. While these sections inevitably draw heavily on our discussions with the companies interviewed, we would stress that the views set out in this section are ours alone.

Lessons

Globally distributed value chains are inevitable

- The trend of New Zealand firms outsourcing components of their value chains is inevitable and offers significant efficiencies and strategic benefits to the firms involved. New Zealand should expect to continue to lose such components of growing, internationally oriented businesses as they structure themselves to successfully develop from their New Zealand base. This is a necessary response to New Zealand's attributes (small market, distance) and constraints (cost structures, lack of under-utilised resources, scale).

- The concept of New Zealand firms having globally distributed value chains should therefore be embraced, and the government's energies should be focused on how to exploit the opportunities, and manage the risks, that are likely to result.

We need to become a more compelling place for components of the value chain

- In many sectors New Zealand currently lacks any compelling advantages as a place to locate economic activity. As a result, we appear to face something like a one-way street: we struggle to retain businesses and elements of the value chain located here, but do not attract much in the way of established activity to offset these losses. New Zealand therefore needs to strengthen retention rates in areas of strategic concern and ultimately to begin to attract greater amounts of new economic activity.

- The loss of economic activity is not limited to low-skilled, low-wage kinds. All parts of the value chain are potentially at risk.

- The necessary improvements in retaining and attracting economic activity could occur in a number of ways, including:

    - improvements in the quality and number of start-up and emerging businesses in the pipeline

    - the development and retention of a truly global business (i.e. the next Nokia)

    - New Zealand becoming 'everything to somebody' – that is, becoming known as a centre for excellence for certain technologies or functions and attracting that activity here (In a globally competitive market there is little to be gained from being 'something for everybody'. Specialisations are what tend to capture the greatest value.)

    - New Zealand firms developing excellence in global value chain management, improving their ability to manage complex business logistics from a distance

    - New Zealand developing the strategic value-added (distribution, relationships, speed to market) which often accompanies foreign direct investment, such as through improving our VC capability

    - the government strengthening the New Zealand lifestyle proposition and actively marketing it to entrepreneurs and managers with the desired skills.

Many countries are competing to attract economic activity

- A significant number of New Zealand's trading partners and neighbours are competing to attract people, capital and business activity. 'Winning' nations will be those that understand their value proposition, know their competitors' relative strengths and weaknesses and have strong linkages with their business community.

Possible Implications for Policy

Development of a sharper vision

- Given its characteristics and constraints, New Zealand is likely to be able to consistently retain and attract only certain types of economic activity. A clearer understanding of these types of activity, and the factors that would increase our attractiveness for them, is highly desirable.

- We therefore recommend that the government consider undertaking an analysis of New Zealand's current and potential 'value proposition' in order to identify the value chain elements in which New Zealand is well placed to establish a dominant market position.

- The following policy tools could be used to inform this work.

    - Competitor Country Analysis: this is a methodology and process that could be used both to evaluate the relative attractiveness of New Zealand as a place to locate 'strategic' business activity and to assess policy options.

- Development of a Business Pipeline Database: regardless of how successful New Zealand becomes at attracting new business activity, the rate and quality of new business start-ups, and their development into mature internationalised firms, are likely to remain vitally important. We see benefits in the government monitoring business activity more at all stages in the development pipeline. This would ideally include the identification of any challenges firms face as they progress. This should help the government improve its understanding of: what constitutes a 'healthy' business pipeline; what the challenges are for firms passing through it; and what the policy implications are for ensuring new business activity is balanced and in the required quantities and qualities to meet New Zealand's economic transformation goals.

- A Programme of Credible Engagement with the Business Community: the government cannot credibly develop a vision for New Zealand's economic development without improving its understanding of the practical commercial challenges New Zealand firms face as they internationalise. A programme of regular engagement with a range of internationalising businesses at all stages along the business development pipeline would help to improve that understanding. It would also help to emphasise to those firms' owners and managers that their importance in economic development is recognised and valued.

Marketing programme to retain and attract people with internationalisation expertise

- Our interviews emphasised the importance of people with strong skills and experience in establishing and growing international businesses, and the important role that the 'recycling' of skills and capital has played in the development of New Zealand's current crop of internationalising firms.

- We see merit in the government attempting to identify more sharply the key skills that are needed, and to develop a strategy to encourage the people with those skills to remain in New Zealand.

- Consideration could also be given to a tightly targeted marketing programme to attract offshore entrepreneurs and managers to relocate to New Zealand. We would envisage an approach that was similar to that taken by Tourism New Zealand when targeting key market segments.

Further development of capital market capability

- A number of the companies we interviewed expressed concerns about the nature of New Zealand's capital markets and about the need for companies to seek offshore partners to secure the strategic benefits to allow them to grow more strongly into international markets.

- We therefore recommend that the government consider options for encouraging New Zealand VC firms to increase their levels of cooperation and partnering with suitable offshore venture capitalists. For example, this could be included as a requirement for domestic VC firms seeking investment funds through the VIF programme.

- More generally, further consideration could be given to ways that the government could (possibly through Investment New Zealand) assist New Zealand companies secure the strategic benefits which so often accompany foreign direct investment without 'sacrificing' ownership.

Capability building

- The interviews identified a number of areas where New Zealand companies could benefit from improved capability. The following are examples where education and training (potentially delivered through New Zealand Trade and Enterprise) could be considered.
    - Value Chain Management: improving firms' abilities in managing globally distributed value chains from a distance.
    - Managing to Maximise Value Capture: teaching New Zealand companies how to maximise the portion of value they capture when structuring deals (i.e. structuring licensing agreements, structuring your business for sale, protecting against dilution through repeatedly accessing capital markets, and succession planning to avoid value destruction).
    - Further Development of the New Zealand Business Model: helping firms to understand how best to structure a business based in New Zealand, given its unique characteristics and constraints.
    - How to Diversify from a Single Customer to a True Internationalised Business: many companies appear to rely on a single large international customer or contract and are struggling to grow and diversify their concentration risk.