Foreign investment and economic integration

Meat industry in the Baltic Sea Region

By **León Poblete & H. Richard Nakamura**

Regional integration processes have been a focus of academic interest since the 1950s and have taken on more importance since the 1980s,[1] primarily because of the development of the European Union. Regional integration in the form of free-trade unions is an important issue because it offers a chance for small open economies to expand the size of their international trade and to obtain similar benefits as larger economies. This comes with all of the implications that this entails for the investment strategies of multinational firms, the development of competitive advantages, and the increase of scale economies.[2] In addition, Stirk (1996) argues that there has been a tendency for richer countries to open up for regional integration with poorer neighboring states.[3] Regional integration offers firms incentives to invest more locally by reducing transaction costs and thereby increasing the rate of return on capital. The European Union's inclusion of the Baltic states and Poland in 2004, for example, brought about a 6% average increase in foreign direct investments measured as foreign direct investment stocks.[4]

Most foreign direct investments have been directed to the manufacturing sector. The food processing industry represents the largest industrial subsector, and accounted for 15%–20% of all manufacturing sector foreign direct investments during the 2000s.[5] Since the mid-1990s, food manufacturing foreign direct investments have increased in quantity because the overall increase in earnings and living standards has led to increased consumption of meat and meat products. This development of the food consumption pattern is in line with a global trend of increasing meat consumption and production.[6]

Despite this development, very few studies exist that cover food industry foreign direct investments in the Baltic Sea region – defined in this study as the European Union member states surrounding the Baltic Sea except for Germany – in general, and even fewer studies cover food industry mergers and acquisitions in particular. The exceptions include the study by Hunya (2004), who covered the food industry as a part of an overview of foreign direct investments in the Baltic Sea region, and the consumer trends study by Kniuipytė (2012).

Thus, the purpose of this paper is to *analyze the motives of the food industry's foreign direct investments in the meat industry in the Baltic Sea region and to determine how institutional factors influence investment decisions.* This study will evaluate and provide a meso-level perspective by investigating the extent to which foreign direct investments in the meat industry, the largest subsector of the food industry, have contributed to economic integration in terms of the integrating and upgrading of local businesses in the Baltic Sea region. Thus, with the intention of finding possible answers to these questions, we investigate a number of interrelated issues that help us understand the impact of the flow of foreign direct investment on the local small and medium-sized firms in the Baltic Sea region's meat industry.

TODAY'S GLOBAL PRODUCTION networks, built up by flexible non-equity modes of international production such as contract manufacturing, outsourcing, and offshoring,[7] have changed the time dimensions of international manufacturing firms, and long-term investment commitments are no longer a prerequisite for production operations overseas. The phenomenon of "born globals", [8] which describes instant or rapid internationalization of business ventures, is an example of today's dynamic global business environment. However, the basic arguments of mainstream internationalization theories are still valid.[9] In order for firms to establish international business activities, the firms must usually possess superior competitive qualities than incumbent firms.[10] Moreover, closeness of markets,[11] business network embeddedness,[12] and cultural proximity[13] have also been forwarded as significant factors to explain the internationalization process of firms.

One concrete expression of business internationalization is foreign direct investment, which is a significant feature of today's globalizing economy. Here, we are referring to two particular modes that multinational corporations can utilize: greenfield investments, where firms build up brand new operations in a foreign country, and cross-border mergers and acquisitions where firms acquire existing firms in the host country. These two modes are generally different not only in nature but also in terms of the type of firms that undertake greenfield foreign direct investments and cross-border mergers and acquisitions. For example, Andersson and Svensson (1994) and Bloningen (1997) have found that firm characteristics, such as industrial affiliation and firm-specific competitive skills, determine what type of foreign direct investment mode is chosen. Furthermore, Dunning (1992) and Dunning and Lundan (2008) have attempted to incorporate these aspects when categorizing foreign direct investments into four different types, namely, resource-seeking, market-seeking, efficiency-seeking, and strategic asset-seeking investments. As Dunning correctly observes, contemporary foreign direct investment activities are pushed by competitive pressures and scale economies.

The location of the host country, the market size, and possession of firm-specific capabilities are all examples of key factors acknowledged in the theoretical literature as being attractive to foreign direct investments.[14] Furthermore, institutional changes, such as the establishment of free-trade areas[15] and large-scale isomorphic industrial organizational patterns among firms[16] inside the free-trade areas, have also been pointed out as important pushing factors for foreign direct investments. Other factors for foreign direct investment decisions that have been intensely discussed in the foreign direct investment and international business literature are host-country technology absorption abilities and institutional risks associated with technological transfers.[17] In this way, institutional factors are recognized as being strong determinants for foreign direct investments[18] and for mergers and acquisitions in particular.[19]

However, industry level studies on mergers and acquisitions in the Baltic Sea region addressing institutional factors in investment decision making are, to the best of our knowledge, very scarce. The long-term retention of the investments made by foreign firms, which is promoted by governments of the Baltic Sea region with the hope of positive foreign direct investment spillovers, is dependent on the host country's institutional context.[20] From the foreign investing firms' perspective, the influence of institutional or contextual embeddedness[21] on corporate governance and strategic managerial decisions made by the internationalizing firms operating in a global context has become more important than ever before in international investment decisions. Still, after some 25 years of transition from the Soviet-style command economy to a European Union economy, corruption and the question of how to handle issues relating to the gray-sector economy[22] are a reality for foreign investors in the eastern Baltic Sea region. Studies on institutional hazards have shown that there is a strong negative correlation between the level of activities of foreign firms and affiliates on the one hand and weak governance structures and general attitudes towards institutional hazards on the other.[23]

Thus, we need to address features of contemporary foreign investments that have been largely ignored by the foreign direct investment literature and introduce institutional aspects to the research when we discuss patterns in foreign direct investment behavior and motives. Obviously, there is a need for mergers and acquisitions research that also introduces complementary perspectives to help us better understand the foreign direct investment patterns in the Baltic Sea region. This work discusses the nature of the mergers and acquisitions in the meat industry by taking an institutional perspective on foreign direct investments in the eastern Baltic Sea region.

THE COMPANIES SELECTED for this research were first identified through the ORBIS/ZEPHYR[24] company, mergers and acquisitions databases, and expert interviews at consulting companies, academies, organizations, and governmental institutions related to the mergers and acquisitions of the meat industry in the Baltic Sea region. We started with 96 companies and narrowed down the selection to 63 approachable companies. A request was then sent to these companies, of which 37 replied to our query. Respondents were contacted via e-mail and telephone to inquire if they were willing to participate in the study, and 24 companies and organizations finally agreed to interviews at the location of their choice. Chairmen of the board and Chief executive officers were chosen as respondents due to their insights into mergers and acquisition decisions. All interview data were checked through respondent validation. Follow-up questions were also sent to the respondents by e-mail after the conclusion of the interviews in order to improve the understanding of particular issues.

The intention of the in-depth interviews was to get perspectives, feelings, memories, and reflections that could not be observed or discovered in other ways.[25] The interviews had a retrospective starting point, and we asked the respondents to describe in detail their companies' journey toward mergers and acquisitions in the Baltic Sea region – illustrating both positive and negative experiences – and to reflect on personal and technical challenges and solutions. Interviews were semi-structured, in that all respondents were asked a series of identical questions, but they were also open ended. This approach ensured commonality of topics across interviews while also encouraging respondents to expand into issues that they regarded as important.[26] The validity was assisted by using multiple sources of evidence,[27] thus not relying solely on the interviews. We supplemented and triangulated the interview data[28] with a comprehensive set of archival data, organizational documents, and publicly available documents such as corporate websites, annual reports, and the firm's documents. In order to come up with the analysis and conclusions, we coded the interview transcripts and organized and analyzed the data systematically. This involved locating, coding, and interpreting the material, and this enabled us to weigh and evaluate importance and visualize the relationships between the variables. Nonetheless, as proposed by Griggs (1987) and Patton (2002), quotations from case studies are included in order to add to qualitative insights and provide support to the data interpretation. The identity of the respondents has been anonymized.

Motives for investments and foreign acquisitions

Internationalization theories state that firms choose new markets according to their perceived geographic proximity and cultural distance, and due to uncertainty they limit investments and only gradually increase commitments to foreign markets.[29] The model also assumes that firms, after gaining international experience, will gradually invest further away from the domestic market. In line with these mainstream internationalization theories, the meat producing companies in this study had started or were about to expand progressively into nearby overseas markets. By using foreign direct investments as their internationalization mode, the meat industry mergers and acquisitions can be broadly grouped into market-seeking and efficiency-seeking motives.[30] Respondents gave the overall market size, costs, location, and opportunities to expand into other markets through exports as the rationale for investing in the eastern Baltic Sea region. For example, the eastern Baltic Sea region is usually regarded as a bridge for exports to other larger markets such as Russia, Belarus, and Ukraine due to their common history, language, and traditions that provide unique knowledge of the market and logistic conditions in the eastern border region of the European Union. Thus, the merger and acquisition decisions of the investing firms have reflected both the new market opportunities that opened up in the eastern Baltic Sea region during the 1990s and the diminishing opportunities for growth in the mature western Baltic Sea region markets. Interestingly, the company respondents argued that foreign direct investments within the meat industry are mainly market-seeking because labor and production costs are not major factors due to the intensive use of machinery in production. Instead, the desire to produce closely to the markets they serve is more prominent. However, these respondents still considered labor and production costs as important factors when *deciding* to invest:

> **"Certain Swedish and Finnish companies have succeeded in decreasing production costs by 30%–40% in comparison to production in their home countries. In terms of distance, since the Baltic states and Poland are close to countries such as Sweden and Finland, it allows quick deliveries, which is very important in the meat production business"**
> *Finnish meat company chief executive officer, interview, April 25, 2011*

Industry competitiveness and cost structures

Increasing animal feed prices and shortages of cattle in some countries constitute another concern for the meat processing companies. Animal feed prices are fluctuating due to the global macroeconomic situation, which obviously also affects the meat industry's cost competitiveness. The Baltic states' inclusion in the European Union has also increased the international competition making it difficult for the Baltic and Polish meat processing companies to compete within the European Union market single-handedly. In addition, our respondents added that consumer demand in the Baltic states for new products of high quality is increasing. At the same time, consumers in western markets are more concerned about the origin of agricultural products, which affects companies in the eastern Baltic Sea region negatively. The analysis of the interview data of the cases also suggested that, in general, western consumers tend to associate products from Eastern European countries with low quality and this decreases the potential demand and pushes local producers engage in price competition. For instance, the meat industry in Lithuania is mainly dominated by meat producers and meat processing companies (e.g., livestock production, slaughterhouses, and meat packaging) that operate on a small scale. This results in low labor productivity, low competitiveness of the primary livestock production, and difficulties in complying with quality, hygiene, environment, and animal welfare requirements.[31]

However, there is currently an ongoing development in the Lithuanian meat industry that is similar to what occurred in Poland during the 1990s when the Polish meat industry was restructured in order to create more productive and cost-efficient companies in the market[32]. Indeed, all respondents agreed that the foreign direct investments in the meat industry have contributed to applying new technologies and innovations to host-country firms in order to decrease costs of production and to ensure food safety requirements, which are required to create new products and to increase value-added meat products. The margins in the meat business are narrow and under constant pressure from price-conscious customers, which has led to technology and scale becoming critical factors for sustained competitiveness.

In line with earlier studies on foreign direct investment spillovers,[33] foreign direct investments in the Baltic Sea region meat industry are perceived by the respondents as having a positive impact on economic development in terms of higher productivity and production efficiency. Foreign direct investment spillover effects in terms of upgraded technology, production improvements, and creation of new jobs are evident. Development and training of labor skills and creating job opportunities for highly qualified labor are also other common spillover effects from foreign direct investments. In other words, by acquiring a company in the eastern Baltic Sea region, western Baltic Sea region firms have decreased production and labor costs. Furthermore, location advantages and logistics are reported by the respondents to be relevant factors for companies operating in the meat industry because infrastructure and proximity to headquarters are perceived as facilitating business control. On top of this, the total population of the Baltic Sea region is large, and the potentials for economic growth are expected to be positive. This gives an additional advantage to foreign direct investments through mergers and acquisitions, namely, to acquire established brands and use them as a platform for building brands new to the host market. Thus, the main motives for the foreign direct investments are principally the opportunities associated with the ongoing economic growth that is still present in the eastern part of the Baltic Sea region while the markets of the western Baltic Sea region countries have become mature. Given this position,

> **"the main motives and driving factors in mergers and acquisitions are to increase efficiency, brand recognition, and market share in order to become stronger in the host market."**
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> *Swedish meat company business development director, interview, June 17, 2011*

Acquisitions and the market adaptation process

Since the dissolution of the Soviet Union, foreign investors have been acquiring food production companies in the eastern Baltic Sea region. In the case of Sweden, Swedish meat companies and investors have made significant investments and acquired a considerable number of firms in the Baltic states and Poland during the past decades. Decisions to invest through acquisition generally allow faster access to a host market because companies can benefit from the existing market share of the acquired company.[34] Although our respondent companies normally started by acquiring minority stakes in companies, they have since moved to full ownership. The rationale for this acquisition behavior is simple: acquiring another company is the fastest and most effective way to further develop an enterprise and gain market share in foreign markets. As one respondent put it,

> **"acquisitions are very interesting because additional market share and brand name can be obtained."**
>
> *Danish meat company chief executive officer, interview, June 22, 2011*

Employing local management is arguably an effective an d efficient way to improve company operations in a foreign country because they are a part of local business networks, native speakers, and understand the local culture and market conditions.[35] Respondents have also highlighted the importance of communicating to the local staff what business culture is desired in the organization in order to minimize risks and uncertainties. Efficiencies generated through mergers and acquisitions can improve the target firms' ability to compete and can result in lower prices, enhanced quality, enhanced services, or new products. As a result, firms prefer to acquire already productive plants and improve their productivity even further after the acquisition.[36]

> **"Foreign direct investments have an important role in the economic development of the Baltic Sea region because foreign direct investments are usually long-term investments, and this money allows companies to rebuild instead of taking a loan from the banks."**
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> *Latvian meat company chief executive officer, interview, March 23, 2011*

However, another respondent also argued that

> **"money is not the only important part but the knowledge that comes along with foreign direct investments, because the Baltic states only have had 20 years of independence from the Soviet Union."**
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> *Lithuanian meat company chief executive officer, interview, April 13, 2011*

All respondents stated that it is essential to understand that the three Baltic states – Latvia, Lithuania, and Estonia – are different markets with individual consumer preferences, buying habits, and competitive conditions. This makes it difficult for foreign companies to design one single strategy that fits all three markets of the Baltic states simultaneously. Indeed, many companies are not aiming to be the number one in the market, but rather, the respondents expressed a wish to be present throughout the region or to be close to some of their customers. Without having strong international brands, companies might start to expand within the Baltic Sea region, thus obtaining a better position for further internationalization and establishment in larger markets such as Russia or Germany. The meat industry companies are usually not driven by a global strategy; the region is still growing and investors identify opportunities in the transition. Our company respondents forecast exports to increase in the next five years because the meat industry is expected to continue increasing its production overall. This is also the view the European Commission (2007) and FAO (2011) have on the future meat market developments, and they expect that the demand for meat will increase steadily in the next ten years.

The meat processing companies from the western Baltic Sea region, particularly the pork producers, are also attempting to relocate their production facilities to the eastern parts of the Baltic Sea region so as to capitalize on the region's comparative advantages such as cheaper land and labor, laxer environmental regulations, and access to other markets. In interviews with the authors on April 13, 2011, representatives of the Lithuanian Meat Processors Association and the Embassy of Sweden, Lithuania, discussed less attractive sides of foreign direct investments, which have caused local discontent and negative attitudes, because these live stock breeding foreign investments often affect the local environment negatively in terms of soil contamination, bad odors, and noise pollution.

In the eastern Baltic Sea region, lack of transparency, bureaucracy, and corruption are still recognized as a major problem when doing business.[37] The same picture is also given by our respondents, and corruption in particular was identified as an obstacle for business development in the region. One respondent believed that

> **"in comparison with Scandinavian countries, the Baltic states have a much lower purchasing power, in particular Lithuania, thus, corruption is considerably high and open. . . . This world might be normal in a global context, but it really contrasts with Scandinavia as people there are more used to transparency, organization, things must be fair, and so forth."**
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> *Norwegian retail company subsidiary chief executive officer, Lithuania, interview, April 14, 2011*

Our respondents have also stated that the meat industry in the eastern Baltic Sea region is still affected by the gray market, and the existence of illegal trade activities such as unprocessed meat and meat products being smuggled in the border regions, particularly from Poland to Lithuania, has been increasing significantly. As a result, transactions with cheap input material without a traceable source for the meat production are still a problematic issue because certain small companies might be pressured to keep production costs low, disturbing free enterprise and free competition in the region.

> **"In some cases, meat is transported from one country to another without monitoring and controls for infections, viruses, etc., which is extremely dangerous for consumers."**
>
> *Norwegian retail company subsidiary chief executive officer, Lithuania, interview, April 14, 2011*

The existence of a heavy bureaucracy is a challenging factor to overcome in the eastern Baltic Sea region because excessive administrative procedures in document handling are required and usually processed inefficiently by bureaucrats. It is hard to assess the spread of corruption in the eastern Baltic Sea region because many intermediary activities are embedded in the local business culture as relationship and/or friendship networks. Nevertheless, this has serious implications in terms of significant transaction costs for daily business operations.[38] In an interview with the authors on April 9, 2011, a representative for Business Sweden Warsaw office suggested that one way to circumvent this problem is to build informal personal networks.

Respondents in this research have highlighted that in many cases the governments are aware that some meat companies in the eastern Baltic Sea region evade taxes and avoid legal salary procedures. Moreover, the Baltic states are relatively less corrupt than other Eastern European countries but are still far behind the world's least corrupt nations of the western Baltic Sea region.[39] This exemplifies differences in perceptions concerning corruption, which can also be reflected by the so-called gray economy. The gray economies of the three Baltic states are the biggest in the European Union behind Romania and Bulgaria and account for about 30% of the gross national product in Lithuania and Estonia and 27% in Latvia compared to the European Union average of 20%.[40]

Conclusions

Over the past decades, there has been a major transformation of the meat industry in the Baltic Sea region. After the fall of the Soviet Union in the 1990s, important parts of the meat industry in the eastern Baltic Sea region were managed and owned by governments and small local companies. The meat industry was relatively weak and underdeveloped with outdated production facilities and low productivity. On the other hand, the potential for economic growth in western economies has been decreasing and markets are, to a large extent, mature. Thus, the transition from a planned economy to a market economy and the opportunities presented by the ongoing economic growth in the eastern Baltic Sea region, along with the lack of opportunities for substantial new growth in the western Baltic Sea region, has led to considerable changes in the meat industry throughout the region. As a result, the ownership structure and the characteristics of the industry have changed significantly. In the eastern Baltic Sea region, the meat industry has moved from an underdeveloped, state-owned, and domestically focused position to a privately owned one focused on the international market. Hence, international ownership has increased over the years, mainly through mergers and acquisitions, and Nordic companies have been important actors in this development. Moreover, inclusion in the European Union and the harmonization of laws and regulations have also enhanced the eastern Baltic Sea region's attractiveness for investors. These factors have changed the way meat is produced, processed, and marketed because companies in the Baltic Sea region are focusing on growth and economies of scale in order to maximize the rate of return on capital and to be competitive in the international market.

LET'S NOW MOVE to the economic impact on local firms from foreign direct investments in the meat industry. Our empirical data suggest that foreign direct investments have had important positive spillover effects on the host-country firms in the eastern Baltic Sea region in terms of productivity, delivery performance, quality standards, technology transfer, efficiency, and upgrading of managerial and labor force skills. Other indications of host-country spillover effects from foreign firms in the meat industry have been increases in productivity and innovativeness of local companies through increased competitive pressure and knowledge flows. Furthermore, increased competition


PHOTO: NEFCONORDIC/FLICKR

Cattle on a farm in Estonia.

has forced host-country companies to cooperate, improve, and further develop a range of qualities such as efficiency, effectiveness, innovation, technology, and working conditions, which are needed to remain competitive. Other dynamic effects from foreign direct investments, which we recognize from earlier research,[41] have also been the creation of new enterprises and performance improvement of local companies after acquisitions.

IT IS OF INTEREST to take into account the institutional factors for investment decisions. Even though countries in the eastern Baltic Sea region have undergone significant reforms involving privatization and changes in legislation and institutional arrangements, the meat industry is still affected by institutionally inclined systemic inefficiencies inherited from the Soviet period. Corruption, lack of transparency, bureaucracy, and a gray economy are still hampering factors for corporate growth, but they also have consequences in terms of food security, animal welfare, the long-term sustainability of the industry, and human health due to inappropriate control and poor monitoring of the meat production. Firms in this study have been aware of these risks when making the decision to invest in the region. Thus, despite the significant market potential of the eastern Baltic Sea region, our respondents considered these issues effective deterrents to a normally functioning market economy and efficient governance of this part of the region. Kivikari (1998) correctly observes that commodity trade alone cannot unify a market and that foreign direct investments considerably promote the creation of new networks and lead to a long-term integration of the national economies. Interestingly, the governmental investment promotion organizations in the region have had a moderate role in the actual investment decision-making process of our respondent firms. Their role has rather been to provide general information on countries' investment environment. Therefore, improving the institutional infrastructure, decreasing firms' transaction costs, and integrating the Baltic Sea region markets at all levels (i.e., not only trade and foreign direct investments in the eastward direction from western Baltic Sea region) would strengthen competitiveness of the meat processing firms in the eastern Baltic Sea region.

This have given several contributions to the economic integration of the region. As discussed in our theoretical framework, one of the key determinants of foreign direct investments is the technology absorption capacity of the host country.[42] In the sense of integration and upgrading of local meat companies in the region, western Baltic Sea region meat producers have contributed to the economic integration of the region. Our empirical evidence has been in line with such a proposition. The respondents stress the importance of the institutional and economic conditions of a host country and their abilities to channel and absorb the technology inflows. Such factors have contributed to shaping and motivating investment decisions of Baltic Sea region meat industry companies as part of their growth strategies. The meat companies in the eastern Baltic Sea region have considerable potential in terms of ability to attain higher levels of competitiveness through continued capability transfers from foreign direct investments to host-country firms. By combining the know-how and technological capabilities of the western Baltic Sea region firms with the diligence and capacity to produce at lower costs than the eastern Baltic Sea region firms, the meat industry can produce more value-added products at competitive production prices. Thus, the future development of meat industry companies in the western Baltic Sea region is to a great extent dependent on the development of the eastern Baltic Sea region meat companies, and vice versa.

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