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THE ROLE OF HOST COUNTRY FACTORS IN ATTRACTING MANUFUCTURING FOREIGN SMES INVESTMENT IN KENYA

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Abstract: *The purpose of the study was to investigate the role of host country factors in attracting foreign SMEs investment in Kenya. The research was exploratory and the sample constituted of 37 manufacturing small and medium foreign firms at the EPZ in Kenya. Top executives of Kenyan foreign SMEs firms were chosen as the key respondents in this research. The results of the study suggest a need for multidimensional, FDI- SME linkages. The study emphasizes the need to pay attention to the broader business environment that affects both SMEs development and their ability to attract FDI, secondly, to making SMEs more attractive as business partners for inward investing enterprises and thirdly to have a strategy for encouraging this type of co-operation. To this regard, Morisset (2000) has underlined the importance of reforms aimed at increasing macroeconomic stability, democracy and a commitment to economic reforms. Morisset (2000) also stresses the importance of high profile publicity efforts, on the basis that potential investors need to have an up to date and accurate picture of the contemporary business environment, rather than one based on (negative) perceptions inherited from the past.*

Clearly, if FDI-SME linkages are to be developed, policy makers need to commit themselves to the creation of a business environment that is conducive both to attracting FDI and to facilitating domestic entrepreneurship and SME development. Four host country factors were considered in the study. These included level of economic development, market potential, environmental uncertainty and availability of resources. The findings indicated that both the level of economic development and environment uncertainty were positively related to performance.

Keywords: *Foreign Direct Investment, Host Country factors, Export Processing Zone, Small and Medium enterprises, Manufacturing firms, Internationalization, Kenya.*

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1.0 INTRODUCTION

The internationalization of SMEs in any sector presents them with an opportunity for growth and development beyond the local market of operation. According to Richard & Brett, 1995, participating in the global market is one of the most exciting and promising avenues for entrepreneurs to expand their businesses. While the vast majority of SMEs may not be interested or ready to move beyond national or local markets, there are many target segments with higher growth potential who would like to pursue international opportunities but may need help in overcoming various market failures or gaps in order to do so.

International expansion is a significant decision for small and medium-sized enterprises (SMEs) who traditionally have a small financial base, a domestic focus and a limited geographic scope (LU and Beamish 2002). While some SMEs are 'born global', most lack the resources necessary to internationalize and traditionally they have appeared reluctant to engage in global business activities (Kirby and Kaiser 2003).

Traditionally, internationalization was described as a gradual sequential process of various identifiable stages which include intermittent exports, exports via agents, overseas sales via knowledge agreements with local firms and foreign direct investment in the overseas market (Johansson & Widersheim-pau, 1975)

The rational was that this approach minimizes risk and investment amounts required at each point in time and allows for learning and experience gaining before further expansion. However, some other research shows that firms do not necessarily follow any consistent pattern in their internationalization although the driving forces behind the process remain the same (Benito & Welch 1993). Foreign direct investment can be a better way to achieve firm growth, although most countries, only a small fraction of SMEs have established subsidiaries abroad (OECD, 2005). SMEs face considerable barriers when attempting to engage in FDI given their limited financial, managerial and information resources and their attitude to risk, though such limitations can be overcome. This study objective looked at the host country factors that determine the foreign SMEs investment in the manufacturing sectors and their performance in Kenya.

The host country factors are critical to enhancing manufacturing SMEs to participate in FDI. Economic development and environment uncertainty are widely considered an important motivation for FDI entry. FDI attractiveness is formed by such factors as public policy, legal framework and support institutions (Core & Wrengly, 2007). FDI SMEs also consider the country's market potential and availability of resources in their country selection. They also consider the size and growth potential of the host country's market (Alexander & Dohert 2009). This study investigated level of economic development market potential, environment uncertainty and availability of resources in line with Mark posh, 2007.

FDI are normally associated with large corporations which have a share holding structure that normally lure investments from those keen in seeing substantial returns on their funds. Foreign Direct Investment normally assesses the potential for returns through documented profiles or published profitability statements, clear growth statements and hence clear growth potential in the companies they seek to invest in (European commission, 2003). This kind of documentation is lacking among SMEs involved in FDI especially in Kenya since little has been done related to this area. Most SME undergo inception, develop, diversity but do not grow to internationalize. Entrepreneurship activity is a pre-requisite for the success of economic growth, development, social well being and political stability (Timmons & Spinnelli 2004). SME sector has remained on an upward trend in the last few decades as a major contributor to the economy of Kenya. According to sectional paper no.2 of 2005, SMEs are recognized as a viable strategy for achieving national goals and contribute greatly to employment creation. It is now widely acknowledged that FDI has potential benefits that can accrue to developing countries. This view is mainly based on the new liberal and development economists, who suggest that FDI facilitates economic growth as it provides the much needed capital for investment and aid local firm to become more productive by adopting more efficient technology or by investing in human or physical capital. Kenya's FDI record over the years has not been impressive. Although Kenya was among one of the most favored destination for FDI in the 1970s in East Africa, it is now among the countries with very low levels of FDI. Few studies have investigated the reasons for low levels of FDI in Kenya and most studies are based on multinationals. This study provides fresh evidence on the determinants of FDI based on a survey of foreign SMEs among the manufacturing firms in Kenya.

Many developing countries have developed a renewed interest in FDI as a source of capital due to the decline in official development assistance (ODA) in the 1990s (Kinuthia, 2010). FDI has several advantages of other types of capital flows in particular its greater stability and the fact that it would not create obligations for the host country. In addition to being a source of capital, FDI has other potential benefits to host countries which include technology transfer, new management skills, market know how and job creation. These real world trends have led to substantial recent interest by various disciplines to empirically investigate the fundamental factors that drive the FDI behavior. There are many theory and studies that have been conducted on FDI determinants. The different approaches do not necessarily replace each other but explain different aspects of the same phenomenon. All the studies point to the fact no single theory can explain FDI drivers. Most of the studies rely on secondary data and therefore tend to be macro in nature. This study however takes a different approach and utilizes a firm survey data in order to explore the main FDI SMEs determinants in Kenya. This subject has received little attention in Kenya. FDI is mainly concentrated in the manufacturing sector and is mainly Greenfield in nature. Most of FDI in Kenya is export oriented and market seeking. The most important FDI determinants are market size in Kenya as well as within the region, political and economic stability in both Kenya and its neighbors and bilateral trade agreements between Kenya and other countries.

1.1 Objective of this study

To investigate whether the host country factors, namely, level of Economic development, market potential, environment uncertainty and availability of resources, and their influence on the foreign manufacturing small and medium enterprises to invest in Kenya.

2.0 RESEARCH METHODOLOGY

This section sets out the methodology that was used to achieve the objective of the study. The methodology includes the population.

The research design constitutes the blue print for collection, measurement and analysis of data. The design aids in the allocation of invited resources by posing crucial choices analysis of records, simulation or combination, whether data collection methods and research situation is highly structured, size of sample and whether analysis will be qualitative or quantitative. A research design is the plan and structure of investigating so concerned as to obtain answers to research questions (Kothari, 2004). There is existing research on internationalization of SMEs but not the case of manufacturing foreign SMEs in Kenya. Therefore exploratory design is appropriate for this study, since this type of design is useful when researchers lack a clear idea of the problems they will meet during the study. This type of design also helps the researchers to develop operational definitions and improve the final research design as well as establish priorities and save time and money. According to Kothari, 2004, this type of design is important especially if an area of investigation is new or vague and by carrying out an exploration study the researcher learns and is able to define variables thoroughly. In human contexts, there are certain facts that are not obvious, on the surface and require deeper investigation. The purpose of explorative design that this study took was to provide familiarity or new insights and discovery of new ideas to the researcher. According to Emil Chandran, 2004, this design encourages drawing together of various pieces of information and thus increases the investigative power of the researcher. This study therefore was an investigative/exploratory research.

2.1 Target population

The study population comprised of the manufacturing foreign firms at the Export processing zone (EPZ). EPZ was established in 1990 and at the time of the study had a total population of 71 firms. According to Saunders et al 2007, target population is that population to which the researcher wants to generalize the results of a study. According to chandran, 2003, a population is the total collection of elements about which inferences are made and refers to all possible cases which are of interest for a study. For the purposes of this study, the population was manufacturing foreign SMEs at the EPZ. Due to the fact that no complete list exists of all manufacturing foreign SMEs in Kenya, the list of foreign SMEs was drawn from EPZ A, the administrative office of all the EPZs in Kenya located at the Athi River.

2.2 The sampling technique

The researcher in the sampling process combined more than one sampling technique via stratified sampling which ensured that all the manufacturing firms were included in the sample purposive sampling which was used to identify 37 sample units that met the research criteria. The basic idea of sampling is that by sampling some of the elements of population, conclusions about the entire population can be drawn. The ultimate test of a sample design is how well it represents the characteristics of the population it purports to (Kothari 2004).

2.3 Instruments

Various data collection methods for qualitative research may be used in a study (Walker, 1985). The study used mainly a questionnaire as the instrument of the study. This was prepared for managers of the manufacturing foreign SMEs located at the EPZs in Kenya. The questionnaire was prepared in various sections detailing all the variables of the study that were derived from the objective.

2.4 Data analysis

The statistical method that was used in this study is descriptive and inferential statistics. Data analysis was done using spss version 17 (statistical program for social studies). Both quantitative and qualitative methods were applied in the data analysis.

3.0 RESULTS OF THE STUDY

The study aimed at investigating the role of host country factors in attracting the manufacturing foreign SMEs to invest in Kenya. The following is the presentation of the results of the research objective.

3.1 Host Country factors

This was the objective of this study. Host country factors have a great influence on decisions made by foreign firms when choosing to invest in a country. This is widely covered in the international business literature mainly on how host country factors influence the entry mode decisions. Since the respondents are already operating from the EPZs where it is presumed that the framework and institutional framework are conducive and attractive for FDI, this study sought to find out the non-traditional critical host country factors that attract foreign SMEs to invest in Kenya. The themes for this objective included; level of economic development, market potential, environmental uncertainty and availability of resources. The findings show that the level of economic development for the host country accounted for 31% followed by market potential at 20%. The overall level of economic development tends to reflect the level of manufacturing.

Table 3.1: Host Country Factors

Host country	Frequency	Percentage
1. Level of economic development	11	31
2. Market potential	10	29
3. Environmental uncertainty	9	23
4. Availability of resources	8	21
Total	**37**	**100**

Some other studies show that host country enterprise development, characteristics and growth prospects are important enticements to manufacturing SMEs seeking growth and profit opportunities (Coe and Wrigley, 2007). Small and medium enterprises assess the country potential to **investment internationally in terms of the size and growth potential of the host country market (Sternquist 2007).**

As indicated in Table 3.1 above the environment uncertainty was ranked third as a host country factors accounting for 23%. A potential risk to overall profitability is environmental uncertainty, which is manifested in country risk factors that include transparency, legal, financial and regulatory system. SME managers weigh numerous risks in FDI. As a result, SME market entry plans are impeded considering riskier business environment (Finnergan and Good, 2009). The last host country factor is availability of resources standing at 21%. The resources are composed of not only capital and labour but also human resources, physical resources, natural resources and climate countries with a relatively large pool of advanced factors such as modern infrastructure and skilled labour force that are used by firms in an effective and efficient way gain competitive advantage in those industries with high potential for FD

3.2 Impact of FDI on Host Country

The respondents were required to indicate the impact of FDI. As indicated in Table 3.2 below 35% of the respondents, indicated that the greatest benefit related to backwards linkages with suppliers.

Table 3.2: Benefits of FDI.

Benefits	Frequency	Percentage %
1. Backwards linkages with suppliers	13	35
2. Forward linkages with customers	11	29
3. Linkages with competitors	8	21
4. Linkages with technology	6	15
Total	**37**	**100**

This referred to the extent to which the services are outsourced from within the host economy, since it can create new market opportunities for local firms. Such linkages ranged from arms length market to transaction to deep long-term inter firm relationships. The productivity and efficiency of local suppliers can benefit from this type of spill-over, as a result of detect knowledge transfer and high quality requirements. The forward linkages with customers accounted for 29% and included marketing outlets which are outsourced. The linkages with competitors was the third benefit standing at 21% where the foreign SMEs set new standards which local firms may seek to compete with. The fourth benefit of the was the linkages with technology partners standing at 15% where some foreign SMEs initiated common projects with indigenous SME partners, including joint ventures, licensing agreement and strategic alliances, which are an important potential source of technology and know-how for firms in the host country.

3.2.1 Regression Results

The performance of FDI SME's and the factors that determine their performance shows that out of the studied four factors, only two of those factors influence . Those that are significant at a confidence level of 99% are the level of economic development and environmental uncertainty. The two factors have a correlation co-efficient of 0.099 and 0.216 respectively. The two co-efficient show that the relationship between performance and level of economic development in positive. The same results for Environmental uncertainty and performance that FDI SME's consider the level of economic development as a key factor in determining how well they will perform in a given country. This may be the reason why FDI in Sub-Sahara Africa and Egypt have a higher level of economic development as compared to other Africa countries.

The other key factor is Environmental uncertainty with a correlation co-efficient of 0.216 or 21.6%, variability. This is an indication that host country factors have the highest influence on FDI SME's performance. Environmental uncertainty could be due to political factors which play a key role in determining performance of firms. Countries with unstable political climate are expected to lead to lower performance by FDI SME's as well as local SME's. Uncertainty affects forward playing and upscale investments as investors are not sure of the political stability of the host country.

Multiple regression analysis was conducted with the firm performance as the dependent four dimensions of FDI as independent variables. The effect was then identified by examining their degree of significance. The Pearson's correlation coefficients for the independent and dependent variables are presented in Table 3.3

Table 3.3: Pearson's Correlation Coefficients for Independent and Dependent Variables

Variables	Mean	Standard Deviation	1	2	3	4	5	6	7
Host Country Factors									
1. Level of Economic Development	0.045	0.153	0.084*	-0.027	-0.027	1			
2. Market Potential	0.0209	0.036	0.000	0.113**	-0.053	-0.053	1		
3. Environmental Uncertainty	>=0.00	0.008	-0.023	-0.010	0.069	0.054	0.054	1	
4. Availability of Resources	1.227	0.305	-0.098**	0.077*	0.049	-0.032	0.019	0.019	1

***= Significant at the 0.05 level; **Significant at the 0.01 level**

3.2.2 Regression Results between FDI and Performance

Table 3.4 shows the results of regression. The model runs with four independent variables.

With respect to host country factors level of economic development and environmental uncertainty are positively related to performance (beta = 0.103 and 0.225 respectively; $p<0.001$). A potential risk to overall profitability is environment uncertainty, which is manifested in country risk factors include transparency and stability of the political, legal, financial and regulatory systems. Managers weigh numerous risks in the international business environment. As the host country environment becomes more unpredictable, total business costs will likely increase, diminishing gross margins and profitability (Evans, Bridson, Bryom and Medway 2008

Table 3.4: Regression Results between FDI and Performance

	Host country factors	
1.	Level of Economic Development	0.103***
2.	Market Potential	-0.024
3.	Market Potential	0.225***
4.	Availability of Resources	-0.038

***** = p<0.01;**= p<0.1. All models run with year and industry dummies. All beta values reflect standardized beta values**

4.0 CONCLUSIONS AND RECOMMENDATIONS

When SMEs are needy to begin their first FDI expansion, attention should be directed at the host country. Four host country factors were considered in this study. These included level of economic development, market potential, environmental uncertainty and availability of resources. The findings indicated that both the level of economic development and environment uncertainty were positively related to performance. The environment under which internationalizing firms operate was also found to influence performance this may encompass the location related factors such as host county's political and legal system, government policy towards foreign investment, economic development, national culture (Hamel, 1991), and the availability of production workers, skill workers and senior managers (Badri et al, 2000; Oviatt and McDougall, 2005)

One of the key factors that policy makers need to consider in seeking to attract and exploit the potential benefits of FDI, is the large number of locations in the world with similar characteristics, which clearly affect the bargaining position of individual governments with potential investors. In the absence of other location advantages, competition between places typically focuses on offering lower costs, which can contribute to the so called "race to the bottom". As with business strategy, competition between places based on non-price advantages is ultimately more sustainable than that based on price alone, which emphasises the importance of policies that seek to upgrade local economies in terms of infrastructure, human capital and a competitive potential supply base. At the same time, there is also a role for specific policies aimed at encouraging and facilitating co-operation between local SMEs and foreign investors, such as by improving the flow of information about suppliers to potential purchaser and about supply opportunities to potential suppliers through the development of a national Website and /or business directories. The penetration and success of such initiatives is likely to be enhanced if they are introduced in co-operation with appropriate business support agencies and actively disseminated through various channels.

To be effective, policies to encourage FDI-SME linkages need to be multidimensional. Firstly, policy need to pay attention to the broader business environment that affects both SMEs development and their ability to attract FDI; secondly, to making SMEs more attractive as business partners for inward investing enterprises; and thirdly, to a strategy for encouraging this type of co-operation. In this regard, Morisset (2000) has underlined the importance of reforms aimed at increasing macroeconomic stability, democracy and a commitment to economic reforms, Morisset (2000) also stresses the importance of high profile publicity efforts, on the basis that potential investors need to have an up-to-date and accurate picture of the contemporary business environment, rather than one based on (negative) perceptions inherited from the past.

Clearly, if FDI-SME linkages are to be developed, policy makers need to commit themselves to the creation of a business environment that is conducive both to attracting FDI and to facilitating domestic entrepreneurship and SME development. In terms of improving the general environment to attract FDI and facilitate domestic SME development, three main groups of measures are identified:

1) Improvement to the general macroeconomic and institutional framework, to increase institutional predictability, including:
    i. Sound macroeconomic policies geared to high economic growth and employment targets and price stability
    ii. The development of secure and transferable property rights, together with systems to protect IPR and assure patents, trademarks and copyrights;
    iii. The promotion of fiscal discipline, together with efficient and socially just social taxation systems
    iv. Guaranteed rights for the repatriation of capital and profits
    v. Strengthening domestic financial systems, in order to make domestic financial resources available to complement FDI

2) The creation of a regulatory environment conducive to attracting FDI by:
    i. Promoting transparency and non-discrimination with respect to regulatory actions and business practices
    ii. Strengthening efforts to consolidate good governance programmes and the rule of law, including stepping up the fight against corruption
    iii. Promoting increasingly open foreign trade in order that the domestic enterprise sector can participate fully in the global economy, linked to efforts to increase competition and the domestic economy through an effective Competition Policy
    iv. Enforcing principles of non-discrimination in the implementation of legislation at all levels of government
3) Upgrading infrastructure, technology and human capital to a level where the potential benefits of a foreign corporate presence for the domestic economy can be realised through positive spill over effects. Specific examples include:
    i. Relevant physical and technological infrastructure, which could be helped by allowing foreign investment through PPP.
    ii. Taking steps to ensure the provision of appropriate, high quality technology services, such as testing centres, research and development institutions and bodies to effectively regulate technical standards.
    iii. Prioritising steps to raise the level of the basic education of the workforce
    iv. Re-assessing current incentives schemes in relation to the types of FDI best suited to local conditions.

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