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Exporting to China: entailed risks and risk management strategies

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To my family

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前言

在上个世纪，由于政治，技术和竞争因素，企业越来越多地参与跨境业务。企业的子公司遍布了国外，企业的出口量增加多了，并且企业与外国企业，机构和银行建立了越来越多的业务关系。在过去十年中，全球金融危机对企业向海外扩张起到了强大的推动作用。意大利企业越来越多地开始寻求新的和更有利可图的国外市场，为了销售他们的产品并扩大他们的商业活动。

从意大利企业类型来看，微型和小型企业占绝大多数。更具体地说，在意大利企业总人口中，员工少于 10 人的微型企业占 95.4%，员工少于 50 人的小企业占 4.1%，员工少于 250 人的中型企业占 0.5%，拥有超过 250 名员工的大型企业占 0.1%。

意大利企业的特点是高水平的专业化和专业知识，这使他们开发出创新和高质量的产品。近年来，他们也表现出高度的灵活性：因为国内市场的增长减少，意大利企业试图越来越地参与出口活动。除了其高度的专业知识和灵活性之外，意大利企业也获得了积极的国际形象:“意大利制造”的品牌具有独特性、精致性和卓越品质。
然而，这些积极的特征往往被一些消极的特征抵消，这可能会影响企业的国际扩张。
意大利小企业的组织结构通常很简单，管理和所有权往往是一致的。这可能会导致公司所有者过度集中决策权，虽然公司所有者拥有创业精神和觉察机会能力，但是往往缺乏管理和战略能力。此外，意大利公司往往缺乏成功进入国外市场所需的组织结构和经验和能力水平。研究表明[1]，绝大多数意大利企业的特征还在于尺寸或生产力不足，这可能成为国际化的重大障碍。特别是，尺寸不足是意大利家具行业公司（本研究最后一章的重点）的平常特征。

在国外做生意可能很有挑战性。尽管意大利获得了积极的国际形象，但许多意大利公司，尤其是微型和小型公司，往来国际市场的道路并未容易。

由于企业脆弱的组织结构，意大利公司传统上在国际环境中接近和运作时表现出明显的限制。并且，地理不近和文化不同市场往往被认为过于复杂并有风险。 进入这样的市场，企业往

[1] Rapporto sulla competitività dei settori produttivi. Edizione 2017, Istat, 2017.

往遇到许多困难。 然而，多年来意大利中小企业在海外业务中的参与程度大大增加，现在许多行业都以跨境经营的中小企业为特色。
出口是迄今为止首选的国际化形式。特别是，出口对全球金融危机后意大利经济的复苏起了很大作用。 2010 年，意大利中小企业占全国出口的 53.9%，其中 25.7%为微型和小型企业。从那时起，出口量一直稳步增长，直到今天。 2017 年，意大利出口额出现意外增长，增长为 7.4%。

参与国际贸易活动开辟了巨大的机会，但却带来了许多相互关联的风险。在世界贸易情景中，新的全球参与者出现，趋势发生变化，新风险出现，要求公司密切关注市场趋势和变化，并审视其国际化和风险管理战略以适应新环境。想要于中国等地理不仅和文化不同市场做生意的企业尤其如此。

中国市场占世界人口的五分之一、拥有世界第二高的 GDP，在机遇方面表现出很高的潜力。中国政府实施的大规模城市化进程和中国中产阶级购买力的提高，促进了内需的大幅增长。此外，这两种现象，加上西方对中国文化和生活方式的影响，决定了消费模式的变化，尤其是中高收入阶层：新的中国中产阶级要求高品质、有名品牌和可以表达新社会地位的奢侈品。因为意大利国际形象用同一特征来识别，所以消费模型的这种变化为“意大利制造”的产品提供有利机会。

尽管这些机会具有吸引力，但中国市场需要密切监控，因为它也会出现一些特定风险。这些风险可能会影响在市场上运营或试图进入市场的外国企业的业绩。
在国际化进程中试图向中国扩张的意大利公司众多;他们在这个过程中可能面临的问题和挑战也是如此。事实上，人口老龄化也可能会影响中国消费水平。此外，市场显示企业债务高，关键行业产能过剩问题，以及保护主义和普遍缺乏透明度的商业环境，引起外国企业的担忧。加入世界贸易组织十七年后，中国尚未能够保证遵守某些全球标准，如公平竞争和对外国企业的平等待遇。关键行业，如服务业，仍然存在进入壁垒，并且似乎由中国国有企业（SOEs）主导。对于想要在中国开展业务活动的企业而言，法律事务往往被视为高阻碍。例如，知识产权和假冒产品是中国与其外国投资者之间争议的主要原因之一。最后，与美国的政治和贸易紧张局势构成了风险因素。

此外，中国市场为外国企业提供了重要的进入壁垒。例如，寻找可靠的当地合作伙伴和买家是中小企业面临的最紧迫的商业问题之一。中国也是一个极度扩展的市场，具有重要的地区差异，特定的语言和文化特征，以及快节奏的发展和转型过程。这样的市场无法从远处成功控制。相反，公司需要投资到销售代理商，代表处或当地子公司。这样公司能够管理本地伙伴德好，密切监控市场趋势，并以迅速的方式回应任何问题。因此，对于希望降低风险通过国家差异化战略的企业来说，并对于希望增加利润通过扩大产品市场战略的企业来说，中国市场无疑是具有吸引力的机会。然而，在中国市场做生意是一项复杂的活动，要求企业采用既定的战略，并在经验，结构和能力以及财政资源方面达到适当的准备水平。

在这方面，企业可以从采用风险管理做法中受益。风险管理采用全面综合的方法，指导企业识别，评估和处理风险。企业风险管理为组织带来了更高的组织效率，并提高了企业的绩效。它支持管理人实现组织目标，使企业避免浪费资源，使企业有效管理业务活动的挑战和危险。

本研究的目的是更清楚地了解意大利企业在走向国际化道路上面临的挑战和风险，并更好地了解他们可以采取的风险管理策略，以减轻此类的风险。重点是中国，因为它是“意大利制造”产品的主要出口目的地。重点也是一些意大利家具行业企业和组织的直接经验。

第一章概述了意大利企业在国际舞台上的国际影响力和经济表现。首先概述了国际化的全球现象，并简要回顾了国际化动机，进入战略，理论和模型，正如众多学者所描述的那样。本章的一部分讨论新兴市场在国际背景下的崛起。这些新兴市场既被视为市场机会，也被视为风险来源。本章的第二部分描述了意大利企业的国际化，提供了意大利出口和投资的规模和方向的数据，并描述了影响其国际化进程的特殊特征。最后一节特别关注意大利企业对中国的国际化，提供范围和模式的数据。

第二章讨论企业风险，并强调企业可以采用的风险管理策略和方法，来识别，评估和应对风险。我先定义风险和企业风险的概念，在讨论企业风险类型（危险，财务，运营和战略风险）的总体情况。本章第二部分讨论风险和风险暴露之间的差异，以及讨论公司可以采取的策略来管理风险暴露；重点是风险评估和风险应对。四种风险应对选择包括风险规避，风险降低，风险转移以及风险保留。所有这些战略都需要成为适当风险管理流程的一部分，以指导企业识别，评估和处理风险。因此，本章的最后一部分介绍企业风险管理（ERM）。这是一种基

于全面综合风险方法的创新风险管理流程。本节分析了这种方法的驱动因素，特征和效益，以及构成其框架的各个阶段：建立背景，目标和风险管理理念;识别风险;评估风险;应对风险;监测和控制。

第三章分析了企业在中国市场面临的风险和障碍，以及企业采用的风险管理策略。分析是在宏观和微观层面上做的。本章的第一部分重点介绍了中国市场对外国企业的风险来源。我先讨论了经济和金融趋势，政治，法律，商业背景，社会，人口和文化趋势以及技术变化，为了突出正在发生的变化和潜在的脆弱性。然而，许多因素决定风险的可能性和影响，比如企业的行业，企业对中国国际化的模式以及他们使用的风险管理策略。因此，本章的第二部分重点关注家具行业，目的是确向中国出口的定意大利企业的主要风险以及这些企业采取的风险管理策略。本章的第二部分是在与意大利家具行业企业和组织的访谈中收集的信息和见解的结果。参与访谈的企业和组织如下：三家意大利家具企业（Arredo3，Smania，Pianca），两家行业协会（Federlegno Arredo Eventi 和 CNA Veneto），以及一家在中国市场经营的代理商（Omnia Design Italia）。

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CHAPTER 1
THE INTERNATIONALIZATION OF ITALIAN ENTERPRISES

INTRODUCTION

The purpose of this chapter is to provide an overall picture of Italian enterprises' international presence and economic performance in the international arena. The chapter starts with a few definitions of the global phenomenon of internationalization and with a brief review of the internationalization motives, entry strategies, theories and models, as described by numerous scholars in literature. A section of the chapter is dedicated to the rise of emerging economies in the international context, seen as both potential market opportunities and risk sources.
The second part of the chapter describes the internationalization of Italian enterprises, providing meaningful data on the scale and direction of Italian export and investments, and describing the peculiar features that influence their internationalization process. The last section focuses in particular on the internationalization of Italian enterprises to China, providing data on the scope and modes of the phenomenon.

THE PHENOMENON OF INTERNATIONALIZATION

Origins and definition of internationalization

The foundation of the General Agreement on Tariffs and Trade (now replaced by the World Trade Organization) in 1946 and of the European Union in 1957 reduced trade barriers and lead to the liberalization of trade and investments. Technological progress lowered the cost of international transportation, and the development of telecommunications reduced the cost of exchanging information between business units located all over the world. In markets traditionally dominated by American and European companies, new global competitors have emerged, and developing countries companies and markets have acquired a growing role in the world economy. Over the years, firms have increasingly engaged in cross-border operations, multiplying their physical presence outside national borders and establishing more and more business relationships with foreign enterprises, institutions and banks.

Although boosted by a convergence of political, technological, and competitive factors in the last century, the internationalization of businesses is not an entirely new phenomenon. From a historical

perspective, international trade is as old as humankind's desire to travel across seas and lands. During Roman times, along the ancient Silk Road that connected the East with the West, trade and communications between China, Southeast Asia, India, the Middle East, Africa and Europe blossomed on an unprecedented scale. Under the power of the maritime Republic of Venice, merchant vessels sailed from the port of Venice to reach the ports of Alexandria, Constantinople, London and Bruges. In more recent times, the East India Company started its import-export activities in South and East Asia in the XVII century.

Over the years, scholars and academics have given numerous and diverse contributions to the definition and analysis of the internationalization process. Their assiduous studies and research work lead to the creation of a rich and varied body of theories, thus making it difficult to deal with this complex concept from one single perspective. A brief mention on the internalization process will be discussed in the following sections considering the focus and scope of this thesis.

There is no agreed definition of internationalization. The term is ambiguous and definitions differ depending on the perspective and variables included. For Johanson and Vahlne (1977) internationalization is the process by which a company gradually increases its commitment in the foreign market and develops knowledge. Welch and Luostarinen's definition (1988) also stresses on an increasing involvement in international operations of the firm. Calof and Beamish (1995) define it as the adaptation of a firm's operations to international environments, including its strategy, structure, and resources. Later on, Eckhardt and Shane (2003) argue that internationalization is related to the discovery, evaluation and exploitation of entrepreneurial opportunities in international markets.

Motives for internationalization

Why do companies engage in international business?

There are several motives behind the internationalization of firms. Firms can receive both internal and external stimuli to internationalize. Internal stimuli, also known as pull factors, indicate that the choice is the result of the firm's internal drive, motivation and commitment to exploit opportunities in a foreign market, as well as its unique competences and resources. External stimuli, also known as push factors, indicate the external forces that lead firms to internationalize. Indeed, changing conditions in the economic environment, such as an increasing fierce competition in the market or certain choices of the competitors, can push the company to pursue internationalization. Both internal

qualities and environmental factors play an important role in the initial phases of the internationalization process.

One of the most common reasons to go global is enlarging the market for a company's product portfolio. In this way, a company expands its sales, achieving growth, benefiting from economies of scale and allocating its overcapacity. Other reasons include acquiring new resources as well as knowledge and competences that are specific of a given country or geographic area that represent a strategic asset for the firm and a competitive advantage over competitors. Minimizing risk exposure can also be a motive for internationalization: companies reduce their exposure to risks by engaging in business activities with different countries and thus distributing embedded risks among countries with different features. Finally, in today's fast changing world, going global can result from an attempt to extend a firm's success from the national market to the international one. Another factor could be the necessity to stay competitive or even survive.

Foreign market entry strategies

Before going international, firm management must take three basic entry decisions. First, it should consider which market is more attractive to the company, seeking a balance between opportunities, costs and risks. Market and resource prospects, the competitive context and the risks of operating in a country are the three broad categories that define country attractiveness. It is important to note that usually countries are first evaluated in absolute terms, and secondly compared with countries sharing similar features. Second, it must consider the timing of entry, adopting either a first-mover strategy or a later entrant one. Add time-risk relationship. Third, firm management has also to decide whether to enter on a large or small scale, depending on the degree of commitment the firm is willing to take, on its resources and risk appetite.

After having considered the factors mentioned above, company management shall decide the mode of entry, meaning what kind of operations to carry on in the foreign country and under which legal form. This choice can be generally reduced to three main alternatives: exports, strategic alliances, and foreign direct investments. When choosing to enter a new country, foreign investors need to base their decision on two major dimensions: the control dimension and the intensity of investment dimension. It goes without saying that different entry modes are characterized by stronger or weaker control on the investment, and show different levels of investment intensity, which can be high, moderate or low. Other factors that determine the choice include the overall attractiveness of the country, the political and operational risks involved, the internal capabilities of the firm to gain

competitive advantage, the overall strategic objectives of the firm and the expected return of the investment, and time pressures.

From a small and medium enterprises (SMEs) perspective, export has been the major international business activity. Export is traditionally associated with flexibility: it involves a lower commitment of resources, especially financial ones, a lower degree of risk, and gives economic returns in the short-term. SMEs' small size, limited resources and scarce market knowledge and experience justify such choice. Although export is still the entry mode preferred by SMEs, during the last decade, some firms have been focusing on other business activities as ways of internationalization, seen to be crucial to achieve competitive advantages. Foreign direct investments, alliances or partnerships with local companies and cross-border networking help facilitate the exchange of market knowledge and technology, thus helping SMEs to build effective international strategies.
In addition, today's advanced level of market globalization, political choices and technological transformations make it now easier than before for SMEs to be successful in foreign markets; while some types of SMEs show a cautious behavior by internationalizing through progressive steps, some other types of SMEs are born global companies that choose to internationalize since their early stages.

With regard to Italian small and medium enterprises, although export is by far the main internationalization form, more complex internationalization ways are gaining success.
For example, in the mechanical engineering sector, distribution contracts and support agreements are quite common, as well as mergers and acquisitions of existent companies. Investments in the delocalization of the production are not very frequent in this field, as Italy's competitive advantage in this sector is provided by the high quality, durability and top performance of its production rather than on price. More specifically, besides export, the two more used modes of internationalization are strategic alliances and acquisitions, as they give more impetus to market development processes compared to greenfield investments and sales network development. Moreover, Italian firms entering strategic alliances can support local partners, which in turn will help them overcome administrative and legal obstacles, especially in countries that are greatly different from Italy or that lack transparency. As for acquisitions, these are preferred when acquired enterprises are already settled in the target market, and have already developed distribution channels, as building and consolidating client relations is a long and expensive process. As an alternative to acquisitions, greenfield investments are preferred when, in order to effectively penetrate the target market, enterprises need to acquire productive factors at the same conditions of local competitors and when the know-how and technologies adopted are unique competitive advantages that need to be retained in the company and

directly controlled by it. Greenfield investments are tough choices for Italian companies: on one side, Italian SMEs do not possess the large financial resources these investments require; on the other, they often lack organizational and management competencies to effectively run and control overseas subsidiaries. For these reasons, joint-ventures with local partners are usually preferred, as they offer a compromise between costs and risks, and direct control needs[2].

Internationalization theories

The internationalization process has been object of continuous studies since the second half of the XX century. The work of numerous scholars and academics has led to the formulation of various theories and models describing strategies and modalities of international expansion.

In the Uppsala model, the internationalization process is described as a gradual and incremental acquisition, integration and use of foreign market knowledge. For Johanson and Wiedersheim-Paul (1975), internationalization is a slow and incremental process marked by four steps, each with a different degree of commitment: irregular export activities, exporting via agents, sales subsidiaries, and wholly owned subsidiaries. Johanson and Vahlne (1977) refined the model defining the internationalization process as a cycle in which market knowledge and current activities influence market commitment and commitment decisions, and the degree of market commitment influences the degree of market knowledge.

The incremental model has been widely criticized. Born global companies, also known as international new ventures (INV), represent a big challenge to it. Since the very beginning of their constitution, these enterprises seek to derive significant competitive advantages from the use of their resources and the sale of outputs in multiple countries (McDougall & Oviatt, 1994). Since the global market is their relevant market since birth, born global companies do not show an incremental behavior in their internationalization process, instead they achieve internationalization rapidly and taking high risks during their expansion.

The network theory as formulated by Johanson and Mattsson (1988) sees a company's internationalization process as a natural development from network relationships with foreign individuals and firms, such as suppliers, customers and other market actors. According to this theory, firms do not follow the gradual process described by the Uppsala model, but achieve a rapid

[2] Fabio Musso, Strategie e competitività internazionale delle piccole e medie imprese. Un'analisi sul settore della meccanica, Torino, Cedam, 2013.

internationalization through the market knowledge, experience, information and resources of their partners in the network.

Cross-border entrepreneurial behavior has been subject of a series of studies as well. McDougall and Oviatt defined international entrepreneurship as the discovery, enactment, evaluation, and exploitation of opportunities across national borders to create future goods and services. According to the theory, the basis of foreign market entry is individual and entrepreneurial behavior. Entrepreneurs are key figures, as they show a proactive, calculated risk-taking behavior, have experiential market knowledge, and can create successful relationships with foreign actors and allocate resources adequately.

Globalization, advancements in technology and in access to information, and declining cultural barriers have opened new markets to all sorts of companies, from established companies to small enterprises. Nowadays, SMEs are increasingly approaching international markets. The literature review exposed above provides small firms with tools in order to help them formulate successful international strategies. Foreign market knowledge, business networks and entrepreneurial spirit and capabilities are all essential variables in the process.

THE GROWING ROLE OF EMERGING MARKETS

Definition and categorization of emerging markets

One of the key elements in today's global business environment is certainly the growing role of emerging countries companies and markets. Among emerging economies, China and India are by far the two countries that have exhibited the fastest growth over the last few years. In 2017, their GDP has grown by 6.9% and 6.7% respectively. The two are also the most populous countries of the world. China is home to approximately 1.42 billion people, while India to about 1.35 billion, accounting together for 36% of the world total population. China and India own some of the largest companies of the world: of the top ten global companies raked by Forbes in 2018, five are Chinese; and of the 2000 companies on this year's Forbes Global 2000 list, 232 are Chinese and 58 are Indian. These are only a couple examples of this vast and growing phenomenon.

Traditionally, the phrase 'emerging markets' has been used to refer to countries in which the economy has not yet reached the degree of development of the so-called industrialized countries, but that have registered an overall high growth. An export-driven economic growth, as well as lower production

costs and final prices, and the opening of their markets to international trade and investments (with significant attraction of foreign direct investments) are also common characteristics of emerging markets. China, for example, because of its geographic location attracts a lot of FDI from neighboring countries such as Japan, Singapore, South Korea and Taiwan. Emerging countries often exhibit other typical features, such as the tendency to move away from a traditional economic system based mainly on agriculture or on the export of raw materials to adopt a free market or mixed economy, as well as a high degree of infrastructure investments, the presence of multinational companies (MNCs) and strong political leaders.

The term was coined in 1981 at the International Finance Corporation (IFC) by a group of economists promoting the first mutual fund investment in developing countries. Since then, definitions have varied widely. For the International Monetary Fund (IMF) "emerging markets are typically countries with low to middle per capita income that have undertaken economic development and reform programs and have begun to 'emerge' as significant players in the global economy". Other scholars provide a more structured definition of emerging markets, referring to any situation in which either the level of information or property rights are underdeveloped (Khanna and Palepu, 2010). The two Harvard professors suggest that what differentiates emerging countries from developed ones is a series of market failures due to institutional context, which they refer to as 'institutional voids'. Examples of such market failures are information problems, misguided regulations and inefficient judicial systems.

Many methodologies of categorizations of emerging markets exist. For example, the Morgan Stanley Capital International (MSCI) Market Classification distinguishes countries in Developed markets, Emerging markets and Frontier markets. MSCI Market Classification Framework consists of three main criteria: economic development, size and liquidity requirements, and market accessibility criteria. MSCI currently classifies 24 emerging markets. The International Monetary Fund lists 21 emerging countries. Other institutions such as Standard and Poor's (S&P) and Russel count 21 countries as emerging markets, whereas Dow Jones lists 22.

Over the years, more terms and acronyms have been created to refer to more specific groups of emerging countries. The acronyms BRICS (which includes Brazil, Russia, India, China and South Africa) or BRIMCS (adding Mexico to the previous five) are by far the most used and well known. They indicate the so-called emerging giants, the most powerful representatives of the emerging world. To echo the IMF definition, researches have stated that the emerging giants have the potential of not

simply becoming significant but also dominant players in the world economy by 2050[3]. Central and Eastern European ex-communist countries are generally referred to as CEECs, counting Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. Most of those emerging markets have now become members of the European Union and are moving toward living standards comparable to the ones of the West. A third category of emerging markets comprises countries of Latin America, Africa or Asia that have witnessed a more recent growth and industrialization and that do not belong to first group (BRICS or BRIMCS). Examples are Malaysia, Indonesia or Chile.

Emerging markets opportunities and risks for foreign companies

As mentioned earlier, one of the first characteristics of emerging countries is that they exhibit a pace of development that surpasses the rest of the world. In 2017, the total economic growth of developed economies was 2.3%. Emerging economies and developing countries registered a total growth of 4.8%, twice as much of the one of developed countries. China and India, which are by far the fastest growing markets, saw their economies grow by 6.9% and 6.7% respectively[4].

A key characteristic of developing economies is their rapidly growing middle class, whose number is increasing faster than the average income. This translate into a higher growth rate of consumption of non-essential goods and services, such as consumer durables and branded goods, and is highly attractive for overseas entities.

The rapid growth of emerging markets can also lead to higher-than-average return for investors. With corporate managers always trying to maximize returns, and with the high potential returns presented by these fast-growing markets relative to developed markets, they are increasingly becoming an essential part of firms' expansion strategies.

Over the last fifteen years, emerging markets have registered a fast increase in their participation in international trade and in their inflow of investments. Between 2001 and 2015, BRICS countries have become key players in global trade: their contribution to total exports and imports increased form 8% to 18% and from 7% to 15%, respectively[5].

Generally speaking, emerging countries' growth pace and opening to international trade and investments are sources of opportunities both for global and local firms, for their market development strategies, sourcing activities and localization of production capacities.

[3] In 2003, researchers at Goldman Sachs forecasted that the economies of Brazil, Russia, India and China could grow to be collectively larger than the then G-6 countries (United States, Japan, Germany, United Kingdom, France and Italy).
[4] World Economic Outlook. Challenges to Steady Growth, International Monetary Fund, 2018.
[5] 10th BRICS Summit. A Review of South Africa's Trade and Investment Relationship with BRIC, Deloitte, 2018.

Despite the wealth of trade and investment opportunities and their potentially attractive rates of return on investments, emerging economies also present a number of risks for foreign entities. The definition proposed by professors Khanna and Palepu discussed above exemplifies this perfectly, as it sees the so-called 'institutional voids' as descriptive features of developing economies.

Among the most common risks are difficulties in acquiring accurate financial information, corruption and potential fraud, ownership and governance practices, regulatory and legal issues. In this complex scenario, one of the most difficult challenge is the lack of predictability. For example, developing countries carry a significant amount of risk when insolvency occurs and companies face bankruptcy. Insolvency laws may be antiquated, non-existent or often not uniformly applied, leaving creditors with unclear expectations of their rights, available remedies and legal options. In China, for example, even though insolvency laws were established more than a decade ago, the bankruptcy system has been relatively inactive until recently.

Ongoing political unrest in many emerging markets also adds to the difficulties, causing foreign investors to shy away from undertaking cross-border acquisitions and other investment opportunities. Further discussion on the risks of operating with emerging markets, and particularly with China, will be carried out in the next chapters of this thesis.

THE INTERNATIONALIZATION OF ITALIAN ENTERPRISES

Italian industrial landscape: SMEs and their characteristics

The concept of small and medium enterprises (SMEs) is usually defined using quantitative criteria, referring to firms of all economic sectors that do not exceed a given size. The size of a company is usually related to level of turnover, profits, total capital or the company's position in the market, but the most common criterion is the number of people employed[6]. A first distinction is between small and medium-sized enterprises, which employ fewer than 250 people, and large enterprises, which employ 250 or more people. SMEs are further subdivided into three categories: micro enterprise (with a number of employees lower than 10), small enterprises (employing 10 to 49 people) and medium-sized enterprises (with 50 to 249 employees).

Overall, in 2016, SMEs in the European Union-28 accounted for almost all enterprises of non-financial business sectors (99.8%) and for slightly less than three-fifths (56.8%) of the value added

[6] This is the criterion used by the Structural Business Statistics (SBS) database maintained by Eurostat.

generated by the non-financial business sector. SMEs accounted also for two-thirds of the total EU-28 employment (66.6%). The data suggest that micro enterprises are by far the most common type of small and medium-sized enterprises in Europe, accounting for 93% of enterprises of all sectors and for 93.2% of all SMEs population in the non-financial business sector. From a value-added point of view, the contribution of the three classes of SMEs is broadly equal, with micro SMEs accounting for 20.9%, small enterprises for 17.8% and medium enterprises for 18.2%. The distribution is more uneven when we look at the employment: micro SMEs account for 29.8% of total employment in the non-financial business sectors, small-sized enterprise account for 20% and medium-sized one account for 16.7% of it[7].

Looking at Italian enterprises population, small and medium enterprises, and especially micro and small SMEs, are the overwhelming majority. As the yearly report published by Confartigianato shows[8], of the total 4,338 million Italian enterprises of 2015, 4,136 million have less than 10 employees (95.4%). Around 176 thousand Italian enterprises have less than 50 employees (4.1%), and only 21 thousand have a number of employees between 50 and 249 (0.5%). Italian large enterprises with a number of employees equal to or higher than 250 are only 3,6 thousand (0.1%) (Figure 1).

Figure 1

	Enterprises (number)	Enterprises (%)
Micro (up to 9 employees)	4,136,831	95,4
Small (10-49 employees)	176,332	4,1
Micro and Small (up to 49 employees)	*4,313,163*	99,4
Medium (50-249 employees)	21,256	0,5
Large (more than 250 employees)	3,666	0,1
TOTAL	4,338,085	100,0

Figure 1

Year 2015. Classification of Italian enterprises based on the number of employees.

Source: Ufficio Studi Confartigianato on Istat data.

From a European comparison, we can observe that in Italy SMEs are even more important in terms of value added and employment level. In 2016, Italian small and medium enterprises accounted for

[7] Annual Report on European SMEs 2016/2017. Focus on self-employment, European Commission, 2017.

[8] Virtù e Fortuna. Piccole imprese nell'era delle trasformazioni, Ufficio Studi - Confartigianato Imprese, 2017.

more than two-thirds (67.7%) of the total value added and for more than three quarters (78.6%) of total employment in the non-financial business sector[9].

The yearly report published by Confartigianato in 2017 provides some meaningful data on the relevance of micro and small enterprises in the Italian economy as well. In Italy, exporting micro and small SMEs were around 80 thousand in 2015, accounting for 90.2% of the total Italian exporting enterprise population. In comparison with other major European countries, the relevance of micro and small SMEs is more accentuated in Italy: in Spain, for example, micro and small enterprises accounted for 87.6% of all exporting companies in Spain, they accounted for 80.9% in the United Kingdom, for 79% in France and 67.9% in Germany. According to the data, in 2015 Italian micro and small SMEs exported for almost 60 billion euros, accounting for a quarter (24.7%) of total manufacture exports of micro and small EU SMEs. In 2015, Italy ranked first in Europe also for the value of micro and small enterprises exports on total national GDP, equal to 3.6%.

The organizational structure of Italian small enterprises is generally simple, and the management often coincides with the ownership. This organic structure with the prevalence of informal working conditions and a low level of standardization can be a winning characteristic of small and medium-sized companies, as it make SMEs more flexible to environmental changes and more likely to survive in contexts where flexibility and adaptation are key factors. On the other hand, it can cause an excessive centralization of decisional power in the hands of the owner of the firm, who, although full of entrepreneurial spirit, often lacks managerial and strategic competencies.

The overlap of the family dimension with the business one is also typical of micro and small firms in Italy, as they are often family run. This helps faster the decision-making process and its implementation, but it might also negatively affect business operations, representing a limit for expansion and development. Another typical characteristic of Italian enterprises is their high level of specialization, knowledge and expertise that allows them to develop innovative and more differentiated products, making them emerge in niche market segments.

Among the main disadvantages of small and medium enterprises, there is their scarcity of resources. In opposition to large firms, SMEs do not possess big amounts of resources for their business and financial needs, such as the collection of information, staff training, and the implementation of investments. Regarding financial needs, SMEs strive to have access to finance. Due the scarcity of resources and the often limited cultural horizon of the leadership, the organizational culture is often export-oriented and rarely aimed at more complex and structured forms of internationalization, and firms are more willing to conduct business activities with closer, similar and well-known markets.

[9] Annual Report on European SMEs 2016/2017. Focus on self-employment, European Commission, 2017.

Italian image and reputation abroad

Italy's role in international trade has changed greatly over the years, because of both specific political choices and the transformations of the global political and economic context. Italian enterprises have reacted to such changes adopting strategies focusing on quality and innovation rather than on price competition. As a consequence of globalization and the opening of new economic markets, Italian enterprises have had to reposition themselves in the international environment, investing on knowledge, new technology and patents. Thanks to their long history and expertise, Italian firms' image abroad is highly positive: Italy has a high reputation in fields such as innovation, high-tech products, project and managerial competence and highly qualified personnel, to mention a few. These winning characteristics are at the core of Italian image abroad and help *Made in Italy* products to be valued and renewed abroad. A recent report published by Istat[10] shows how Italian manufacture companies are strongly quality oriented. Between 2000 and 2016, Italy is the EU country that registered the highest growth in the average unit value of exports (+13.9%). The average unit value of exports is an indicator of the real or perceived quality of exported products, and thus provides meaningful information about quality-based competition of Italian enterprises. Other data show that, over the years, the average unit value of exported products has grown further more than their production prices. This suggests a higher perceived intrinsic value of the products, determined by an improved design, higher quality raw materials, new functionalities and innovation.

The internationally renowned value of the brand *Made in Italy* is certainly a winning card for Italian enterprises operating in the international arena. Thanks to their geographic origin and the positive country image, Italian products communicate the expertise, reliability, and know-how of the Italian industrial sector. Benefiting from being recognized as excellences, Italian products are often positioned in the high-end markets, targeting consumers who are willing to pay superior prices for superior value. This is the case of many Italian brands that are nowadays renowned as excellences worldwide.

Towards internationalization: issues and challenges for Italian firms

Despite Italy's renewed reputation abroad, the path towards international markets has not been – and is still not - easy for Italian firms, especially for micro and small-sized ones.

[10] Rapporto sulla Conoscenza 2018. Economia e società, Istat, 2018.

In the last decade, the global financial crisis has strongly affected Italian firms' growth and development in the domestic markets, pushing them to look for new and more profitable markets. In the wake of multinational companies, more and more SMEs have started to approach foreign countries to find niche markets for their products and business activities. Due to an often-fragile organizational structure and difficulties of dealing with physically and culturally far markets, often perceived as too complex and risky, Italian SMEs have traditionally exhibited obvious limits in approaching and operating in international environments. In such circumstances, SMEs have showed a tendency to engage in occasional and passive business activities. Looking at Italian trade flows with foreign countries, we notice that their duration tends to be short. In general, only a third of Italian outflows lasts for at least 5 years. More precisely, exports activities toward European Union countries are characterized by a higher degree of continuity, with half of them lasting longer than 5 years, while a lower continuity is typical of export activities with emerging markets: in this case, less than 30% lasts 5 years.

However, a number of industries is nowadays characterized by a significant presence of small and medium enterprises that operate cross-border, mainly through export. With particular regard to Italian SMEs, their involvement in foreign operations has considerably increased over the years, especially for trade and sourcing activities.

On the other side, larger companies tend to choose strategically and organizationally more complex forms of internationalization. However, as mentioned above, multinational companies and large firms in Italy are a minority, given that small and medium-sized companies that internationalize through trade activities dominate the Italian economic context.

Doing business can be challenging for small and medium enterprises. According to the Annual Report on European SMEs 2016/2017, 'finding customers' is cited as the most pressing business issue faced by SMEs in 2016. The SMEs participating in the survey cited also 'availability of skilled staff or experienced management', 'competition', 'regulation', 'costs of production or labor', and 'access to finance' as significant business challenges. The latter, although improved from 2013 (+15%) thanks to better financial conditions and the availability of a number of SME-focused financial programs implemented my EU member states, was still specified by 9% of the SMEs interviewed.

International performance of Italian enterprises: export

The internationalization process of Italian enterprises, especially small-sized ones, is strongly export-centered, with a limited appetite for direct investments or other internationalization forms other than

trade. Export is the 'light' internationalization form that has given Italian enterprises international successes. The major reason behind Italian firms' willingness to engage in export activities is the lower degree of organizational and financial commitment required, which well matches the characteristics of Italian small enterprises. Together with international trade, investments have also increased over the years; however, these are mostly carried out by large or medium enterprises.
Italian small companies have traditionally carried out internationalization forms such as production facilities, research and development foreign units and sourcing activities with the collaboration with external entities and through supply and subcontracting agreements. Delocalization of corporate units abroad has occurred less frequently. More recently, however, the number of small firms investing abroad or developing commercial relations with foreign partners has increased.

The last ten years have witnessed a period of extreme economic difficulty and tension on a global scale. The economic crisis started in 2007-2008 with the collapse of the Lehman-Brothers group and financial markets has spread worldwide, with profound effects on international trade. The effects of the crises have reached the Italian economy and its export activities as well. Under these hard times, Italian exports suffered a sharp slowdown and collapsed in 2009 (loosing 20,94% on the previous year). In 2009, Italian economy started a long process of recovery, to which exports have contributed greatly. In 2010 Italian small and medium enterprises represented the 53,9% of national exports, of which 25,7% was represented by micro and small enterprises. From then on, the volume of exports has increased steadily until today. In 2017, the value of Italian exports showed an unexpected leap, increasing by 7.4%. Italian exports are expected to keep growing in 2018 and in the next three years as well, with an increase of 5.8% in 2018, 5.2% in 2019, 4.1% in 2020, and 4.2% in 2021 respectively[11] (Figure 2).

[11] Keep Calm & Made in Italy. Un mondo di possibilità per l'export italiano, nonostante le incertezze. Rapporto Export 2018, SACE, 2018.

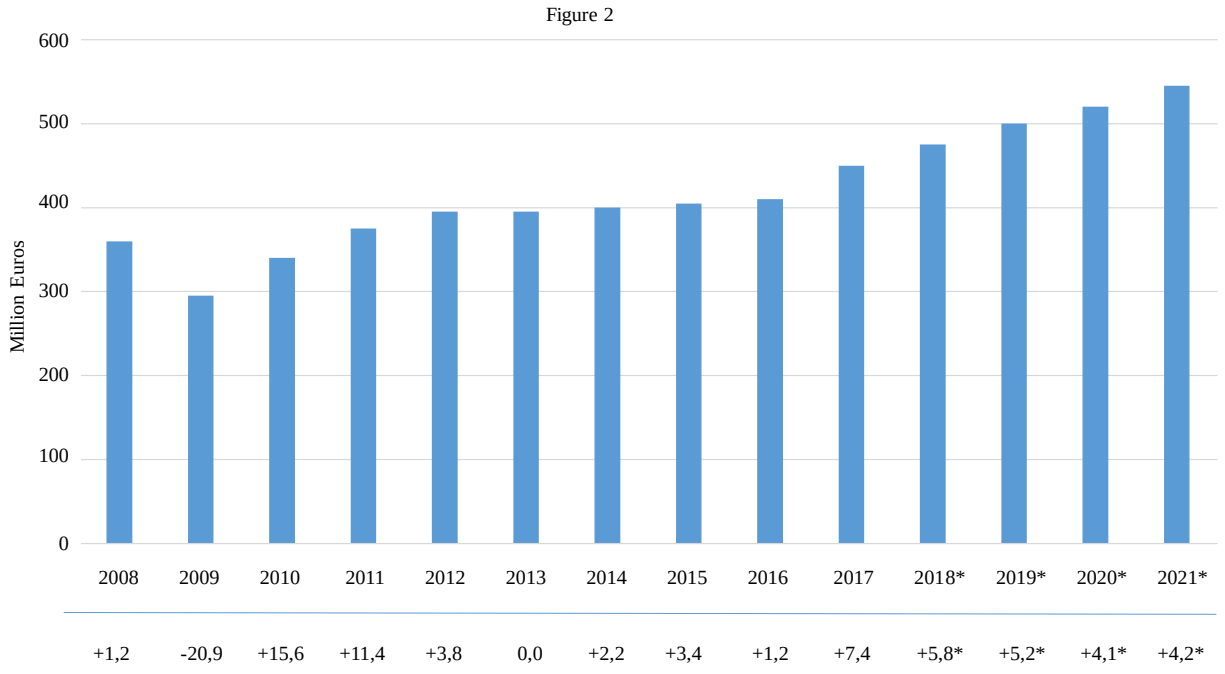

Figure 2

Representation of Italian exports, years 2008-2021. *Projections; SACE. Source: Osservatorio Economico Ministero dello Sviluppo Economico; SACE.

This acceleration reached all product categories, from consumer goods, to intermediate goods and capital goods, following a positive global trend that sees international trade beginning to grow again at a sustained rate (+4.6% in 2017), after the slowdown in the post-crisis period. In 2017, both developed countries and emerging economies showed an acceleration in international trade growth, that accounts respectively for +3.8% (+1.6% in 2016) and for +5.7% (+1.3% in 2016). Year 2017 witnessed also a recovery in global growth, which raised from 3.2% to 3.8%, with a growth of +4.8% of emerging markets and an improvement of +2.3% of advanced economies[12].

From a geographical point of view, the distribution of Italian market shares relative to exports is still determined by distance: Italy engages into more frequent and solid business relations with geographically closer countries, such as EU countries, other European countries like Switzerland and the Balkan area, and other Mediterranean countries like Turkey, Russia, and North Africa. The Italian share of total exports matches the average in farther countries of Central and South America, North America (USA), and Australia, while it is much lower in Central and East Asia.

In 2017, the area that contributed the most to the growth of Italian export is represented by extra-EU countries. The significant role of such areas is not surprising, as over the years Italy as well as other

[12] Rapporto Annuale 2018. La situazione del Paese, Istat, 2018; Mappa dei rischi SACE 2018: Adelante con juicio, Sace, 2018.

European countries have started diversifying their target markets, by gradually reducing export activities in European countries and increasing their business relations with other areas, especially with Asia.

Italian exports in the European Union have increased by 6.7% in 2017. More specifically, in the last three years, Italian exports to Germany and France, the two major European markets for Italian products, have exhibited an acceleration in the last three years. In 2017, Italian exports have also showed significant results in Spain and Portugal, Ireland, as well as many central and eastern European countries, such as Poland, Check Republic and Hungary. Overall, the Italian share of the EU market has remain stable in 2017 (4.9%).

With regard to Italian exports to non-European Union countries, they have also been growing constantly from 2009 onwards, except for a slight slowdown in 2014. In 2017 Italian exports have shown a strong expansion in extra-EU countries such as China (+22.2%), Russia (+19.3%) and United States (+9.8%). In particular, Italian export have increased by 12.6% in East Asia, which remained the fastest growing geographical area in 2017. To this significant improvement have contributed the expansion in China, but also the positive performance in other markets, such as Japan, South Korea, Malaysia, Singapore and Taiwan. Data suggest that the competitiveness of Italian enterprises is rising in this area, thanks to the improved purchasing capacities of Italian firms in China and the more effective promotion campaigns implemented in the area[13].

The improvement of Italian export in the last few years reached all sectors. It has not only involved those industries that have traditionally been successful in export, such as the mechanics and transportations sector or the traditional sectors of the *Made in Italy*, but also those industries that have exhibited a negative performance over the years, such as chemicals and the agri-food sector. The improvement of Italian export has brought benefit to the national economy: among others, it has been one of the major reasons for the recovery of Italian commercial balance, which has moved from a deficit of 8,6 billion euros in 2007 to a surplus of 47,5 billion euros in 2017 (2.3% of national GDP). In particular, micro and small SMEs brought a significant contribution to the performance of Italian foreign trade, accounting for 27.7% of total exports and for 20.9% of total imports in 2017[14].

Focusing on the export sector, the structure has not been subject to relevant changes from 2000 on. The manufacturing sector is the first one in Italy, counting for the 96% of the total amount of exported goods. The mechanics together with transportations and textile and clothing products are the three major sectors for Italian exports, accounting respectively for 17.9%, 11.3% and 11.4% of total exports

[13] Rapporto Annuale 2018. La situazione del Paese, Istat, 2018.

[14] Virtù e Fortuna. Piccole imprese nell'era delle trasformazioni, Ufficio Studi - Confartigianato Imprese, 2017.

in 2017. The metallurgical sector is relevant as well, accounting for 10.5% of national exports, while food, drinks and tobacco sector has improved in terms of both value (+7.5%) and quantity (+5.7%) in 2017. The chemicals has also acquired more relevance in the share of Italian exports, growing by 16% from 2016. This sector has started to expand in 2007, and has now become one of the strongest for national export.

International performance of Italian enterprises: investments

Aside from export, the other important internationalization channel for enterprises is represented by Foreign Direct Investments (FDI), which include both greenfield investments and acquisitions of shares of foreign companies. Exports and direct investments are the two extremes of a much more complex system, which is also made up by a plurality of "light" internationalization forms, such as supply agreements, business and production licenses, franchising agreements and joint ventures.

In 2017, the number of foreign companies with Italian participation amounts to 35 thousands, and has registered a slight rise (+0.8%), in comparison with the decline of 2016. In terms of number of employees, there have not been significant changes from 2016 to 2017, while the turnover began to increase again (+2.7%) after the decline of the past few years. Looking at the last five years, the total number of foreign companies that are partially or fully Italian-owned has increased by 4% on average; their total turnover and number of employees have been declining until 2016, and have only registered a slight improvement in 2017[15].

For many years, small and medium enterprises have seen the international market only as one of their potential strategical opportunities and not as a necessary playing field worth investing on. Foreign markets did not represent a strategical hub to research resources and capacities for the enterprise (through foreign subsidiaries or agreements with local partners), but were only seen as the best destination for goods and services that exceeded domestic markets demand.
During the last ten years, however, internationalization of small and medium enterprises has changed. We have witnessed an acceleration of the internationalization process of Italian SMEs, which have not only increased abroad by number, but have also repositioned themselves in the international panorama adopting new strategical, organizational and financial policies. Data show that from 2012 and 2017, SMEs is the category of companies that have contributed the most to the increase of foreign

[15] Rapporto ICE 2016-2017. L'Italia nell'economia internazionale, ITA - Italian Trade Agency, 2017.

companies with Italian participation: small and medium enterprises have grown of 8.5% and 7.4% respectively, compensating the decline in the number of large companies.

Geographical distance still matters in the distribution of Italian participations in foreign companies, although its role is not as significant as for the distribution of Italian exports. In general, the European Union is by far the major destination for Italian participations, accounting for half of the total investments (50.6% in 2017). Other European countries including Switzerland, Russia and Turkey and North America have also remained two of the main target markets for Italian investments in 2017, both accounting for 10% of the investments. However, East Asia (and China in particular) has reached a higher relevance in recent years, especially in terms of total turnover, which has grown from 6.4% in 2012 to 8.1% in 2017.

With regard to company size, small enterprises tend to concentrate the most in European countries and, in terms of employees, in African countries. Their presence in more distant markets is still quite scarce, which confirms their tendency to establish export relationship with business actors of these areas. As for medium enterprises, their presence abroad is more significant in European countries as well, but also in Central and Latin America, Central and East Asia, and, in terms of number of employees, in Africa and in the Middle East. Finally, the presence of large firms with more than 250 employees is relatively higher in North American and Oceania, while it is relatively scarcer in Africa, Asia and in the Middle East[16].

Globalization has intensified and intertwined internationalization and delocalization processes of Italian enterprises, especially for firms operating in the manufacturing sector, which represents a backbone of Italian economy. According to the latest available data provided by Confartigianato[17], in 2015 the foreign companies partially or wholly Italy-owned were 6.5 thousand, with an average size of 130 employees. The data also suggest that Italian-controlled enterprises located abroad have grown over the last eight years, leading to a significant raise in employment: from 2007 to 2015, the employment of Italian enterprises located abroad has registered a +12.5% growth. With regard to investment sectors, the two most relevant ones are the manufacturing sector, accounting for half of the total Italian foreign investments, and the wholesale and retail sector, which accounts for 16.8% in terms of employees and for 25.1% in terms of turnover in 2017. Among all manufacturing activities, the most significant investment sectors are the automotive, machineries, metallurgy, IT and food, drinks and tobacco.

[16] *ibidem.*
[17] Virtù e Fortuna. Piccole imprese nell'era delle trasformazioni, Ufficio Studi - Confartigianato Imprese, 2017.

ITALIAN INTERNATIONALIZATION TO CHINA

Brief political and economic outlook

Looking back in history, after years of governmental control of all business activities, China began a rapid development process with a large-scale program of economic reforms carried out in 1978 under the lead of Deng Xiaoping[18]. Before the implementation of the market-oriented economic reforms, China alternated periods of expansion with strong regression phases in 1960-61 and in 1966-68, which come to coincides with the so-called Great Leap Forward and Cultural Revolution, two major policies carried out by Mao Zedong[19]. In 1978, Chinese government started an incremental process of decollectivization of agriculture, privatization of state-owned companies, partial opening to foreign trade and investment, and increasing permissions to entrepreneurs to start private business. Governmental control has become less restrictive and investments in industrial production and workers training have increased. The private sector thrived. These reforms have given an impetus to economic development and growth, which reached unprecedented levels, and have brought radical changes to Chinese economy and society.

Why to expand to China

As discussed earlier, when selecting a target market, enterprises need consider a series of factors, both internal, such as such as their competitive strength relative to their business rivals, and external, such as risk, geographical and cultural distance, and demand size and economic growth of the target market. Together with risk, economic growth is the most fundamental element: indeed, very few firms would attempt to expand in markets that show limited economic growth. It is mainly because of this reason that in the last years the focus has moved from advanced economies to developing ones, and especially to emerging markets. The rapid growth that characterizes emerging countries, together with a relatively easy market access and a relatively moderate degree of risk in many cases, has pushed foreign enterprises to consider such countries attractive targets for conducting and developing their business activities.

[18] Deng Xiaoping (1904-1997) was *de facto* at the lead of Chinese Communist Party from 1978 to 1992.
[19] Mao Zedong (1893-1976) was Chairman of the Chinese Communist Party from 1943 to 1976.

Among emerging countries, China exhibited a unique economic development, both for the strength of its economy and for its unparalleled pace of growth. Thanks to a change in its economic development model, which moved its focus from exports to the stimulus of internal demand, Chinese economy has continued to perform well also during the global slowdown due to the 2008 financial crisis. Although its growth rate is not as high as it was in the last decade, Chinese GDP is the second highest in the world (second only to the USA) and it keeps on growing at a sustained rate. Year 2015 has been positive for its national growth, despite the difficult global economic context, and years 2016 and 2017 as well: in 2017, Chinese GDP increased by 6.9%.

Another reason that makes the Chinese market extremely attractive for foreign companies is its enormous size. China's population amounts to 1.3 billion people, one fifth of the world population. This number becomes even more interesting if we consider that the massive urbanization process implemented by the government, together with the increase in the purchasing power of the Chinese middle class, have contributed to a significant growth of the internal demand. This significant growth has not only been registered in the first-tier cities, such as Beijing, Shanghai and Guangzhou, but also in the second and third tier ones, which are home of 7-10 million people each, as well as in a number of other highly populated urban areas. The rise in the income of the Chinese middle class, the higher urbanization and the Western influence in Chinese culture and lifestyle have determined changes in the consumption models, especially with regard to medium-high income class: the new Chinese middle class shows a high interest for high quality, branded and luxury products that can express their new social status. Such changes in the consumption model represent profitable opportunities for the products of the Made in Italy, whose international image is often identified with the same set of adjectives.

In China, a large number of sectors generates high profits for foreign companies: machinery, chemicals, transportations, IT and foods, as well as retail and wholesale have registered high growth rates in recent years. China is the first market in the world for the automotive industry, and all the main global competitors of this sector are already present in the market with local facilities.

In conclusion, Chinese market is very attractive for Italian companies: it showed great potentialities and it could become even more profitable for those enterprises that are able to benefit from the advantages it offers, in terms of turnover, business-to-business cooperation, and export of Made in Italy products to niche market segments. Being physically present in China with sales agencies, representative offices, or local subsidiaries is increasingly becoming a source of advantage, as it helps understanding future trends and peculiarities of Chinese clients and consumers, shortening the distance between producers and buyers from a both geographical and commercial point of view, and regularly monitoring the evolution of the legal and administrative context.

Entry modes and sector opportunities

Home to one fifth of the world population, China is today the second global economic power and one of the major actors in global financial markets. Analysts have described its rapid economic development occurred in a period of only thirty years as one of the greatest economic successes of modern times. Its unprecedented growth performance, large population and relatively low labor costs make it a highly competitive global actor and target market. As noted earlier, the increase in the average income per capita has lead to an increase in the import of high quality foreign products in many sectors. This creates a great export opportunity for Italian small and medium companies specialized in niche, high quality and high value productions.

Italian enterprises are aware of China's strong potential and need to approach this unique and valuable market with specific and structured strategies. Italian companies aiming at entering the Chinese market need to evaluate the entry strategy properly. This decision is of extreme relevance, as it will influence the overall organizational strategy, especially production and marketing choices, the difficulties and risks the organization will face during the penetration process and the new competencies the firm will need to develop in order to be successful. Export is by far the most common entry strategy chose by Italian small and medium enterprises. Another frequently adopted entry mode for Italian SMEs in China is represented by partnerships with local business actors, as it allows Italian firms to penetrate the market in a faster and easier way: China is surely rich in labor force, financial resources, raw materials and productive capacity, but it lacks the technologic know-how Italy is renewed for. Finally, many Italian SMEs are present in the Chinese market with representative offices, showrooms, sales and marketing offices, and production facilities.

A report by the Embassy of Italy in China[20] lists the Chinese business sectors that offer the strongest future opportunities for foreign investors and exporters.

With regard to investments, the machineries and renewable energies sectors have exhibited high growth rates in the last years and show positive signals for the future. Enterprises specialized in advanced technologies for drugs production, high quality medical appliances and hospital facilities will have plenty of opportunities, as well as companies operating in the water supply sector. The food industry also shows favorable factors of growth: the large market base, the developing distribution system and the relatively low level of services, and the rise in the demand of high-end products suggest wide room for development.

[20] Rapporto Cina, infoMercatiEsteri, www.infomercatiesteri.it.

The above-mentioned sectors show positive future factors of growth with regard to export as well. In addition to this list, Italian exports exhibit a positive trend also in the clothing and textile industry, thanks to the strong image of Italian fashion and lifestyle in China.

Italy–China economic and business relations

Italy has always been a major trading partner for China. Over the last decade, economic relations between the two countries have shown signs of increasing interdependence, through both trade and investment, as the two economic partners share similarities and complementarities in their production systems.

Although European Union and the United States are the two major destination markets for Italian goods and services, Italian exports exhibited an exceptional growth in China in 2017, increasing by 22.2%. In the same year, the Italian share of global exports showed a positive performance in East Asia and especially in China, suggesting a rising trend for future years. The positive variation is even more evident if we look at the comparison with the total EU share of exports to China, for which Italy is ranked fourth, accounting for 8.4%. With regard to imports from China, Italy ranks fourth among EU countries as well.

The two economies are strongly intertwined through trade flows. In recent years, Italy has witnessed increases in both its imports from and exports to China. In 2017, Italy exported to China goods for a value of 13.5 million euros and imported from China goods for a value of 28.4 million euros (+4%). As these numbers suggest, the Chinese markets is today one of the major Italian business partners: it is the third main country for imports, after Germany and France, increasing from 6.6% in 2012 to 7.1% in 2017; it ranks eight in terms of exports, increasing from 2.3% in 2012 to 3% in 2017.

Strong complementarities characterize the leading economic sectors of both countries. Italian exports to China concentrate in the machinery and mechanical appliances, which will be in great demand also for future years. Other sectors have performed well over the years, acquiring a key role Italian export to China. Among the most relevant there are vehicles, pharmaceutical products and medical appliances, clothing and textile products, as well as the traditional sectors of the Made in Italy. Italy's role on Chinese imports has especially increased in those sectors in which Italian industry is particularly specialized, innovative and adopts advanced technologies. From China, Italy imports mainly computers, electronic devices and appliances, and clothing, leather and textile products. Imports of machineries, chemicals and plastic products are also high in value.

The Chinese markets is also one of the major recipients of foreign investments in the world, holding the third position in 2016. In 2017, China has received 134 billion dollars of global FDIs, a value that decreased of only 1% from the previous years and which remains notably higher compared than the other BRICS countries. With specific reference to Italy, in 2017 4.7% of foreign enterprises partially or wholly Italian-owned concentrated in China. From 2012 to 2017, this number has remained pretty much the same, with a slight increase for 4.6% to 4.7%, as well as the number of employees, which accounts for 8.7% in 2017. The relevance of the Chinese market as a destination for Italian investments is more evident if we look at the increase in the turnover value: in the last five years, China has registered a growth from 3.5% to 4.6%.

On the Chinese side, Chinese companies have increased their overseas investments in order to diversify their assets and location portfolios. This outward expansion through large-scale FDIs has notably speeded up in recent years, making China the second largest investor in the world in 2017[21].

[21] World Investment Report 2017. Investment and the Digital Economy, UNCTAD – United Nations Conference on Trade and Development, 2017.

CHAPTER 2
RISK AND RISK MANAGEMENT STRATEGIES

INTRODUCTION

The purpose of this chapter is to discuss enterprise risk and to highlight the risk management strategies and approaches that enterprises can adopt to identify, assess, and respond to it. The chapter starts with the definition of the concepts of risk and enterprise risk. The definitions are followed by an overall picture of the types of enterprise risk, each of which is described and analyzed in detail. The risk categorization proposed is the one developed by the Casualty Actuarial Society (CAS), which classifies risks in hazard, financial, operational, and strategic. The following section of the chapter discusses the difference between risk and risk exposure, and the strategies companies can adopt to manage their exposure to risk, focusing or risk assessment and prioritization, and on risk response. The four alternative risk response choices, which include risk avoidance, risk reduction, risk transfer or hedging, and risk retention are explained and examples are provided. All these strategies need to be part of a proper risk management process, which guides enterprises in the identification, assessment and treatment of risks. For this reason, the last part of the chapter is dedicated to the illustration of Enterprise Risk Management (ERM), an innovative risk management process based on a comprehensive and integrated approach to risk. The section analyses the driving factors, characteristics and benefits of this approach, as well as the various stages that make up its framework: establishing context, objectives and risk management philosophy; identifying risks; assessing risks; treating risks; monitoring and control.

THE CONCEPT OF RISK

What is risk?

Many definitions of risk exist in common language. Dictionaries define risk as the "possibility or threat of damage, loss, injury, liability or any other adverse or unwelcome occurrence that is caused by external or internal vulnerabilities". Although this definition is widely used, it does not fully cover the concept of risk, as it only focuses on the negative outcome of risk taking, identifying risk only as a danger. As respected scholars have shown (Bernstein, 1998; Cline, 2004), the etymology of the term "risk" in many languages does not only emphasize the downside dangers but also the upside potentials. For Bernstein (1998) the term "risk" derives from the early Italian "risicare", which means

“to dare”. In this sense, risk is not only a fatal event that happens us, but also a choice. Moreover, in Ancient Greek, Latin and French the word for “risk” is also the word for “chance” and “venture”. The duality of the concept of risk is also outlined by the Chinese character for “crisis, risk” (危机)[22]. The two-character word is in fact created by juxtaposing the symbol for “danger” to the symbol for “opportunity”, defining the concept of crisis-risk as a combination of both danger and opportunity. The etymological examples presented above show that danger and opportunity represent the two sides of the same coin. They remind risk managers that any risk management approach that focuses only on reducing risk exposure reduces also the potential for opportunities. Thus, a first important truth is that an effective risk management approach is one that allows the organization to minimize the potential negative effects of events on one side, and to seize potential opportunities on the other.

After having established the dual concept behind the term “risk”, we are now going to analyze the relationship between risk and uncertainty. In the common usage as well as in its economic and financial sense, the term “risk” is often associated with the concept of uncertainty.

With this regard, a first contribution to the definition of risk is the one proposed by economist Knight. In his book *Risk, uncertainty and profit* (1921), Knight shares his view on risk, highlighting its relation but distinction with the concept of uncertainty. From his point of view, risk can be measured, transferred and insured; the potential outcomes, and sometimes even the odds of the outcomes, of a risky event can be predicted in advance, while, with uncertainty there is not such possibility. With his words, “uncertainty is an unknown risk, while risk is a measurable uncertainty”.

A similar idea is the one shared several years later by Cline (2004). According to his point of view, while uncertainty should be seen as an unknown, potential, unpredictable or uncontrollable outcome, risk is defined as the “human interaction with uncertainty”.

Another relevant definition that stresses on the strict relationship between the two concepts is the one adopted by the International Organization for Standardization (ISO). In 2009, ISO published the standard *ISO 31000 – Risk Management,* which is of critical importance for organizations as it provides principles and guidelines on risk management[23]. In the standard, uncertainty is defined as the state of full or partial deficiency of knowledge, understanding or information related to an event, its consequences, or likelihood. The same standard defines risk in the following way: “risk is the effect of uncertainty on objectives”. In other words, risk is the effect that uncertain events (positive or negative) have on the elaboration and implementation of business strategy, and on the achievement of corporate objectives.

[22] Aswath Damodaran, Strategic risk taking: a framework for risk management, Pearson Prentice Hall, 2007.

[23] The first version of the standard, ISO 31000:2009, has recently been revised by the latest version ISO 31000:2018.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is on the same line of thought with the view exposed above. It defines risk as “the possibility that an event will occur and adversely affect the achievement of objectives”, and, on the other side, opportunity as “the possibility that an event will occur and positively affect the achievement of objectives”.
As all these contributions suggest, risk is strictly related to uncertainty. Uncertainty generates from the environment in which companies operate, from external factors such as changes in regulations, competition, or technology. Uncertainty generates also from the firm’s own strategic choices, for example when it decides to expand to another country. Risks and opportunities emanates precisely from uncertainty about the likelihood, occurrence and the severity of the consequences of a given activity on company’s objectives. The challenge for enterprises is to effectively implement a risk management process that enables them to deal with uncertainty and associated risk and opportunity, determining how much of such potentially negative effects the organization is willing and capable to bear and how much of such potentially positive effects the firm is able to manage and exploit.

Enterprise risk

Uncertainty and risk represent an essential part of an enterprise’s business activity. Changes in the external environment and uncertainty about the consequences of management choices make it necessary to adopt effective risk management strategies.
Whatever their type or size, every organization has a purpose for being and objectives to achieve. In general, the recurring purpose of every business organization is to build value overtime. With this regard, we can define enterprise risk as related to the possibility for an enterprise to fail in pursuing its objectives. Enterprise risk is thus something that may affect the achievement of enterprise’s objectives (Hopkin, 2017). Therefore, given that every enterprise has objectives to achieve, even though such objectives may differ from company to company, an enterprise’s business activity always includes a certain degree of risk.

The definition of enterprise risk provided above is of course very broad. Risk derives from both enterprise’s specific internal characteristics and the external environment in which it operates, so it is important for companies to define their own view on and approach to risk, in accordance with their risk management philosophy and strategic objectives.
However, some characteristics of enterprise risk are generally valid for all enterprises, and can be discussed below.

As the enterprise is a dynamic entity that operates in an ever-changing environment, when assessing the universe of risks the enterprise is exposed to, it is important to understand that these risks are dynamic as well. Thus, a good risk management approach monitors the changes and transformations in the environment to identify new potential risks or variations in the company's risk profile.

The various risks to which an enterprise is exposed to are linked one another by interdependencies and complementarities. They are part of a system in which they influence one another. For this reason, it is not possible for an enterprise to assess every risk separately from the others, because the global enterprise risk is not a mere sum of the risks it includes. On the contrary, an integrated and holistic approach to risks is necessary.

Risk has a great economic relevance for enterprises as it is also strictly related to value: if poorly assessed and managed, it can destroy value, but if properly identified and treated, risk can reveal growth opportunities and thus creates value for the enterprise and its shareholders. The ability of enterprises to exploit the positive component of risk (upside risk) and at the same time to reduce the exposure to the downside risk comes from the implementation of an effective risk management process.

TYPES OF ENTERPRISE RISK

Enterprise risks are of various nature. The risk categorization exposed below is the one proposed by the Casualty Actuarial Society (CAS), which groups risks in the following four types[24]:

1. Hazard risk
    a. Fire and other property damage
    b. Windstorm and other natural perils
    c. Theft and other crime, personal injury
    d. Diseases

2. Financial risk
    a. Credit
    b. Price (commodity, currency, interest rate)
    c. Liquidity

3. Operational risk

[24] Overview of Enterprise Risk Management, Enterprise Risk Management Committee, Casualty Actuarial Society, 2003.

   a. Business operations
   b. Information technology and information reporting

4. Strategic risk
   a. Reputational damage
   b. Competition
   c. Demographic and social/cultural trends
   d. Regulatory and political trends

It is important to notice that the magnitude of each risk category varies according to the nature of transaction in place, on whether it is an import-export transaction or an investment, to the type of company, to the industry and to the kind of product involved in the transaction, whether it is an investment product or a consumer product. In other words, different types of transactions, companies, industries and products entail different sets of risks.

Hazard risk

The first category of risk faced by corporate organization is hazard risk. As the Casualty Actuarial Society specifies[25], examples of hazard events are fires and other property damage, windstorm and other natural perils, thefts and other crime, personal injury, business interruption, disease and disability (including work-related injuries and diseases), and liability claims. Arising from property, liability, or personnel loss exposures, such events can all potentially occur causing significant damage to companies' operations. For these risks are generally well known and understood by companies, they are commonly covered through insurance policies.

Financial risk

Financial risk can be generally defined as the risk that an organization will be unable to meet its financial obligations. Types of financial risk include credit risk, price risk, which refers to commodity risk, currency risk and interest rate risk, and liquidity risk, all of which will be discuss in detail in the following sections.

[25] Overview of Enterprise Risk Management, Enterprise Risk Management Committee, Casualty Actuarial Society, 2003.

Credit risk

Credit risk refers to risk of the buyer becoming insolvent, meaning that it is not able or willing to pay, partially or fully, the credit to the counterpart. Credit risk is part of any economic or financial transaction, regardless of whether the counterpart of the transaction is domestic or foreign. However, when companies engage in business activities with foreign counterparts or in foreign countries, credit risk becomes more insidious. Collecting information on foreign partners' creditworthiness may not be as simple as it is with domestic ones, credit information may not be reliable or even available, and, in case of insolvency, credit recovery processes and costs may be more complex and governed by different regulations or practices. For these reasons, an anticipated credit risk management is even more important in the case of trading with foreign parties.

With a focus on the moment that precedes the actual economic performance, anticipated credit risk management aims at evaluating the degree of credit risk, which the company can keep or avoid by transferring it to a third subject (banks and insurance companies). Credit risk management starts with the analysis of clients' creditworthiness, and involves the settlement of contractual terms, the selection of payment forms and methods, of potential guarantees, and so on.

In order to avoid credit risk, organizations can transfer it to banks through instruments widely adopted in international trade: the letter of credit satisfies the need of payment and liquidity for the exporter and the need of receiving the performance/delivery of goods for the importer; bank guarantees insure the exporter on the fulfillment of contractual obligations by the importer. Credit risk can also be transferred to specialized insurance companies through credit insurances. In the event of insolvency, the exporter receives a compensation from the insurance company, thus mitigating the risk of full credit loss.

Price risk

Commodity risk

Although not exclusively typical of international trade, commodity price risk often arises in cross-border operations. It is thus important to manage its impact in order to avoid losses that might reduce corporate profitability. Deloitte defines commodity price risk as the "financial risk on an entity's

financial performance or profitability upon fluctuations in the prices of commodities, which are out of the control of the entity since they are primarily driven by external market forces"[26].

Commodities price volatility causes corporate actors to face uncertainty when sourcing or selling a product at a price, and create significant challenges for business, as they can have an impact on several business aspects, from production costs to product pricing, earnings and credit availability. Volatility in commodity prices can affect different players differently. A potential rise in commodity prices can determine higher costs of production for the businesses consuming such commodities and higher sales revenues for the seller (if demand is not impacted by the price increase). On the other side, a potential fall can determine lower costs of production for companies consuming such products and lower sales revenues for the producers, potentially reducing the value of the organization; producers can also decide to change business strategies, alter production levels or even eliminate production in response to lower prices.

Due the intrinsic different characteristics they have by nature or to their different degree of transformation, commodities are extremely varied. Commodities include agricultural products, industrial products such as paper, as well as products like oil, coal and metals. Consequently, the nature and type of commodity price risk varies from industry to industry, and requires also specific management strategies and hedging products, which organizations need to define in clear risk management policies and models. Whatever the commodity, fluctuations in prices can cause cash flow fluctuations in the business. One of the advantages of hedging commodity price risk is the possibility to reduce and minimize cash flow fluctuations, as it offsets the impact in the occurrence of commodity price fluctuations. Given that hedging solutions vary on the commodity, the most widely used financial instruments to hedge commodity price risk are future contracts; other typical products available are Basis swaps, Three way participations, Zero cost collars, and Plain vanilla call options.

Currency risk

When a company performs payments in a different currency (a foreign one) from the one in which it incurs its costs (usually its domestic one), a new risk arises. This risk is called currency risk and refers precisely to the possibility that changes between the currency of the foreign country and the domestic country depreciate the value of business activities conducted abroad. The size of currency risk

[26] Commodity Price Risk Management. A manual of hedging commodity price risk for corporates, Deloitte, 2018.

depends on the type of currency and on the time that elapses between the promise of payment and the actual payment transaction.

The measurement of transaction exposure starts with identifying all transactions that might generate future cash flows and grouping them according to the currency they are originally denominated in. Besides financial products, business actors can use natural hedging, which is the best possible way to manage currency risk. Unlike other hedging instruments, natural hedging is free and consists in the netting between cash inflows and cash outflows denominated in the same currency and occurring in the same period. Over the months, a company has both cash inflows and cash outflows in a given foreign currency; in this way, the transaction exposure related to the foreign currency will be referred only to the net balance resulting from the netting. If a company belongs to a group, the natural hedging can even be maximized: the netting process is not only carried out within each company of the group, but also between the different subsidiaries of the group, through a FX clearing center.

As noted earlier, time involves an element of risk, thus it needs to be managed. Dealing with foreign currencies, firms necessarily need to convert amounts of foreign currencies into domestic ones, buying domestic currency against selling foreign one. If the transaction is carried out with immediate delivery (in two business days), the risk is lower, as the transaction is done at a spot exchange rate. However, if a company is expecting a future cash flow, it does not know the value of a future exchange rate. In order to eliminate this uncertainty, the company can predetermine the exchange rate of a future transaction in foreign currency: it is the case of a forward exchange rate. The possibility of setting a forward exchange rate is extremely important in international trade, as it helps business actors eliminate the uncertainty of not knowing the domestic currency value of a future transaction denominated in foreign currency. Thus, hedging a risk simply means eliminating the uncertainty. The financial instruments that help to reach this result are outrights, swaps, futures, and finance in foreign currency. These financial tools are all symmetrical instruments, as they secure a fixed price whatever the direction and width of the fluctuation in the exchange rate are. In this case, an exporter will be concerned by the potential weakening of the foreign currency, which would undervalue their cash flow, but will benefit from the potential strengthening of the foreign currency. If an exporter wants to hedge the downside risk, they can use asymmetrical hedging products that secure a fixed price beyond which the foreign currency cannot grow weaker, but can get stronger. The most common example of such financial instruments are options.

Interest rate risk

This section is dedicated to the risk connected to interest rate fluctuations and to the associated volatility of the financial burden a firm might have to bear. Interest rate risk refers to the possibility that interest rate fluctuations cause a change in future cash flows or in the price of financial products. For example, an exporter who buys a given financial product at a variable interest rate is exposed to the risk of a future increase of the interest rate, which can potentially lead to higher financial costs. In order to avoid such risk, the exporter might prefer to buy the financial product at a fixed interest rate, thus eliminating the volatility of their financial burden.

Not all financing operations offer a fixed interest rate since the very beginning, especially long-term ones. On the other side, not all companies want fixed interest rate from the start; instead, they might prefer to keep a variable interest rate at first if they expect costs of debt repayment to be lower. Firms can also obtain finance at a variable interest rate and afterwards decide to convert it into a fixed interest rate, or vice versa. To do so, a company can buy derivative contracts, which convert variable-rate debt into fixed-rate debt. The decision to buy such derivative contracts, which are also quite expensive, should be the result of a well-defined risk management model, and not the choice of a single individual in the organization. This is why measurement of interest rate exposure is a fundamental activity for corporate organizations, and should be carried out in the framework of the organization's strategical choices and managerial responsibilities. Interest rate exposure measurement is usually related to the amount of loans receivables and loans payable, but can also involve perspective financial exposure, which needs to be reliable or at least highly probable. The aim of interest rate risk measurement systems is to provide the management of the organization with the necessary information to carry out management and hedging activities. In order to control and limit interest rate risks, a number of derivate contracts is available for organizations, such as Forward Rate Agreements (FRA), Interest Rate Swaps (IRS), Interest Rate Futures (IRF), and Interest rate options.

Liquidity risk

Liquidity risk is the possibility that a company is not able to fulfill its contractual obligations because it is not able to find the resources to finance such activities. As one of the most studied topics in finance, liquidity risk management together with credit risk mitigation are of major interest for FCOs. As researches show, companies prefer to adopt financial structures characterized by diversified and medium-to-long-term financial sources with the retention of cash reserves. Therefore, although reducing the cost of collecting finance is one of the main concerns of FCOs, a more expensive

financial structure can provide the company with continued and long-term financial resources, thus hedging liquidity risk.

International trade activities can generate financial needs both in the short term, such as in the case of exports, and in the medium-to-long term, such as in the case of foreign investments and projects. The banking system provides companies with a number of financial products that can meet their financial needs. In most cases, the access to such financial tools is not connected to the specific foreign transaction, but to the ability of the company to repay the debt to the capital market. Thus, in order to obtain credit from the market, firms need to understand how the banking system works and the logic behind the provision of finance.

A general principle in corporate finance is that before looking to obtain finance from the capital market, companies should work internally improving their use of cash flows and reducing their prospected need of finance. Financial planning and control activities are important as they allow firms to forecast and control their future potential cash needs through managerial choices aiming at maximized cash inflows and minimizing cash outflows, before turning to the capital market. Careful corporate financial planning and control are essential activities for effective financial management of organizations. More specifically, it involves identifying the various possible scenarios that a company faces along its own strategic development, and determining the key solutions to reach its expected financial and strategic goals. The forecasting analysis, which is based on the income statement, balance sheet and cash flow statement, is followed by a regular check in order to determine and adopt possible strategic adjustments or changes.

Operational risk

Operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems. More specifically, it includes risks arising from business operations (such as human resources, product development, capacity, efficiency, product or service failure, channel management, supply chain management and business cyclicality), information technology and information or business reporting. As the definition highlights, operational risk is not simply related to the industry in which the company operates or to the products it sells, but it refers to how the organization works internally, to its processes and procedures, its prioritization choices and management decisions.

As its wide scope includes both human error and failures of information technology systems, operational risk can be further divided into two main subcategories: risk related to business operations and risk arising from information technology problems and failures.

Uncertainty of profits or danger of losses are entailed in any business activity, as unforeseen events may occur causing the operations to fail. Business operation risk refers to any potential cause of loss arising from the organization's inefficiency, issues in the management of its business cycles and failures in its supply chain management. As supply chains have become longer, extending across different countries in different parts of the world, managing risk failures in supply chains has become a hot topic. In a global supply chain of significant dimensions every link might turn into a weak spot, bringing a potential of risk of failure. A survey by Deloitte from 2014 shows how business success is strictly linked to effective supply chain management. The survey reports that 79% of companies with high-performing supply chains obtain a growth in revenue that is higher than the average of their industry. On the contrary, a higher-than-average growth is reported by only 8% of companies with less efficient supply chains.

For example, a key element in the management of global supply chains is the logistics and transportation system. First, transport represents a cost that affects seller's margins and/or the final price of the product; second, the client perceives transportation as a service; third, the physical movement of the merchandise from the exporter to the importer always involve an element of risk. Therefore, it is important for companies to reconcile the need of effectiveness and speed with cost-efficiency and safety, evaluating effectively the impact that transport has on the company's competitiveness compared to its competitors. Organizing a winning logistic system characterized by a better service for foreign clients, faster and more precise deliveries and a more efficient distribution system, is a factor of success in international trade, creating value for the company client and for the business itself. In order to do so, logistics and supply chain choices need to be evaluated adopting a holistic approach to the organization, which sees all organizational functions as part of a single entity. Integrating and optimizing all company's flows from procurement to transport and distribution of the final product is key to increase company's competitiveness.

With regard to information technology failure, ISACA (previously known as Information Systems Audit and Control Association) defines information technology risk as "the business risk associated with the use, ownership, operation, involvement, influence and adoption of IT within an enterprise"[27].

[27] COBIT 5. A Business Framework for the Governance and Management of Business IT, ISACA, 2012.

In other words, IT risk refers to events related to the information technology system that, with their uncertain occurrence and magnitude, might impact the business and cause issues in meeting the organization's strategic goals and objectives.

Information technology is nowadays crucial for businesses. Therefore, a failure in the IT system can cause several issues. It might cause issues and inefficiencies in the daily operations or in the delivery services of the company. It also might cause the organization to miss important opportunities to increase business value by adopting IT enabled or improved processes. The availability of the necessary or adequate IT systems equipment and their maintenance is also seen as an element of IT risk.

Due to the relevance of information technology systems to the overall organization, IT risk should not be considered a merely technical issue of the IT department, but should be treated like all the other risks that impact the business.

Strategic risk

Strategic risk is typical of any business activity. However, unlike domestic markets, in international ones this risk becomes particularly critical and relevant, as it is worsen by a lower knowledge of the market, local competitors, distribution system, local laws and regulations, different culture and business practices. These elements all together represent a potential source of risk for foreign enterprises, and contribute to put them in a disadvantaged position compared to local competitors when first approaching the new market.

As described by the Casualty Actuarial Society[28], strategic risk includes reputational damage, competition, customers wants, demographic, social and cultural trends, as well as technological innovation, capital availability, and regulatory and political trends.

With regard to culture, it is important to notice that commercial relationships are built primarily on a web of personal relations. Because people have different traditions, values and behaviors, placing the right importance on linguistic and cultural matters is crucial. This becomes more important when companies engage into commercial relations with countries culturally very distant from them. Under such circumstances, organizational management needs to undertake an adequate learning process, that gives them the right information and tools to understand the social and cultural context they are

[28] Overview of Enterprise Risk Management, Enterprise Risk Management Committee, Casualty Actuarial Society, 2003.

dealing with and the ways in which it is best to operate, in order to implement effective business strategies.

A recent event that involved the Italian fashion brand Dolce & Gabbana can teach us a lesson on the importance that culture and communication have when dealing with distant and culturally different markets. The promotional video posted by the fashion house was deemed deeply racists, sexist and disrespectful to Chinese people and their culture. A sentiment of outrage spread in all Chinese social networks and even turned into concrete action, with a significant loss for the brand image: D&G products were removed from the main Chinese e-commerce platforms and their Shanghai catwalk show was immediately cancelled. This event certainly gives us an idea of the dimension of reputational - let alone financial - damage that communication mistakes and neglecting cultural differences can cause.

With regard to regulations, laws that exist in Italy might not exist in a different country. Given types of contracts might have a different name abroad or might have the same name but refer to very different laws and practices. Acts considered legal in Italy might not be so elsewhere. It might be hard for foreign subjects to enforce their rights in a dispute with a local subject in a foreign tribunal. And so on. Knowledge of the legal and regulatory system is thus extremely important, and neglecting one of these aspects can cause serious damage to the company, from loss of capital to, in extreme cases, jail.

As for political risk, it arises from events of socio-political nature, such as wars, internal or external conflicts, uprisings, terroristic attacks, or social tensions caused by ethnic, religious or ideological reasons. Foreign trade restrictions, expropriations and nationalizations, ability to draft, implement and enforce laws, bureaucracy and corruption, democracy and degree of representation of minorities, and degree of social inequality are also included in the political risk category. As they refer to the specific legal and social context, these risks are less predictable, and their evaluation is usually subjective.

RISK MANAGEMENT STRATEGIES AND APPROACHES

Risk vs risk exposure

Hampton (2009) defines exposure as the state of not being protected from an action or event. A similar definition is proposed by Aven (2011), who sees risk exposure as the extent to which an individual

or organization is subject to or affected by a given event or action. Risk exposure can be measured by enterprise management in order to determine the amount of risk the company is willing and capable to bear, and the amount of risk the firm should avoid and transfer to a third party. For this reason, Berg (2010) defines risk exposure as the quantified potential for loss which can occur as a consequence of an activity.

A point that it is better to highlight since the start is the difference between risk and risk exposure. While risk is the potential for an event to happen and to affect the enterprise and the achievement of its objectives, risk exposure has to do with the degree to which the enterprise is subject to or exposed to that risk, which is what the enterprise can actively manage. In other words, enterprises might not be able to act on the event itself, but can adopt certain strategies or take hedging choices in order to manage the vulnerability and preparedness of the entity to that event, thus managing the likelihood of that event, its impact on the organization or its speed of occurrence. The objective of such management activities is to reduce or, if possible, eliminate the negative consequences that an event might have on the organization's performance.

Companies working in the same market or industry might have very different risk exposures. Although the risks that characterize a given market or industry are the same, different companies have different risk exposures, as it varies according to a wide web of factors.
For those companies that engage into foreign trade, their risk exposure may vary depending on the internationalization strategy they are pursing and on the degree of commitment they have on a given foreign market. Are the firm's export activities sporadic o continuous? How much weight does a specific country have on the overall turnover of company? Is the company trying to penetrate the market or increase its presence in it by using local agents or resident managers? Clearly, if the foreign market has a little weight on the company's overall turnover, potential risks arising on that market have a little impact on the company as well. Otherwise, if the foreign market weights for a good 15-20% of the company turnover, the market is key and as such needs to be monitored closely by the company to prevent negative events to affect its business performance. Moreover, companies operating in the same industry might possess very different internal characteristics, dimensions, structures and organization. For example, in international trade, the degree of organization of a firm's commercial structure has a strong influence on the level of preparedness the company shows when dealing with risks. Small dimensions, shortage of personnel in the commercial department, lack of previous experience and limited market research might result in a strong disadvantage for companies aiming at expanding into a new foreign market, as they raise the firm's level of vulnerability, and so

its exposure to all kind of risks. On the contrary, risks that are typical of a certain complex foreign market, such as legal risks, credit risks or cultural risks, might have a little or no impact on the firm, as it has already implemented measures to protect itself from those risks.

The point is that certain risks might be very likely in a given market but have a very low impact on the enterprise's overall performance. In fact, however the likelihood of the event is high, the risk does not represent a big threat for the enterprise, as its consequences fall out of the firm's scope of operations, or else, the company has already adopted measures that significantly reduce the consequences of those events.

As we will see when discussing the risk management process, the starting point for managing the company's overall risk exposure is assessing and measuring risk criteria such as the likelihood of occurrence of an event, the impact on the organization, the vulnerability of the company to the event, and the speed of occurrence.

Impact is generally defined as the extent to which a risk event might affect the enterprise[29]; it is usually a combination of many types of impact, such as financial, reputational, regulatory, operational, environmental and many others. Likelihood refers to the possibility that a certain event will occur[30]. Likelihood scales can be created using qualitative terms (such as frequent, likely, possible, unlikely and rare), or using numerical values, expressing the percentage of chance of occurrence or the frequency of occurrence.

Besides impact and likelihood, many enterprises consider also dimensions such as vulnerability and speed of onset. In fact, many likely events might not occur at all or occur at a low speed, while unlikely events occur all too often and at very fast speed; also, certain enterprises might be particularly vulnerable to certain risks thus making impact and likelihood even higher. Vulnerability is the susceptibility of the entity to a risk event in terms of the entity's preparedness, agility and adaptability[31]. Assessing the degree of vulnerability of the enterprise to a given event allows management to understand whether the company is ready to face an event; it gives management useful information to direct risk response. Finally, speed of onset is defined as the time it takes for a risk event to manifest itself, or the time between the occurrence of an event and the point at which the enterprise first feels its effects[32].

[29] Enterprise Risk Management – Integrated Framework, Committee of Sponsoring Organization of the Treadway Commission, 2004.
[30] *Ibidem.*
[31] *Ibidem.*
[32] *Ibidem.*

To understand the key risks to which the company is mostly exposed to, enterprise management usually uses a two-dimensional risk map, often called *heat map*. The heat map is usually the representation of impact versus likelihood, but it can also represent the relationship of impact plotted against other risk criteria. An example of heat map is represented in Figure 1. Risks plotting in the red zone (on the upper right of the graph) are the ones with the highest impact and likelihood for the company, while risks plotting in the green area are the ones with the lowest impact and likelihood.

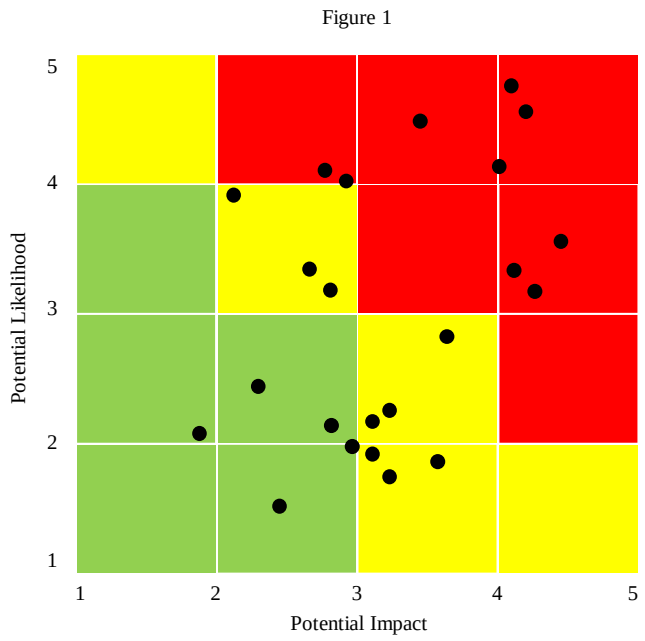

Figure 1

Representation of a heat map. Dots represent risks.

Another useful tool that enterprises have to prioritize risks and refine their assessment is the MARCI chart (Mitigate, Assure, Redeploy, Cumulative Impact). The MARCI chart is a two-axes graph that represents impact plotted against vulnerability; it also indicates speed of onset by the size of the data points. Similar to the heat map, the upper right quadrant of the graph indicates the highest impact and vulnerability for the company. The MARCI chart provides crucial information for company managers, as it offers a first evaluation of the risk response to be adopted. It helps management assess the level of readiness the company has to face risk, and it helps evaluate whether the adopted risk management choices or hedging programs are adequate to reduce enterprise's vulnerability to risk. It might suggest that the company needs to redeploy resources used to hedge risks that do not have a high impact, or it might require the company to enhance its risk mitigation measures to reduce its vulnerability to some other risks. An example of a MARCI chart is illustrated in Figure 2.

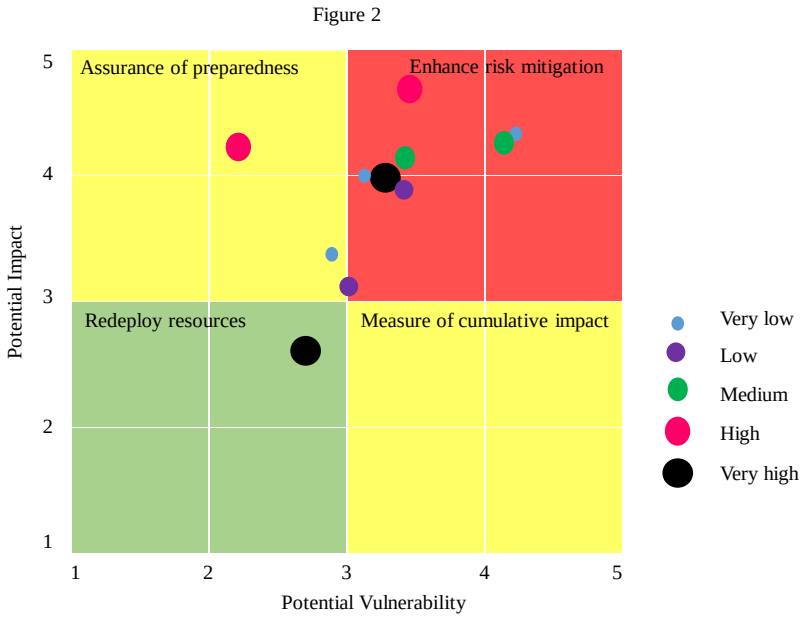

Figure 2

Representation of a MARCI chart. Dots represent risks; dots' size represent speed of onset (from very low to very high).

This whole work analysis produces a rank of the key risks that are the ones to which the enterprise is mostly exposed to. Enterprise management then adopts and reviews treatment strategies to manage firm's exposure and keep it within the firm's risk appetite. Company managers conduct these analyses and measurements during the risk assessment and risk treatment stage, the phases of risk management process that follow risk identification. A more in depth look on risk assessment will be provided in the section of the chapter dedicated to the risk management process.

Key risk management and response strategies

As we have just seen, these tools allow managers to assess the firm's exposure to risk, and provide helpful insight and guidance on the ways to manage such exposure.

First of all, it is important to note that risk exposure management is not a standardized activity. Instead, it needs a specific evaluation. Enterprises might choose to repeat strategies adopted in the past or by others to treat certain risks, but other times changes in the circumstances or other specificities might require them to adopt new strategies, or to adapt old strategies to a new situation. Therefore, the selection of the strategy the respond to a certain risk is a complex activity that requires an open mindset.

Despite the peculiarities of each enterprise, activity, and risk, the strategies adopted by companies to manage risk exposure and respond to risk can be grouped in four categories, which are described in

this section of the chapter. Usually, such strategies are not adopted by enterprises alone. Instead, they are a part of a complex risk management process that managers implement in their organization to effectively identify, assess and respond to risks. This process, described through an integrated point of view, is discussed in the final section of this chapter.

As we have mentioned previously, four are the risk response strategies available to enterprises[33]:

1. Risk avoidance
2. Risk reduction
3. Risk transfer or risk hedging
4. Risk retention

Risk avoidance

Every business activity brings along a certain amount of risk. Sometimes the firm's vulnerability to certain risks or the impact and likelihood of risks related to certain activities cannot be reduced to be within the enterprise risk tolerance levels. Other times, the cost of hedging or transferring such risks to third party is higher than the value generated by the activity. Either way, the activity exposes the company to a level of risk that is not consistent with the enterprise risk appetite and investing in such activity will result in value destruction. In this kind of situations, management should avoid these risks by avoiding investing in such activities.

Risk reduction

Instead of avoiding risk altogether, enterprise management may choose to adopt a risk reduction strategy. What is reduced is not the risk in itself, but the company's exposure to risk. In practice, enterprises can carry out actions to reduce the risk impact, likelihood, speed of onset or the company's vulnerability to risk in order to keep the company's risk exposure within the fixed risk tolerance levels. In other words, this category refers to all of those activities and practices that the organization carries out internally in order to reduce their risk exposure.

Examples are numerous and vary on the basis of several factors, such as the type of risk, the peculiarities of the company, and the external context. Examples of internal management strategies that enterprises can implement to reduce their exposure to operational, financial and strategic risks are provided below.

[33] Risk Taking: A Corporate Governance Perspective, International Finance Corporation, 2012.

To reduce their exposure to operational risk, which refers to loss resulting from inefficient or failed processes, people and systems, enterprises may take preventive actions. A measure they can adopt is to identify all those factors, events or practices that might create inefficiencies and costs. With regard to product development and production, this can be done by ensuring that raw materials, intermediate products, and the entire production system have the desired quality and features; that necessary materials, machineries, systems and personnel are available and that they do not waste resources and value; or that personnel is professional and has the competence, expertise and possibilities to effectively perform tasks. Ensuring that corporate culture promotes positive behavior and cooperation for prevention against inefficiencies is also necessary. The ultimate aim of such management practices is to increase the company's efficiency. By adopting such preventive measures enterprises can reduce the firm's vulnerability to the risk and the likelihood or impact of a negative event, and can cut the cost of a subsequent and often less effective action.

In order to reduce inefficiencies and costs, enterprises might consider outsourcing certain specific business processes. This strategy has several advantages. By outsourcing certain business functions, enterprises can cut on recruitment and operational costs, as they do not carry out those processes internally. Outsourcing to partners that own expertise and specific equipment in certain fields can result in tasks completed faster and with higher quality output. Another advantage of outsourcing is risk-sharing, as certain risks are shifted to the outsourced partner. Choosing the right partner is of course extremely important. A wrong choice can result in delays and higher costs, making outsourcing a disadvantage for the organization.

Risk reduction strategies can help mitigate the firm's exposure to financial risks as well. A problem that may arise is that of granting too many payment deferrals to customers, which might cause the enterprise to be low on cash to pay its suppliers. As companies usually pay their suppliers before being paid by their customers, granting too long or too many payment deferrals might lead to liquidity issues. To prevent this from happening, companies need to evaluate accurately for how long they can remain exposed to this shortage of cash, defining their cash cycles and negotiating payment deferrals accordingly.

A proper definition of the cash cycle and of the payment deferrals helps also reducing credit risk. The longer the time the company grants its customers to issue payments, the higher the risk of not being paid. The risk becomes even higher in the case the business partner of the company is new, foreign, or if the company does not have much credit information about it. To reduce the potential for this negative outcome, enterprises can adopt credit risk management. As discussed previously in the

chapter, the credit risk management activity analyses clients' creditworthiness, defines contractual terms, payment methods, and potential guarantees for each clients.
Companies can also adopt strategies to manage their exposure to price risk. Management choices include the accurate definition of product prices considering potential fluctuations in the costs of raw materials, in the exchange rate, inflation levels or other unexpected expenses. The definition of the price is a crucial activity that needs to be evaluated very well. Prices are part of the contract, so if between the time of price definition and the time of business performance unexpected expenses arise, it might be very difficult for the company to raise the price. In order to manage prices, companies can decide to buy the same raw materials and components from many suppliers (multiple sourcing), thus taking advantage of their competition to keep prices low.

As we have seen, strategic risk refers to loss or damage resulting from a number of different factors, such as the legal and political context, social and cultural trends, technological innovation, competition, customers wants and so on. The risk can become even more significant when companies deal with countries that are very different from the ones enterprises are used to.
Under these difficult and new circumstances, firms need to undergo through a long learning process. Before starting to approach their target market, they need to collect all the necessary information regarding the macro picture of the country (political, economic, demographic, social and cultural outlook) and the micro picture of the business context and industry in which they are going to operate. Market analysis needs to be conducted in order to identify potential sources of risk and take preventive actions. For example, common problems that arise in complex markets are related to legal issues. In many cases, the process to solve such issues is long, resource consuming, and might cause significant losses. Instead, acting beforehand taking measures to prevent such issues is a much wiser strategy.
Another strategy that firms can consider to reduce the firm's vulnerability to strategic risks is operating with a local partner. The advantage of this option is that the partner knows the local context well, is more capable than the foreign company to identify changes in local trends and respond to them in short times. Despite the pros, this is a complex strategic choice and management need to ponder it very well.
Finally, risk reduction can be obtained also by choosing a policy of investment portfolio diversification. By adopting this strategy, enterprise management can diversify investments by splitting them into diversified activities and assets with uncorrelated returns. For example, a company might decide to invest in many projects in different geographical areas and businesses, thus reducing the firm's exposure to losses.

Risk transfer or risk hedging

Enterprise management can also choose to protect the company from risk generated by an activity by transferring risk (or part of it) to a third party (a bank or insurance company), which is external to the company. While risk reduction reduces the likelihood of an event, its impact on business activity or the vulnerability of the firm to the risk, risk transfer or hedging mitigates the consequences of the events when it happens.

Another significant difference with risk reduction strategies is that risk hedging choices do not require managers to change or modify enterprise's processes or strategies. This characteristic of risk hedging is both an advantage and disadvantage. On one side, it is a simple decision which prevents the enterprise from spending time and resources to make the otherwise needed changes. However, it has a cost, which varies depending of the type of risk to hedge and the product used for hedging. If for certain types of risks it makes sense to use risk transfer strategies, for other types of risks it might not. In order to evaluate the adoption of transfer strategies, the benefits that hedging brings to the company need to be weighed against its costs. It is also important to note that hedging choices should not be based on inertia or on fear of potential losses. Instead, enterprise management need to base such decisions on a rational assessment of the risks the company is facing and of the alternative management options available to mitigate the consequences of such risks. Companies need to adopt hedging strategies only when it makes economic sense to do so. In fact, while making cash flows more stable, hedging might also reduce firm's value by preventing the company to seize the desirable opportunities represented by upside risk[34].

A typical example of risk transfer or hedging is the purchase of insurance policies. Other commonly used tools to transfer risks to third parties are financial derivatives such as futures and options. Insurances are widely adopted in the treatment of hazard and operational risks. Financial products, as well as insurances, are generally used to mitigate the firm's exposure to financial risks.

Risk retention

Adopting a risk retention strategy means to maintain the risk inside the enterprise. In other words, it means that management does not take any action as the impact and likelihood of risk are seen to be within the risk tolerances levels of the enterprise. Management can choose to retain certain risks as they can show desirable opportunities or generate high returns for the organization. However, there is another and more dangerous way to retain risks. If not expressly retained, risks remain in the

[34] Risk Taking: A Corporate Governance Perspective, International Finance Corporation, 2012.

enterprise because they have not been identified or assess correctly in the initial stages of the risk management process.

Generally, enterprises do not adopt only one of the strategies described above. As risks are numerous, interconnected and related to more than one department or business unit, enterprise management need to adopt a mix of risk treatment strategies taking an enterprise-wide perspective. Moreover, since each of the listed strategies has both advantages and disadvantages, the selection of the strategy need to be the result of a proper evaluation. To choose the mix of strategies that best reduces the organization's risk exposure, management looks at a number of factors. First, it evaluates how alternative risk response strategies affect the likelihood, impact and other risk dimension. For doing so, enterprises examine past events, new changes and future trends. Second, they perform cost-benefit analysis for any alternative risk treatment decision. In this way, the enterprise is able to make a conscious decision, without wasting resources. Third, if management's main aim is to bring the enterprise's residual risk within the predetermined risk tolerance level, a second important aim is to seize opportunities. In choosing risk response strategies, enterprises need to implement those risk treatment decisions that allow them to take advantage from potential opportunities.

The evolution of risk management approaches

Enterprise approach to risk management has changed a lot overtime, and companies are now opting for more evolved and proactive risk management models and methods. It is precisely among these new risk management methods that we can collocate Risk Management (RM) and its newer form, Enterprise Risk Management (ERM).

The changes in the view and approach towards risk management are a direct consequence of the evolution of the concept of risk itself. In the past, risk was seen as a danger from which people and goods needed to be protected: at that time, the focus was only on the negative component of risk, and insurances were developed to reduce this down-side risk; no risk management method was yet developed and adopted. Only later on enterprises started to see the potential source of opportunity in risk, the so-called up-side risk, and started to implement models that seized these opportunities in order to create value.

The very first forms of risk coverage date back to the VIII century BC. Such forms of risk coverage were introduced by the Phoenicians and were widely adopted to cover the risks of trade in the Mediterranean Sea until the XIII century AD. The need to be protected against the risks of maritime

trade is also the reason behind the appearance of the first insurance forms and the first insurance companies, which were born in the XV century in the Maritime Republic of Genoa. Overtime, insurance companies developed, starting to provide coverage not only for maritime trade risks but also for other hazard risks, and started to spread throughout Europe and America.

It is precisely in the United States around the half of the XX century that the first ideas on Risk Management began to spread. As academics of the time described in academic articles and business reviews, Risk Management was seen as a set of tools aimed at changing the traditional approach towards risk, moving from a mere insurance coverage towards an internal risk management system. In the Seventies, the idea that insurance was not the only way to protect against risk gradually spread in the enterprise world, and companies started to adopt new risk management methods. In the following years, more and more enterprises developed and implemented risk management models, which became more and more efficient overtime. It was then clear that an effective risk management could not only help the enterprise cut on costs, but also seize opportunities and build value for the company. More specifically, Risk Management (RM) can be defined as an organizational function that has the objective of identifying, assessing, managing and controlling those events that might represent a threat or risk for the enterprise (Forestieri, 1996). Even though many different models developed, in general, Risk Management promoted an approach of handling risks separately, with no coordination among the various business units.

Around the end of the Eighties and the beginning of the Nineties, a new concept or risk developed, and a systemic and long-term oriented enterprise view started to emerge. Following the financial and economic scandals of those years, the private and insurance sectors decided to create a study committee with the aim of developing an innovative system of control for enterprises: the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was established in 1985. After publishing a framework for the assessment and improvement of internal control systems (*Internal Control – Integrated Framework*) in 1992, the Committee started to work on a risk management framework to help managers evaluate and improve their enterprise's risk management activities. Their work led to the development of *Enterprise Risk Management – Integrated Framework* in 2004. This publication, together with the works of many other associations and institutions, brought the traditional risk management techniques to evolve to a more innovative and comprehensive approach, the Enterprise Risk Management (ERM). According to the ERM view, risks are not assessed and managed from the point of view of a single business unit or function, but from an enterprise-wide

point of view. In this way, risks and their interrelations are assessed in a comprehensive and integrated way, and risk management becomes a responsibility of the enterprise as a whole.

Enterprise risk management approaches and frameworks are still evolving. From the publication of *Enterprise Risk Management – Integrated Framework* by COSO in 2004, lot has changed. The growing complexities and uncertainties in the economic and business environment together with the challenges in the interpretation and implementation of the framework have created a need for updating. During the years, the Committee of Sponsoring Organizations of the Treadway Commission has worked in order to modify and improve the framework, addressing such issues. The new version of the COSO ERM Framework aims at providing even more insight into the links between risk, strategy and performance. If the 2004 version of the framework has helped enterprises identify, assess and manage risks to the selected strategy, the 2017 version of it considers the possibility that the strategy selected does not support the entity's mission and vision and its implications. Therefore, the new framework stresses on strategy selection, which requires management to evaluate alternative strategies and their potential impact on the entity's risk profile and to align the allocation of resources with the entity's mission and vision[35].

Enterprise Risk Management: integrated approach to risk management

Identifying, assessing and prioritizing risks as well as treating them by transfer, insurance or other financial products have long been common management practices inside organizations. As discussed previously, before the emergence of Enterprise Risk Management (ERM), organizations' departments or divisions used to manage risks in isolation, each of them being responsible for the risks embedded in its specific activities. Towards the end of the last century, however, a series of driving factors have created the need for shifting away from the old approach. Enterprises felt the need of managing risks in a more cautious and conscious way, which led them to adopt comprehensive approaches towards risk and to assign the risk management activity to the responsibility of the senior management instead of the various departments.

Driving factors

[35] Enterprise Risk Management - Integrating with Strategy and Performance, Committee of Sponsoring Organizations of the Treadway Commission, 2017.

Among the driving factors that lead to the creation of what is now called Enterprise Risk Management (ERM) there is the increasing recognition of the number, variety, and interactions between risks that organizations face. If hazard risks such as environmental damage or liability for goods sold have been managed for a long time, other risks, such as financial ones, operational and strategic ones are more recent. The advancement in technology, the changing conditions of the business environment, the transformations brought by globalization, as well as the increasing sophistication in the financial world and the uncertainty of wars, terrorism and demographic movements have all contributed to the growth in the quantity and variety of risks. Moreover, the failures of high-profile organizations due to ineffective or insufficient risk management practices have certainly raised awareness on the importance of adopting risk management approaches that manage all risks and their interactions in a holistic way.

In addition to this, enterprises felt the external pressure of regulators, rating agencies and stock exchanges, which started to require senior management to have more responsibility in risk management practices, and organizations to adopt an enterprise-wide approach to risk management. In 2005, for example, the rating society Standard & Poor introduced ERM among the list of elements considered in its evaluations of insurance companies. Consequently, ERM models started to be widely adopted in the insurance industry, and their success lead to their diffusion among other industries.

Another force that helped ERM spread among enterprises is the development of financial theories on the holistic view of risks. Such theories, which referred only to financial risks, were generalized to include all organizational risks, which represent the portfolio risk of the organization. As well described by the Casualty Actuarial Society[36], the main principles of the portfolio risk view state that portfolio risk is not the mere sum of the individual risk elements, but is given by the risks of individual elements plus their interactions. Risk portfolio is thus relevant for the risk decisions of the organization. Managing organizational risks within silos is not only inefficient, but can be also counter-productive, as certain risks can be natural hedges to each other. On the contrary, managing risks in a holistic manner gives organizations a true perspective on the relevance and magnitude of all risks.

Finally, enterprises increasingly started to shift form a defensive posture towards risk to a more opportunistic outlook. Over time, companies have developed expertise in managing the risks they

[36] Overview of Enterprise Risk Management, Enterprise Risk Management Committee, Casualty Actuarial Society, 2003.

face and new and better information on new risks has become available. This allows enterprises to better evaluate risks and risk treatment decisions: in some cases, adding certain individual risks does not change the impact of overall risk on the company; in others, adding certain risks might work as a natural hedge for others, thus reducing the impact of the overall risk on the company.

Definition, characteristics and benefits

The emergence of the ERM view brought significant benefits to organizations, as it introduced a holistic approach in dealing with risks and a focus on coordination across the organization's various departments and divisions. It provided enterprises with a framework to effectively identify, assess, treat and monitor all events (both risks and opportunities) potentially affecting the organization, with the ultimate objective of making the firm more valuable. The focus on coordination is also of great importance for enterprises as it helps them to understand how risks are interrelated with each other and to exploit firms' natural hedges against those risks, thus reducing the cost of hedging and adding value to the company.

Besides Enterprise Risk Management (ERM), many ways and terminologies referring to managing risks in a holistic and integrated way exist in literature. Some academics refer to it as Enterprise-Wide Risk Management (EWRM), others as Integrated Risk Management (IRM), Holistic Risk Management (HRM), and so on. Definitions vary as well. Lam (2003), for example, stresses on how ERM is an integrated approach to risk management, with the final aim of maximizing company's value. The importance of identifying, evaluating and addressing risks in a systematic and coordinated way emerges also in the definition proposed by Hampton (2009), who adds also that managing risks should be a responsibility of key individuals in the enterprise. The most complete definition of enterprise risk management is the one provided by the Committee of Sponsoring Organizations of Treadway Commission (COSO). In the view of the Committee, Enterprise Risk Management is:

"a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives"[37].

[37] Enterprise Risk Management – Integrated Framework, Committee of Sponsoring Organization of the Treadway Commission, 2004.

The definition proposed above effectively sums up the purpose of the new approach. The adoption of the ERM process results in a strong source of benefit for the organization. Its key characteristics and benefits will be analyzed in the following section.

First, enterprise risk management considers all the risks to which a company is exposed to and the ones to which it might be potentially exposed to. Ignoring certain categories of risk or not taking proper measures to manage certain dangers might expose the enterprise to high risks and costs. Adopting ERM helps reducing the frequency of unexpected events, as well as their related costs and losses. Of course, after listing all the possible risks that make up the company's risk profile, management does not treat all of them, which would be resource consuming, but focuses on managing the ones that have a higher impact (likelihood, speed on onset or other risk dimension) on the enterprise. ERM offers company management the techniques and methodologies to choose the best risk management strategy, helping management to determining when it best to avoid, reduce, transfer or retain a given risk.

Second, ERM promotes an integrated approach towards risk. As mentioned before, enterprises are moving away from the silos by silos approach proposed by traditional risk management models. According to some academics, the old approach is incomplete, inefficient and inconsistent (Segal, 2011). In fact, such approach does not take into account the multiple risks deriving from the interactions between individual risks, resulting in an incomplete risk profile for the company. In addition to that, the lack of coordination among the company's various business units makes risk treatment more costly, as it is likely that different business units hedge the same risks, and useful pieces of information and best practices are not shared across the enterprise. Moreover, inconsistency results from the fact that each business unit adopts its own approach to risk and tends to manage it according to its own appetite. On the contrary, one of the main benefit of ERM is that it provides management with the tools to face individual risks and to identify and manage the interrelations between them, assessing their potential impact and consequences on the organization. In addition, with ERM a certain risk faced by a given business unit is not only evaluated by itself, but is also put in relation with the whole set of risks and opportunities for the enterprise. This implies that risks belonging to different business units or departments are managed with the same strategy, thus improving efficiency and cutting on costs. Moreover, with ERM risk management strategies are aligned with the risk appetite of the entire organization, and not only one of its units: following a top-down approach, top management fixes the enterprise's risk appetite and risk boundaries, which need to be observed by all departments.

As already mentioned in the chapter, unlike the traditional risk management approach, ERM sees risk not only as a danger from which the enterprise should be protected, but also as a key opportunity to manage, seize and that is able to create value for the enterprise. The idea of considering all events that might impact the enterprise's profits and future growth is a strong benefit, as it allows management to identify also those events that might turn into a positive advantage and build value for the company. Another important characteristic of ERM is that it does not only focus on the short term; it monitors also risks that might not have a significant impact on the enterprise in the short term but that might turn into a danger in long run. Finally, ERM implies the adoption of a proper structure to manage enterprise risks. A series of mechanisms, habits and procedures that help the various departments of an organization to share information, best practices and past experiences related to risk management need to be adopted throughout the enterprise. This kind of structure can represent a strong advantage for the enterprise, as it helps management to understand better the overall need for capital for risk management and also to improve capital allocation.

To sum up, the adoption of ERM brings more organizational efficiency to the organization and improves the enterprise's performance. It supports management in achieving organizational objectives, allowing the enterprise to avoid wasting resources and to manage the challenges and dangers of business activity effectively.

ERM framework

There is no universal agreement on the framework to follow for the implementation of effective enterprise risk management.

Over the years, a number of works on the subject have emerged, and many frameworks have been developed. In the previous sections, we have mentioned *Enterprise Risk Management – Integrated Framework* published by COSO in 2004, which has gained broad acceptance by enterprises. Firms have increasingly started to adopt this framework, which has become an international reference point for the implementation of ERM.

Despite its broad diffusion, the ERM Integrated Framework by COSO is not the only proposed and widely-adopted ERM framework. The Casualty Actuarial Society (CAS), for example, based its ERM framework on the Australian/New Zealand Standard in Risk Management (AS/NZS 4360), and the Association of Insurance and Risk Managers (AIRMIC) certified a process which consists of a reduced number of phases. In addition, the works of acknowledged scholars and practitioners such as

Lam (2003), Berg (2010) and Segal (2011) have all contributed to define the components and the underlying structure of integrated risk management process. Although the components of the framework might be different from one work to the other, the underlying characteristics and principles remain the same.

As there is no consensus on the framework to be followed, the process proposed below is a synthesis of all of these contributions. Its main components are the following:

1. Establishing context, objectives, and risk management philosophy
2. Identifying risks
3. Assessing risks
4. Treating risks
5. Monitoring and control

It is important to note that enterprise risk management is a dynamic and multidirectional process, in which every component is linked to and influences the others. Enterprise risk management also varies according to the enterprise that adopts it. Every enterprise has its own characteristics, risk management practices, and needs that vary on the basis of the culture, environment and industry it operates in. For these reasons, organizations can use the ERM framework as a model of reference, but they need to contextualize it and adapt it to their own specific business reality.

Establishing context, objectives and risk management philosophy

The risk management process starts well before risk identification. Before listing out the universe of risks that represent the entity's risk profile and before making decision on how to treat them, enterprises need to establish the external environment and internal culture in which they operate, set their own strategic objectives, and define their own risk management philosophy.

The first step of enterprise risk management starts with the establishment of the enterprise's external and internal environment. As for the external one, management need to define the relationship the enterprise has with the environment it operates in, identifying all its stakeholders and its strengths, weaknesses, opportunities and threats.
The internal environment of an enterprise is the result of its history, corporate culture and a number of peculiar values and characteristics that vary from organization to organization. The organizational

structure, for example, varies firm to firm based on the size, industry, or objectives; powers and responsibilities might be assigned in different ways, and different organizations might adopt different human resources management policies. In addition, the integrity and ethical values of a firm have a direct influence on the methods the enterprise uses to achieve its strategic objectives; similarly, the risk management philosophy determines the enterprise's approach towards risk.

An organization's risk management philosophy is the set of shared values and attitudes that determine how the entity sees risk in its daily activities as well as strategic decisions[38]. Such philosophy influences the way the company operates and its decisions related to risk and risk management. The degree of concern and the attitude top management has towards enterprise risk management may or may not be formally codified in a risk policy, but it needs to be clearly defined, continuously reinforced, and permeate the whole internal environment of the organization.

In order to do so, the definition of the enterprise's risk appetite and risk tolerance might be a useful tool. The Institute of Risk Management defines risk appetite as the "amount of risk an organization is willing to seek or accept in pursuit of its long-term objectives"[39]. As noted by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), risk appetite is reflected in the company's risk management philosophy and, in turn, influences the culture of the organization and the way in which it operates[40]. There is a strict relationship between an organization's risk appetite and its strategy. Organizations set strategies to achieve desired objectives, growth, and returns. Of course, to different strategies are associated different degrees of risk; a given strategy can be more or less risky than another one, and can bring higher or lower returns for the organization and its shareholders. Similarly, different organizations have different risk appetite: some are more risk-averse; others are more risk-seeking. Therefore, enterprises need to define a strategy that is consistent with their attitude towards risk, or in other words, with their risk appetite.

As for risk tolerance, the Institute of Risk Management defines it as follows: "the boundaries of risk taking outside of which the organization is not prepared to venture in the pursuit of long-term objectives"[41]. Similarly to risk appetite, risk tolerance is strictly related to the company's objectives, as risk tolerances are set considering the degree of relevance of related objectives. Risk tolerance is also aligned with the entity's risk appetite, representing a further assurance that the company remains within its risk boundaries in pursuing its strategic objectives.

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[38] Enterprise Risk Management – Integrated Framework, Committee of Sponsoring Organization of the Treadway Commission, 2004.

[39] Risk Taking: A Corporate Governance Perspective, International Finance Corporation, 2012.

[40] Enterprise Risk Management – Integrated Framework, Committee of Sponsoring Organization of the Treadway Commission, 2004.

[41] Risk Taking: A Corporate Governance Perspective, International Finance Corporation, 2012.

As mentioned earlier, a second precondition to effective risk management process is objectives setting. Only after objective setting, it will be possible for enterprises to identify the events that might have an impact on the enterprise, assess risks and effectively respond to the risks the entity is exposed to. In other words, without setting the enterprise's objectives and consequently establishing the activities the enterprise will carry on, it is not possible to evaluate enterprise risks.

Every enterprise has a purpose. Therefore, management needs to define the company reasons for being and what it wants to achieve. Company's strategic objectives are thus set, and, from these, management designs strategies and establishes more specific objectives for the business unit or functional level. Strategic objectives are aligned with the company's risk appetite and risk management philosophy, and are set within risk tolerance levels. Such strategic objectives are generally stable, on the contrary, strategies and more specific objectives are more dynamic and tend to change overtime, according to changes in the internal or external conditions in which the organization operates. In the objectives setting phase, two are the important elements management needs to consider: the company's mission or purpose and the acceptable risk. Defining the right objectives means to choose those objectives that meet the company's reasons for being and that respect the risk appetite and tolerance defined by the company. Among the alternative strategies that an organization can potentially adopt, it is important for the management to choose the ones that are coherent with the type and amount of risk the company is willing and able to accept.

Identifying risks

The second step of enterprise risk management is risk identification, whose objective is to identify the organization's exposure to uncertainty.

In this phase, enterprises identify all the events that might have an impact on organizational activities and objectives. Events can have a positive impact, a negative impact, or both, and can thus be distinguished in opportunities and risks. If an event has a negative impact, it represents a risk, which needs to be assessed and treated accordingly; if it has a positive impact, it represents an opportunity, which needs to be seized by the enterprise.

In order to evaluate the relevance and the degree of impact such events might have on the enterprise and its business activities, management looks at both external and internal factors originating such events. External factors are of economic, environmental, political, social and technological nature, while internal factors include infrastructures, personnel, processes and technologies. Together with the factors that originate the events, also relations between events are examined, in order to highlight

interdependencies. The risk identification process requires management to have a sound knowledge of the organization, of the market in which it operates, and also of the political, legal, social, and cultural environment. The enterprise's strategic and operational objectives set in the previous phase need to be clear to senior management, as well as all the factors that are critical for the firm's success and the dangers and opportunities that the firm might meet in achieving of its objectives.

At the end of this process, a comprehensive map or list of risks (and opportunities as well) is defined in order to understand the enterprise's risk profile. The risk profile of an organization is precisely the representation of the set of risks the entity is potentially exposed to. The standard ISO 31000:2009 notes that the set of risks can contain those that relate to the whole organization, part of it, or as otherwise defined[42]. The risks listed out in the risk profile are usually categorized into groups. At this stage, each risk may seem significant to management at the function and business unit level, but the list requires prioritization to focus the attention on key risks. Prioritization is carried out in the risk assessment stage, which follows risk identification.

Assessing risks

Risk assessment is the third stage of the ERM framework on which we are going to focus. Within the framework, it follows risk identification and precedes risk response. Risk assessment is the activity that companies implement to determine the impact that risks (or events in general) have on the realization of organizational objectives. Risks are assessed both individually and collectively in order to focus management's attention on the most relevant threats and opportunities. Measurement and prioritization are granted so that the organization's overall exposure remains within its risk appetite and risk tolerances levels, and so that desirable opportunities are caught as well.

To do so, risk assessment includes four steps[43]:

1. Develop risk assessment criteria
2. Assess risks
3. Assess risk interactions
4. Prioritize risks

[42] International Standard ISO 31000. Risk Management – Principles and guidelines, ISO, 2009.
[43] Risk Assessment in Practice, Deloitte & Touche LLP, Committee of Sponsoring Organizations of the Treadway Commission, 2012.

Develop risk assessment criteria

First, management needs to develop a common set of assessment criteria, which will be deployed across the organization's various business units and functions. These common criteria help management compare risks and keep the evaluation consistent across the whole organization. As we have discussed earlier in the chapter, criteria typically include risk dimensions such as impact, likelihood, speed of onset and firm's vulnerability.

Assess risks

Once criteria and rating scales are defined, manager assess impact, likelihood, speed of onset and firm's vulnerability for each risk. This assessment is usually carried out in two stages. The first stage consists of an evaluation with qualitative techniques; more specifically, management assigns values and rates risks and opportunities according to each risk dimension. In the second one, the most relevant risks and opportunities are evaluated also through quantitative techniques. This stage requires numerical values for risks dimensions, which are assigned using several sources. This process is more complex and strict, as it is carried out with mathematical methods, such as benchmarking, scenario analysis, probabilistic and deterministic models.

Assess risk interactions

The third activity within the risk assessment process is to assess risks interactions. As explained in the previous sections of this chapter, one of the main characteristics of ERM is that it promotes an integrated or holistic view of risks, focusing not only on individual risks but also on their interactions with one another. In fact, while an individual risk might seem irrelevant for the enterprise, its interactions with other events might have amplifying effects causing greater damages than expected. Enterprises use many ways to capture risk interactions, with different levels of complexity and richness of information. For example, a simple graphical representation of risk interactions is provided using a risk interactions map, where the same enterprise risk are listed on both x and y axes and their interactions are indicated by an X. A more complex technique to identify risk interactions is to adopt bow-tie diagrams. These commonly used diagrams analyze factors or combinations of factors that lead to the occurrence of an event or risk, and analyze also the consequences arising from a risk occurrence.

Prioritize risks

Finally, enterprise management proceeds with risk prioritization. This process consists in determining which risks are to be considered priorities for risk response. The choice is made by comparing risk

levels with the previously set risk tolerances and strategies. Similarly to risk assessment, risk prioritization is also often carried out as a two-step process. First, management ranks risks according to one criteria, such as their impact rating multiplied for the likelihood rating; second, the ranking is revised based on other considerations, such as other risk dimensions or more detailed knowledge on the nature of the impact. The most commonly used techniques to prioritize risks include risk hierarchies, which organize risks by risk type, business unit, geography, or strategic objective, heat maps and MARCI chart, which we have illustrated earlier.

Treating risks

The results of risk identification and risk assessment processes are of primary input for risk treatment or risk response. In this stage, enterprise management examines treatment options, performs cost-benefit analyses and chooses the most appropriate risk response strategy. To be more specific, once the assessment of all the risks to which the enterprise is exposed to has been completed, and all risks have been categorized by business unit or organizational function, management chooses the strategies that best respond to such risks, so that the overall residual risk (the risk that remains after the adoption of risk treatment strategies) is within the risk appetite and risk tolerance levels predetermined by the organization.

Risks can be either avoided or accepted. If not completely avoided, risks can be either retained by the firm, transferred to a third party (risk transfer or risk hedging), or else reduced through internal management strategies.
As we have seen previously in the chapter, enterprises have four potential treatment options[44]:

1. Risk avoidance
2. Risk transfer or risk hedging
3. Risk reduction
4. Risk retention

Enterprises do not usually adopt only one of the strategies listed above; instead, they adopt a mix of risk treatment strategies. In choosing the mix of strategies that best works, enterprises take an enterprise-wide approach, with the aim of mitigating the down-side risk and seizing the up-side one.

[44] Risk Taking: A Corporate Governance Perspective, International Finance Corporation, 2012.

Monitoring and control

The final step of the enterprise risk management process is monitoring and control. As the internal and external environment in which the enterprise operates is dynamic, risk responses that were appropriate in the past might not be appropriate anymore. For this reason, risk and risk management process require periodical control and formal review.
Risk monitoring and control include a number of activities. Enterprise management re-assesses existing risks to check if likelihood, impact, speed of onset has changed; it measures and controls the effectiveness of risk responses adopted and takes corrective actions if the outcomes are not as expected. Management also keeps controlling the internal and external environment in order to identify new risks or changes in existing risks or risks interactions; it also monitors trigger conditions, assesses and starts planning for new risks. The overall aim is to verify that the risk management decisions that have been adopted are having the desired effects, that the documentation, data and information are still valid, that new events or changes in existing events are not affecting the effectiveness of the risk management strategies adopted.

It is important to note that not only risks should be monitored and reviewed, but the risk management process itself as well. Enterprise management should ensure that the whole process is updated, appropriate and effective overtime. In addition, management should put particular attention on retained risks. As risk cannot be completely eliminated, the enterprise's residual risk should be monitored regularly, reviewing their likelihood-impact matrixes or their risk score.

It is also important to add that throughout the implementation of the process, the enterprise needs to collect a significant amount of information for risk identification, assessment and treatment, and to communicate it to the organization's stakeholders, both internal and external. Information systems and communication processes should be developed effectively: this will allow information to be collected and to flow inside and outside the organization in a form and time that enable people to perform their responsibilities.

CHAPTER 3
THE RISKS OF EXPORTING TO CHINA. CASE STUDIES OF ITALIAN FURNITURE ENTERPRISES

INTRODUCTION

The first part of the chapter focuses on the sources of risk in the Chinese market for foreign enterprises. The economic and financial trends, the political, regulatory a business context, the social, demographic and cultural trends as well as technological changes are discussed, in order to highlight the transformations that are going on and the potential vulnerabilities. The likelihood and impact of the identified risks, however, varies based on the industries enterprises operate in, the modes of their internationalization to China and the risk management strategies they use. For this reason, the second part of the chapter focuses on the furniture sector, aiming at identifying the main risks for Italian enterprises exporting to China as well the risk management strategies they adopt to respond to such risks. This second part of the chapter is the result of the information and insights collected during the interviews with Italian enterprises and entities operating in the industry. The entities involved in the interviews are the following: three Italian furniture enterprises exporting to China (Arredo3, Smania, Pianca), two trade associations (Federlegno Arredo Eventi and CNA Veneto), and one distribution agency operating in the Chinese market (Omnia Design Italia).

THE MACRO PICTURE: SOURCES OF RISK IN THE CHINESE MARKET

Not only a market for opportunities

As we have seen in the first chapter, the Italian companies that have attempted to expand to China during their internationalization process are numerous; and so are the issues and challenges they might face during this process. The Chinese market, as we will see, exhibits a number of specific risks that might affect the performance of foreign enterprises operating in, or trying to enter, the market.

Reports drafted by rating agencies, export credit agencies and several other world financial and economic institutions rate risk in the Chinese market as medium or moderate.

In fact, even though China's solid growth prospects represent an attractive factor for foreign enterprises, it is also true that the population is aging, which might affect private consumption. Moreover, the market shows a high corporate debt, overcapacity issues in key sectors, and a business environment characterized by protectionism and a general lack of transparency, raising concerns among foreign enterprises. Seventeen years after joining the World Trade Organization, China has not yet being able to guarantee the compliance with certain global standards such as fair competition and equal treatment for foreign enterprises. Relevant sectors, like services, still present barriers to entry and appear dominated by China's state-owned enterprises (SOEs). Legal matters are often perceived as high obstacles for enterprises that want to engage into business activities in China. Intellectual property rights and counterfeit, for example, are one of the major causes of dispute between China and its foreign investors. Even though China has strengthen its legal framework adding and modifying laws on this matter over the years, the measures adopted are still not effective enough to avoid violation episodes. Finally, political and trade tensions with the United States represent an element of risk.

This section of the chapter aims at describing the specific risks of the Chinese market that might affect foreign, and specifically, Italian enterprises. Sources of issues arising from the economic and financial situation, the political, regulatory and business context, from social, demographic and cultural trends as well as from technological changes are discussed in detail.
It is important to note, however, that the likelihood and impact that identified risks have on enterprises varies based on a number of factors. As we have seen in the second chapter, the industry enterprises operate in, the modes of their internationalization and their level of commitment in the Chinese market, the firm's internal structure and level of organization as well as the risk management strategies they have implemented overtime are all elements that determine their risk exposure in the market. For this reason, the second part of the chapter focuses on a specific sector, the furniture industry, analyzing the internationalization strategies Italian furniture enterprises adopt in the Chinese market, and thus the risks to which they are mostly exposed and the measures they take to manage their exposure to such risks.

Economic and financial trends

The size of Chinese growth

As we have seen in the first chapter, China has witnessed an unprecedented growth in recent years. The country's continued strong growth has definitively gave a critical contribution to global demand,

especially during the slowdown due to the global financial crisis. However, this strong momentum for Chinese economic growth comes at the cost of further increases in public and private debt over the medium term, and thus in further rises in downside risks in the medium term. For this reason, Chinese government has engaged in a process of transition towards a more sustainable growth path, putting increasing weight on the quality rather than quantity of growth.

In 2017, Chinese GDP growth has slowed down to 6.9% from an average of 9.91% from 1979 to 2010. China has gradually started to reduce its growth after 2012, with growth rates lower than 8% and 7%. For 2018, Chinese government has determined a growth target of "at least 6.5%", which is to be read under the light of Xi Jinping and China's *New Normal*. The transformations outlined in the *New Normal* reflect China's new economic model: Chinese economy is moving away from a credit-intensive growth and rebalancing towards services and internal consumption.

With regard to services, in recent years China has witnessed an increase of the services industry over the primary and secondary sectors, gradually moving away from an economic model that depicted China as the "world factory". For the first time in 2012, the weight of the services industry (45.50%) on Chinese GDP has surpassed the weight of the secondary sector (44.97%); in 2017, the weight of the tertiary sector on GDP grew to 51.7%, while the secondary and primary sector reduced to 40.4% and 7.9% respectively[45].

With regard to internal consumption, China is undertaking measures to lower its excessively high national savings by increasing public spending on health, pensions, and education. Estimated at 26 percentage points higher than the world average, China's national savings are mainly due to the household sector, as the weak welfare system pushes Chinese citizens to accumulate high amounts of money for precautionary reasons. These excessive savings represent a problem for Chinese welfare and macroeconomic stability. Taking specific measures to address the problem, together with a revision of the fiscal policy, will reduce households' need for precautionary savings, thus boosting private consumption and a more sustainable growth[46].

[45] Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.
[46] People's Republic of China. 2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China, International Monetary Fund, 2017.

State-Owned Enterprises and competitive neutrality

State-owned enterprises (SOEs) have historically represented a rule in the Chinese industrial and financial landscape. State-owned enterprises have benefited from government support, such as credit and land, and from favorable policies compared to national (and foreign) private companies. However, they have been less efficient than the private sector in terms of profitability and have performed negatively in terms of growth and productivity. Many of such enterprises have continued their activity even when underperforming, thus collecting losses and mining state assets. According to recent data, in the industrial sector SOEs account for 40% of industrial assets and for more than 50% of corporate debt, but for less than 20% in terms of industrial value added. In today's Chinese economy, the role of state-owned enterprises remains significant. In fact, they amount to 155 thousands, employing tens of million workers and with a contribution to national GDP estimated between 30% and 40%[47].

The Chinese government has promoted a reform to modernize SOEs before 2020, which aims at improving the management of national assets, promoting a public-private management of the assets, and reduce the inefficiencies in the performance of state-owned enterprises. Over the years, the number of underperforming and unprofitable state-owned enterprises has drastically reduced, thanks to mergers and closures carried out by the government, but work can still be done to make the market more efficient.

As illustrated above, state-owned enterprises represent a critical issue for the Chinese economy as a whole; but they are also an issue for the private sector and for foreign enterprises in particular, as they constitute an obstacle to competitive neutrality.

With respect to the Chinese investment and trade climate, certain sectors are still closed to competition from private and foreign companies; barriers to entry and trade barriers are still present, especially in the services sector. In this regard, the International Monetary Fund indicates that the services sector in China (financial, IT, transportation and logistics) is still highly closed in comparison with OECD countries and other emerging markets, and that it is mainly dominated by state-owned enterprises. Furthermore, the private sector and foreign firms are still disadvantaged in the access to resources, such as land, natural resources, credit and government subsidies, and too often they do not receive equal treatment in regulations, taxation, government procurement and administrative approvals[48].

[47] *Ibidem.*
[48] *Ibidem.*

Thus, further reforms are necessary to improve competitive neutrality, such as opening additional sectors to competition from private and foreign firms, reducing the barriers to entry and guaranteeing equal and fair trade and investment conditions.

Overcapacity, corporate debt and zombie enterprises

Defined by excessive production, extremely low utilization rates and firms incurring losses, the overcapacity issue in China has serious effects, as it is damaging China's growth in the medium term, contributing to lower global prices and mining national financial stability.
The problem of protracted overcapacity in China extends to at least ten sectors, including coal, steel, cement, aluminum, plated glass, paper, solar powers, chemicals, ship building, and coal-fueled power. A few examples will highlight the scale and severity of the problem. According to estimates, in only two years - 2011 and 2012 - China has produced as much cement as the United States did in the entire XX century. The production of steel has also been completely disconnected from the real market demand, amounting to more than double the production of Japan, India, United States and Russia (the four leading producers after China) all together[49].

Efforts to reduce China's excess capacity have been made, but a series of factors mine the full enforcement of the reforms. For example, Hebei province produces more than 23% of the total national production of steel; a drastic cut on the production of steel will seriously affect the economic stability of this province[50]. This reason, together with a tendency of local governments to attract excessive investments, weak enforcement of regulations, a philosophy that privileges market shares over profitability and other factors, has lead to the protraction of the overcapacity issue.
Chinese provincial and total economy is the primary victim of this problem, but other global regions are also affected. The export of China's excess capacity at extremely low prices has risen trade tensions among global players and trade partners.

Related to overcapacity, another issue is affecting Chinese's economy: corporate debt. Debt in non-financial sector has recently increased, rising concerns for the medium-term macroeconomic stability.

[49] Overcapacity in China. An Impediment for the Party's Reform Agenda, European Union Chamber of Commerce in China, 2016.
[50] Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.

From 2008 to 2016, private sector debt relative to the GDP has risen from 80% to 175%, urging for deleveraging measures[51].

A significant amount of bank lending is flowing into companies with overcapacity problems. Companies that are burdened by overcapacity and debt are referred to as zombie enterprises. Such companies rely intensely on capital and suffer from low profits and even losses, meaning that it is difficult for them to pay interests on loans, let alone pay back loans. These companies are often state-owned enterprises that benefit from government support and bank loans at a price below the market rate. Zombie enterprises represent a serious issue in China, especially in industries with high overcapacity: in the steel and cement industry, for example, zombie firms account for more than 20% of total enterprises[52]. Such companies negatively affect national economic productivity and growth, as they waste resources that could be more profitable if allocated to enterprises with high production efficiency and good business conditions. Not only, zombie firms are also a threat to market competition: they create distortions in competition and increase its intensity level in the market, as they take advantage of government and bank help. Business competitors have a hard time to compete with zombie enterprises low product prices and high wages, and potential new entrants are hindered to enter the market.

In order to lower corporate debt issues and clear zombie enterprises, the Chinese government is carrying out reforms that aim at reducing the flow of new debt towards companies affected by overcapacity (state-owned enterprises and zombie enterprises), restructuring weak firms, and hardening budget constraints. As a consequence of restructuring initiatives and overcapacity reduction, corporate debt is now growing more slowly.

Political, regulatory and business trends

US-China trade war and Chinese protectionism

US President Donald Trump complains about China's unfair trading practices, which aim at increasing the US commercial deficit with China. After having launched an investigation into China's trade policies in 2017, Trump started to impose tariffs on Chinese products worth billions of dollars, which was followed by Chinese retaliation. The reasons behind this trade war are the desire of the

[51] People's Republic of China. 2017 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China, International Monetary Fund, 2017.

[52] Jingru Liang, Can "Zombie Enterprises" find Self-Help Road through Technological Innovation?, Scientific Research Publishing, 2017.

United States to reduce its commercial deficit with China, by encouraging US citizens to "buy American"; on the other side, China wants to protects its most strategic sectors and its desire to gain increasing power in the global economy. The scenario is still evolving and foreign enterprises monitor it closely, feeling concerned about its effects on global trade dynamics.

Closely related to the trade war with the United States is the Chinese push for protectionism. Not only China is likely to keep on protecting and supporting its national enterprises by limiting foreign access to the sectors in which SOEs operate, but also through plans like Made in China 2025. The plan represents a potential threat to foreign tech enterprises, as it aims at comprehensively upgrading Chinese industry, with a focus on tech sectors. In some cases, Chinese government has already favored national producers compared to foreign ones. This has raised concerns among foreign tech companies, which fear a reduction of their opportunities in the Chinese market and the emergence on new competitors.

Legal issues, intellectual property rights and counterfeit

A report recently published by Euler Hermes, ranks complexities related to court as severe[53]. The court system is characterized by a lack of transparency together with long delays and high costs. Enforcement results of court judgements are poor, thus the preferred option is amicable or non-litigation procedures. Insolvency proceedings are severely complex as well. Other causes of issues are represented by the arbitrary interpretation of documents by local banks and tribunals, which are in some cases creative and differ significantly from the recommendations given by the International Chamber of Commerce (ICC).

The European Commission considers China a first cause of concern in terms of protection and enforcement of intellectual property rights (IRP)[54]. Although China has advanced a series of legislative amendments in the field of patents, copyright, unfair competition and e-commerce regulations, however none of these amendments has been completed (except for the law on trademarks finalized in 2014). Moreover, the dimension of the problem is further aggravated by online counterfeiting and piracy, and the initiatives adopted by the Chinese government have proved to be unable to counter the scale of infringements and to keep pace with the technological advancement in the country. With the regard, the OECD-EUIPO study *Mapping the economic impact*

[53] Collection Profile. China, Euler Hermes, 2017.
[54] Commission Staff Working Document. Report on the protection an enforcement of intellectual property rights in third countries, European Commission, Brussels, 2018.

of trade in counterfeit and pirated goods shows that China together with Hong Kong is the origin more than 80% counterfeit and pirated goods arriving in the European Union[55].

The main reason behind the lack of enforcement of intellectual property right in China seems to be the deep differences in administrations and court standards throughout the country. In more developed areas such as the cities of Beijing and Shanghai, standards are considered satisfactory, while in the rest of the country corrupt practices and lack of expertise represent a source of concern and an obstacle to the enforcement of IRP. Deficiencies in the cooperation between administrative offices and police entities, extremely long litigation processes, and difficulties in obtaining interim injunctions are only some of the problems encountered by organization operating in China. In addition to this, organizations indicate that the amount of damages awarded for the infringement of intellectual property right not only does not compensate the loss, but is not even a deterrent for other infringement in the future.

The rise of labor cost

The rise on total costs for enterprises is a structural factor of the Chinese economic system that will push enterprises to adjust their business strategies in China. The last five years have witnessed a contraction in the labor supply and a rapid rise in labor costs, becoming one of the greatest challenges for production facilities localized in China. The high rise of production costs in China is the result of a more dynamic labor market, and of government efforts to increase salary levels and improve working conditions. Among the main causes, we find the growing scarcity of workforce in the industrial sector, higher expectations on labor conditions, higher education levels, a higher degree of trade union representation of worker rights, rising wages levels in many provinces, laws on labor contract and welfare policies, higher living costs, and increasing work opportunities in emerging cities. With the increase of the above-mentioned factors, a rise in total costs will affect not only the industrial sectors, but also high-growth sectors of the services industry. In addition to this, from 2011 other issues such as higher taxation and environmental costs have represented a challenge to enterprises operating in China.

In order to address these future issues, companies operating in China will need to adjust their strategies, focusing on cost control and solutions to maintain their profit margins in spite of the rise of labor costs. Despite the ongoing transformation trends in the labor costs, it will take many years

[55] *Ibidem.*

before China reaches the levels of economies like Japan, Korea and Taiwan, therefore, the Chinese industrial sector will remain competitive in terms of costs for the new coming years.

Credit information and collection

The first issues for foreign enterprises trading with China start with the collection of financial information on Chinese potential trading partners. On a general note, in China, publicly available financial data on companies are heavily characterized by a lack of transparency. While it is a fact that listed companies are obliged to disclose their financial statements, for the rest of the enterprises, in most cases data are not reliable, as they do not reflect the real business situations, or in other cases, they are not even available. In addition to this, business owners do not have any restrictions on opening a new business activity after shutting down a previous one without solving debt issues.
Other significant risks may arise when it comes to collect payments form Chinese companies. On a four-level scale from notable to severe, Euler Hermes ranks complexities relate to payments as severe[56]. In China, payment terms vary from a minimum of 30 days in the high tech industry to a maximum 120 days in the trading of commodities. This been said, in recent years, the average days sales outstanding (DSO), which measures the average number of days for the company to collect payments from customers after a sale, has dramatically increased, reaching 89 days from 78 days in 2012. Due to a restriction in direct financing and bank loans, Chinese firms recur to payment delays as a cask management method and frequently insist for longer payment terms, even up 180 days. Such conditions, if not effectively assessed, can constitute a potential source of risk for foreign partners.

Demographic, social and cultural trends

Ageing population, urbanization and the rise in private consumption

According to the data published by the National Bureau of Statistics of China, at the end of 2017 China counted a population of 1.39 billion people[57]. Although the country has the highest population of the world, it has also to deal with a rapid ageing process, as a consequence of improved living standards, better health services, and a low fertility rate. In 2016, people of the age of 60 were 230 million (16.15% of total population), while people over 65 years of age were 150 million (10.8%). A direct consequence of this phenomenon is the decline in the working age population, a trend that

[56] Collection Profile. China, Euler Hermes, 2017.
[57] 国家统计局 *Guojia tongji ju*（National Bureau of Statistics of China), http://www.stats.gov.cn/.

started to gain attention in 2012 and is expected to characterize the labor market also in future years. Companies are starting to respond to the ageing population phenomenon, together with the labor cost issues, by investing deeply in mechanization, industrial automation and robotization of industrial processes.

Of the 1.39 billion people in China at the end of 2017, 813.47 million live in urban areas, representing 58% of the total population. The urbanization process that characterized China in the last 20 years has witnessed 15 to 20 million people moving from countryside areas to urban cities, the biggest urbanization phenomenon in whole history. And the trend is still growing: studies forecast the between year 2030 and 2035, 70% of the total Chinese population will live in 600 cities. This means that the dimensions of the Chinese market will grow, creating new challenges in terms of offer, distribution and marketing strategies.

Urbanization is also one of the major driver of the rise in private consumption. This increase is driven by the rise in the disposable income and the exponential growth of Chinese middle class, which represents the main population segment in these 600 cities. In general, forecasts show that expenses on products of first and second necessity will decrease, while the expenses on discretionary products will increase, with opportunities for enterprises of the high-end sector.

Cultural distance

Chinese consumers show typical characteristics that distinguish them from average Western ones. One of these is their need for approval from their peers and the society at large. This idea is connected with the concept of *mianzi* (literally "face"), which refers to a person's reputation or position in the society. As *mianzi* can be lost or gained, Chinese people try to gain respect and social status by dining in fancy restaurants, enjoying expensive services and purchasing branded high-end products. This explains why for Chinese people brand awareness and reputation are extremely important. As a major drive of the purchase is gaining social approval and recognition, the products that they purchase need to be widely known and have a high reputation.

Moreover, Chinese people tend to follow the suggestions and the influences of key opinion leaders, celebrities, bloggers and other respected people in their circle when purchasing a product. In fact, despite their attraction for expensive and branded products, the Chinese market shows levels of brand awareness and loyalty very different from Western ones. As China has witnessed a rapid evolution and growth, Chinese people are still not well informed about the brands available and are often completely unaware of internationally renowned brands.

Together with the brand, another characteristic that Chinese consumers appreciate is the story and tradition behind it. For this reason, foreign companies targeting China are increasingly adopting storytelling as their marketing strategy to explain consumers the additional value of their products. In fact, a common mistake for foreign companies is to give for granted that Chinese investors and consumers are able to recognize the additional value of a unique design product and are willing to pay a premium price for it, without knowing anything of its story. The challenge is precisely to correct this mistake and show and explain the tradition and values the product is made of, together with the needs it satisfies.

According to a recent research published by McKinsey&Company[58], Chinese consumers are becoming more sophisticated, demanding and are starting to take a more nuanced view on brands. For these consumers, brand origin matters less, and what they are more interested in is value for money: they look for quality products that meet their tastes, and expect good after sale services.

Digital consumers

Internet users in China are 751 million, making China the country with the highest number of Internet users in the world. However, looking at the entire Chinese population (1.4 billion people), only 53% of it is connected to the Internet, with a great room for growth. Chinese users prefer mobile devices to connect to the Web: mobile phones are preferred over computers for most activities, from using social network to searching for information and to making online purchases. As for e-commerce, China is the world biggest market of commerce online, with 581 users that made a purchase online in 2017.

Digital channels are fundamental for enterprises that want to sell in China. According to a research published by McKinsey&Company, Chinese consumers find three out of five main contact points with companies in the web: website, social network and influencers. Bloggers and Key Opinion Leaders enjoy great reputation and influence over their followers, and can help companies increase their brand awareness. Social networks such as Wechat, Weibo and video sharing platforms are very important for communicating with customers, promoting companies, and offering customer services. The adoption of QR codes is also necessary when dealing with a Chinese target, and it is especially helpful during exhibitions and fairs.

[58] W. Baan, L. Luan, F. Poh, D. Zipser, Double-clicking on the Chinese consumer. The new health craze, the rise of the post-90s generation, and other trends worth watching. 2017 China Consumer Report, McKinsey&Company, 2017.

Technological trends

Push for technological innovation

As we have discusses earlier, technological advancement is of crucial relevance for Chinese government. For this reason, China is carrying out a series of medium-to-long-term programs for scientific and technological development, with massive investments. Made in China 2025 is an example of these plans, whose overall aim is to turn China into a superpower leader in technological innovation, development and high quality production. From this point of view, Made in China 2025 may represent a threat for foreign enterprises of the high-tech industry. The objective of the plan is to restructure Chinese enterprises towards products and services of higher value, aligning their positioning with the one gained by foreign enterprises in China (especially in the high-tech industry). This move will cause a rise in the level of competition between local and foreign enterprises in the high-tech industry. In addition to this threat, there is the issue of the Chinese government favoring technologies produced by Chinese firms compared to foreign ones, arising concerns and worries among international companies.

In order to pursue innovation, China has increased its investments in Research and Development (R&D), becoming the second world's biggest investor in R&D. Now, also many foreign high-tech companies look at China as a potential source of technological innovation. However, foreign companies that wish to benefit from the Chinese push for innovation will still have to deal with issues and risks related with the creation of local R&D centers. Integrating the R&D center in China with the organization and the costs of related to the violation of intellectual property rights are only two of the challenges firms have to face.

THE MICRO PICTURE: FURNITURE INDUSTRY ANALYSIS

As we have seen earlier, even though the risks discussed above are certainly specific of the Chinese market, not all of them might be relevant for all firms. Certain risks might only be relevant for firms adopting a FDI strategy in the market, other risks might only be relevant for firms operating in a specific sector, such as the tech one, others might not be particularly significant for companies producing consumption goods.

As factors determining the relevance of a given risk for a certain company are numerous, this section of the chapter focuses on a specific industry, the furniture sector, examining the risks that are most relevant for Italian furniture enterprises exporting to the Chinese market.
It is structured in two parts. The first part provides a brief overview of the furniture market for Italian companies in China and of the companies and entities interviewed. It describes the type of internationalization strategy that adopt in the Chinese market, the sales and distribution channels they use, their positioning, and their target customer. The second part places a stronger focus on risk. It examines the firms' level of preparedness or vulnerability with respect to the challenges they face in the Chinese market, and their perception of risk in the Chinese market. It also discusses the main relevant risks for them and the risk management strategies enterprise adopt to such risks, grouping them according to the four categories discussed in the second chapter: risk avoidance, risk reduction, risk transfer and risk retention.

Furniture market overview

As we have discussed in the first section of this chapter, Chinese GDP has registered a constant growth over the last decade. Following economic growth, the disposable income and living standards for Chinese consumers have risen, and so has their purchasing power. Although the distribution of purchasing power is not uniform among Chinese population, the average data show an important fact, that internal demand and spending capacity in China are growing: in fact, in the last ten years, Chinese people have doubled their average spending capacity. Consequently, expenses on discretionary products have grown and are expected to keep growing, with opportunities for enterprises of the high-end sector.

This increase is reflected also in the furniture industry: as the purchasing power grows, the standard of living improves and Chinese people become more willing to invest in houses and furniture. Looking at Chinese economic and demographic trends, it emerges that the per capita consumption of furniture and house products has been constantly growing, and that it has doubled in the last ten years[59]. As data show, over the last decade, per capita consumption has grown by 12% on average every year. As a term of reference, the per capita consumption for the same products in Europe has grown only by 2% on average every year, thus highlighting the potential of the Chinese market. More specifically, looking at the data on consumption for furniture and house products, it results that the

[59] Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.

province with the overall higher consumption levels is Guangdong (the province of Guangzhou), followed by Zhejiang (on the east cost of China). Looking at per capita consumption, the cities of Shanghai and Beijing rank first, with a per capita consumption of 12,264 and 11,187 euros respectively[60].

The segment of Chinese consumers involved by the increase in purchasing power and consumption is the so-called Chinese middle class, made up by consumers who are willing to further improve their newly gained status, by rising their standards of living and purchasing high-end products and services that highlight their social position. In fact, researches have shown that in 2017, Chinese consumers have increased their consumption of high-end products by 20% from 2016, reaching a total of 18 billion euros[61]. This definitely opens up opportunities for Italian furniture exports towards the Chinese market, which has registered a growing trend in the last years: from 2010 on, Italian furniture export has tripled, growing by 299%, and has grown by 36% in the last year (Figure 1). The furniture sector currently ranks seventh among the best Italian sectors exporting to China and Hong Kong, lead by the performance of Monza Brianza design furniture district. In general, for the year 2017, Italy remains the first supplier country for the furniture industry, followed by Germany, Vietnam and United States. The most imported products are upholstered furniture, office furniture and kitchen furniture[62].

The star-graded hotel market is also growing. Data show that in 2017 the number of five-star hotels has grown by 5.3%, while the number of four-star hotels in the same year has increased at a growth rate of 1.9%[63]. These data suggest that the demand for furniture replacement in four-star and five-star hotels in China has a high potential of economic return.

[60] Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.
[61] *Ibidem.*
[62] *Ibidem.*
[63] China's Furniture Market, Hong Kong Trade Development Council (HKTDC) Research, 2018.

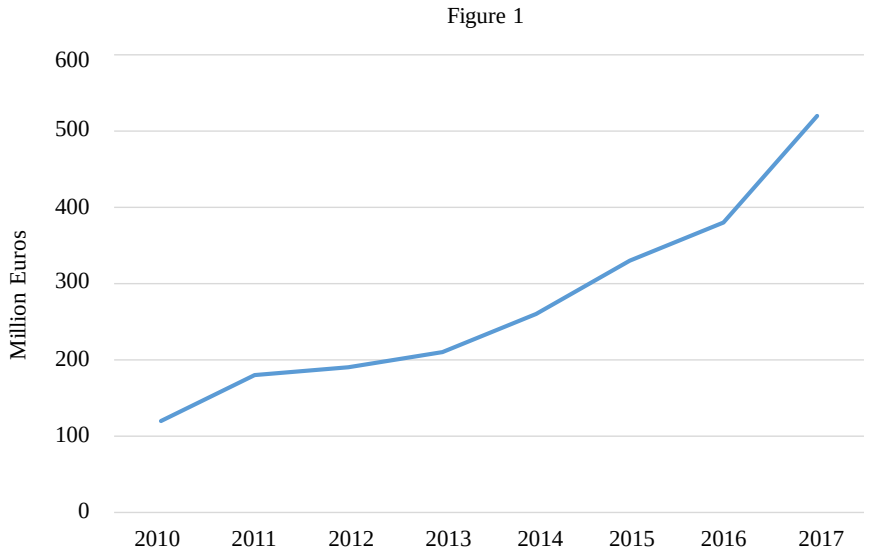

Figure 1

Italian furniture exports to China in million Euros, years 2010-2017. Source: Centro Studi FederlegnoArredo on Istat data.

Entities interviewed

Arredo3 Cucine S.r.l.

Arredo3 was founded in 1984 in Scorzè (VE), having more than 30 years of history. It designs, manufactures and markets kitchens, living furniture and furniture accessories. Quality, design, innovation, and savoir fair are among its core values. It has 150.000 sq. m. of facilities, 240 internal employees, and a yearly turnover of about 130 million euros. Its main target market is Italy, counting for 80% of the turnover, while foreign markets count for 20%. It currently exports more than 47 countries.

In China, it is positioned in the medium high-end market. It is still quite new in the Chinese market, having only recently (about one and a half year ago) found a Chinese partner willing to distribute its product in the market. At the moment of the interview, is has just arranged the display of its products in 15 stores owned by the partner, which will open soon.

Smania Industria Italiana Mobili S.p.A.

Smania was founded in 1967 in Cazzago di Pianiga (VE). Characterized by an unconventional style and a daring personality, Smania manufactures and markets living, dining and bedroom furniture, both for indoor and outdoor. Savoir fair, design and creativity, and handcraft culture are among its

distinctive values. It is a small company, employing less than 50 people, and has a yearly turnover of around 10 million euros.
In China, it is positioned in the luxury market, where it entered around 3-4 years ago. The Chinese market is now its third foreign market, counting for around 15-20% of its turnover. In China, it operates with an Italian agent based on site, both in the retail and in the contracts channel, counting respectively for 35-40% and 60-65%.

Pianca S.p.A.

Pianca was founded in 1954 in Gaiarine (TV), having 65 years of history. Made in Italy, history and tradition, design, savoir fair and customer care are among its core values. It manufacture and markets living, dining and bedroom furniture. It now has 75,000 sq. m. of manufacturing facilities, 250 employees, 1,000 stores in Italy and 500 worldwide, for a yearly turnover of 40 million euros.
Entered the Chinese market more than 5 years ago, it operates with an Italian agent based in China, both in the retail (through a web of 12-15 stores), and in the contract market. China is close to become their third foreign target market. In China, it is positioned in the medium high-end market.

Federlegno Arredo Eventi, Club Made in Italy

Club Made in Italy is a project coordinated by Federlegno Arredo Eventi, the trade association for companies operating in the wood and furniture sector. Club Made in Italy is aimed at Italian furniture enterprises that want to further develop their business relations in the Chinese market. It offers a number of services, such as: incoming and outgoing activities with Chinese distributors, dealers, real estate and architecture companies; market information and all kinds of business support and services; training courses on several subjects; a wide network of contacts in the wood and furniture sector, both in Italy and in China. Its mission is to create bridges between Italian enterprises and Chinese partners, in order to favor enterprises' development and internationalization to China. It also acts as an "institutional umbrella" towards the Chinese government and institutions. The Club is a successful example of network, in which all subjects have a defined role and utility.

CNA Veneto

CNA Veneto, Confederazione Nazionale dell'Artigianato e della piccola e media impresa del Veneto, represents small and micro enterprises of Veneto region operating in the craft and industrial sectors.

Among other activities, it manages a system of services aimed at supporting the internationalization of associated enterprises. The confederation coordinated two projects aimed at creating business opportunities with Chinese partners and investors, and one project aimed at training associated enterprises on countries along the new Silk Road and on how to approach them. Same micro and small furniture enterprises were involved in the projects.

Omnia Design Italia Ltd.

Omnia Design Italia is a Hong Kong based consulting and distribution agency that has been working with Italian firms in the Chinese market since 2014. Specialized in the home and office furniture sector, the agency develops and manages the distribution of Italian products in the market, under the supervision of its Italian director. Omnia Design Italia works with a number of Italian furniture brands, including Fantoni and Visionnaire.

Enterprises' dimensions

In order to analyze their different approaches to the Chinese market, the enterprises interviewed are divided into two groups, according to their level of commitment in the market:

- **Group A**, represented by those enterprises that have a low level of commitment in the Chinese market, as they have only had limited or occasional exporting activities in the market; to this group belong CNA Veneto's enterprises;
- **Group B**, represented by those enterprises that have a high level of commitment in the Chinese market, as they have already developed habitual commercial relations with Chinese partners, acquiring a good presence in the market; to this group belong: Arredo3, Smania, and Pianca.

With regard to dimensions, we can observe that to **Group A** belong companies of small and micro dimension, with a number of employees under 50 and in many cases even under 10 (CNA Veneto enterprises).

Group B presents a more variegated picture, including a small company with less than 50 employees and 10 million of turnover (Smania), a medium company with 250 employees and around 40 million of turnover (Pianca), and a large company with around 250 employees and 130 million of turnover (Arredo3).

Figure 2 represents the enterprises of the two groups according to their dimension and their level of internationalization in the Chinese market.

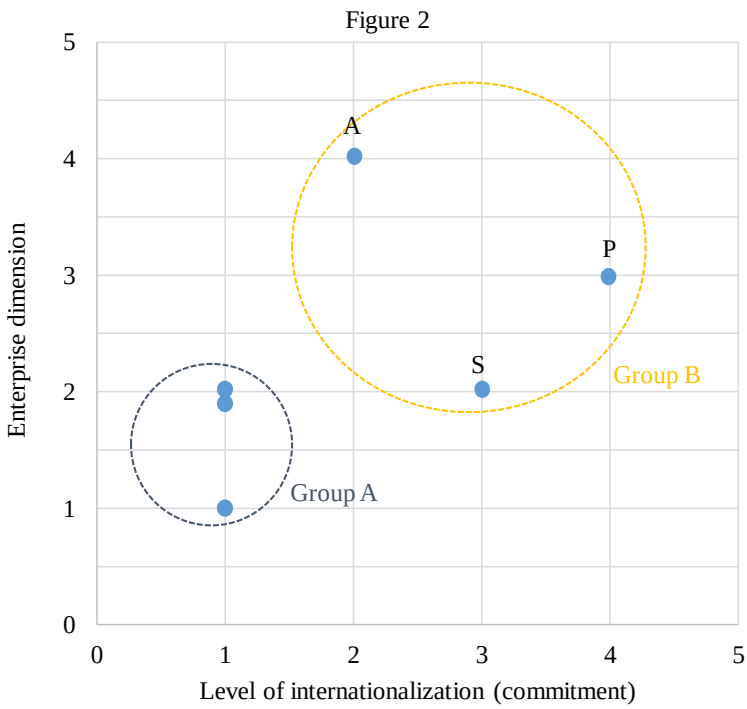

Figure 2

Representation of Group A and Group B according to their level of internationalization (commitment) in the Chinese market and their dimension.

Qualitative scale from 1 to 5. Level of internationalization (commitment): 1=very low (occasional export to China), 2=low, 3=medium, 4=high, 5=very high (structured and habitual business relations with agent, sales representative, or subsidiary on site). Enterprise dimension: 1=micro, 2=small, 3=medium, 4=large, 5=very large; in terms of enterprises turnover.

Group A: CNA Veneto enterprises

Group B: Arredo3 (A), Smania (S), Pianca (P)

As we can see from Figure 2, companies belonging to **Group A**, the ones characterized by a smaller dimension, are also the ones that show a lower level of internationalization in the Chinese market, perhaps suggesting that small dimension represents a limit to internationalization.

However, this is not always the case. Dimension alone is not necessarily a limit for enterprise's expansion to China. For example, Smania (Group B) is a small company employing less than 50 people, but which has been present in the Chinese market for 3-4 years now. On the contrary, Arredo3 (Group B) is a large company which has had sporadic export activities with Chinese importers for a while and has just started creating its sales network in the local market. Therefore, more than company's dimension, other factors determine the success of enterprises internationalization to China. As we will discuss later in the chapter, the presence of well-developed internal sales and export

department, a sound experience in exporting to far and complex markets, a defined internationalization and risk management strategy are all elements that contribute to enterprises' success.

Internationalization strategies

As discussed in the first chapter, dedicated to the internationalization of Italian enterprises, a number of different strategies are available to target foreign markets. According to the information collected through the interviews, the vast majority of Italian enterprises export to China in two main ways: some enterprises have occasional and irregular export activities with Chinese importers (represented by companies belonging to **Group A**), while others export habitually to their customers and clients through local agents or through their own sales representatives (represented by companies belonging to **Group B**).

Generally, occasional or irregular export activities are usually adopted in the very first stages of a company's internationalization to China. It can be a first attempt to enter the market at a time in which the company has not yet established regular commercial relationships with Chinese investors, architects, distributors or sales agents. This is, for example, the case of Arredo3, which after a few years of occasional exporting to China has recently signed a deal with a local distributor[64]. More often, occasional export is chosen by enterprises of micro or small dimensions, which are less structured or organized to focus on a complex market such as China, which do not have the financial resources to do so, or which are not interested in investing in China as they perceive it as too distant or complex compared to other markets. This is the case of CNA Veneto enterprises, which have tried to build continuous commercial relations with Chinese partners, but with little or no success. Such enterprises, employing less than 50 and in many cases even less than 10 people, did not have enough experience in managing this activity from an operative point of view (transportation, payments, etc.), and did not have sales and export department structured in a way that allowed them to manage their expansion the Chinese market[65].

As for habitual export activities, this internationalization mode is adopted by more structured enterprises that aim at expanding in the Chinese market with a clear and well-defined strategy. In an early stage, enterprises can choose to delegate the responsibility of building and carrying on

[64] See Appendix for full interview with Arredo3.
[65] See Appendix for full interview with CNA Veneto.

commercial relations with Chinese investors and distributors to their own Italy-based export manager, who travels from Italy to China on a regular basis. This is the case of Pianca, for example, which in the early years of its internationalization to China started to build its commercial relations in China thanks to the contacts of its export manager[66]. However, as the commercial relations develop and the web of contacts grows, enterprises need to rely on somebody on site to manage their sales. In fact, with its large extension and high population, located in a different continent and time zone, with specific business culture and traditions, and with strong regional differences in consumer tastes, preferences and needs, it is very difficult to manage and control the Chinese market from afar.
For these reasons, enterprises generally adopt two strategies. The first option consists in relying on a sales agent based in China, who manages the Italian firm's accounts and develops new ones, negotiating deals with existing customers and finding other opportunities for further expansion. The second option consists in hiring a country sales representative, based on site, who is in charge for managing the firm's accounts in that given country. The difference between the two options is that while a country sales representative is a company's employee, who only focuses on selling and promoting the company's products and developing the firm's accounts, sales agents do not represent only one brand, but a number of brands. Therefore, when choosing an agent it is important to look at the brands that it represents and make sure that they are not too similar in terms of product or style. Another fundamental element that should drive the choice of the right agent or country sales representative is their experience. In order to be successful, the enterprise needs to rely on somebody who has a sound knowledge of the market, the industry, its main players and regulations, the local culture and language, and who is educated on the brand, its values and its products[67].

As it emerged from the insights that enterprises and entities have shared with me, the enterprises that have been more successful in the Chinese market are the ones that have established habitual commercial relationships with Chinese customers or clients through local agents or their own sales representatives. If possible, the Chinese market should not be approached as an attempt, but enterprises should define a clear strategy. For example, enterprises sometimes engage into irregular export activities with more than one distributor; this might seem positive in the short term, as they receive payments from the Chinese counterpart, but if this sale is not followed by other orders, the firm will need to look for other partners and start the entire process again. Thus, from a long-term perspective, engaging into irregular export activities without a proper plan might result in a waste of time and resources[68].

[66] See Appendix for full interview with Pianca.
[67] See Appendix for full interview with Smania.
[68] See Appendix for full interview with Federlegno Arredo Eventi.

Sales and distribution channels

Based on the interviews collected, two are the main distribution channels that Italian firms of the furniture industry adopt in China. The first channel is represented by contracts with architecture firms, interior design and real estate companies, investors and buyers. The second and most traditional one is retail. A third distribution channel can be identified with e-commerce, which has gained popularity among Chinese consumers. However, Italian furniture companies have not yet developed this digital channel properly.

For enterprises, contracts certainly represents a key sales channel. Enterprises establish contacts and sign up deals with architecture firms, real estate companies and buyers for supplying furniture for the realization of a project. The project can be private, such as a private house or luxury villa, or public, such as a residential building, a hotel, a restaurant, offices and so on. Working on a project does not only allow firms to gain a significant economic return from a single client, but offers also other advantages. That same client, for example, might sign new deals with the company for other future projects; and the project itself becomes a living ambassador promoting the company among new clients. This is the case of Smania, for example, for which contracts represent a good percentage of its business in China counting for more than 50% of its turnover in the market[69].

With regard to retail, furniture companies have two options. Enterprises can choose to display and sell their products in specialized furniture stores, showrooms or luxury malls. Showrooms are usually divided into a number of areas, each assigned to a different brand. A key factor that enterprises need to consider in the choice of the showroom is its positioning: it is important that the positioning of the other brands and of the overall store is consistent with the company's own or with its desired one. Alternatively, companies can rent premises and sell their own products themselves through their own flagship stores. This strategy increases the company's brand awareness, and allows enterprises to have more control on the sale process, on its dealers and on the entire shopping experience, but it is also more costly.
Whether they sell their products through a distributor or their own flagship stores, enterprises can benefit from the advantages that the retail channel offers: a powerful emotional shopping experience for the customers. Retail stores are characterized by a sophisticated and luxury atmosphere, which recalls Italian territory and traditions. In these stores, customers are able to connect with the product

[69] See Appendix for full interview with Smania.

and to experience it through their senses. The power of touch and of this emotional experience is an extremely important element driving consumers' purchase intention[70].

This explains why retail is a key distribution channel for the companies interviewed and for the entire furniture industry. Data confirm this evidence: in 2017 retail sales of the furniture sector have registered a growth of 12.8%, one of the highest performances of all Italian export industries in that year[71]. Moreover, according to a recent research conducted by HKTDC[72], large furniture stores have developed very rapidly in recent years, spreading in many areas of China, both as single-brand chains and as multi-brand malls. Furniture and home supplies clusters have also emerged. First-tier cities and the South East of China are the most targeted areas, but large districts for the distribution and sale of furniture products are emerging also in second and third-tier cities, as a consequence of the rapid urbanization and development process witnessed by the country.

Another potential distribution channel for Italian furniture enterprises is e-commerce.

E-commerce has gained increasing popularity with Chinese consumers, and it is growing in the high-end and luxury market in particular, with brands continuously evolving to adopt new strategies to target Chinese consumers. Moreover, Chinese furniture manufacturing enterprises such as Qumei and furniture hypermarkets such as Easyhome have also developed Online to Offline (O2O) strategies to draw potential customers from online stores to physical ones. Enterprises and sellers use their online platforms to showcase images of their products and to accept orders, but also invite potential customers to visit their physical shop and buy products at online prices. This business strategy links online sales and marketing activities with physical stores and purchases, reaping the benefits of both online and offline commerce.

Based on the insights and information collected through the interviews, Italian enterprises have no yet developed the e-commerce channel, let alone the O2O one. Smania, for example, believes that retail is a much more powerful channel than e-commerce, because the e-commerce buying experience does not allow the consumer to touch and try the product, feel its quality and its shape, and get the entire luxury shopping experience offered by the showroom. Pianca believes that it is still too early for them to focus on the e-commerce channel in China, as they have not yet gained a high brand awareness in the market. For this reason, it is better to keep on developing the retail channel, increasing the number of stores in the market. However, they do not neglect the potential of digital

[70] See Appendix for full interview with Smania.

[71] Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.

[72] China's Furniture Market, Hong Kong Trade Development Council (HKTDC) Research, 2018.

channels. For the years to come, they plan to invest on WeChat and on the other social networks popular in China, as a way to communicate with final consumers[73].

Positioning and target

In the Chinese market, Italian furniture enterprises are generally positioned as medium high-end brands. This is true also for those furniture companies that in Italy or other European markets have a lower positioning. Italian companies in China benefit from a positive country of origin effect, and thus are perceived, and presented, as targeting the medium high-end market segment. Thanks to internationally renowned Italian brands (such as the ones of the fashion industry), *Made in Italy* products have gained a high reputation abroad and are seen as symbols of excellence, wealth and social prestige[74].

Even though they are all positioned in the medium high-end market, the companies interviewed can be further divided into two groups: those companies with a medium-high positioning, and those belonging to the luxury market. Arredo3, Pianca, and CNA Veneto's craft companies all belong to the first category, while Smania belongs to the second one.

Targeting customers belonging to the medium high-end market segment, Italian furniture companies emphasize the superior value they are able to deliver with their products, and the consumers' needs that they satisfy.
As mentioned, one of the strongest competitive advantage that Italian furniture companies have in China is the positive image and reputation of *Made in Italy*, which is known and appreciated for its design, quality, and innovation. Chinese consumers and investors are extremely attracted to Italian products, which they associate with excellent craftsmanship, sophistication, luxury and high social status. As we have seen earlier in the chapter, a typical characteristic of Chinese consumers is the importance that they attach to brand image and strength, as they purchase high-end products to gain social recognition. In addition, Chinese consumers highly appreciate the history and traditions that are behind the brand, which adds value to the product. Italian products certainly satisfy these two conditions, but there is still room for improvement. As it emerged from the interviews collected, the Chinese market is still quite unacquainted with Italian furniture and design products and their value. Chinese customers tend to associate Italian products with famous Italian brands that have built a

[73] See Appendix for full interview with Smania and Pianca.
[74] See Appendix for full interview with Federlegno Arredo Eventi.

powerful reputation and a strong brand awareness in the market, but little do they know about how such products are crafted. Italian furniture sector delivers products of superior value represented by the expertise, knowledge, long history and traditions, which are all intrinsic to the product. However, since this superior value is not always understood, communication and marketing strategies play a crucial role. In fact, it is important for enterprise to communicate and explain this additional value to the target customers, by showing them the production process, the Italian territory and our traditions[75].

Another interesting trend that started to emerge in recent years is the power of customization. According to the 2017 China Luxury Market Study, 67% of Chinese customers prefer customized high-end and luxury products rather than standard high-end and luxury ones. Tailor-made products are becoming popular as consumers can personalize them according to their own taste and individual needs. With this regard, among the enterprises interviewed, Smania has decided to invest and adapt their offer to Chinese taste, designing and manufacturing a few products tailor-made for the Chinese market. Examples are a round marble top dining table, with a rotating Lazy Susan on top of it, and a sofa with a lower and deeper seating. Other companies, such as Pianca, have chosen not to adapt their offer to Chinese tastes[76]. In addition, a recent report published by McKinsey&Company on the Chinese consumers[77] suggests that consumers are increasingly demanding a high level of service after the purchase. Experts of the furniture sector operating in the Chinese market confirm this trend as well (Omnia Design Italia)[78].

Level of preparedness

As seen previously, the enterprises interviewed are divided into two groups:

- **Group A**, represented by those enterprises that have a low level of commitment in the Chinese market, as they have only had limited or occasional exporting activities in the market; to this group belong CNA Veneto's enterprises;
- **Group B**, represented by those enterprises that have a high level of commitment in the Chinese market, as they have already developed habitual business relations with Chinese partners, acquiring a good presence in the market; to this group belong: Arredo3, Smania, and Pianca.

[75] See Appendix for full interview with Smania, Federlegno Arredo Eventi and CNA Veneto.
[76] See Appendix for full interview with Smania and Pianca.
[77] W. Baan, L. Luan, F. Poh, D. Zipser, Double-clicking on the Chinese consumer. The new health craze, the rise of the post-90s generation, and other trends worth watching. 2017 China Consumer Report, McKinsey&Company, 2017.
[78] See Appendix for full interview with Omnia Design Italia.

As emerged from the interview with CNA Veneto[79], the enterprises belonging to **Group A** were involved into a couple of projects aimed at creating and developing a sales network in China for the distribution of their products. The enterprises that took part to the first project, which consisted in selling a small quantity of products to be displayed in the showroom of the Chinese partner, encountered numerous issues in carrying on the project, which ended with no success. After this failed trial, some of these enterprises decided not to invest in further sales attempts in China and looked for other opportunities in other markets, perceiving the Chinese market as too risky. Other companies were able to build business relations with Chinese partners, but mostly in a limited and occasional form. The second project consisted in incoming and outgoing activities with Italian enterprises and Chinese designer and investors, aiming at building continuous business relations between the two parties. The enterprises involved in this second projects had better results, as they concluded a number of sales in the market, but, as well as the firms of the first project, they were not able to establish habitual business relations with their Chinese counterparts.

In general, enterprises belonging to this group were attracted by the potential opportunities represented by the Chinese market, as it is an extended country, exhibiting high growth and an increasing spending capacity. However, such opportunities have not been evaluated properly by enterprises. Instead of conducting in-depth market analysis beforehand, entrepreneurs of micro and small firms still rely on their intuition to guide their business choices. Despite their good nose for opportunities, it emerged that these enterprises do not possess a well-developed internal sales and export department, structured and organized in a way that allows the company to place a greater focus on the Chinese market. Moreover, these firms did not have much or any previous experience in exporting to China or to equally complex markets.
For these reasons, these companies encounter a number of issues, which range from managing a single export activity, to finding local partners and developing continuous business relations with them, to cultural differences[80].

To summarize, looking at the experience of **Group A** companies, we can observe that:

- they lack significant experience in exporting to the Chinese market or similarly complex markets;

[79] See Appendix for full interview with CNA Veneto.
[80] *Ibidem.*

- they lack an organized and well-developed sales and export department, able to focus on the Chinese market;
- they lack training on Chinese market and business values;
- they tend to follow their intuition instead of conducting in-depth market analysis.

These factors are all elements that can affect the entity's degree of preparedness to face a risk event. In the case of Group A companies, these elements all suggest that the companies' level of preparedness is low. As discussed in the second chapter, a low level of preparedness suggests a high degree of vulnerability, as entity's preparedness is one of the main factors determining entity's vulnerability (together with agility and adaptability). Understanding the level of preparedness/vulnerability of a company provides useful information to guide risk response. In the next section, we will look at the risk management strategies adopted by the enterprises of this group, given their vulnerability.

Unlike enterprises of Group A, firms belonging to **Group B** have achieved a stronger presence in the Chinese market. Over the years, these companies have acquired precious experience in dealing with far and sometimes complex markets, in managing orders and arranging shipping and other services for foreign clients properly. Their internal sales and export department is well-structured, larger, highly-skilled, and able to focus on the Chinese market. Moreover, Smania, Pianca have entered the Chinese market more than 3 years ago and thus have already acquired a sound knowledge of the market, the industry and the main players. For these reasons, they have developed a good sales and distribution network in the market, with a number of stores selling their products, and useful contacts in the architecture, interior design and real estate field. With this regard, Arredo3 represents a bit of an exception. Despite its large dimensions and high turnover, the company has only recently entered the market with a Chinese partner. However, before acquiring this continuous distribution channel for their products, it has carried on irregular export activities in the market for some years.
Group B companies also conducted in-depth market analyses and in the early years of their expansion to China underwent specific training to understand the cultural values that shape business relations, the specificities of the market, and the ways to approach it.
With regard to companies belonging to **Group B**, we can observe that:

- they acquired significant experience in exporting to the Chinese market;
- they possess an organized and well-developed internal sales and export department, able to focus on the Chinese market;

- they undergo training on Chinese market and business values;
- they conduct in-depth market analysis.

As these factors suggest, these companies show a level of preparedness much higher than companies of Group A. Their vulnerability is thus much lower. Being aware of the company's degree of vulnerability directs the choice of the risk treatment strategy.

Risk perception

To understand enterprises' perception of risk in the Chinese market, entities have been asked the following questions:

- Do you see the Chinese market as an opportunity or a risk?
- Do you think the company is prepared enough to face the risks and challenges of the Chinese market?

Enterprises belonging to **Group A** see China as a potential opportunity and as an interesting market for Italian furniture. However, the risks and challenges in the market are numerous. Entering the market and establishing habitual business relations with local partners is not as simple as they thought in the first place. This is a lesson they learned especially after the failure of the showroom project. China presents demographic, cultural and business characteristics very different from the markets to which enterprises were used to export to (Europe, United States), and they were not able to focus on the Chinese partners and satisfy their needs. If in the first place, enterprises were only attracted by the business opportunities in the Chinese market and overlooked the risks. Now, after their negative experience and a much-needed cultural training, they are more aware. As we have seen, certain firms of this Group adopted a risk aversion strategy. For them, entering the Chinese market is an investment they are currently not prepared to make; for these companies, China represents a high risk. The companies that did not adopt a risk aversion strategy, tried to build habitual relations with Chinese partners but were not very successful as well. For these reasons, although being aware that China is an interesting market for Italian furniture, these enterprises sees it as difficult and risky to enter[81].

[81] See Appendix for full interview with CNA Veneto.

As for enterprises belonging to **Group B**, Pianca and Smania share a similar perception of risk in the Chinese market, strongly seeing China as an opportunity. Arredo3, given its recent experience in the market, adopts a more cautious approach to it.

For Pianca, China is undoubtedly an opportunity. The company has started exporting more than 25 years ago, thus it has gained an export-oriented mentality and a sound experience. They carried on in-depth market analyses and training in the early stages of their internationalization to China; having spent more than 5 years in the market, they believe to know quite well the market and the main players in the furniture industry. Being hedged from transport and credit risks, they believe their level of preparedness is good and they do not see significant risks arising from the market. Given the high potential of the market, they plan to increase their business in China in the current year.
Smania is very confident about the Chinese market as well. The company believes China represents an opportunity given the emergence of a middle class with an increasing spending capacity and a strong desire for a product that satisfies its need for social recognition, as *Made in Italy* does. In general, Smania believes that China is an opportunity if the company is able to adopt the right strategy to operate in the market, by choosing the right agent and distribution channels. This being said, considering the company's preparation, its experience and the strategies they adopt in the market, they do not see significant risks arising from the market. Instead, they believe it is nowadays necessary to be present in the Chinese market and they expect their turnover in the market to significantly increase.
Arredo3 sees China as a new frontier, an interesting market given its spending capacity and its attraction for *Made in Italy* products. They see the opportunity it represents, but they are also aware of the risks. In fact, the company's export orientation is still limited, being Italy its main target market (80%). Moreover, the firm is still quite new in the Chinese market and remembers very well the obstacles and challenges it faced to enter the market, from finding the right partner and developing a distribution network, to the legal issues related to the trademark and domain name "theft". For this reason, the company believes in the potentialities of the Chinese market but also adopts a prudent approach to it[82].

As we can see from figure 3, there is a correlation between entities' level of internationalization in the Chinese market and the way they see the Chinese market, whether as an opportunity or a risk. We have seen in the previous section that companies with a higher level of internationalization in the market generally show also a higher level of preparedness. The higher the enterprise's experience in

[82] See Appendix for full interview with Arredo3, Smania, Pianca.

dealing with foreign markets, China, and other complex markets, the higher the ability to understand trade dynamics, operational processes, as well as the economic, cultural and legal contexts. All these factors, determining companies' level of preparedness shape firm's risk perception. Companies with a higher level of preparedness have thus a more positive perception of the Chinese market, seeing it as an opportunity more than a risk, while firms with a lower level of preparedness have a more negative perception of the Chinese market, seeing it as a risk more than an opportunity.

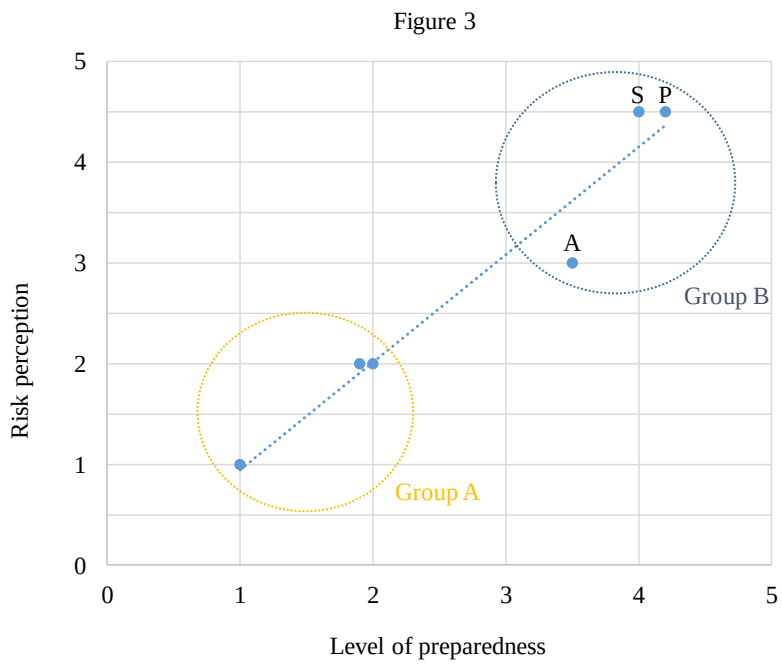

Figure 3

Representation of Group A and Group B according to their level of preparedness and their risk perception.

Qualitative scale from 1 to 5. Level of preparedness: 1=very low, 2=low, 3=medium, 4=high, 5=very high. Risk perception: 1=high risk, 2=more risk than opportunity, 3=both risk and opportunity, 4=more opportunity than risk, 5=only opportunity.

Group A: CNA Veneto enterprises

Group B: Arredo3, Smania, Pianca

Types of risk and risk management strategies

Types of risks

Enterprises of Group A and enterprises of B adopt two very different strategies in the China. Since enterprises belonging to Group A are not yet present in the Chinese market, their aim is to enter the market in a more structured way. For this reasons, the risks they encounter are mainly related to the obstacles they face in finding a local partner and in managing their export activities in the China.

On the contrary, enterprises belonging to Group B are already present in the Chinese market. Their aim is to further develop their presence in the market and to maintain their competitiveness.

Enterprises belonging to **Group A** encounter most difficulties on the operational and strategic level. On the operational level, the difficulties range from managing a single export activity, by carrying on tasks such as organizing the transportation, taking care of the customs practices, arranging the product display in the showroom, or providing other services to the Chinese partner, to carrying on more frequent export activities with local buyers, and developing sales networks in the market.
On the strategic level, an important risk is represented by the difficulty in finding local distributors and potential buyers (business risk). Engaging into habitual commercial relations with local partners represents a significant investment for the enterprise, and thus finding the right partner is of key importance for the firm. The furniture retail market is characterize by a high turnover of local distributors selling foreign high-end products. This happens because these distributors have high financial resources but limited if any knowledge of Italian products and of how to sell them. Thus, running into such distributors translates into a loss of precious time and resources for enterprises[83].
To try to overcome this risk, enterprises rely on potential local partners suggested by institutional entities such as Chambers of Commerce, the consulates, the Italian Trade Agency (ICE), and other associations such as Federlegno Arredo and CNA Veneto. However, there is no guarantee for a business opportunity: enterprises should always verify that partners have the desired characteristics and should be prepared to develop continuous export relations with them[84].
Another strategic risk relevant for enterprises of Group A is represented by cultural difference. Italian enterprises often do not realize that Chinese consumers are not well-educated on design products and that lack knowledge and awareness of Italian brands. Overlooking this cultural difference might cause the product to remain unsold, as the customers do not perceive its intrinsic value.
Finally, among financial risks, credit risk is certainly high if not properly hedged by the enterprise, as credit information is often scarce and unreliable.

For enterprises belonging to **Group B,** strategic risks represent the major cause of concern.
As well as for Group A enterprises, culture represent a risk also for firms belonging to Group B, and its relevance is even higher. The intrinsic value of Italian design furniture is often not recognized by Chinese consumers, who are not as educated on the concept of design as Western are, and who are also attracted by other factors, such as the brand awareness, and its price. On the strategic level, this

[83] See Appendix for full interview with Federlegno Arredo Eventi.
[84] See Appendix for full interview with CNA Veneto.

represents a significant risk for companies with a high level of commitment in the Chinese market and a defined strategy. In fact, Chinese clients and consumers' lack of knowledge might cause the company to be perceived as similar to firms having very different product characteristics, design, and market positioning. Differences in the tastes, in the buying behavior and the ways to communicate (different social networks) are also important[85].

Other strategic risks relevant for firms belonging to group B are business risks and changes in the global trade scenario. Business risks such choosing the wrong distributor or the wrong agent, not being able to further develop their sales network, or not being able to display the product in the target showroom can cause great damage to the company, making it loose competitiveness and turnover. With regard to the global trade scenario, the trade war between China and the United States concerns the enterprises, as they fear a reduction in the Chinese spending capacity and thus a reduction in the import of Italian products[86].

Finally, strategic risks such as legal issues, intellectual property violation, and counterfeit are also typical of the Chinese market. Over the years, many episodes of this kind have involved foreign high-end brands exporting to the Chinese market, and the more famous the brand is, the higher the likelihood for such event to happen.

To sum up, we can represent the most relevant risks for Group A and B enterprises in a hypothetical heat map, plotting potential impact against potential likelihood. We will see that for enterprises of Group A the most relevant risks are operational risks (transport and customs procedures, managing accounts), and some strategic risks (business risk such as finding the right partner, cultural difference). Other strategic risks such as legal ones are less relevant given enterprises' low commitment and brand awareness in the Chinese market (Figure 4).

As for enterprises belonging to Group B, the most relevant risks are strategic risks (cultural difference, business risk such as choosing the right partner, legal risks), while operation risks are not a cause of concern (Figure 5). For both groups of enterprises financial risks matter if not properly managed. Given that enterprises can "easily" adopt a hedging strategy to protect from financial risks, the factor of success in the market is determined by enterprises' ability to manage their exposure to operational and strategic risks.

[85] See Appendix for full interview with Federlegno Arredo Eventi.

[86] See Appendix for full interview with Arredo3, Smania, Pianca.

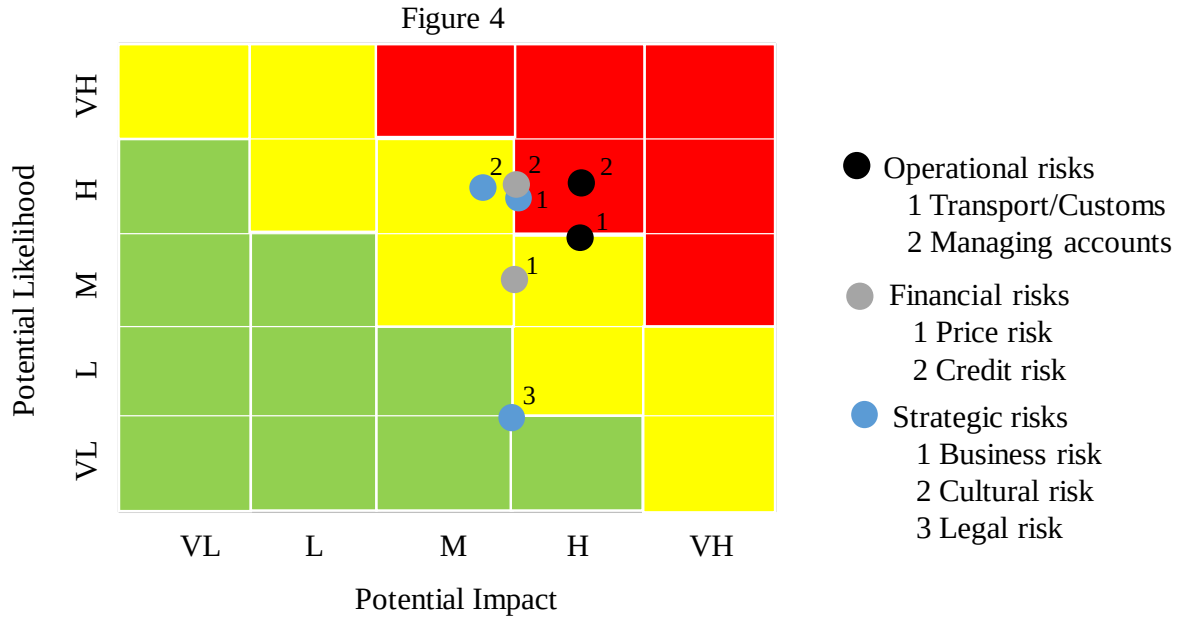

Figure 4

Hypothetical representation of operational, financial, and strategic risks for Group A enterprises. Likelihood – Impact risk map. Qualitative scale: VL=very low; L=low; M=medium; H=high; VH=very high.

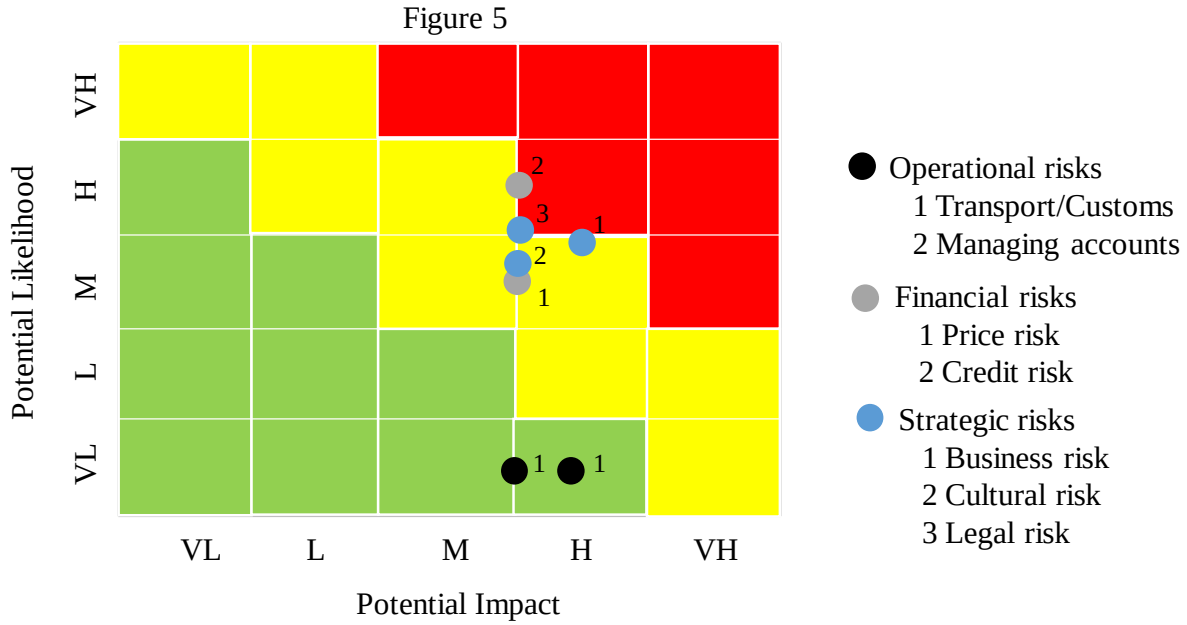

Figure 5

Hypothetical representation of operational, financial, and strategic risks for Group B enterprises. Likelihood – Impact risk map. Qualitative scale: VL=very low; L=low; M=medium; H=high; VH=very high.

Risk management strategies

As we have seen in chapter 2, four are the risk response strategies available to enterprises:

1. Risk avoidance
2. Risk reduction
3. Risk transfer or risk hedging
4. Risk retention

With regard to firms belonging to **Group A**, after the failure of their first attempt to export to China, some companies decided to adopt a risk aversion strategy. Such companies realized that their level of preparedness was not high enough to successfully enter the market. For this reason, they decided not to make any more investment in the Chinese market and looked for other opportunities elsewhere. Not all Group A companies decided to completely avoid risk. Instead, some firms tried to manage their exposure adopting mainly risk transfer and risk retention strategies, and, in a limited way, risk reduction. Operational risks such as transport and financial risks such as credit risk and currency risk are hedged through the adoption of Ex Works mode of transport, the adoption of the letter of credit, and the use of Euro currency, respectively. Strategic risks are mostly retained. These companies do not have a high level of commitment in the Chinese market. They only provide occasional sales, and do not adopt a long-term strategy to target the market. Given their limited commitment to the Chinese market, strategic risks such as changes in the political, economic and local context, counterfeit, competition, and so on do not have a high impact on the company's local business activities as well as its overall performance. For this reason, companies do not take many actions for such risks. As discussed earlier, the risk of running into inexperienced and incompetent distributors is high. Firms try to reduce the likelihood of such a negative event to happen by relying on the support of institutions, however, institutional entities do not provide much guarantees on the Chinese investors, thus leaving the risk on the firm. Finally, in order to increase their level of understanding of the Chinese country and its culture, some enterprises take part to cultural training courses on the characteristics of the Chinese market, the ways to approach it, and on the differences in culture and in the ways of doing business there.

Companies belonging to **Group B** mainly adopt risk reduction and risk retention strategies. Risk transfer or hedging is adopted but in a limited way.
With regard to cultural risks, enterprises have managed to reduce Chinese partners' lack of education on Italian design by investing in training their Chinese partners and distributors on Italian furniture design products and on how to sell them. In order to reduce their exposure to cultural risks such as changes in the local tastes and preferences, these firms work closely with their local partners,

monitoring the market constantly. Some companies even managed to design and manufacture a number of products specifically addressed to Chinese customers (Smania). They also invested in Chinese communication channels (WeChat as well as other social media) and in translating the prices list in Chinese. Their vulnerability to business risks is partially reduced through a number of strategies. Enterprises adopt a local agent to manage the firm's local accounts and business; they carry on daily contacts with agents, clients and distributors, as well as frequent local visits, and control their results by fixing sales targets. Moreover, Pianca adopts a differentiation strategy, assigning the distribution of its product to more than one distributor. Even though such measures reduce the likelihood for risks to arise, business risks cannot be fully eliminated. Losses caused by mistakes in the choice of the local sales agent, distributor's failure, poor product proposition and so on might always arise.

Risks such local competition and counterfeit are also treated with risk retention. Chinese local competitors and counterfeit products do not target consumers of the high-end market. As emerged from the interviews, despite the negative effect of counterfeit on Italian companies, firms believe that such risks would only have limited consequences on their business. Other and more severe legal risks are often unknowingly treated with risk retention. Two companies belonging to this group (Arredo3, Pianca) did not carry out proper preventive measures to reduce their exposure to these risks: these firms failed to register their trademark in the local market and to take the proper measures to protect their domain name, thus incurring into "thefts" by local individuals. This issue might represent a relevant problem for the enterprise, which needs to undergo an often long legal procedure and is sometimes unable to carry on its business activities in the market.

As for operational risks, transport is managed with the Ex Works mode, while quality certificates and quality checks are carried on before the delivery, to ensure that the quality standards are met and to reduce the likelihood for customers' complaints. Similarly to enterprises belonging to Group A, currency risk is hedged through the adoption of the EUR currency. Payments are hedged through the adoption of the letter of credit, or of credit transfer; the payments are either settled half at the order and half at the delivery, or in full before the delivery[87].

In conclusion, from the interviews collected it emerges that companies of Group A and of Group B adopt similar strategies to mitigate their exposure to financial risks (credit and price), and to the risk of transport. However, it also emerges that enterprises of Group A are not able to properly protect themselves from the risks related to managing frequent business relations with Chinese buyers (operational risk) and to the business risk of finding right partners (strategic risk), which are the risks that might have the highest consequences on the business activities in China.

[87] See Appendix for full interview with Arredo3, Smania, Pianca.

For enterprises belonging to Group B, strategic risks such as cultural difference, business risk, and legal risks are the most relevant. As we have just seen, these enterprises adopt a number of risk management strategies for cultural difference and business risks, being able to reduce their exposure to such risks. As for legal risks, actions are taken but too often only after the risks have arisen.

CONCLUSION

As we have seen, international trade activities have acquired a growing relevance for Italian enterprises. In the last decade, the contraction of the internal demand following the global financial crisis has represented a strong push for Italian firms' expansion abroad. In the wake of multinational companies, more and more enterprises, including small-sized ones, have increasingly started to look cross-border for new and more profitable markets for their products and business activities.

Foreign markets certainly represent appealing opportunities for enterprises wanting to minimize their risk exposure by pursuing country differentiation strategies and increase their profits by enlarging the market for their products. However, targeting foreign markets is a complex activity, which requires enterprises to reach a proper level of preparedness, in terms of experience, structure and competences, as well as financial resources. More specifically, having acquired meaningful export experience, having developed an organized sales and export department, and having undergone specific training on foreign markets and foreign business culture are all factors that greatly influence enterprises' success in approaching foreign markets and in developing habitual business relations in such markets.

As we have seen, the Italian industrial landscape is made up by an extremely high number of micro and small firms, representing the 99,4% of the total enterprises population. Such firms exhibit high levels of specialization, knowledge and expertise, and have acquired a very positive international image in terms of innovation and high quality. In recent years, they have also shown a high level of flexibility, as they have tried to increase their involvement in export activities, in response to a growth reduction in the domestic market. However, such positive characteristics are often countered by some negative ones, which might affect enterprises' international expansion. In fact, Italian firms often lack the organizational structure and the level of experience and competence necessary to approach foreign markets successfully. As studies have shown[88], the wide majority of Italian enterprises is also characterized by dimensional or productivity deficits which can represent significant obstacles to internationalization. In particular, the dimensional deficit is a common characteristic for Italian firms of the furniture sector, which is the focus of the last chapter of this work.

Due to the often fragile organizational structure of Italian companies and the high degree of fragmentation characterizing the Italian industrial landscape, Italian enterprises still show limits in

[88] Rapporto sulla competitività dei settori produttivi. Edizione 2017, Istat, 2017.

entering and operating in international environments. Such difficulties emerge with even more relevance in geographically and culturally far markets such as China.

According to these considerations and based on the insights collected for the purpose of this work, we can draw some conclusions.

Exporting to China certainly opens up great opportunities but brings along a number of risks, which enterprises need to be prepared to face. The Chinese market presents significant entry barriers for foreign enterprises. Finding reliable local partners and buyers is one of the most pressing business issues faced by small and medium enterprises. As this study has shown, Italian firms of the furniture sector are no exception to this. Chinese real estate, architecture and retail companies operating in the local market are extremely large and complex compared to Italian SMEs, making it difficult for them to establish business contacts individually. After finding local partners, maintaining and carrying on relations with Chinese accounts is pretty challenging for many Italian firms as well, given their organizational and structural deficits. Moreover, China is an extremely extended market, exhibiting significant regional differences, specific linguistic and cultural characteristics, and a fast-paced process of development and transformation. Such a market cannot be controlled successfully from afar. Instead, companies need to invest in sales agencies, representative offices or local subsidiaries enabling them to properly manage their local accounts, closely monitor market trends, and respond to any issue in prompt and short ways. Therefore, operating successfully in the Chinese market requires enterprises a high commitment in terms of preparation, time, and financial resources. Given its peculiar and unique characteristics, China cannot be approached as an attempt, but requires enterprises to adopt a clear and defined strategy. Adopting opportunistic logics might give returns in the short term, but it often results in a waste of time and resources in the long one.

The Chinese market, however, is approached with a widespread approximation. Engaging into export activities with China might represent a desirable opportunity for enterprises, but the market exhibits also a number of specific risks that might affect the performance of foreign companies operating in, or trying to enter, the market. This is something that Italian firms often overlook. In fact, for many Italian enterprises the choice of targeting China is all too often the result of intuition instead of a conscious analysis of opportunities, costs and risks.

With this regard, such enterprises could benefit from the adoption of risk management practices. In particular, emphasis should be put on the early stages of the risk management process, namely

establishing context and identifying risks (and opportunities). First, companies should effectively assess their level of preparedness, taking a more conscious look at their organizational and structural characteristics, at their internal competences and experience, and at the financial resources they can allocate to their Chinese operations. Second, enterprises need to scan the external environment identifying their strengths and opportunities but also their weaknesses and threats. Conducting market analyses and participating in training courses also provide enterprises with a deeper knowledge of the market and a more realistic idea of the strategies they can adopt to target the Chinese market, of the amount of investment it requires, and of the type of risks they need to be prepared to face. These activities all together would help companies gain a higher level of awareness of both their internal characteristics, the external context and of their relationship with it. A higher attention in the risk identification phase would also help enterprises in understanding the complexities of the Chinese legal context, which seems to be recurrently overlooked by Italian enterprises. This would represent a solid starting point, on which firms could build the following stages of the risk management process.

To overcome difficulties related to Italian enterprises' dimensional disadvantage and their structural and organizational limits, a possible solution could be grouping enterprises in networks.
Convincing enterprises to group together is not simple. Entrepreneurs (especially in the Veneto region, which is the focus of the cases studies collected in this work) are often lone actors who find it hard to share with others. Despite common individualistic approaches, however, successful examples of networks exist. Club Made in Italy, a project coordinated by Federlegno Arredo Eventi, is one of such examples. As we have seen, its mission is to connect Italian furniture enterprises and Chinese partners, fostering Italian firms' success and development in the Chinese market. Acting as an institutional umbrella, the Club favors enterprises in their relations with Chinese authorities and companies; it also suggests them useful local contacts and potential partners, creating a number of appealing business opportunities for the two parties, and reducing some of the most common obstacles firms encounter in the market. Moreover, the wide number of partners involved in the project provide enterprises with specific support and expert assistance in their Chinese operations. In this network, every member has a specific role and utility, which is the key to the success of the project.

As we have seen, China is an extremely fast evolving market, which needs to be monitored closely and continuously. In fact, new trends and changes can rapidly turn into ignored risks or missed opportunities for foreign enterprises. In particular, a new significant social and technological trend is represented by the digital economy.

Digital channels are increasingly acquiring relevance all over the world. This phenomenon is even more pronounced in emerging markets and, especially, in China. Today, China is the first market for e-commerce in the world; e-commerce giants, such as Alibaba, are revolutionizing traditional distribution channels. Moreover, Chinese consumers are younger and more digitalized than the global average, conducting the most of their online activities through their smartphones. Chinese consumers find three out of the five main contact points with enterprises online (website, social networks and influencers); they are heavily influenced in their purchasing decisions by Chinese social networks and Key Opinion Leaders; they increasingly rely on online platforms to buy products, including foreign ones[89].

As these data show, the potential for growth opportunities represented by such channels is enormously high. However, many Italian enterprises still adopt traditional approaches and place little investment on digital channels. This is an evidence reflecting a broader picture, which sees Italian firms as still occupying a marginal role in the digital economy compared to OECD countries[90].

Given that traditional sales and distribution channels are certainly necessary in the furniture sector, this new trend should not be overlooked. In fact, investing in Chinese social media such as WeChat, QQ, Weibo and Youku, in Key Opinion Leaders and apps, together with traditional retail stores, could foster enterprises' brand awareness in the market and help them communicate companies' traditions, values, and excellence to final consumers. Moreover, integrating traditional distribution channels with new models that conjugate the advantages of offline purchasing with the ones of online marketing and e-commerce (O2O model) could represent a solid support to Italian export activities, as they meet the needs and habits of Chinese consumers. Investing in these new channels could be a winning strategy for firms operating in a market so heavily dominated by digital technologies.

In addition, such choice could be perceived as a service enterprises offer to their customers. As it has emerged from the insights collected for this work, competition in the furniture market is starting to grow. Following the increase in the per capita income, the market for furniture products is enlarging, new players are entering the competitive arena, and retailers are increasingly lowering their final prices. On the other side, the work of education on Italian design and furniture carried out by Italian institutions, associations, and enterprises in the Chinese market is slowly starting to have an impact

[89] L'Italia nell'economia internazionale. Rapporto ICE 2016-2017, ICE, 2017; Cina. Scenari e prospettive per le imprese. IX rapporto annuale CeSIF – Edizione 2018, Centro Studi per l'Impresa Fondazione Italia Cina, Fondazione Italia Cina, Milano, 2018.
[90] L'Italia nell'economia internazionale. Rapporto ICE 2016-2017, ICE, 2017.

on Chinese companies and consumers, which will evolve into increasingly discerning, brand savvy, more demanding and sophisticated buyers in future years [91]. Today, the positive image and perception of the brand *Made in Italy* certainly represents a strong competitive advantage, however, this might not be enough tomorrow. For these reasons, instead of relying solely on product quality and country image, Italian enterprises should place a stronger focus on service, which appears to be highly appreciated by consumers of medium and high-end products.

[91] W. Baan, L. Luan, F. Poh, D. Zipser, Double-clicking on the Chinese consumer. The new health craze, the rise of the post-90s generation, and other trends worth watching. 2017 China Consumer Report, McKinsey&Company, 2017.

APPENDIX

INTERVIEWS

Interview with Arredo3 Cucine S.r.l.

Massimo Ghedin, General Manager

1. **When did the company enter the Chinese market and why?**

China is a new frontier. It is an extremely interesting market for our product. The country is showing an increase in purchasing power and welcomes well Italian products; these are very attractive factors. After a few years of occasional exporting to China, around two year ago we started looking for a local partner. One year and a half ago we found a partner, which invested in our product and with which we took part to the Shanghai Kitchen & Bath Exhibition.

2. **What type of internationalization strategy do you adopt in the market?**

We are developing our sales network with our local partner. In a market like China, with high entry barriers, it is necessary to find a local partner which invests in your product and owns stores in vary parts of the territory. We choose not to look for an Italian sales representative based in China for the moment. We work well with our partner and we choose to grant him the exclusive distribution of our product, so our partner is also investing on us.

3. **Which distribution channel do you use?**

The retail channel. We distribute our products through the stores of our partner. Our partner has around 15 stores, spread between Shanghai and Hong Kong.

4. **What is your positioning?**

In China, we are positioned in the medium, medium high-end market.

5. **Which are the main obstacles and risks that you encounter in the Chinese market?**

High entry barriers and the resistance of local competitors. We entered the Chinese market alone, trying to follow our export orientation. We did not rely on any type of support. Many initiatives and support are mostly addressed to small and medium enterprises, while we are a large one, and also the wood and furniture sector is characterized by some jealousy among entrepreneurs, so everybody

prefer to work alone. The problem in China is that you work in order to develop a sales network and build a presence in the market and then they "steal" your trademark and your business. This is what happened to us, a local competitor registered a trademark very similar to our, so know our local partner cannot sell our product in the market. We are currently trying to solve this problem through our layer, but it will take a long time.

The language can also be a problem, but we communicate through our partner, which is also in charge for our brand promotion and communication in the market. As for the cultural difference, we tried to understand and adapt to their culture.

6. **Which currency and pricing strategy do you use?**

We sell in Euros. We prepare a price list based on market trends, our costs and tariffs. Each price list lasts for 24 to 36 months.

7. **How do you manage payments?**

We manage payments through L/C so that we are not exposed to any risk.

8. **How do you manage transport?**

We use the Ex Works mode of transport. Our product arrives to the clients in 6 to 8 weeks, counting the transit time, customs procedures and transfer to the distributor.

9. **Do you see the Chinese market as an opportunity or a risk? Do you think the company is prepared enough to face the risks and challenges of the market?**

China as a new frontier, an interesting market given its spending capacity and its attraction for *Made in Italy* products. It represents an opportunity, but we are also aware of the risks. We mostly sell in the Italian market (for 80% of our turnover) and we export for a 20%. We try to go abroad when we see opportunities. So we see the potentialities of the Chinese market but also adopts a prudent approach to it.

10. **What risk management strategies do you adopt to face such challenges?**

We protect from credit risk with the L/C. We also learned to collect detailed information on the market we want to target, on the main partners, and to verify in detail all the relevant legal aspects (registration of the trademark, domain name, etc.). We also regularly monitor the market, its trends, and the global trade scenario (such as the trade war between China and the US). We have weekly feedbacks with our local partner on what it is happening in the market and on what they are doing to promote and sell our product.

Interview with Smania Industria Italiana Mobili S.p.A.

Giuliano Pastorino, Sales Manager

1. **When did the company enter the Chinese market?**

We entered the Chinese market around 3-4 years ago.

2. **What type of internationalization strategy do you adopt in the market?**

In other markets (such as the European ones), we do not have intermediaries, but manage the accounts directly, with frequent contacts and visits. However, in an extended market such as China (or Russia), you need rely on somebody on site to manage your accounts and sales network. We choose to rely on a sales agent since the start. We have just changed our sales agent in China. Our new agent is Italian, has a long experience in the market and with Italian products, and represents a few more foreign brands, which are all different from us in terms of product and style. We plan to increase the number of distributors and strengthen our business relations with architects and interior designers.

3. **Which distribution channel do you use?**

Two channels, contracts (55%) and retail (45%). Contracts with architecture firms, real estate companies and buyers for the realization of a project are certainly key. The project can be private (a private house or luxury villa), or public (a residential building, a hotel, a restaurant, offices, etc.). Working on a project does not only allow you to gain a significant economic return from a single client, but offers also other advantages. That same client, for example, might sign new deals with you for other future projects; and the project itself becomes a living ambassador promoting your company among new clients.

Retail is also a very important channel. We are currently present in 20 showrooms in 20 different cities. We have gained a good brand awareness. In the luxury showroom, customers are able to connect with the product and to experience it through their senses. The power of touch and emotion drives consumers' purchase intention. This is why I believe that retail is a much more powerful channel than e-commerce, because the e-commerce buying experience does not allow the consumer to touch and try the product, feel its quality and its shape, and get the entire luxury shopping experience offered by the showroom.

4. **What is your positioning?**

We are positioned in the luxury market.

5. **Which are the main obstacles and risks that you encounter in the Chinese market?**

A first obstacle is finding the right partner/sales agent. You need to know the market, and the sector, the main players, the main showrooms, the main interior designers and architects. Looking at what your competitors do in the market can be of help. Then the culture is different, you need to understand what consumers like, use, and need. The most relevant risks for us are business risks and changes in the global trade scenario. Business risks such choosing the wrong distributor or the wrong agent, not being able to further develop their sales network, or not being able to display the product in the target showroom can cause great damage, making us loose competitiveness and turnover. With regard to the global trade scenario, the trade war between China and the United States concerns us, as we fear a reduction in the Chinese spending capacity and thus a reduction in the import of Italian products.

6. **Do you produce everything internally?**

Almost everything. We rely on suppliers for upholstered products, but they all produce in the nearby area.

7. **Did you adapt your product to Chinese tastes?**

Since China is one of our main markets, we decided to invest and adapt our offer to Chinese taste, designing and manufacturing a few products tailor-made for the Chinese market. Examples are a round marble top dining table, with a rotating Lazy Susan on top of it, and a sofa with a lower and deeper seating.

8. **What currency and pricing strategy do you use?**

We sell in Euros so that we do not run risks. Every 2-3 years, we prepare a price list, which can have a slight increase of 2-5%.

9. **How do you manage payments?**

We adopt the L/C. Our clients pay 50% at the moment of the order and the remaining 50% before delivery, so we do not run risks in this way.

10. **How do you manage transport?**

We use the Ex Works mode of transport. It takes around 60-70 days to have the products ready for delivery. Before delivery, we conduct precise quality checking activities. We do no deliver anything that has not been verified. In this way, we reduce customers claim and offer a better service.

11. Are counterfeit and local competition a risk for associated enterprises?

We have had a number of court procedures for fake products. It is a long process. As soon as we notice a counterfeited product, we adopt legal procedures. I believe that counterfeit has limited consequences on our business. Our Apart from being protected with the certificate of authenticity and warranty, our product has a unique intrinsic value, as it is crafted with expertise, history, tradition and passion. Nobody can copy us.

12. How do you communicate this intrinsic value?

Communication and marketing strategies play a crucial role. We communicate with our customers through our agent/partners and the company itself. It is a storytelling. We communicate and show clients and customers our territory, our traditions and the ways we craft our unique product.

13. Do you see the Chinese market as an opportunity or a risk? Do you think the company is prepared enough to face the risks and challenges of the market?

We are very confident about the Chinese market. China represents an opportunity, given the emergence of a middle class with an increasing spending capacity and a strong desire for *Made in Italy* products. In general, China is an opportunity if you are able to adopt the right strategy to operate in the market, by choosing the right agent and distribution channels. With regard to us, we do not see significant risks arising from the market. Instead, we believe that it is nowadays necessary to be present in the Chinese market and we expect our turnover in the market to increase significantly.

14. What risk management strategies do you adopt to face such challenges?

The company is hedged from credit and transport risks, so that is not a problem. We rely on a local trusted agent who has a sound knowledge of the market, the industry, its main players and regulations, the local culture and language, and who is educated on our brand, our values and product. Our agent is the first person that monitors the market and our business. We fix sales targets for our agent; we constantly keep in contact; we frequently visit our local agent and partners.

Interview with Pianca S.p.A.

Fabio Malattia, Export Area Manager

1. **When did the company enter the Chinese market and why?**

Around 5-6 years ago. At that time, the company was already diversified, exporting to the US, Europe (France, UK, Germany, Spain, etc) and Russia and Ukraine. At that time the Italian market counted for around 60-65% of our turnover, while foreign markets for the remaining 35-40%. The global economic crisis of 2008 hit mostly the Italian market. So, in order to reduce the risks and increase the turnover, we decided to enter the Chinese market. At the moment, foreign markets represent the 50% of the company's turnover. We plan to make China our third foreign market by the end of the year.

2. **What type of internationalization strategy do you adopt in the market?**

During the first two years of our presence in China (habitual business relations with partners), I developed the company's accounts and sales network personally, through frequent contacts with partners and business visits. Afterwards, we choose to rely on a local sales agent. Our agent is Italian and represents five more Italian brands, which all belong to different furniture sectors.

3. **Which distribution channel do you use?**

We adopt two channels, retail and contracts. The company is present in 12 showrooms spread all around China (Shanghai, Beijing, Wuxi, Tianjin, Shenzhen, Jinan, etc.) and we are about to open three more stores in the next months. We do not own the premises but the 90-95% of the products displayed in the showroom is Pianca's. The next step would be opening our mono brand showrooms. Contracts are also a great channel. Pianca Contract Division, owned by Pianca, is in charge for that. As for e-commerce, we are currently starting to sell online to France and UK, where we have a high number of stores and brand awareness is high. I believe it is too early to do the same thing in the Chinese market, as we have not yet gained a high brand awareness in the market. However, we do not neglect the potential of digital channels. For the years to come, we have planned to invest on WeChat and other social networks, and to translate our price lists in Chinese.

4. **What is your positioning?**

Medium-high, but in China we have a higher positioning.

5. **Which are the main obstacles and risks that you encounter in the Chinese market?**

A first cultural problem is the high personnel turnover in Chinese firms. Chinese people, especially high-skilled and English-speaking ones, often change jobs. This can be a problem for Italian firms, because you establish contacts with a reference person and train them on your product and on how to market it, and then they leave the company. This mean you have to start over again, losing money and time. For this reason, diversification is key. We work with more than one distributor, so that we are less exposed to this risk. Language is also a problem. Buyers and administrative offices can speak English pretty well, but salespeople and interior designer do not. You always need to rely on a linguistic mediator otherwise it is not possible to communicate. To try to reduce this linguistic gap we will have our price lists translated in Chinese by the end of March. We also encountered legal issues. We did not completed properly the trademark registration process, and we had to deal with trademark "theft". It took us around one year to solve the legal problem, but we did not have to stop selling in the Chinese market for that time. It was our mistake. Now, every time we enter a new market we register our trademark in the local market, we have that on the budget.

6. **Do you produce everything internally?**

Almost everything. We have some suppliers in the nearby, and two German suppliers for boards and hardware.

7. **Did you adapt your product to Chinese tastes?**

We chose not to adapt our product. We believe that we can meet customers' needs in other ways, such as with colors and materials. We manufacture in all shades of color and in seven types and woods, we can use marbles, etc.

8. **What currency and pricing strategy do you use?**

We sell in Euros, so we are not exposed to currency risk. We prepare price lists for the retail market, which change every two-three years, when the collections change. We give our distributors an indication for the final price, but in the end they are free to decide. As for contracts, we fix the final price for our clients.

9. **How do you manage payments?**

We usually use the transfer mode of payment. Clients usually pay 50% at the moment of the order and the other 50% before delivery. In this way, we do not run many risks. To old and financially solid clients we ask to pay in full before delivery. The alternative is to use the L/C but it is quite complex

with Chinese banks and our Chinese clients prefer the transfer as well. We never had problems in this way, we do not have unpaid debts.

10. How do you manage transport?

We use the FCA mode of transport. Our products arrive to the final customer in around 4 months. The production process takes around 6-8 weeks, then 35 days of transit time, customs procedures and the transfer to our distributor and to the final customer.

11. Are counterfeit and local competition a risk for the company?

I think this is not a big deal. If they want to copy your product, they do it, even if you try to avoid it. But customers who buy fake products are not our target, so this is not a problem for us. A huge counterfeit scandal in 2011 involved a high-end furniture store, Da Vinci, which distributed all of the top foreign brands of the sector. I think that scandal protected us, people are now more aware.

12. Do you see the Chinese market as an opportunity or a risk? Do you think the company is prepared enough to face the risks and challenges of the market?

China is undoubtedly an opportunity. The company has started exporting more than 25 years ago, thus it has gained an export-oriented mentality and a sound experience. Being hedged from transport and credit risks, we do not see significant risks arising from the market, expect for business risks, but we put these risks are part of the game. Given the high potential of the market, we plan to increase their business in China in the current year.

13. What risk management strategies do you adopt to face such challenges?

We carried on in-depth market analyses and training in the early stages of our internationalization to China; having spent more than 5 years in the market, we know quite well the market and the main players in the furniture industry. We also control the performance of our sales agent in China with regular contact and visits, and sales targets, but we are all professionals. Moreover, the company is diversified, both in terms of target markets and in terms of distributors and clients in the Chinese one.

Interview with Federlegno Arredo Eventi, Club Made in Italy

Valeria Sotera, International Promotion department, in charge of the project *Club Made in Italy*

1. **When did the project Club Made in Italy start and why?**

The project started in 2014. From in-depth analyses and researches, it emerged that the Chinese market was potentially very interesting for Italian furniture. From the analysis, it emerged also that, given its dimensions and unique characteristics, China is not easily approachable without a proper preparation and a defined strategy. Italian enterprises encountered a number of difficulties and obstacles in the market, and needed to be trained on the specificities of the market and on how to approach it. At the beginning, the project placed a strong focus on training and aimed at supporting enterprises entering in the market. Now, the projects aims at supporting firms in maintaining and further developing their presence in the market.

2. **Which type of companies is it addressed to?**

At the moment, the project is more useful for enterprises that have already entered the Chinese market, and that have an export manager, a local agent, or a subsidiary or office in the market. The Club is addressed to brands with both high and low brand awareness.

3. **What are its advantages for associated enterprises?**

The Club is a hub that connects Italian furniture enterprises and architecture firms with Chinese buyers, distributors, design and architecture companies, and real estate enterprises. Club Made in Italy offers Italian enterprises a number of services: tailored business initiatives, such as incoming and outgoing activities with Chinese partners; market information and all kinds of business support and services; training courses on several subjects; and a wide network of contacts in the wood and furniture sector, both in Italy and in China.

Its mission is to create bridges between Italian enterprises and Chinese partners, in order to favor enterprises' development and internationalization to China. It also acts as an "institutional umbrella" towards the Chinese government and institutions. Chinese authorities and large companies are sometimes difficult to approach four our companies, which are small and micro compared to the Chinese ones. For this reason, it is necessary for firms to group in networks. Even though Italian firms tend to adopt individualistic approaches, Club Made in Italy is working well, as creating network of enterprises is a necessity arising from the Chinese market.

4. **Which are the main obstacles and risks associated enterprises encounter in the Chinese market?**

One of the main obstacles is cultural difference. Italian enterprises often give for granted that Chinese consumers are well-educated on design products and that have knowledge and awareness of Italian brands. In fact, this is not true. Overlooking this cultural difference might cause the company to be perceived as similar to firms having very different product characteristics, design, and market positioning. Other obstacles are represented by the language, geographical extension, different time zones, counterfeit and different legal contexts. Differences in communication can also represent a risk (see Dolce e Gabbana). Economic obstacles are also high: the Chinese market needs time, continuous investments, a planned strategy and financial resources. These are characteristics that enterprises do not always have, especially the small ones.

Moreover, the furniture retail market is characterize by a high turnover of local distributors selling foreign high-end products. This happens because these distributors have high financial resources but limited if any knowledge of Italian products and of how to sell them. Running into such distributors is risky as it translates into a loss of precious time and resources for enterprises. Chinese real estate firms and architecture and design companies are large and complex; for our enterprises, it is difficult to contact them and establish business relations with them individually. It is also difficult to understand who is the decision maker, and to convince him to prefer a given Italian product to another (perceived as) similar one.

5. **What practices could enterprises implement to overcome such obstacles and risks?**

In order to ensure that the dealer has experience and knowledge in the field, enterprises conduct their evaluations choosing the ones that have more experience. However, this is not always the case, and they sell to distributors using short-term strategies. It is also not always possible to establish relations with experience distributors, as their number is limited. In general, if possible, the Chinese market should not be approached as an attempt, but enterprises should define a clear strategy. For example, enterprises sometimes engage into irregular export activities with many distributors; this might seem positive in the short term, as they receive payments from the Chinese counterpart, but if this sale is not followed by other orders, the firm will need to look for other partners and start the entire process again. Thus, from a long-term perspective, engaging into irregular export activities without a proper plan might result in a waste of time and resources.

6. **Is counterfeit a risk for associated enterprises?**

Counterfeit in China is a phenomenon that has involved almost all the most famous foreign brands. Recently, the gap between authentic and fake products has reduced, so the final price of fake products is less competitive than it once was. Even though the risk still exists and it certainly is not an advantage for our firms, consumers buying fake products belong to low-end market. On the contrary, in China, Italian furniture enterprises are positioned as high-end brands, targeting the high-end market. This is true also for those furniture companies that in Italy or other European markets have a medium or medium-high positioning.

7. **Which are the services associated enterprises request the most?**

One of the most requested services is management of digital communication channels, such as WeChat, Youku, Baidu, Weibo, etc. Legal services are also very requested, especially after legal problems arose. Distribution and finding partners and distributors are also requested.

8. **Have the services offered to associated enterprises changed overtime in order to better meet their needs?**

The objective of the project Club Made in China switched from training enterprises on specific aspects of the Chinese market, to supporting enterprises maintain and strengthen their presence in the market, creating channels and "bridges" with large local architecture firms, real estate companies and mall and distributors.

9. **Is the project giving the desired results?**

The project has evolved over the years. The Club is currently made up by 20 enterprises and it is working well. I believe that this project is one of the few successful internationalization initiatives coordinated by a business association able to group furniture enterprises (and other companies) in a network. This project is successful because every member of the network has a different role and utility. This was possible thanks to an in-depth research and analysis of the Chinese market and of the furniture industry in China, and to the fact that we work with a business orientation (every activity we organize has an economic return for the enterprises involved).

Interview with CNA Veneto, Confederazione Nazionale dell'Artigianato e della Piccola e Media Impresa

Matteo Ribon, Regional Deputy Secretary and Executive, in charge of innovation, competitiveness and Made in Italy

1. **Which projects did CNA Veneto coordinate to support associated enterprises export to China?**

We worked on three projects. The first project involved a number of associated enterprises, among which a few firms of the furniture and design sector, which did not have much or previous experience in exporting to China, and a Chinese partner, a society that had already worked with other Italian brands in China. The Chinese society owned a showroom in Beijing and wanted to develop new business relations with Italian firms that were not yet present in the Chinese market. The involved enterprises had to sell a small quantity of products to the partner, taking care of the transportation, the customs procedures and the display of the products in the showroom. The firms were not able to take care of these operational tasks. They encountered numerous issues in carrying on the project, because they did not have a well-developed internal structure that allowed them to dedicate to the Chinese market and to this projects.

The second project involved enterprises of the fashion and furniture and design sectors. We found a Chinese designer and investor interested in developing business relations with Italian enterprises. We organized both incoming and outgoing activities for our associated enterprises and the Chinese investor. The enterprises involved in this second projects had better results, as they concluded a number of sales in the market. However, they were not able to carry on the business relation in the long term.

The third project was not a business project, but aimed at training associated enterprises on countries along the new Silk Road and on the strategies to approach them, as they might reveal appealing opportunities. This project was very successful, as it provided firms with knowledge of the markets, products, cultural and business aspects, as well as of the strategies to adopt to be successful in these countries.

2. **Why were the enterprises unable to succeed?**

Entrepreneurs of micro and small firms still rely on their nose and intuition to guide their business choices, even in foreign markets like the Chinese one. They rarely conduct in-depth market analyses and researches. And if they do, they most likely do it as they go instead of beforehand. This is an old approach that nowadays does not work as well anymore. Veneto enterprises have a good nose for

opportunities but their internal structure is not as well developed. When firms want to go abroad they do not necessarily need large dimensions, but they need a well-developed structure. They need a structured internal sales and export department organized in a way that allows the company to dedicate to the target market and clients, responding to their needs and requests promptly and shortly. Compared to other markets, China is very complex. To succeed firms probably also need to have had experiences with other equally complex markets. Many firms were not aware of this complexity.

3. **What did the enterprises do after the end of the first project?**

After the first failed trial, some of these enterprises decided not to invest in further sales attempts in China and looked for other opportunities in other markets, perceiving the Chinese market as too risky. Other companies tried again independently, being able to build some business relations with Chinese partners, but mostly in a limited and occasional form.

4. **Which are the main obstacles associated enterprises encounter in the Chinese market?**

The main obstacle is finding partners. Enterprises often rely on institutional entities such as chambers of commerce, consulates, or the Italian Trade Agency (ICE) to find partners in China, but there is no guarantee for a business opportunity. Firms need to verify that partners have the desired characteristics and credit position, and need to be able to develop the business relation with them. Given that firms are able to find a partner, a strong difficulty is being able to carry on the business relationship and develop a structured presence in the market. It is necessary to develop a partnership with somebody on site who knows the market and the industry; otherwise, they will not be very successful in the long term.

5. **From the cultural point of view, did the enterprises encounter any difficulty in the Chinese market?**

Chinese people tend to identify *Made in Italy* products with world-famous *Made in Italy* brands. It is hard to change this idea, because buying those brands means gaining a status symbol for them. In order for our firms to be successful, Chinese people should desire Italian high-quality and design products that are not the world-famous Italian brands they know. This, of course, requires a long time and a long education process. Chinese people should be educated on the value of Italian design products, because they do not understand it. On the other side, Italian firms give for granted that the Chinese investors know and are able to recognized the value of their products. It is a mutual misunderstanding, that can be overcome with time, and education. For example, using storytelling to tell the history, tradition and the creation process behind a product can help.

6. **Which are the tasks associated enterprises request support for the most?**

Enterprises request all kinds of services, from the most easy to the most complex ones. With specific regard to the Chinese market, firms ask for support mostly for operational problems, such as customs procedures, transport, and finding partners or buyers.

7. **Is counterfeit a risk for associated enterprises?**

Counterfeit becomes a problem when the market knows your brand. The phenomenon of counterfeit suggests that the product is potentially attractive for the consumers. This problem certainly exists in China but does not affect our enterprises, as they have not gained much awareness in the market yet.

8. **Do associated enterprises see the Chinese market as an opportunity or a risk?**

Firms see China as a potential opportunity and as an interesting market. However, the risks and challenges in the market are numerous. Entering the market and establishing habitual business relations with local partners is not as simple as they thought in the first place. This is a lesson they learned especially after the failure of the showroom project. China presents demographic, cultural and business characteristics very different from the markets to which enterprises were used to export (Europe, United States), and they were not able to focus on the Chinese partners and satisfy their needs. Some enterprises decided not to target China anymore, as they were not prepared to make such an investment. If in the first place, enterprises were only attracted by the business opportunities in the market and overlooked the risks, now, after their negative experience and a much-needed cultural training, they are more aware.

9. **Have you planned any other future project to support associated enterprises' internationalization to China?**

We plan to work more on incoming activities. By inviting more potential Chinese buyers to Italy, we can show them our territory, our history and tradition, and the ways our artisans manufacture our unique products. We think that this will help them understand the intrinsic value of our products.

10. **In order to offset enterprises' small dimension and lack of structure, do you have any network projects planned?**

Currently no. It is not easy to convince enterprises to group together, when they do not want to do so. Entrepreneurs, especially in the Veneto area, are not made to cooperate with others; they are self-made entrepreneurs, so it is very difficult for them to group in a network. Projects such as grouping

enterprises to display products in a showroom where space and expenses are shared equally among enterprises are more attractive than other network projects where the management is delegated to a third entity. However, this is a need that should come from the enterprises and not from a third part.

Omnia Design Italia Ltd.

Alberto Turchet, Director

1. **When did the agency start to work with Italian enterprises in the Chinese market?**

We started to work with Italian enterprises in the Chinese market in 2014. We now develop and manage distribution of Italian firms' products in the market, specializing in the furniture sector.

2. **What type of Italian enterprises does the agency work with?**

We work with Italian enterprises of the furniture sector, both home and office. The brands that work with us mostly have a medium positioning.

3. **Which geographic area of China do you target?**

We operate in the whole country.

4. **Which distribution channels do you use?**

We mostly develop and manage retail channels, as contracts are usually carried on through a local partner.

5. **What is your target consumer?**

Our target consumer is the emerging Chinese middle class.

6. **How does the Chinese market perceive Italian products?**

Chinese consumers perceive *Made in Italy* products as high quality and design products.

7. **Which are the main obstacles and risks that Italian enterprises encounter in the Chinese market?**

Difficulties and risks are often the result of the widespread approximation with which enterprises approach the Chinese market. China is a greatly extended and continuously evolving market; its culture is very different from ours, as well as its economic context; these elements certainly have a significant weight on decisional and strategic processes. Problems are usually not related to price, product and quality levels, but to service ones. Italian enterprises often fail to understand the fast pace at which the Chinese market moves and the importance that receiving prompt responses and services has for Chinese consumers.

The office furniture market, for example, is much less developed than the home furniture one. It follows different business logics, and it is still evolving.

8. **According to your experience, which are the mistakes that Italian enterprises make in the approach and management of the Chinese market? Which measures could they adopt in order to avoid such mistakes?**

The main mistake enterprises make in the Chinese market is trying to manage it according to the experience they gained in other markets. Strategies that succeeded in Russia or in the Arab countries might not work as well in the Chinese one. Organizing regular business trips in the Chinese market, relying on expert consulting and distribution agencies, and, if possible, working with a sales representative based in China are must-take measures for firms wanting to understand and approach the Chinese market successfully.

9. **Do you see the Chinese market as "difficult" or "risky" for foreign enterprises?**

The Chinese market is not simple to approach, but it is increasingly growing. Once enterprises have managed to enter the market, they can grow at a significant pace. The main risk is related to the choice of the local partner: as choosing the wrong partner can be a problem, enterprises should always closely monitor the market. I do not see significant economic risks, but firms should not see delayed payments as the only source of competitive advantage compared to competitors. By doing so, firms would just run unnecessary risks.

10. **Have you perceived any new trend or evolution in the market over the years?**

I perceived an evolution in the furniture market starting in 2017. Today the furniture market is not made up only by luxury products, but also by more affordable products addressed to less wealthy consumers. The level of market maturity is starting to grow. This has brought an increasing (price) competition among retailers, which gradually reduced their final prices and their profit margins. Italian medium-end products have thus started to appear in local stores. Now, Chinese consumers can have Made in Italy products at a more affordable price.

This is going to be a real turning point for enterprises operating in China, being the Chinese market a large, growing, and very rich market. China is also a market in which it is possible to sell products with high profit margins and with anticipated payment.

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