Growing Beyond

Opportunities in a downturn

Ernst & Young's attractiveness survey

FDI in Europe:
2012 performance and 2013 prospects

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Foreword

Opportunities in a downturn

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Europe remains mired in an economic crisis characterized by debt, unemployment and poor growth. And there is little sign of a resolution. However, this has not deterred investors, who continue to commit resources and create jobs in the continent. It may seem counterintuitive, but the numbers show that the continent pulled in more foreign direct investment (FDI) projects and created more jobs in the first half of 2012 than it did in the same period last year.

While the inflow of foreign investment into Europe cannot compensate for the tens of thousands of jobs that have been lost due to restructuring or downsizing, these new investments, which are often strategic or technology-intensive, are a sign of confidence in the continent and are also likely to be one of the pillars of its future growth.

Investors appear to have accepted the uncertainty and volatility in some European countries and industries as a "new normal," while continuing to take into account the continent's fundamental qualities: the biggest concentration of high-power consumers; diverse and productive labor skills; an unmatched innovation climate; and superior infrastructure. These factors have outweighed the continent's economic woes and attracted a range of investors from inside and outside Europe.

Europe's encouraging FDI performance in the first half of 2012 also reflects increasing attention from emerging global giants, especially China and India, as they attempt to move up the value chain and find a new type of growth.

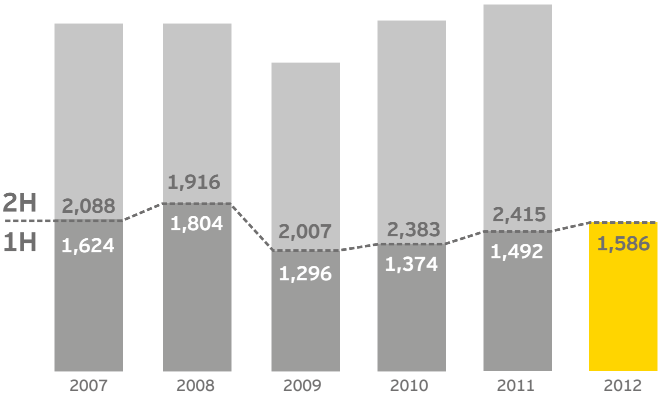
Our analysis encompasses the diversity of corporate projects that are being undertaken, along with the macroeconomic trends, industrial shifts and cost pressures that are affecting investment decisions. This half-year report – a preview of our much-awaited 2013 *European attractiveness survey* – aims to provide our clients and partners in the public service with a clearer view of the value created by this cross-border economic activity. We would like to thank all the executives who have taken the time to share their thoughts with us.

Ernst & Young's attractiveness surveys are widely recognized by our clients, the media and major public stakeholders as a key source of insight on FDI. Examining the attractiveness of a particular region or country as an investment destination, the surveys are designed to help businesses to make investment decisions and governments to remove barriers to future growth. A two-step methodology analyzes both the reality and perception of FDI in the respective country or region. Findings are based on the views of representative panels of international and local opinion leaders and decision-makers.

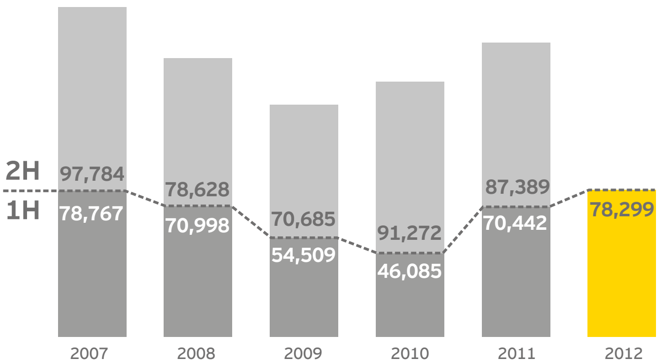
Main facts and figures

Despite the global downturn and the uncertainties created by the ongoing Eurozone crisis, Europe continued to attract FDI. In the first half of 2012, foreign companies made more than 1,500 investment decisions in Europe, an increase of 6.3% on the first six months of 2011. Jobs created by FDI in the first half of 2012 (78,299) go some way to compensate for the jobs lost as a result of restructuring and supply chain squeezes across many industries in Europe.

Number of FDI projects in Europe



Number of jobs created by FDI projects in Europe



+6.3%
Investments by foreign investors (1,586)

+11.2%
Jobs created by foreign investors (78,299)

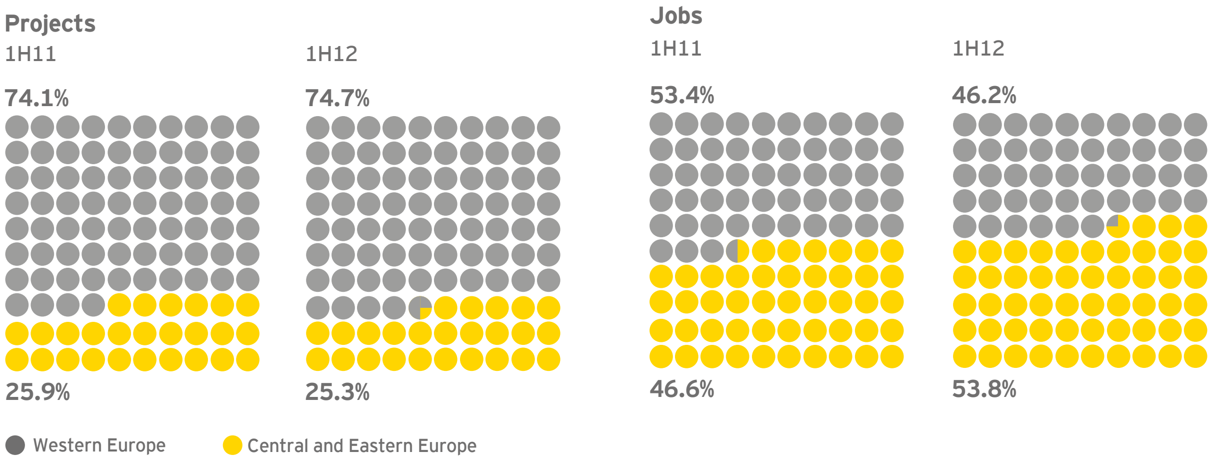
49.3
Average number of jobs created per FDI project (highest since 2007)

Clearer skies for Central and Eastern Europe

Western European (WE) countries continued to attract a greater number of investments, but they were of lower value and created fewer jobs than projects elsewhere on the continent. However, the main story of the first half of 2012 is the recovery of Central and Eastern Europe (CEE) as an FDI destination, after a significant slowdown in 2010 and 2011, when investment in the region hit historic lows.

In the first half of 2012, WE attracted 75% of all FDI decisions. However, more than half (53.8%) of the jobs created by FDI were in CEE countries. Salary cost differences have strengthened Europe's overall competitive position. In the services sector, for example, pay in some countries has fallen, leading to increased competitiveness in the market for near-shore outsourcing operations.

FDI in Europe by region



Source: *Ernst & Young's European Investment Monitor 2012* (interim).

Rise of FDI boosts volatile Eurozone

The Eurozone continues to wrestle with unemployment and low growth, so the increase in FDI in Europe is a welcome boost. The latest ***Ernst & Young Eurozone Forecast*** predicts that GDP in the currency zone will fall about 0.5% in 2012 as a whole, and expand by 0.1% in 2013. Uncertainty surrounding the ability of the Eurozone to stay intact has put a dampener on corporate investment. And it is not just big corporates that are hesitating. Consumers are split into two camps: those with jobs and those without. With unemployment reaching 18 million, there has been a marked decline in consumer spending. The drop in consumer spending has required companies to review their strategic direction in order to survive.

But companies are not only adapting to new consumer behavior. They are also taking the opportunity to review strategy for the long term. German businesses have led the way in implementing cost reduction programs, reshaping their supply chains and enhancing their flexibility and agility. These are important steps to take. As revenues, margins and profits are squeezed, companies will be more vulnerable to external risks. The International Monetary Fund (IMF) has encouraged Eurozone periphery countries to privatize state-run industries and improve competitiveness. Greece, Spain, Portugal and Ireland have all launched substantial programs to sell state assets, ranging from gas, water and electricity utilities to airports, state lotteries and postal services. Such sales are likely to attract both financial investors and specialist utility companies from around the world. This provides further encouragement for FDI in the Eurozone.

Source: *Ernst & Young Eurozone Forecast, Autumn 2012*.

Three sectors drive FDI in Europe

▶ Added attraction of Europe's services sector

Together, business services and software companies (mostly from the US, UK, France, Spain and India) held their positions as the top two generators of FDI projects in Europe, accounting for 29.4% of investment decisions in 1H12. However, manufacturing sectors such as automotive, machinery, chemicals and consumer goods maintained their importance in terms of job creation.

▶ Automotive creates a third of total jobs

FDI projects in the automotive sector continued to grow, mostly in CEE. In 1H12, the sector ranked third in terms of the number of FDI projects and was the largest contributor of FDI jobs — thanks to substantial investments from German, US and Japanese original equipment manufacturers and suppliers.

▶ Global logistics firms turn to Europe

In 1H12, there was a strong increase in FDI projects undertaken in Europe by logistics services companies, primarily by US and German providers. Companies looking to navigate Europe's dense, yet complex, supply chains, to streamline processes and find efficiencies, are increasingly outsourcing to third-party logistic firms. In 1H12, US-based FedEx Express invested in 17 new European logistics facilities and offices. Deutsche Post AG and Rethmann AG & Co KG also made large investments in the sector during the same period.

Increase/decrease (in share of FDI projects and jobs)

Projects

Increase:
- Business services
- Automotive components and assembly
- Machinery and equipment
- Other transport services
- Chemicals
- Plastic and rubber

Decrease:
- Software
- Financial intermediation
- Electronics
- Food
- Others

Jobs

Increase:
- Business services
- Automotive components and assembly
- Other transport services
- Chemicals
- Plastic and rubber

Decrease:
- Machinery and equipment
- Software
- Financial intermediation
- Electronics
- Food
- Others

FDI by sector

Sectors	Projects		Jobs	
	1H11	1H12	1H11	1H12
Business services	16.8%	19.4%	4.4%	10.7%
Software	11.0%	10.0%	4.3%	2.2%
Automotive components and assembly	7.4%	8.0%	23.5%	33.1%
Machinery and equipment	6.7%	7.3%	9.2%	8.3%
Other transport services	4.0%	6.1%	1.0%	2.0%
Chemicals	4.0%	4.7%	1.4%	4.5%
Financial intermediation	4.9%	4.4%	2.7%	1.6%
Electronics	4.5%	3.8%	4.8%	4.4%
Food	4.4%	3.7%	3.8%	3.6%
Plastic and rubber	2.4%	3.5%	1.9%	3.6%
Others	34.0%	29.3%	43.0%	26.0%

Source: *Ernst & Young's European Investment Monitor 2012* (interim).

European FDI is transatlantic

In terms of FDI funds, the US remains the largest external investor in Europe, with 32.5% of the total, mostly in the business services and software sectors.

In the same period, 7 European countries were among the region's top 10 investors in the continent. Germany strengthened its place as the largest European country investing in Europe, accounting for 12.5% of projects and creating 27.2% of the total FDI jobs. Large manufacturing investments were announced by Draexlmaier, Thyssenkrupp AG and Volkswagen AG.

Emerging market companies are investing in an effort to move up the value chain

Our half-year report also indicates that companies from emerging markets are expanding, albeit carefully, into selected European markets. During 1H12, entrepreneurs from the BRIC countries accounted for 5.7% of FDI projects and 7% of job creation in Europe. Emerging market entrepreneurs see an opportunity to invest in the continent as a means to move up the value chain by gaining access to European expertise and technology.[1] Interest from Chinese companies in Europe has been particularly active across a wide range of industries.[2] They are investing in industrial technology and brands to help them become more competitive.

1. Aaron Back, "China turns investment eye to Europe," *The Wall Street Journal website*, 14 February 2012, online.wsj.com, accessed 2 November 2012.
2. Kenneth Rapoza, "China companies inching into Europe," *Forbes website*, 10 August 2012, www.forbes.com, accessed 2 November 2012.

Positive lessons learned

Although the study period is short, we can draw some important conclusions. It is clear that, despite the wider economic gloom — in fact in part because of it — Europe has a positive FDI story to tell. FDI growth offers a rare source of new jobs that provides relief for policy-makers and citizens alike. It is crucial that this momentum continues over the next six months.

Number 1 ... after all

The uncertainties created by the Eurozone crisis have increased and they continue to worry European executives and foreign investors. However, the international business community realizes that the European market is too big to ignore. It is acknowledged that Europe retains strong fundamentals that cannot be overlooked. The highest output of any region in the world; unparalleled research and innovation capacities; a diverse and qualified workforce; and a highly dependable transportation infrastructure are factors that continue to attract investors from all over the world.

Investors able to drive a hard bargain

Many European economies are accommodating the demands of foreign investors, at least to some extent, in order to maintain good levels of industrial investment. In May 2012, Nissan Motor Company negotiated with Spanish labor unions on the terms of employment for a project that will create 700 jobs.[3] In June, chemical giant BASF SE announced a €40m investment in Catalonia, Spain.[4] Similar arrangements have been made in the case of the automotive sector. Jaguar Land Rover, for example, has agreed a pay deal with unions in the UK as part of an ambitious investment plan.[5]

3. Holly Ellyatt, "Nissan is worried about Europe, but invests in Spain," *CNBC website*, 23 May 2012, *www.cnbc.com*, accessed 2 November 2012.
4. "BASF will invest 40 million this year in Catalonia," *Catalan News Agency website*, 7 June 2012, www.catalannewsagency.com, accessed 2 November 2012.
5. John Reed, "JLR agrees to pay deal with union," *Financial Times website*, 8 October 2012, www.ft.com, accessed 2 November 2012.

The importance of FDI

Despite understandable worries about Europe's economic prospects, foreign investors are considered and discerning supporters of the continent. A factor that supports FDI is the increasing flexibility of policy-makers, who recognize the important role FDI plays in creating jobs and stimulating economies. As a result, many are seeking to facilitate investment by the judicious use of incentives such as tax credits and strengthened infrastructure. The European Central Bank has played its part by instigating a vast bond purchase program that has delivered a welcome boost. And perhaps the very fact that the crisis has been ongoing for a number of years has also played a part. Investors have now become accustomed to the volatility and, looking around the world, there are few regions or countries that offer them an entirely risk-free environment.

Local markets tell different stories

Geographic differences remain prevalent; WE countries are attracting more projects while their CEE neighbors are benefiting from more jobs. Look a little closer and the performance of some individual countries stands out. Who would have thought that Spain would temporarily overtake Germany to become the third-largest recipient of FDI projects in the first half of 2012? Germany — so long Europe's powerhouse — will certainly reverse its slight decline in FDI market share. France, by contrast, has performed relatively well and is second only to the UK in its share of European projects. There has been a welcome increase in both services and manufacturing, especially in CEE countries such as the Czech Republic. What's more, there has been a substantial increase in the logistics sector, with US and German firms the principal investors.

The other side of the coin

However, our research indicates that despite the strengthening of FDI, corporate layoffs continue. They are even accelerating in Western Europe, particularly in low-margin, slow-growth and highly competitive industries such as automotive and steel.

Restructuring hits Europe hard

In the first six months of 2012, the Eurozone reported a total of 677 restructuring cases: 406 cases that resulted in job losses, 263 cases that created jobs and 8 that involved both job loss and gain. With 158,806 job losses and 110,332 job gains, the net effect was a loss of 48,474 jobs in the Eurozone. The manufacturing sector was the worst hit with a net loss of 31,917 jobs. Transport, storage and communications and financial intermediation were other sectors that suffered owing to restructuring.[6]

Many companies in Europe have realigned their operations in response to changing industry dynamics and the new focus of European governments on austerity. In manufacturing, cost-competitiveness has become the most pressing concern. Contracting demand and chronic overcapacity in WE has combined with market growth in emerging countries to compel automakers, such as PSA Peugeot Citroën, Fiat SPA and General Motors Company, to reduce production or shut down some of their WE plants.[7] At the same time, they are expanding production in promising and cost-competitive countries, including CEE destinations.[8] Government policy and slowing economic activity also provide compelling reasons to relocate operations. In Spain, sharp cuts in incentive payments to renewable energy projects prompted companies, including T-Solar Global SA and Gamesa Corp Tecnologica SA, to look at opportunities in Peru and India.[9] In the banking sector, institutions such as ING Groep NV have shut their emerging European equities operations in London, Moscow, Hungary, the Czech Republic and Romania, to counter the negative effects of the slowdown in merger and stock trading activity.[10]

There has been a noticeable decline in FDI activity toward some emerging economies – noticeably India, where investors are more careful about "low-cost" promises and wary of infrastructure and regulatory roadblocks. However, Asia is still a popular destination for displaced European operations. Relocations from Europe have spread to new segments of the European economy. For example, Nokia has shifted device assembly to Asia in a bid to improve its time to market.[11]

6. *European Restructuring Monitor (ERM) quarterly*, April 2012, European Monitoring Centre on Change, 2012, accessed via www.eurofound.europa.eu, 2 November 2012.
7. Jack Ewing and Bill Vlasic, "Europe's auto industry has reached day of reckoning," *The New York Times website*, 25 July 2012, www.nytimes.com, accessed 2 November 2012.
8. Jan Cienski, "CEE carmakers: Poland slips back, as Slovakia and the Czech Republic roar ahead," *Financial Times website*, 13 September 2012, blogs.ft.com/beyond-brics, accessed 2 November 2012.
9. Alex Morales and Ben Sills, "Spain ejects clean-power industry with Europe precedent: energy," *Bloomberg website*, 30 May 2012, www.bloomberg.com/news, accessed 2 November 2012.
10. Maud van Gaal and Jason Corcoran, "ING cuts 130 jobs, closes emerging European equities unit," *Bloomberg website*, 1 October 2012, www.bloomberg.com/news, accessed 2 November 2012.
11. "Nokia cuts 4,000 jobs as assembly moves to Asia," *Telegraph website*, 8 February 2012, www.telegraph.co.uk, accessed 2 November 2012.

Europe's competitiveness divide

Charting a course away from uncertainty and toward prosperity remains the top priority for policy-makers across Europe and around the world. It is no easy task. The US has faced the uncertainty of upcoming elections and the impending "fiscal cliff." Rapid-growth markets (RGMs) are displaying the first signs of fragility and Europe itself is still wrestling with the challenge of carving out a competitive position in the global economy of the future.

Many of Europe's difficulties can be traced to the disparities in competitiveness that continue to exist between its northern and southern regions. The continent could also do more to ensure that countries other than Germany benefit from demand in Asian and Latin American RGMs. And yet the fact that companies from all over the world continue to choose to invest in Europe is evidence that, for now at least, the region retains rich and deep-rooted strengths.

Innovation: the key to sustainable growth

Máire Geoghegan-Quinn,
European Commissioner for Research, Innovation and Science

The economic and financial crisis has taught us that, while we certainly need an economy that grows and provides jobs, that economy must also be resilient. We need an economy that generates sustainable growth, not growth fueled by debt, speculation and greed; an economy that can cope with shocks and challenges.

Resilience and competitiveness now come from generating knowledge and ideas, not from tangible assets. A recent European Commission survey of some of Europe's companies that invest the most in R&D, showed that they expect their investment in research and development to grow by an average of 4% annually over the period 2012 to 2014.

This figure shows the importance that business places on R&D as a key factor for growth and prosperity. In-house R&D is seen as the most relevant driver of innovation by the surveyed companies, followed by market research and related activities for new product introduction. This positive trend is essential for European competitiveness and we need to complement it with robust public investment in innovation.

Our companies are the main drivers in making the European economy more knowledge-based and smarter.

When asked about the effects of policies and external factors on their innovation activities, surveyed companies highlighted the strong positive effects of fiscal incentives, national grants, EU financial support and public-private partnerships, both at national and EU level. In contrast, the time needed to obtain intellectual property rights protection and the costs of that protection were seen by many companies as key factors impacting negatively on their innovation activities.

The Commission is delivering what it has promised to make life easier for innovative companies, under our Innovation Union banner. This includes progress on the unitary patent, on venture capital, on public procurement and on standards. We have also proposed to increase EU-level funding significantly for researchers and businesses. Horizon 2020, our future research and innovation program, has a proposed budget of €80b over seven years, up from €55b in the current program. This would provide direct research grants for everything from blue-sky research to demonstrator projects. It would also leverage private funding to provide finance to innovative companies.

Discussions on the overall level of the next EU budget are now heating up, with EU Member States and the European Parliament involved. If there are cuts to the current proposal, Horizon 2020 is at risk of getting squeezed as supporters of agricultural subsidies and structural funds fight for their corner. We need researchers and especially innovative businesses to make the case for more research and innovation funding at the European level. Our companies are the main drivers in making the European economy more knowledge-based and smarter. Horizon 2020 will give them a further boost. It needs the support of us all.

Viewpoints

"Five years on from the start of the financial crisis and its impact continues to reverberate across European borders. Policy-makers in Brussels and beyond are confronted by a multitude of challenges, not least the issue of how to help EU economies move forward at a time of intensifying global competition.

Being at the forefront of driving innovation and entrepreneurship is an important starting point. FDI is most likely to occur in those regions that have been able to implement pockets of innovation — and governments have a key role to play in this process. The German Government, for example, has had a pivotal role in the development of Germany's clean technology industry, whereas UK policy-makers have had similar success in helping the UK biotech businesses grow and develop.

Removing the excessive bureaucracy and red tape that hinders entrepreneurship is crucial. Reducing the time it takes to register a patent or set up a business are just two of the ways in which policy-makers can help. But it's not just about government. Europe's universities can also help foster a culture of entrepreneurship by encouraging the next generation to be innovative and open to the possibilities of starting their own businesses."

Julie Linn Teigland

Ernst & Young's Accounts, Industries and Business Development Leader for Europe, Middle East, India and Africa

"The economic situation in Europe continues to deteriorate. Demand is weakening across the continent as a result of confidence slumps and de-leveraging by consumers, governments and corporates. Faced with challenging domestic markets, Europe's governments and companies are looking to exports and inward investment as the means to improve their own performance. The result is increasing competition for the sales and resources that are available.

Trade is a two-way business. Increasingly, we are seeing inward investment flows reflect patterns of export and import. So Chinese investment is flowing to Germany and German goods are flowing to China. Success in this environment requires a clear strategy and flawless execution: only the excellent will succeed. In practice, this means: identifying your sources of competitive advantage that may be cost, quality or innovation; working through how these advantages can be developed and maintained; and articulating and selling the benefits of investing or partnering to customers, partners and investors."

Mark Gregory

Chief Economist, Ernst & Young, UK and Ireland

"Amid the immediate worries of the Eurozone, sovereign debt and high unemployment, it's easy to forget that Europe is falling behind in a global race: a race for investment, a race for trade and a race for growth.

While EU policy-makers have been focused on fighting recession and stimulating their economies, Asian and Latin American countries have been moving forward — at a pace. Trade patterns, research and innovation successes and economic growth are all long-term trends that are threatening Europe's position in the global economy. The pressure is on.

With innovation essential for Europe's economic growth and creating much-needed jobs, governments' ability to support entrepreneurial activity is key to increasing productivity. Investments are being made, but EU governments and businesses should work together to overhaul the fragmented landscape that currently exists. A more streamlined and coordinated approach would lead to new product development, process improvement and entrepreneurship."

Dave Read

Ernst & Young's Government & Public Sector Leader for Europe, Middle East, India and Africa

Methodology

The half-year report is based on interim data (January–June 2012)

Our evaluation of the reality of FDI in Europe is based on Ernst & Young's European Investment Monitor (EIM). This database tracks FDI projects that have resulted in new facilities and the creation of new jobs. By excluding portfolio investments and M&A, it shows the reality of investment in manufacturing or services operations by foreign companies across the continent.

Data is widely available on FDI. An investment in a company is normally included if the foreign investor has more than 10% of its equity and a voice in its management. FDI includes equity capital, reinvested earnings and intracompany loans. But many analysts are more interested in evaluating investment in physical assets, such as plant and equipment, in a foreign country. These figures, rarely recorded by institutional sources, provide invaluable insights as to how inward investment projects are undertaken, in which activities, by whom and, of course, where. To map these real investments carried out in Europe, Ernst and Young created the Ernst & Young EIM in 1997.

The EIM is a leading online information provider, tracking inward investment across Europe. This flagship business information tool from Ernst & Young is the most detailed source of information on cross-border investment projects and trends throughout Europe. The EIM is a tool frequently used by government and private sector organizations or corporations wishing to identify trends and significant movements in jobs and industries, business and investment.

Ernst & Young's EIM, researched and powered by Oxford Intelligence, is a highly detailed source of information on cross-border investment projects and trends in Europe, dating back to 1997. The database focuses on investment announcements, the number of new jobs created and, where identifiable, the associated capital investment, thus providing exhaustive data on FDI in Europe. It allows users to monitor trends, movements in jobs and industries, and identify emerging sectors and cluster development. Projects are identified through the daily monitoring and research of more than 10,000 news sources. The research team aims to contact 70% of the companies undertaking the investment directly for validation purposes. This process of direct verification with the investing company ensures that real investment data is accurately reflected.

The following categories of investment projects are excluded from EIM:

- M&A or joint ventures (unless these result in new facilities, new jobs created)
- License agreements
- Retail and leisure facilities, hotels and real estate investments
- Utility facilities including telecommunications networks, airports, ports or other fixed infrastructure investments
- Extraction activities (ores, minerals or fuels)
- Portfolio investments (pensions, insurance and financial funds)
- Factory and other production replacement investments (e.g., a new machine replacing an old one, but not creating any new employment)
- Not-for-profit organizations (charitable foundations, trade associations, governmental bodies)

International Location Advisory Services

Ernst & Young International Location Advisory Services (ILAS) can assist governments and corporate clients who have questions related to FDI promotion strategies, business mobility, plant and office locations, real estate investments and divestments. After an analysis of an investment project's specific needs, our teams work with management on the best long-term options in terms of cost savings, appropriate labor pools, service providers and secure infrastructure. Based on our multidisciplinary experience and knowledge, they offer an evaluation of optimum conditions for the best deals on real estate, incentives and tax solutions.

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Growing Beyond

In these challenging economic times, opportunities still exist for growth. In *Growing Beyond*, we're exploring how companies can best exploit these opportunities — by expanding into new markets, finding new ways to innovate and taking new approaches to talent. You'll gain practical insights into what you need to do to grow. Join the debate at www.ey.com/growingbeyond.