



## Promoting Business Linkages

### Overview and Tool

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65760 Eschborn  
Internet: <http://www.gtz.de>

Economic Reform and Private Sector Development Section  
Sector Project 'Innovative Tools for Private Sector Development'  
[private.sector@gtz.de](mailto:private.sector@gtz.de)

Responsible:  
Sabine Becker, gtz

Author:  
Fr. Dr. Schulenburg

Layout:  
Elisa Martin, Document and Graphics Centre, gtz

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## Executive Summary

### Background and Aim

Pro-poor growth is a topic of particular relevance in the light of the Millennium Development Goals (MDG). It is agreed that growth is necessary for the reduction of the number of the poor and that private sector development (PSD) should contribute to growth. But the poor benefit to differing degrees depending on the pattern of growth. Pro-poor growth is defined as disproportionate reduction of the number of the poor in relation to the growth rate of the economy. A cross country study revealed that countries fostering their agricultural sector and countries opening up urban and non-agricultural employment possibilities were particularly successful in reducing the number of poor.

Furthermore, there is agreement on the necessity to strengthen business linkages between local enterprises in the developing countries and national and global value chains as a way of fostering growth dynamics.

The private sector in developing countries consists mostly of numerous micro-, small, and medium-sized enterprises (MSMEs). The majority of them regularly operate with limited resources within the informal sector. Additionally there is a small amount of competitive enterprises operating in the modern sector.

A typical situation in the developing countries is one of underdeveloped linkages between the modern and informal urban and rural sectors. Whilst the integration of the local modern sector enterprises into international value chains is progressing in some developing countries at a high speed, the potential of the informal urban and rural sector to profit from these tendencies is not fully utilized.

This report therefore has the following aims:

1. Definition and analysis of the different kind of business linkages between enterprises
2. Analysis of the potential of business linkages between the enterprises of the modern and informal urban and rural sector
3. Identification of target groups for the business linkages approach in the context of pro-poor growth
4. Overview on approaches to foster business linkages
5. Design and recommendation of a tool for PSD programmes to foster business linkages by PSD programmes in the context of pro-poor growth

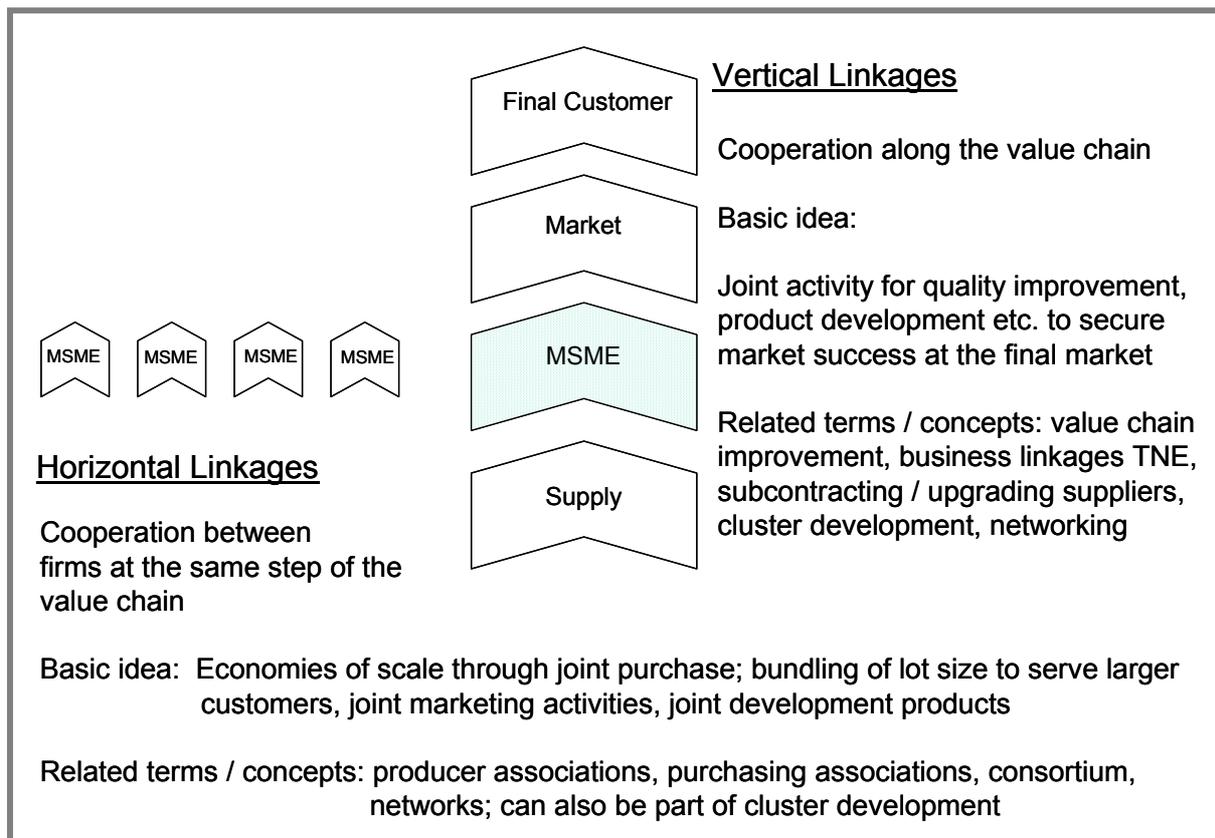
### Definition and Analysis of Business Linkages

In general, all commercial interactions, all selling or buying activities between firms can be classified as business linkages. However, different from this general definition, this report focuses on **collaborative business linkages**, which are explicitly built up by firms out of

mutual interest. Enterprises join a formal or informal group with the aim of bringing about a win-win situation for the parties involved.

The report differentiates between two types of collaborative business linkages: horizontal among MSE or SMEs or vertical with suppliers on the one hand and buyers on the other:

Horizontal business linkages are especially advantageous for MSMEs because, by cooperation, they can overcome the limits set by size. Through vertical business linkages MSE and SME integrate themselves into market driven domestic or international value chains.



Within the report the economic rationale and the suitability of different types of business linkages for different groups of enterprises are discussed. Furthermore, cluster development as a process from incipient to mature clusters is presented. Also pattern of linkages within value chains (i) arms' length market relations (ii) balanced networks (iii) captive network and (iv) hierarchy are distinguished and set in relation with upgrading paths of enterprises. Four steps within the upgrading path can be differentiated: (i) process upgrading (ii) product upgrading (iii) functional upgrading and (iv) inter-sectoral upgrading. Process and product upgrading is supported within captive network by national or international buyer out of own interest.

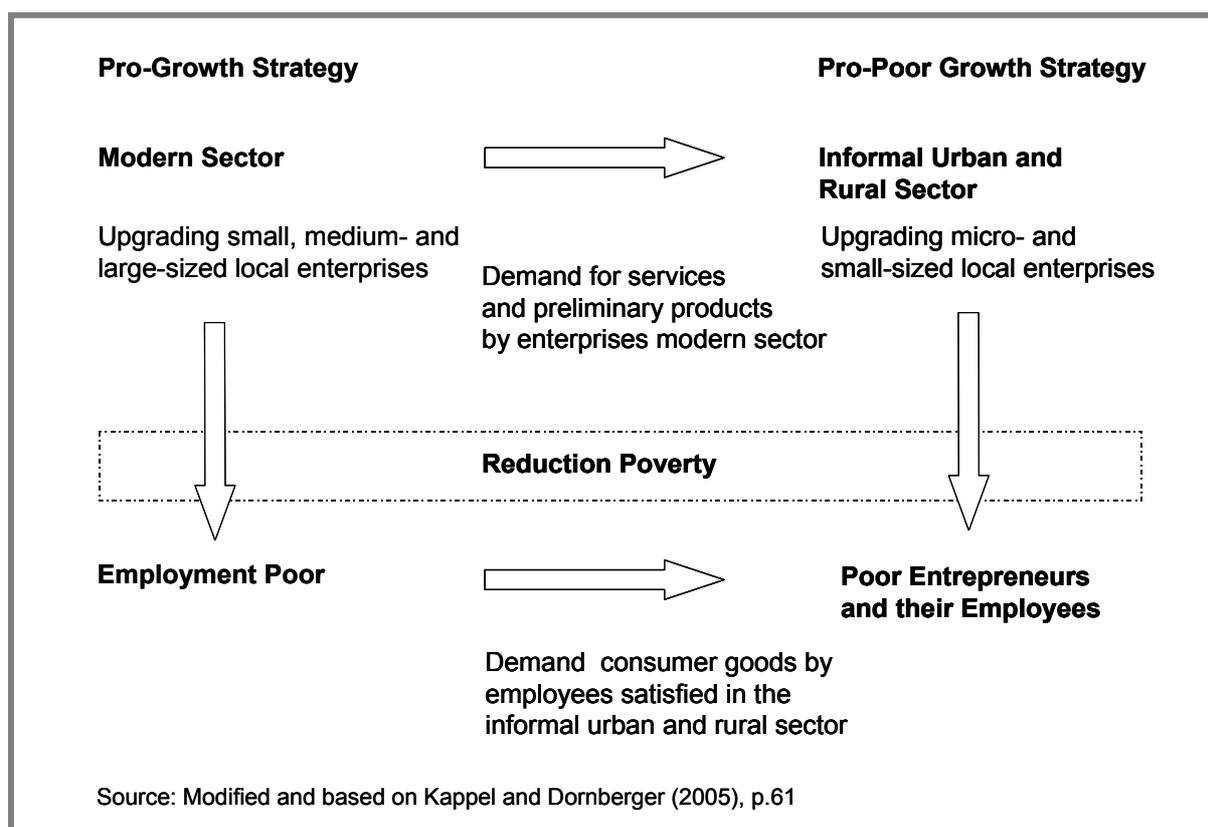
## Pro-Poor Growth and Target Groups

Poor people can benefit from PSD either through the opening up of employment possibilities or as entrepreneurs. There are a number of interdependencies between the modern sector and the informal urban and rural sector in terms of impact on poverty. As entrepreneurs in the informal urban and rural sector, the poor can benefit from

- the rising demand for their services and preliminary products from the enterprises of the modern sector with respect to the core business and non-core business (business linkages)
- the rising demand for consumer goods from employees of the modern sector to be met by the informal urban and rural sector (market opportunities)

It can generally be stated that, in regions of dynamically increasing employment opportunities, there is considerable potential for supporting the entrepreneurs in the informal urban and rural sectors through micro-finance and customised BDS-measures. This will enable them to tap into the full potential of the market of rising consumer demands amongst employees.

The report analyses why the potential of direct business linkages between poor entrepreneurs and the national or global value chains is limited. This is due to the typical characteristics of poor entrepreneurs: limited access to assets, comparatively low technological and management skills and small size.



An important feature also is the target market. An important distinction is the one between markets served by mass production and specific small market segments. Within the ladder the specific strength of MSMEs, namely flexibility and high proportion of handmade components is advantageous and poor entrepreneurs can be integrated more easily.

The report recommends four areas for the promotion of vertical and horizontal business linkages:

1. Linking local competitive SMEs to the global value chains of trans-national enterprises (TNE) with the TNEs serving markets of mass production. This is where contribution to economic growth is possibly highest. The main pro-poor impact is indirect, through opening up of employment opportunities. Moreover, poor entrepreneurs benefit from indirect effects through rising consumer demands of the SME employees to be met by the informal sector.
2. Upgrading local value chains of mass production, directed at domestic markets. The main pro-poor impact is the opening up of employment opportunities in competitive SME. In addition, there is more scope for integrating smaller micro and small enterprises (MSE) in local than in international value chains. Functional upgrading i.e. through branding, design and marketing is an integral part. Poor entrepreneurs can benefit from the indirect effects through rising consumer demands of the SME employees to be met by the informal sector.
3. Fostering horizontal business linkages among MSE and SME, directed at specific small market segments. The competitive advantages of MSE i.e. flexibility and high proportion of handmade components is relevant. Poor groups can benefit either as entrepreneurs or through employment.
4. Promoting agricultural value chains and rural markets. This will directly reduce poverty because the majority of the poor live in rural areas and earn their living from agriculture.

### **Overview of possible tools to support business linkages**

The report presents the various methodologies used by development agencies to facilitate cluster and network management. Almost all donors have the issue of business linkages on their agenda, but with different priority. As UNIDO has the most comprehensive approach, their methodology and their lessons learnt is presented in more detail. Additional approaches to business linkages such as public private partnership, databases, matchmaking and group consultancy are presented, drawing on experience from the donor community and GTZ. Moreover, the report provides an insight into European experience by presenting the German approach “Innoregio” and the follow-up initiative “Unternehmen Region” for the new federal states. The benefits and limits of the various approaches serve to guide the elaboration of the business linkage tool.

## **The Principles of the business linkage promotion tool**

Principle 1: The tool includes the concept of its dissemination: Brokers are central for the effective management of cluster and networks. With a view to financial and institutional sustainability of the business linkage service, these brokers should be local consultants. The institution in charge of coordinating and training the brokers should also be a local institution, i.e. a business association, NGO or chamber of commerce depending on the particular situation in the country or region.

The role of GTZ is limited to co-financing the initial phase and to disseminating the methodology and the idea of networks and cluster (see graph below), among other through training of trainers (ToT). For sustainability and sufficient impact, interventions for the promotion of business linkages need to be on a sufficiently large scale and thus in selected countries.

Principle 2: The implementation of the tool should be concentrated in priority partner countries. The business linkages approach can be appropriate both for Least Developed Countries (LDCs) and Middle Income Countries (MICs). But it has to be considered that clusters and business networks need certain preconditions e.g. sufficient number of potentially competitive MSMEs, regional proximity of these MSMEs, potentially capable BDS suppliers and a promising domestic or international market perspective for the sectors involved.

With regard to regional income disparities in most MICs and LDCs, cluster and network development can contribute to pro-poor growth in rural areas. However, it is not suitable for remote areas with low population density, a small number of enterprises and poor connections to markets because of lack of roads.

The more functioning clusters and networks there are the more effective the business linkages approach will be. It is therefore an area of PSD where cooperation with other development agencies would be particularly effective.

Principle 3: The business linkages approach should be incorporated into the PSD strategy of the individual country. This is in order to unleash the full potential of this approach. With the definition of a PSD strategy, sub-sectors with potential for growth and employment creation are identified and support to strengthening business linkages should focus on those sub-sectors.

Principle 4: Special emphasis must be placed on the market potential of the individual cluster, value chain, or network. Experience with the business linkages approach shows that the market potential is decisive for sustainability.

Principle 5: For maximum ownership and sustainability a cost-sharing approach to setting up and running linkages services is necessary, involving the local partner institution, the MSMEs and the TNEs.

Principle 6: The implementation of the business linkages approach should be monitored with a pro-poor perspective. Upgrading of cluster and value chains can have winners and losers. Particularly vulnerable groups e.g. unskilled workers, woman or ethnic minorities, can be left behind in this process. Therefore the effects on the poor should be monitored by mapping the bottlenecks and designing customized approaches to integrate them, i.e. through interventions from other development fields like education, health or infrastructure.

### **Modules of business linkage promotion**

The report presents three types of business linkages that are distinct and require distinct phases and tools.

#### **Module Vertical Business Linkages**

The aim of the module is to support integration of local SMEs into the value chains of large national enterprises and/or TNE. The focus during implementation is on training activities to enable the local SMEs to fulfil qualification requirements within the value chain.

The motivation of the client enterprise is decisive. The client enterprise defines the possible products and services to be purchased on the local market. Vertical cooperation is part of the given market strategy of the buyer.

The basis of the legal relationship between the suppliers and the lead firm is defined by a contract regarding price and quality specifications.

State of the art within GTZ and next steps: Currently activities regarding vertical linkages are underway in several programmes, i.e. in Vietnam, Brazil, Sri Lanka (Core Groups) and Ghana. In several of the programmes it is the programme staffs that directly identify the potential buyers to link up with. This allows developing deep understanding of the practical problems involved in the qualification process of the SMEs and the problems of bundling lot size at SME level. However, the question at stake is how to institutionalise the identification of business partners and particularly of potential buyers.

#### **Module Horizontal Business Linkages**

Horizontal networks are cooperative-type of activities of MSMEs at the same level of the value chain for mutual benefit. Typical short-term activities include joint visits to fairs, joint purchase of inputs or the set-up of a common shop to sell products. Typical long-term activities (strategic goals) touch upon activities for product and process upgrading including branding activities with the purpose of opening up new markets for the MSMEs involved.

To effectively establish horizontal business linkages, the elaboration of a promising market strategy is decisive. The report describes phases of horizontal network development as well as the required tools.

Professional network management and the facilitation of the process by a broker are essential for the success of horizontal networks. Horizontal networks with strategic aims will generally end up with a formal legal status.

State of the art within GTZ and next steps: Currently activities regarding horizontal linkages are being implemented in programmes in Vietnam, South Africa, Philippines and Ghana. There is need for more systematic promotion of horizontal networks that are based on market potential. The report provides the necessary components.

### **Module Cluster Development**

Cluster development supports the upgrading of a sub-sector in a given locality. Within a cluster, horizontal and vertical linkages are highly relevant. Cluster development needs a common vision and mission on the part of the stakeholders involved e.g. enterprises, business associations, regional government, BDS providers. The implementation requires a common work plan. The main focus of a development programme would be the establishment of linkages to the relevant support institutions.

Cluster development needs professional cluster management. Where donors support cluster development, a coordinating institution must be involved or built up. This umbrella organisation (e.g. NGO, regional agency) coordinates the different activities of the cluster and can be co-financed by public funds and contributions from the companies involved.

State of the art within GTZ and next steps: For cluster development the required methodologies and tools are at hand. However, there is need to document implementation experiences (best practice), i.e. as part of the existing LRED programmes. These methodologies and the best practices can be used in training manual for business linkage brokers.

## List of Abbreviations

BDS	Business Development Services
BLCF	Business Linkages Challenge Fond
BMBF	Bundesministerium für Bildung und Forschung
CND	Cluster and Network Development
DFV	Deutscher Franchise-Verband e.V.
DIFD	Department for International Development
GTZ	Deutsche Gesellschaft für technische Zusammenarbeit (GTZ)
LDCs	Least developed countries
LRED	Local and Regional Economic Development
MICs	Middle Income Countries
MSME	Micro-, Small and Medium-Sized Enterprise
PSD	Private Sector Development
PTJ	Projekträger Jülich - PTJ
SBP	Small Business Project (NGO)
SME	Small- and Medium-sized Enterprise
TNE	Transnational Enterprise
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
UNIDO	United Nations Industrial Development Organisation
WTO	World Trade Organisation

## Introduction

### I. Background

Sustained and rapid growth of GDP has a positive impact on the reduction of poverty. This was again confirmed by an analysis of the relationship between growth and the reduction of poverty in a cross-country study.<sup>1</sup> However, poor people benefited from the overall growth rates in the analysed countries to a variable extent. Participation in the benefits of overall growth depended on policies enhancing the capacity of the poor. Two major fields of action were identified:

(1) The study showed that countries supporting the development of their agricultural sector have made above average advances in the reduction of poverty. This is because the majority of the poor live in rural areas and earn their living from agriculture.

(2) Countries creating non-agricultural and urban employment opportunities for poor households were also above average. This is because urbanization is continuing at a fast pace in developing countries and under-employment is still significant in the agricultural sector.

This leads to the conclusion that private sector development aiming at pro-poor growth should put a clear emphasis on agricultural sector development and on non-agricultural and urban employment opportunities for the poor.

The private sector in developing countries consists mostly of numerous micro-, small, and medium-sized enterprises (MSMEs). The majority of them regularly operate with limited resources within the informal sector. Additionally there is a small amount of competitive enterprises operating in the modern sector. One of the fundamental questions in Private Sector Development (PSD) is which approaches will contribute to growth and have a pro-poor impact at the same time.

Pro-growth strategies concentrate on upgrading enterprises with growth potential, as it is these enterprises that will contribute to growth and employment creation. They are characterized by a certain level of management ability, technology and financial and other resources. These enterprises with growth potential are found within the modern and partly within the informal sector, with the borders between the modern and the informal sector being fuzzy. The respective entrepreneurs generally do not belong to the poor. The question at stake is whether and how a pro-growth strategy can be linked with a pro-poor growth strategy.

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<sup>1</sup> World Bank (2005), p.2 et sqq. The report is based on a joint effort of Agence Francaise de Developpement (AFD), Bundesministerium für Wirtschaftliche Zusammenarbeit und Entwicklung (BMZ), Kreditanstalt für Wiederaufbau Entwicklungsbank (KfW), Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), Department for International Development (DFID) and The World Bank.

A promising approach is to promote business linkages between MSE and SME with larger national and transnational enterprises and thus integrate local businesses in dynamic markets and value chains. In developing countries, linkages between the modern and informal urban and rural sectors are largely underdeveloped. Whilst the integration of the local modern sector enterprises into international value chains is progressing in some developing countries at a high speed, the potential of the informal urban and rural sector to profit from these tendencies is not fully utilized.

## **II. Aims and Approach**

This study therefore has the following aims:

- Definition and analysis of the kind of business linkages between enterprises
- Analysis of the potential of business linkages between the enterprises of the modern and informal urban and rural sector
- Identification of target groups for the business linkages approach in the context of pro-poor growth
- Overview on approaches to foster business linkages
- Design and recommendation of an instrument to foster business linkages by GTZ in the context of pro-poor growth

The report is structured in two parts. Part I delivers the conceptual framework and an overview of possible tools. Part II gives the outline of the best practice tool for business linkage promotion.

Part I: Chapter 2 defines the term 'business linkages' and describes the economic rationale of different kinds of business linkages. Promotion of business linkages will only be sustainable if an economic rationale for the entrepreneurs is given. Based on this insight, the potential for business linkages between enterprises of the modern and informal urban and rural sector is outlined in chapter 3. This leads to the identification of target groups with pro-poor growth effects. Chapter 4 gives an overview of different approaches and tools to foster business linkages, presents relevant lessons learnt with the implementation of these instruments and discusses benefits and limitation of these.

Part II: Chapter 5 presents the principles of the recommended tool. The modules cluster promotion, vertical cooperation and horizontal networks are described in chapter 6. For the implementation of the modules tools must be at hand. Currently existing tools within GTZ and next steps to further elaboration are mentioned.

The elaboration of the business linkage tool was guided by the criteria outreach, sustainability and impact.

**Part I: OVERVIEW 'BUSINESS LINKAGES'**

## **I. Business Linkages**

### **I.1 General meaning of the term business linkages**

In general, all interactions between firms are business linkages. Every selling or buying activity is a business linkage between two partners. By analysing the business relationships of firms it becomes obvious that the relationships between a given firm and its customers and suppliers often have a long-term character. This is due to the fact that repeated interaction with known business partners is more efficient (lower transaction cost) than constantly changing over to new ones. The evolution of new business linkages is always an investment in the future with an impact beyond the profit of the single interaction.

The evolution of business linkages between enterprises is influenced by basic conditions set by:

- (1) Distance and physical infrastructure: the existence and quality of roads, shipping routes, railway and airports, as well as services needed for trade, such as refrigerated trucks and storage facilities for exporting fresh products. Both the quality of, and the distance travelled by, various transportation modes and the availability and quality of services influence the transportation costs.
- (2) Trade policy: import and export restrictions and the level of custom duties have a fundamental influence on the possibility of cross-border business linkages.
- (3) Existing business linkages: Choosing new business partners gives rise both to costs incurred in the search itself and to the risk involved in experiencing whether the new partner is reliable and performing effectively. If given business relationships between enterprises exist, the entrance of new partners into this market is difficult.

These basic conditions are mentioned because they are important for the integration of a business linkages approach into a consistent country strategy. The following example serves to highlight this: Some developing countries are on the verge of WTO membership. Within the PSD programme in Vietnam a public private partnership with Metro AG evolved. Metro was granted the license to open up wholesale markets, and in turn committed to source as many products locally as possible. In order to do so, the company is investing heavily in upgrading its local suppliers of their fresh product range to be able to fulfil quality and hygiene standards, as well as to improve the overall efficiency of the supply chain. With this approach, the competitiveness of the suppliers will increase sufficiently to withstand any future competitive pressure created by membership of the WTO.

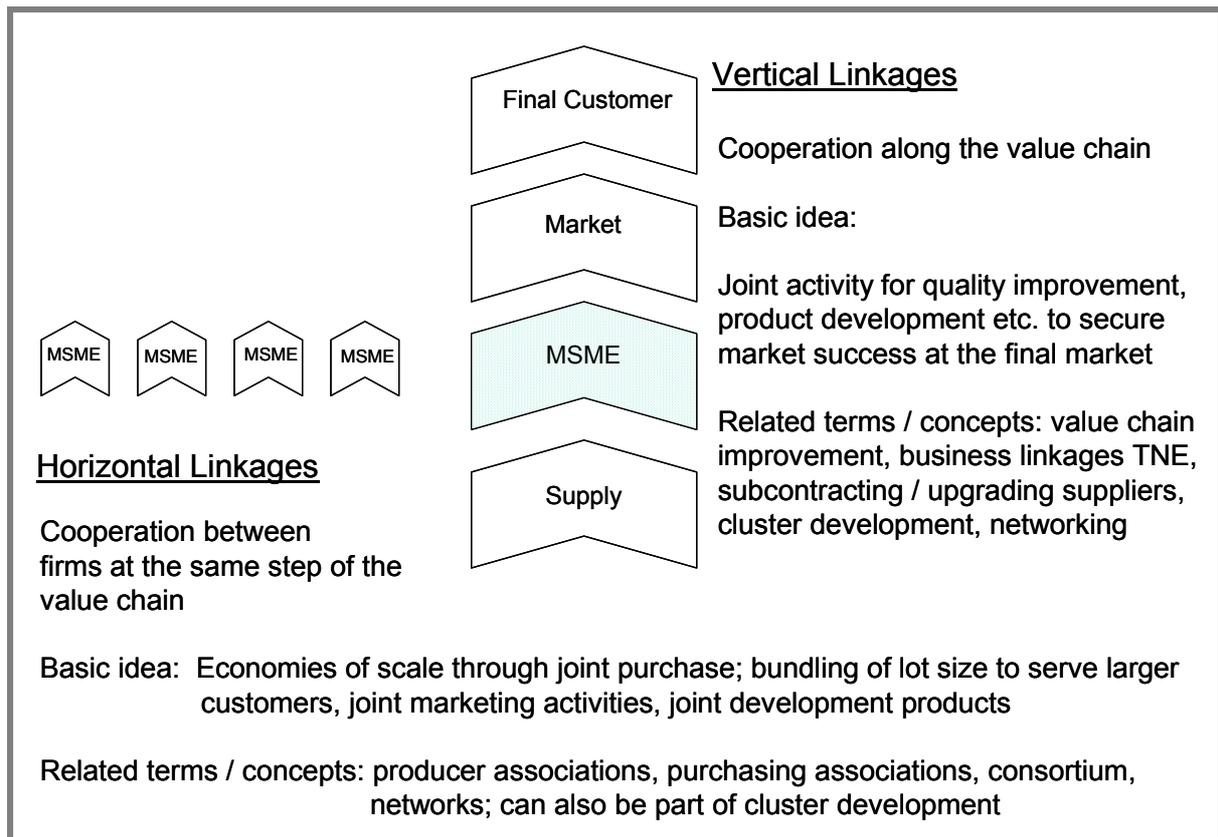
### **I.2 Horizontal and vertical business linkages**

Collaborative business linkages between enterprises evolve out of mutual interests. Enterprises join a formal or informal group with the aim of bringing about a win-win situation for the parties involved. Business linkages can have a formal or informal character. It can be

stated as a general rule that 'institutional character follows strategy'. If the cooperation has a long-term character and involves significant resources, legal institutionalisation with written rules and sanction mechanisms is preferable.

Business linkages are especially advantageous for MSMEs because, by cooperation, they can overcome the limits set by size. The following graph shows the two directions of collaborative business linkages:

**Graphic 1: Overview of horizontal and vertical linkages**



Horizontal linkages are cooperative-type of activities between firms on the same step in the value chain. The underlying economic imperative is that

- the individual firms are too small to implement economies of scale in purchasing (benefit to MSME: reduction of the purchasing costs)
- the individual firms are too small to have the scope to serve certain customers (benefit to MSME: new market; increased turn-over)
- by cooperation, the marketing costs can be reduced through joint trade fair attendance or by producing a joint catalogue (benefit to MSME: reduction of marketing costs and further marketing reach) or

- it allows for joint development of products and advent of an umbrella brand name (benefit to MSME: new market; increased turn-over)

Horizontal linkages often have a formal character. Purchasing associations play a prominent part especially in retail. The bundling of lot size in institutionalised cooperation agreements plays a role in agriculture; in other cases, the formation of consortia is important in handicrafts, for example, to serve public customers.

Vertical linkages are cooperations between firms along the value chain. The underlying economic reason for this is that, by co-operating, success in the destination market can be enhanced. This arises through the reduction of costs in the value chain and/or quality improvement, e.g. by

- the definition and meeting of certain quality, environmental and social standards (benefit to firms: reduction of losses and improved consumer satisfaction)
- the creation of communication channels e.g. interfaces, and the resulting increase in information flow (benefit to firms: reduction of the costs of warehousing in the value chain and higher consumer satisfaction through punctual delivery)
- joint action for product improvement in the value chain (benefit to firms: maintenance of consumer satisfaction)
- joint action for the development of new products (benefit to firms: new markets and the ability to keep pace with dynamic technological changes as well as changes in the buying behaviour of the end consumers)

In the context of horizontal and vertical business linkages, two terms need to be distinguished: value chain and cluster.

A value chain is a sequence of activities involved in transforming raw materials into a product that is acquired by the final customer. Parts of the value chain can be concentrated locally but the value chain as a whole is normally stretched over several regions and/or nations.

Systematic upgrading of vertical linkages between the enterprises along the value chain can be done without public support. Firms invest time, money and knowledge out of their own interest. This is especially true in either buyer-driven (typical for consumer goods) or producer-driven (high technological requirements) value chains. It is due to the fact that the management of value chains can lead to competitive advantages (unique selling points) that are difficult to match by the competitors<sup>2</sup>. This is a strong economic incentive for the lead firms of a value chain to manage linkages actively.

The upgrading or establishment of value chains has been a focus of donor agencies's PSD support in recent years. A major objective for the development community is to open up

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<sup>2</sup> Porter, M.. (1985): Competitive Advantages, p. 49 et sqq.

markets for either farmers or local MSMEs by linking them to global or national value chains. This often involves Public-Private Partnerships (PPP), i.e. through cost-sharing approaches between international buyers and donor agencies.

A cluster is defined by a regional focus and a product group. Clusters evolve out of the comparative advantages of a region for a given product group e.g. textiles. The comparative advantage initially can be based on natural conditions (e.g. micro-climate for fruit or wine production), geographical factors (e.g. closeness to harbour for pick production), specific skills available in a region or other factors, such as population density. A cluster therefore contains a high density of MSMEs from the same sector. In more advanced clusters, there are large numbers of vertical and horizontal business linkages. In the medium- and long-term the evolution of innovation and specialized knowledge within clusters is of decisive importance for competitiveness. A continuous process of innovation can be fostered by the regional proximity of the players. This is supported by evolving specialized services e.g. BDS providers.

The range of clusters varies from incipient clusters at the one end of the scale to mature clusters at the other end.<sup>3</sup> In reality, clusters are to be located somewhere along the line between those two poles, with most clusters in developing countries at the incipient state.

**Chart 1: Ideal characteristics of incipient and mature clusters**

Criteria	Incipient Clusters	Mature Clusters
Location	urban informal, rural sites	urban formal
Technological level	low	high
Labour force	unskilled	skilled
Markets	local	global
Products	simple	sophisticated
Collaborative linkages	few to nonexistent	many
Surrounding support by e.g. BDS suppliers	non – existent or no linkages to existing support	intensive
Division of labour	low	high
Growth dynamic	stagnant	high

The regional proximity of firms with the same business activity is a worldwide phenomenon. However, it does not automatically lead to competitiveness of that business activity.

<sup>3</sup> Nadvi and Barrientos (2004), p. 9 et sqq. Also compare the their cited Gulati (1997) with the distinction “modern” urban clusters and “artisanal” rural clusters, Sandee (2002) with the distinction “dormant” clusters and “dynamic” clusters and Altenburg and Meyer-Stamer (1999) with the distinction “survival” clusters, “advanced mass production” clusters and “clusters of transnational corporations”. Within the latter the linkages between the transnational corporations and the local enterprises are weak or non-existent.

Firms in mature clusters are highly competitive in national or global markets. Thus, promoting clusters is an important economic development approach that is relevant for industrialised (Silicon Valley as a model) and developing countries alike. Cluster development approaches are generally characterized by:

- identifying the competitive advantages of a given region and the resident enterprises for certain products and services
- developing a joint strategy with participation of the local stakeholders
- linking the local PSD measures to the strategy
- fostering business linkages between the enterprises of this sub-sector and related sub-sectors and
- developing capacity of public and private business service providers.

### **I.3 Public support for promoting business linkages**

Although business linkages are advantageous to enterprises, they often do not develop on their own because of the investment involved. For enterprises to get involved in building up linkages, several preconditions have to be met:

- awareness of the opportunity on the part of the enterprises
- coverage of the transaction costs incurred in building up business linkages
- experience of, and therefore faith in, the advantages of collaborative actions

Because business linkages do not develop simply as a result of market forces, there is need for public support in enhancing their establishment.

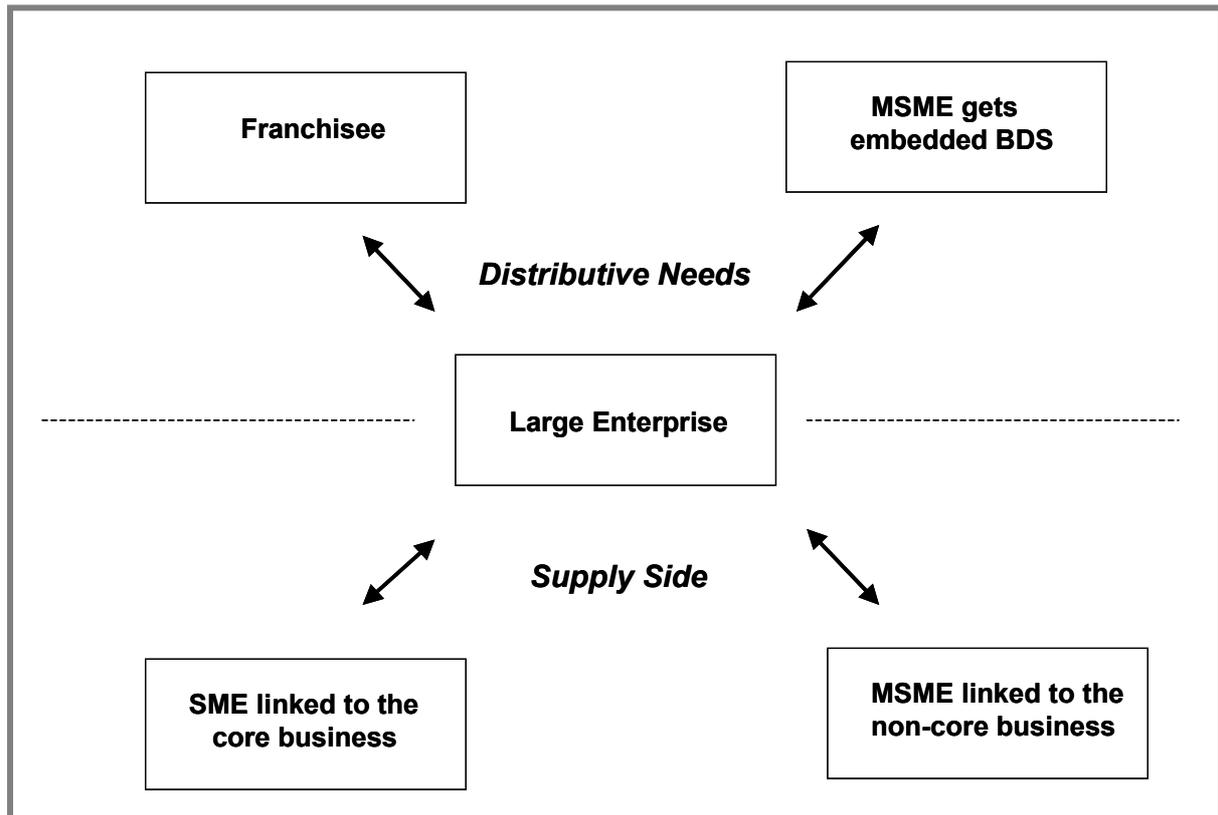
Moreover, business linkages support the process of innovation which is in the interest of governments as well. Continuous innovation and the increasing ability to adjust to rapidly changing market conditions are necessary pre-conditions for the maintenance of competitiveness. This is true irrespective of the size of the enterprise and the complexity of innovation, be it high technology or basic handicraft activities.

A third reason why the public sector should support the establishment of business linkages is that the evolution of collaborative business linkages strengthens the process of division of labour. By co-operating with other MSMEs, the entrepreneurs can more easily start to concentrate on their core competencies. This contributes to the overall competitiveness of the enterprises involved and a country's or region's private enterprise sector as a whole.

## I.4 Business linkages between enterprises of different sizes

Business linkages between enterprises of different size can have different specifications which need to be taken into account when supporting business linkages. The following graph gives an overview and distinguishes between business linkages based on distributive needs and those on the supply side.

**Graphic 2: Type of business linkages between enterprises of different size**



### I.4.1 Business linkages for distributive needs

Opening up the consumer market in a developing country can be very attractive for TNEs and large national enterprises. The end users can be poor households, small farmers or MSE. Within this context two typical patterns can be discerned:

- franchise-like systems
- embedded BDS to enable or further enhance the use of products

#### Franchise-like systems

With a franchise-like system, underdeveloped markets can be penetrated. The large enterprise typically has a product or service with a brand name. To bring the product or

service closer to the customer, a regionally dispersed distributional structure i.e. in form of large numbers of small retail outlets, street vendors or doorstep sellers is preferable. Distribution in such markets can be carried out most regularly and efficiently by single entrepreneurs or entrepreneurs with few employees.

The franchiser (large enterprise) supports its franchisees by

- association with the brand name and its advantages,
- elaborated business models
- training in basic skills such as pricing, stocking, forecasting, legal requirements, sales, customer relations and marketing
- preferential access to working capital and equipment
- innovative solutions such as transport bicycles or mobile coolers for vending.

The setting-up of one's own business within a franchise system is much easier and less risky than the development of a one-off business model. It is therefore especially advantageous for people with less formal education and less entrepreneurial experience and can be an attractive opportunity for poorer households. The distribution of benefits and costs depends on what is agreed in the franchise contract.

In 2000, Coca-Cola started to establish a franchise-like system in South Africa. As a result of the program, 7000 people were trained and 6.500 outlets emerged. In total, 12,900 jobs were created within the Coca-Cola System. Coca-Cola's main partners were the local bottling companies. State involvement was restricted to the reduction of taxes on sugar by the South African government.<sup>4</sup>

Generally, franchise-like systems can be left to market forces. There are strong incentives for the large enterprises to actively building up respective business linkages.

However, public support could be helpful in stimulating franchise fairs to promote the franchise concept. Through fairs potential franchisers and franchisees can meet and match. They regularly take place in developed countries organised by franchiser associations. If a national franchiser association does not exist in the developing country, the World Franchise Council or the German Franchise Association (DFV) could be a potential partner.

### **Embedded BDS to intensify or enable use of product**

Because of limited financial means, embedded BDS are often the only services at the disposal of micro- and small enterprises.<sup>5</sup> For TNEs or large national enterprises, delivering

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<sup>4</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p. 30

<sup>5</sup> Eiligmann (2005), p. 31

training and linking their customers to financial services are ways of enhancing their sales. The typical contents of embedded services are:

- product training with respect to effective use and safety considerations,
- financial arrangements to meet liquidity shortages arising from long drawn out production processes, and
- additional training in basic management issues e.g. financial planning.

An example is the activities of DuPont in Colombia. DuPont initiated a partnership with a group of organizations that focused on identifying the issues limiting the use of inputs in the case of small farmers. They identified provision of financial planning and soft credits as the best approach. As a consequence of this analysis, DuPont introduced the Integrated Agricultural Plan (PAID) to provide farmers with financial and commercial solutions, as well as technical assistance, through an integrated support system. The main positive impact for the small farmers is the reduction of risks. In this context, DuPont works together with the Ministry of Agriculture, Finagro, the Agrarian Bank and the National Agriculture and Livestock Board. It is therefore a typical example of joint effort being based on mutual interests.<sup>6</sup>

Donors can be the neutral facilitators of such public private strategic partnerships. For the embedded services to be advantageous for the MSE, the TNE or large national enterprise must be willing to establish a long-term customer relationship. If such willingness is there and based on sound economic consideration, service provision will result in a win-win situation.

#### **I.4.2 Business linkages on the supply side**

It is useful to distinguish MSME linkages to TNEs or large national enterprises as follows:

- linkages to the core business of the large enterprise
- linkages to the non-core business of the large enterprise

The core business of a company consists of those activities that create value; e.g. the production of textiles in the textile industry, whilst service activities such as transport, cleaning, and bookkeeping are non-core business.

##### **Linkages to the core business**

Generally, linking SMEs to the core business of the TNE is more demanding, as the quality of the supply to the core business is vital for the large enterprise. In exchange, the potential for growth is larger. The linked SMEs can grow in line with the growth rate of the larger enterprise's core business.

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<sup>6</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p. 28

If the core business of the TNE is involved, their hands-on involvement with the training and qualification process for upgrading their suppliers will be more extensive. The following case describes the training approach of the car manufacturer FIAT in India and it highlights the combination of on-the-job and class room training, study tours, and benchmarking.

FIAT linked their decision to set up of an automobile assembly plant in India with a push to give local suppliers adequate qualification. Qualified local suppliers were one precondition of the investment. The training programme covered a 9 month period and consisted of

- ten of days of shop-floor assistance spread over a certain time and concentrating on production process issues
- five days of additional classroom training on critical management issues e.g. human resource, environmental standards production, or production process benchmarking methodology
- two study tours to help benchmark the performance of participating enterprises
- an international study tour to Paris
- factory visits in France and Italy<sup>7</sup>

However, the involvement of the large enterprises in upgrading the supplier is subject to preconditions and depends on pattern of linkages to the core business<sup>8</sup>:

**Arms' length market relations:** Enterprises deal with each other in arms' length transactions. The product is standardised or easily customized. The suppliers are easily exchangeable. No economic incentive exists on the side of the TNE or large local enterprise to invest in the relationship. Cost pressure is high and the linkage does not lead to the opening up of a know-how based development path.

**Balanced networks:** Enterprises co-operate and have complementary competencies but no control over each other. This is typical for enterprises of comparable size, and rare between enterprises of different sizes and at different technological levels. The focus is on the joint development of new products and processes. This is a well-known relationship within innovative networks in developed countries. Local innovative networks of MSMEs, which focus on the local market, can also sometimes form this kind of relationship.

**Captive network:** The lead firm sets the parameters under which the linked MSMEs in the chain operate. These relate to the characteristics of the product and the specification of the processes. The relationship is quasi-hierarchical, and TNEs and large national enterprises have an economic incentive to invest in the relationship with the supplier. This is due to the fact that the lead firm pursues a strategy of product differentiation through design and branding and, therefore, needs to ensure that the suppliers meet the quality requirements. Increasing product cycle speed is another factor behind this phenomenon. Research findings

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<sup>7</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p.15

<sup>8</sup> Schmitz 2004, p.3 et. sqq.

have revealed that the membership of captive networks can provide a fast track development path for the MSMEs involved with respect to product and process upgrading.

**Hierarchy:** The local production units of TNEs are subsidiaries. Hierarchy linkages are necessary if complete control of the local production process is of decisive importance for the TNE.

To understand the potential of upgrading for the linked MSMEs, the ideal upgrading path is outlined as follows<sup>9</sup>:

The first step is process upgrading. The internal efficiency within the MSME increases and processes are mastered with respect to delivery time and quality requirements. This goes hand in hand with improved management capacity or the introduction of superior technology.

The second step is product upgrading. The capacity to produce improved or new products evolves. The sophisticated product lines can be defined in terms of increased unit values.

As mentioned above, process and product upgrading is imperative within captive networks. The lead firm invests out of self-interest.

The third step is functional upgrading. Functional upgrading refers to acquiring new, superior functions with higher value in the chain (e.g. branding, design, and marketing) or abandoning existing functions that have a low value added.. This step has been successfully accomplished by some East Asian firms, but it is generally the most difficult step which is not necessarily linked to being integrated into global value chains. This is partly due to the strategic governance of lead firms. Local supply firms are discouraged by their main buyers who have no incentive to share their core competencies in design, marketing etc. but seek to control the phases with the highest value added. However, power relationships may change and SMEs may acquire new capabilities and explore new markets. In addition, functional upgrading is influenced by the upgrading firm's strategic intent and its technical capabilities, marketing skills and financial/human resources. There is, however, no consensus about the determinants for functional upgrading.

Studies from India and Brazil indicate that firms specializing in national markets are more likely to develop their own designs, brands and marketing channels.<sup>11</sup> Arguments in favour of this strategy are the intimate knowledge of the local demand patterns and the resulting potential competitive advantage in the branding and invention of customized products for the local market. Necessary preconditions are sufficient local market size and adequate purchasing power.

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<sup>9</sup> Kaplinsky and Morris (2003), p. 38 et sqq.

<sup>11</sup> Schmitz (2004), p. 5

Finally, inter-sectoral upgrading can evolve. The enterprise moves into a totally different sector e.g. calculators to computers, with higher values based on their subsequently acquired knowledge or customer relationship.

### **Linkages to the non-core business**

Potential for increasing linkages to the non-core business of the TNE or large local enterprise evolves from outsourcing tendencies. These outsourcing tendencies are the consequence of increasing specialization and the paradigm of concentrating on the core-business for efficiency purposes. Often, relatively simple activities, such as cleaning or transport, are being outsourced. As these activities do not require high technical abilities, potential is created for informal sector enterprises with basic managerial qualifications.

Maximising efficiency, however, is not the only reason for TNE or large local enterprises to outsource non-core business activities. Political and public pressure may also influence investment decisions. An example is the commitment of BP to spend \$45 million by 2006 on social investment projects in Azerbaijan.<sup>12</sup> In Africa, TNEs interact more with the SME sector based in black communities due to the same reasons. Business linkages to the non-core business of TNEs are more likely than to their core business, because shortfalls and initial subsidies do not harm the core business directly.

Training schemes are of a more comprehensive kind, and the personnel of the TNE are less involved in the training issue. TNEs co-finance the training schemes or, as the case may be, training centres, and these training measures can, or indeed should, be linked to the build-up of a database of SMEs.

Anglo American established Zimele SME Support Program in South Africa in 2000:

- Within Anglo American Group companies, Business Development Officers (BDO) actively identify business opportunities for SMEs
- They support the SMEs in the tender procedure but are not involved in the adjudication process
- Provision of technical assistance , business planning services and the transfer of skills
- Loan finance and equity support to promising enterprises<sup>13</sup>

Generally, the growth potential for MSMEs linked to the non-core business is less than if they are linked to the core business. This is because the supportive activities do not increase proportionally to the volume of the core activities.

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<sup>12</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p. 18. Includes linkages to core and non-core business.

<sup>13</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p. 21

## **II. Business Linkages approach and pro-poor growth**

### **II.1 General considerations**

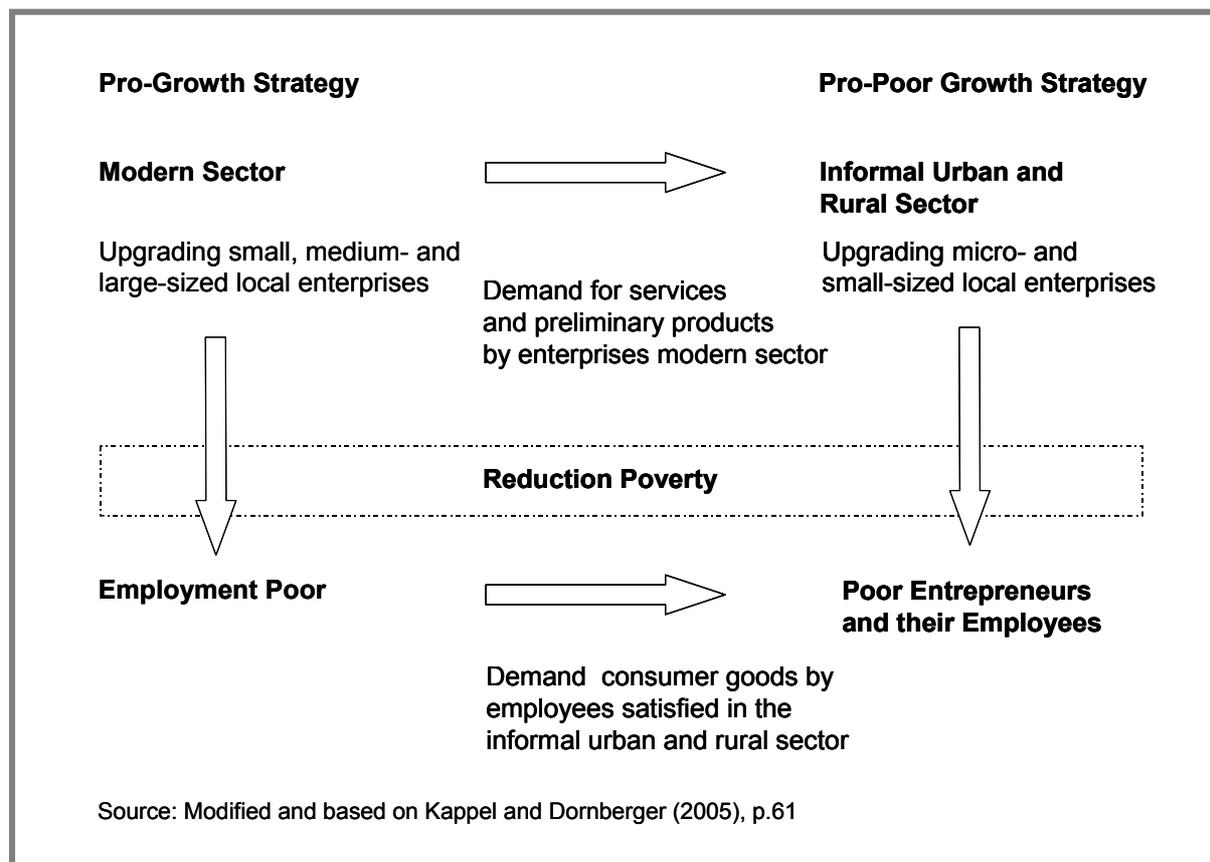
A pro-poor growth strategy involves two major ways of reducing poverty:

- 1) Providing employment opportunities for poor people
- 2) Opening up development paths for poor entrepreneurs

The potential effect in those two areas is used here to assess whether the business linkages approach can contribute to pro-poor growth. The assessment is based on the core recommendation by Kappel and Dornberger to make use of potential positive effects between a pro-growth and a pro-poor growth strategy by strengthening the business linkages between enterprises of the modern and the informal urban and rural sector. With growth in the formal sector, poor entrepreneurs of the informal sector can benefit from

- the rising demand for services and preliminary products from enterprises of the modern sector with respect to the core business and non-core business (business linkages)
- the rising demand for consumer goods from employees of the modern sector satisfied by the informal urban and rural sector (market opportunities)

**Graphic 3: Relationship between the modern and the informal urban and rural sector**



In regions of dynamically increasing employment opportunities, there is also considerable potential for supporting the entrepreneurs in the informal urban and rural sectors through micro-finance and customised BDS-measures. This will enable them to tap into the full potential of the market of rising consumer demands amongst employees.

Before discussing whether poor entrepreneurs can establish direct business linkages to the enterprises in the modern sector, there is need to look at the typical characteristics of enterprises of the poor which are their small size, their comparatively low technological and management skills and their limited access to assets.

The following table shows a definition of enterprises by size.

**Chart 2: Definition of size**

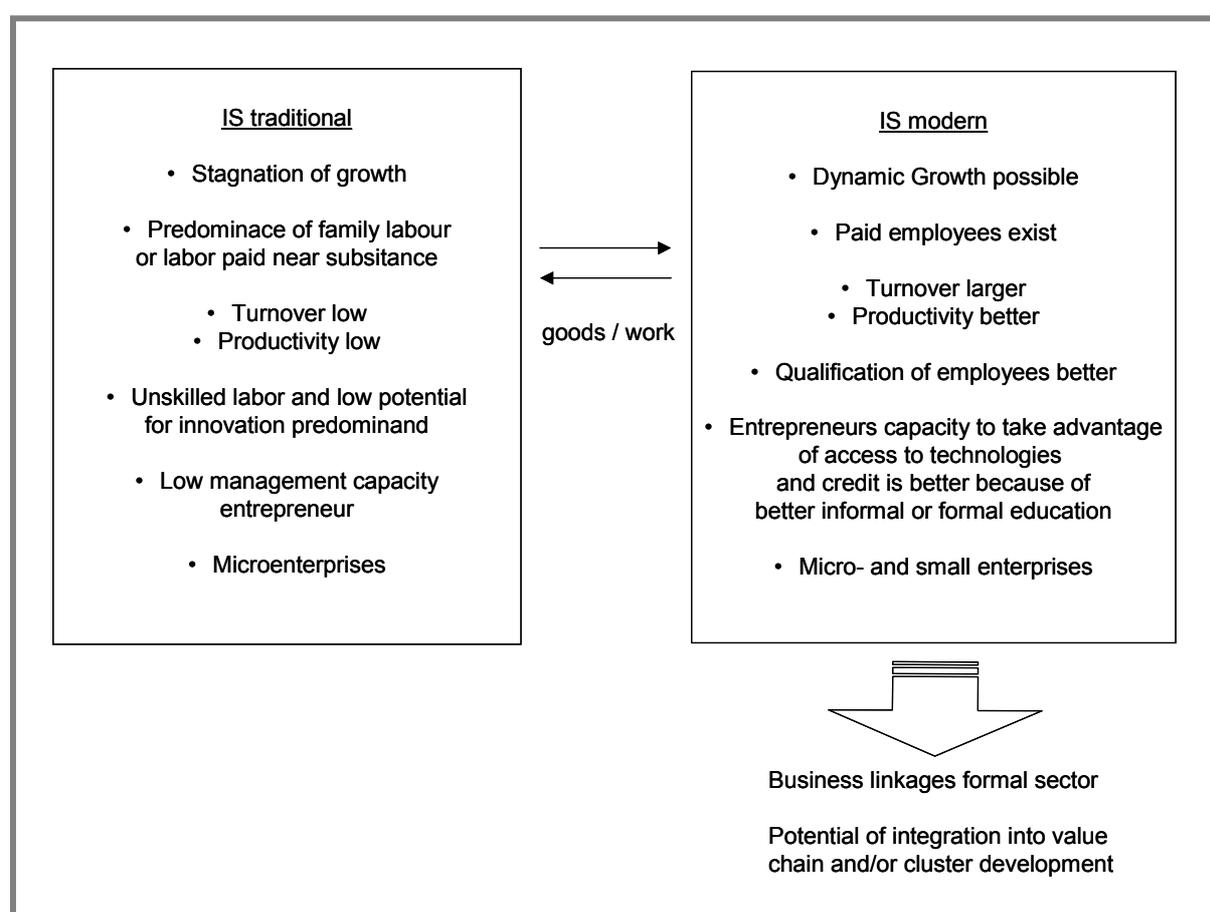
Name	Employees	Total Assets	or Sales
Micro Enterprise	< 10	< 100.000 \$	< 100.000 \$
Small Enterprise	< 50	< 3 Mio. \$	< 3 Mio. \$
Medium Enterprise	< 300	< 15 Mio. \$	< 15 Mio. \$

Source: SME Department World Bank

We assume that poor entrepreneurs normally belong to the group of micro-enterprises. It is important to clarify this, as the compatibility of enterprises linked by business linkages is not only a matter of level of management capacity and technology but also of size.

A further distinction between enterprises in developing countries is in whether they belong to the formal or the informal sector. Enterprises of the formal sector are officially registered, have better access to assets, and dispose over higher technological and managerial capacities. Their entrepreneurs normally do not come from the poor classes. These enterprises form the modern sector.

**Graphic 4: Characteristics of enterprises in the informal modern and the informal traditional sector**



The border between the informal traditional and the informal modern sector can be fuzzy with changes over time and transitory states. The border between the formal and the informal modern sector also depends on the local conditions of official registration, and can therefore differ widely from country to country.

Kappel and Dornberger postulate that there is development potential for entrepreneurs of the informal modern sector through business linkages with the formal modern sector. According to their recommendations, these business linkages should be supported by<sup>14</sup>

- transfer of know how and technology
- financing of growth
- cooperation and network management

The following chapters 3.2 to 3.6 suggest different types of business linkages from the point of view of pro-poor growth and discuss the extent to which the entrepreneurs of the informal modern sector can be integrated.

However it is assumed here that poor entrepreneurs from the informal traditional sector will not be able to directly take part in business linkages. This corresponds with the experience in micro-finance programmes. Evidence shows that it was possible to reach target groups close to the poverty line, but only if beneficiaries had a certain amount of assets and skills in order to successfully participate in the programmes<sup>15</sup>. The same applies to the business linkages approach: prospects of reaching poor entrepreneurs are limited by the required level of existing skills and assets.

The poor would then benefit from growth in the private sector not through direct linkages but through employment opportunities or by exploiting development potential as entrepreneurs. This will be distinguished further in the following.

## **II.2 Business Linkages embedded in cluster development**

The potential for business linkages can be better maximised within a supportive environment. One option is therefore to have the business linkages approach embedded into cluster development. In the course of cluster development, regional stakeholders reach agreement on priority branches and elaborate a regional action plan. This action plan includes measurements regarding BDS, finance, local enabling environment etc. and is therefore the supportive frame for developing business linkages.

Substantial evidence is available that cluster upgrading gives rise to increased employment opportunities, and that the wages within clusters are above the regional level.<sup>16</sup>

There is no clear answer as to whether incipient or more mature clusters should be given preferential support with respect to the pro-poor objective. On the one hand, dynamic growth processes are more likely to unfold in more mature clusters; on the other hand, the poor are

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<sup>14</sup> Kappel and Dornberger (2005), p. 47 and 65

<sup>15</sup> Eiligmann (2005), p. 8

<sup>16</sup> Nadvi and Barrientos (2004), p. 16 et sqq.

more involved with direct entrepreneurial activities in incipient clusters. However, in more general terms, cluster development will only succeed when a clear prospect of market growth can be demonstrated.<sup>17</sup>

Empirical evidence suggests that the development of clusters from incipient to more mature forms has both winners and losers. Particularly vulnerable groups e.g. unskilled workers, can be left behind during this process. At the same time, the rising purchasing power within the region can open up other income opportunities for these groups. Therefore, the effects on the poor should be monitored by mapping the bottlenecks of the poor within these clusters and by designing customised approaches to enable their participation.

### **II.3 Business linkages directed at global markets**

TNEs serve mass markets with large quantities, and the individual markets are characterized by precise customer segmentation (e.g. young fashion for H & M). Economies of scale are most important. There are three main arguments in favour of linking SMEs to the global value chains: growth dynamics, opening up of development paths and tapping the full potential of local content.

Growth dynamics: Direct and indirect job creation by TNEs, and their relevance, is increasing dynamically. Whilst estimates assumed a level of about 24 million employees in the foreign affiliates in 1990, this number increased to 54 million employees in 2001. This does not include independent suppliers<sup>18</sup>. In addition, linked local SMEs have access to the global market, and this is therefore an opportunity to participate in the growth rates of the global market.

Opening up of development paths: The economic incentives for TNEs to ensure adequate qualification on the part of local suppliers have been described above. The linkages can open up development paths; the concrete pattern must therefore be considered. Linking local enterprises to TNEs should therefore be connected to an upgrading strategy<sup>19</sup>. As analysed above, this concerns mainly product and process upgrading.

Tapping into the full potential of local content: It is assumed that there is considerably more potential for business to be done between local SMEs and the TNEs. At the moment, TNEs are still reluctant to develop linkages with local suppliers for fear that they should fail adequately to meet quality requirements<sup>20</sup>. This potential could be unleashed by public private partnerships between the TNEs and donor activities, if they combine their efforts to effect measures to enable the local SMEs to live up to international standards.

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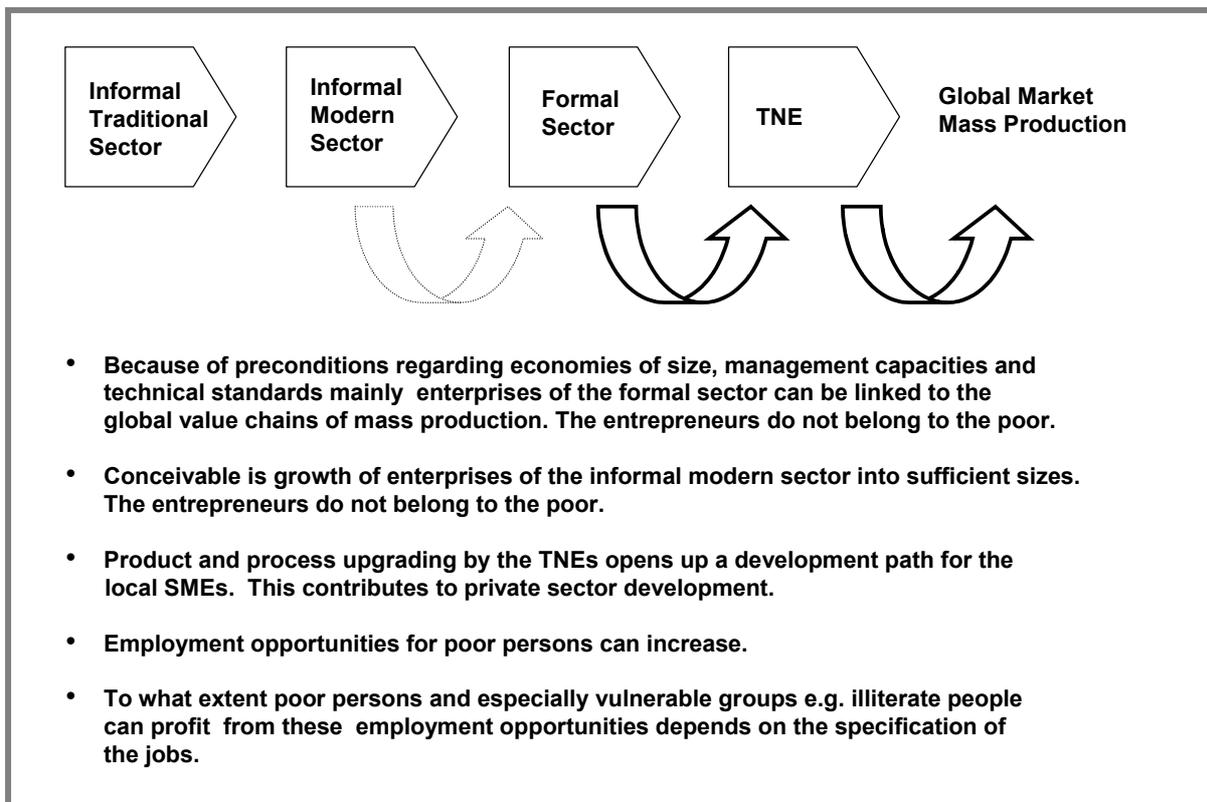
<sup>17</sup> Nadvi and Barrientos (2004), p. 43 et sqq.

<sup>18</sup> Mayoux (2005), p.2

<sup>19</sup> Kaplinsky and Morris (2003), p. 18 et sqq.

<sup>20</sup> Russo (2002), p. 15

**Graphic 5: Linking local enterprises at the core business of TNE**



With reference to the aim of pro poor growth, several arguments have to be stated:

- The entrepreneurs capable of exploiting this opportunity do not belong to the poor. This is due to the fact that the capacity to fulfil the requirements of the TNEs goes hand in hand with preconditions regarding size, management ability and technical standards. The typical local enterprise linking directly to the international value chain is bigger than other micro- or small-sized enterprises and belongs to the formal modern sector.
- The number of jobs increases because a growth path is opened up for local enterprises. Subject to the concrete working conditions (wages, safety standards, working hours etc.), the creation of these jobs can contribute to the reduction of poverty. In this context, two tendencies in favour of this job creation can be mentioned: (1) Economic damage to the TNE can be substantial if the production of consumer goods in poor working conditions - "sweat shops" - becomes public. For this reason, the TNE can become an advocate for the improvement of working conditions. (2) The fulfilment of quality requirements depends on good management including human resources management. This can lead to a change in attitude by the management, moving away from seeing the work force as a pure cost factor to regarding it as a partner for quality.
- To what extent poor households and especially vulnerable groups e.g. illiterate people can profit from these employment opportunities depends on the specification of the jobs.

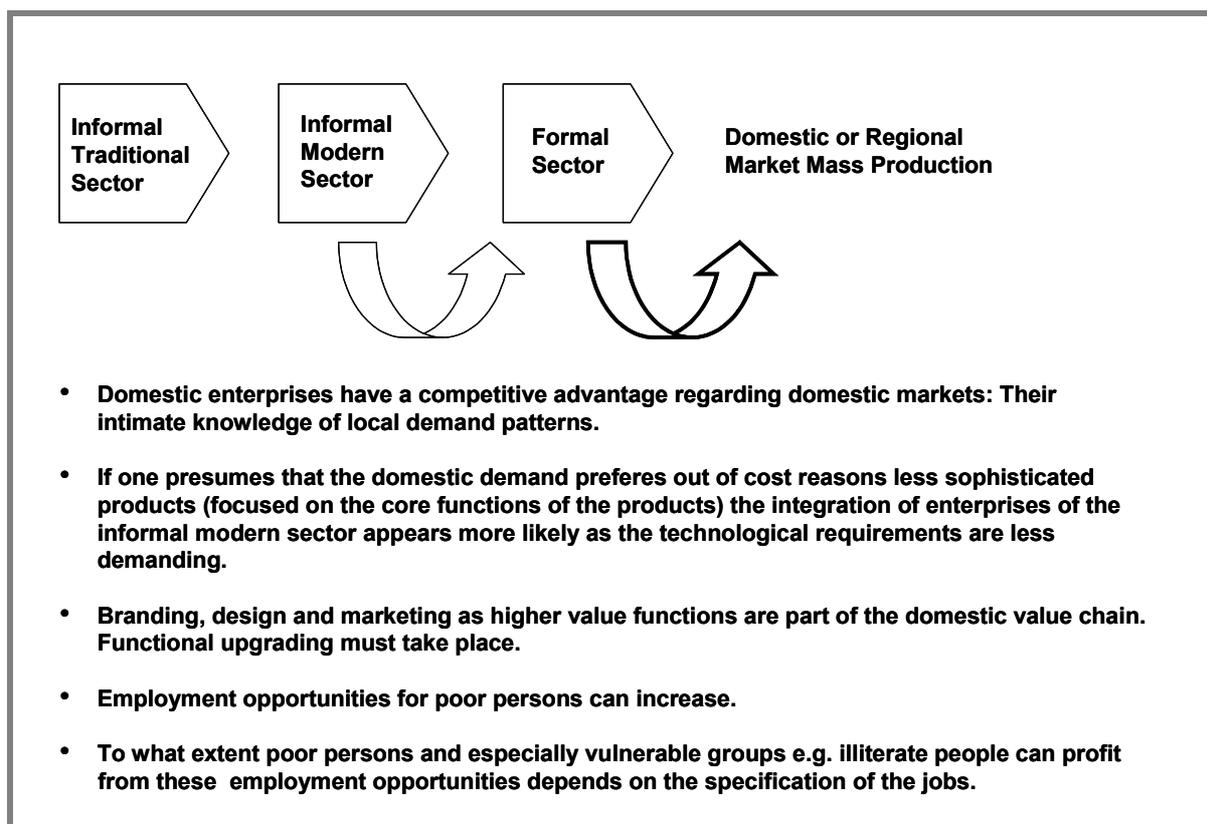
- Demand for simple products and services from the informal sector is increasing. This concerns employee demand for consumer products and, in part, preliminary products. The micro- and small-sized enterprises from the informal sector can also therefore benefit from the increasing purchasing power within the region.

Taking all these arguments into consideration, it is recommended that business linkages between local enterprises and the core business of TNEs be fostered, also with a pro-poor objective. The main argument is the rising employment opportunities for the poor. But the effects on the poor i.e. the vulnerable groups such as women and unskilled workers, should be followed up by mapping the bottlenecks of the poor within these linkages and the design of customized approaches to enable their participation.

#### **II.4 Business linkages directed at domestic markets**

Large developing countries like India, Brazil or Indonesia have attractive domestic markets. Strategies to upgrade value chains or clusters with the focus on this market potential are promising. The domestic enterprises have competitive advantages because of their intimate knowledge of local demand patterns.

**Graphic 6: Upgrading domestic value chains aiming at domestic markets**



Based on this intimate knowledge, development and branding of adapted products and services can be very successful. If it is supposed that the products manufactured for the domestic markets have a tendency to be less technically sophisticated - focusing on the core functions of the product (e.g. cars and bikes mobility) with fewer frills - then the production process is less demanding. This makes it easier for enterprises from the informal modern sector to start the growth process to enable their integration into the value chain.

The building up of domestic value chains requires horizontal networking (joint product development) and vertical cooperation along the value chain. It is also recommendable to integrate foreign enterprises disposing of special competencies case by case.

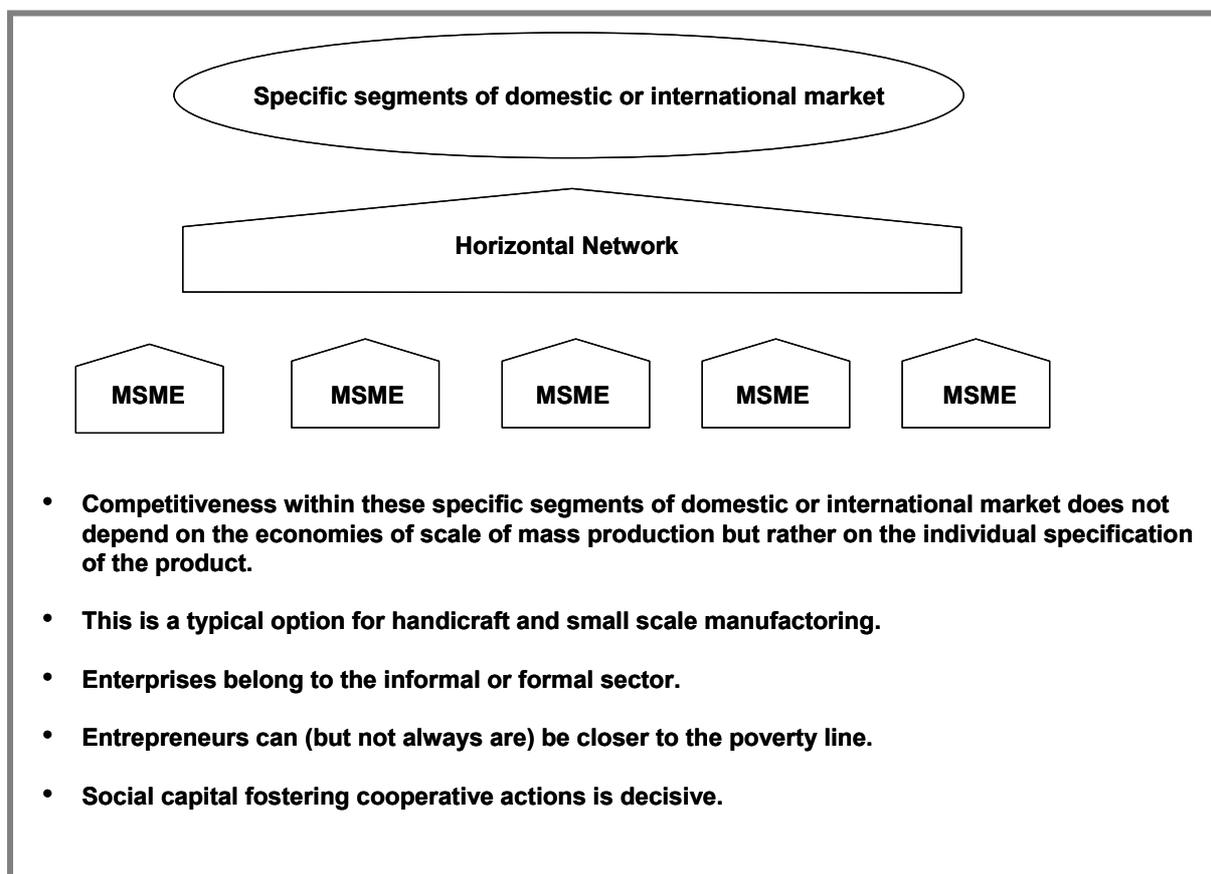
The support of domestic value chains aiming at domestic markets can make for a very interesting approach. Again, the effects on the poor i.e. the vulnerable groups like women and unskilled workers, should be followed up by mapping the bottlenecks of the poor within these linkages and by designing customised approaches to enable their participation.

## **II.5 Business linkages directed at specific small market segments**

The focus is on specific small market segments not sufficiently served by standardised mass production. Economies of scale are of minor importance – instead, the customised specifications focused on specific customer groups are central. Typical examples are arts

and crafts products, whose markets can be served by small enterprises. Their typical strengths of flexibility and of a high proportion of handmade product components are advantageous in these specific small market segments. The customers can either be domestic or foreign. Of central importance is the focus on their specific preferences.

### Graphic 7: Horizontal networks aiming at specific small market segments



Within this business linkages approach, the MSMEs of the informal modern sector and to some extent the MSMEs of the formal modern sector are the major target group.

MSMEs cooperate in horizontal networks to upgrade their product, focusing on specific customer preferences. This regularly includes changes in the production process, the inputs utilised, the specification of the product, and the invention of an umbrella brand name.

**Horizontal networks aiming at specific small segments of domestic or international markets are a promising option for micro- and small enterprises.**

## II.6 Agricultural value chains and rural markets

As mentioned in the introduction, the empirical evidence has shown that countries supporting the development of their agricultural sector have made above-average advances in the

reduction of poverty. This is because the majority of the poor lives in rural areas and earns its living from agriculture. Again, improved market access is the focus of the business linkages approach in agriculture. This involves several interconnected actions:

- Bundling of lot size at production level e.g. the farmers themselves. This is necessary to provide the processing units with a sufficient amount of a defined quality
- Recruitment of investors for the development of local processing units to make sure that a larger part of value within the value chain is produced in the developing countries.
- Opening up of export markets through trade fairs and further marketing activities. To be successful, prior exhaustive market analysis is necessary.

Poor households can benefit from business linkages along the agricultural value chain in the following ways:

- Small farmers can increase their income
- Unemployed rural workers benefit from the opening-up of employment opportunities either at the farms or in the processing units
- Increased rural incomes contribute to the demand for consumer products and services and for the demand for agricultural inputs (Agricultural Demand Led Industrialization (ADLI)).

As the majority of the poor lives in rural areas and earns its living from agriculture the promotion of business linkages contribute to the pro-poor objective.

### **III. Overview of tools to support Business Linkages**

The initiation of collaborative business linkages is the focal point. The chapter therefore starts with the experience gained through using methodologies to facilitate cluster and network management (chapter 4.1). Almost all donors have the issue of business linkages on their agenda, although the issue is of higher priority for some than for others. As UNIDO has the most comprehensive approach, we shall start by presenting their methodology and the lessons learnt. In addition, an insight into European experience is given by presenting the German approach “Innoregio” and the follow-up “Unternehmen Region” for the new federal states. Both examples serve to guide the elaboration of the instrument presented in Chapter 5.

In addition, facilitating the management of cluster and network by supportive instruments can be of use. Chapter 4.2 introduces two examples of the financial instrument public private partnership, chapter 4.3 presents the instrument databanks and matchmaking and chapter 4.3 deals with methods of group consultancy. The presented benefits and limits of these supportive instruments also guide the elaboration of the instrument presented in Chapter 5.

#### **III.1 Facilitation of cluster and network management**

##### **III.1.1 The example of UNIDO**

UNIDO began its program “Development of Clusters and Network of MSMEs “as early as 1993.<sup>21</sup> The programme is the most comprehensive within the international donor community. It supports the development of clusters, and horizontal and vertical networks by facilitating the management process. The program has a clear focus on MSMEs. The majority of the documented examples deal with MSMEs from the handicraft sector. As the programme has matured, topics closely related to cluster and network promotion have been covered. In 2003 a guide to export consortia was published, and a report on synergies between cluster development and micro-finance was completed in 2005. The link between industrial districts and poverty reduction has been the subject of recent research.

A characteristic feature of the programme is the reliance on brokers. These brokers have a central role as facilitators for the establishment of the networks and the initiation of joint actions within the clusters.

Which institution in the target country takes over the brokerage role varies from case to case. Sometimes it is a local SME development agency and in other contexts it is a business association or an NGO. As a rule, the UNIDO projects recruit local consultants in the initial stage, train them and subsequently equip them to train other brokers. This is for the purpose of sustainability after the withdrawal of the UNIDO projects.

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<sup>21</sup> For detailed information see Ceglie and Dini (1999), Russo (2002), Ceglie (ed.), Dawson and Paris (2003) and [www.unido.org](http://www.unido.org).

To disseminate the idea of cluster and network development (CND) and associated methodologies globally, annual two-week training courses aimed at government officials and MSME practitioners from developing countries have been developed jointly with ILO. They are held in ILO's International Training Centre in Turin.

The methodology imparted to the local counterparts consists of a whole set of tools designed for three distinct situations:

- (1) Horizontal networks
- (2) Vertical networks
- (3) Clusters

For networks<sup>22</sup>, a manual on network promotion has been developed. This manual is intended to assist the network brokers. It focuses on the conceptual framework for network promotion, operational steps involved in development process, players and institutions needed for its implementation, and examples of networks and network brokers.

For the promotion of horizontal networks it distinguishes between 5 phases:

1. Promotion and motivation activities for the potential network partners
2. Assistance in strategic planning of the network activities
3. Pilot projects (usually short-term activities to engender confidence and trust)
4. Strategic projects (of longer-term and more strategic nature)
5. Self-management phase

For horizontal networks the network manual is complemented by

- Guidelines on how to elaborate network business plans
- description of the legal forms the networks can adopt
- guidelines to brokers on some practical aspects such as promotion of leadership, group dynamics or conflict resolution

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<sup>22</sup> The term network in the terminology of UNIDO refers to a group of firms that co-operate on a joint development project - complementing each other and specializing in order to overcome common problems, achieve collective efficiency and become established in markets beyond their individual reach.

A typical *example* is the network EcoHamaca in Nicaragua. 11 enterprises formed a network, which currently exports 3000 hammocks monthly to the USA and European countries. There was no previous export experience. To get to this point, the 11 enterprises agreed on standardization of the hammocks to meet quantity targets suitable for export. Analysis of the export market led to an ecologically driven strategy. They switched from chemical dye to natural dye and the wood used was changed from cedar (due to the threat of extinction) to other more abundant exotic types of wood. In order to consolidate results and further common work, the network has acquired legal status and hired a manager.

For the promotion of **vertical networks**, four distinct phases have evolved:

1. Evaluation of potential and current suppliers
2. Round table talks between the client and supplier firms
3. Detailed analysis to determine areas of improvement within the suppliers' operations
4. Integrated improvement plans

The focus in vertical networks is clearly on the upgrading of suppliers' capabilities. As a rule, the larger client enterprises are incorporated right from the start. The existence of a client company is a strong incentive for the SMEs to undertake the necessary changes.

Client firms have also frequently been trained in the methodology because, once they have experienced the advantage of working with local suppliers, they become interested in continuing beyond the end of the project. For the development of vertical networks the network manual is complemented by

- guidelines on how to conduct enterprise audits,
- tools for assisting seminars on strategic planning
- modern management techniques etc.

A typical *example* is the activities in Mexico. Together with the counterpart institution (business association in the one case and chamber of commerce in the other) technical support centres were set up with three tasks:

- to help enterprises to identify subcontracting opportunities
- to co-operate with the technical personnel of the lead firm on the definition of support programs targeted at upgrading the capabilities of the identified subcontractors
- to identify and channel technical support, training and loans (when required) from locally available institutions to the subcontractors to assist them in meeting the requirements of the main contractors

The financial costs are shared equally between the private sector counterpart, the state government, and the programme of industrial integration.

The network tools are supported by two training courses (one for horizontal, one for vertical networks) to develop the capabilities of the brokers. They consist of a mixture of classroom

training and supervised fieldwork for the duration of one year. These elements are complemented by local learning forums to promote the exchange of experience between brokers.

Finally, NET – Network Evaluation Tool complements the tool kit for the foundation of networks. It consists of a matrix containing the various phases of network establishment and seven indicators: group cohesion, internal organization, strategic analysis capability, strategic planning capability, restructuring of production, economic performance, and the ability to connect to the institutional environment. As an instrument, it is supposed to provide a guide to the various steps of network establishment, and is at the same time used to evaluate the network performance.

For the support of cluster<sup>23</sup> development, a set of tools has also been developed. The cluster development methodology helps practitioners to initiate a participatory process with the following phases:

1. Cluster diagnostic analysis regarding
  - production system composed of firms engaged in production, their suppliers
  - and buyers
  - skill development system
  - institutional coordination and enterprise representation system
2. Identification of a joint vision
3. Prioritisation of activities
4. Implementation and monitoring

These clusters are regularly characterised ex-ante by low levels of trust, latent conflicts, and cut throat competition between firms. Therefore, the establishment of a participatory approach based on dialogue is essential. As mentioned above for the networks, the typical pathway within cluster development is a progression from short term-projects with low investment requirements (time and money) on the part of the parties involved to more strategic and long-term activities.

The cluster diagnostic analysis is enriched by case studies of performing and under-achieving clusters and by a set of modules dealing with specific problems such as

- low information technology penetration

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<sup>23</sup> The term cluster in the terminology of UNIDO indicates a sectoral and geographical concentration of enterprises, which produce and sell a range of related or complementary products and are thus faced with common challenges and opportunities.

- low process and product quality
- low levels of managerial and technical skill etc.

A methodology to assess the impact of cluster development actions on the levels of

- firms
- their associations
- the cluster as a whole

The cluster development methodology is the basis of a two-week classroom training for cluster brokers and six weeks of supervised fieldwork.

Particular emphasis is placed on the integration of the regional support services. Often they do exist but are not sufficiently linked to the MSMEs.

A typical *example* is the case of hand-block printers in Jaipur, the capital of Rajasthan. Approximately 550 small firms engage in both hand block and screen-printing and provide employment for almost 10,000 workers. A diagnostic study conducted by UNIDO in 1997 identified an unexploited capacity for the traditional artisans in the cluster to target profitable national and global markets. The following necessary actions were identified

- reducing the cluster disarticulation, i.e. lack of communication between the cluster players
- enhancing the design, production and marketing capacity of the firms; as the hand-block printers had grown accustomed to working as sub-contractors for exporters, they were lacking these capabilities
- developing a product image including a common brand in line with current market demand
- improving and increasing the types of business support services available in the cluster, and
- improving access to credit.

As part of the process, the local artisan association, Calico Printers Cooperative Society (CALICO), was revitalized. The membership increased from 26 to about 120. A common show room was set up, an export consortium – Consortium of Textile Exporters – (COTEX) – was founded and several networks were formed.

The mobilization of support institutions was a very time-consuming process. No initial interest was shown; the cluster approach and the projects identified by the entrepreneurs had to be presented repeatedly. The ice was broken when the first support institution (National Bank) made a 15 % contribution to the costs of participation of cluster artisans in a local fair in Jaipur city. Altogether, a lot of energy had to be invested to get the communication channels working between the support institutions on local and national level and the cluster. Success can be measured by the pro-active interest, stimulated by the process, shown by the support institutions in working with the cluster. They nowadays pro-actively ask which the current initiatives are and how they can contribute financially and technically.

In addition to cluster development methodology, a local development methodology was adapted from it for application in regions with more sectorally dispersed firms. It aims at promoting collective efficiency and joint actions in less developed regions in poorer countries.

Finally, the cluster development methodology is complemented by the idea of cluster-to-cluster learning. This is facilitated by bringing stakeholders from less developed clusters into contact with stakeholders from advanced clusters.<sup>24</sup>

### **III.1.2 Lessons learnt by UNIDO**

UNIDO's CNP can look back on a long period of implementation. Lessons learnt are based on wide-ranging experience and they are quite well documented. The following sums up the lessons learnt<sup>25</sup>:

#### **Time frame**

CND is a long-term process and not suitable for quick returns. Short-term activities are a good way to stimulate interest and participation as a starting point, but substantial impact on competitiveness depends on the switch to strategic projects.

The time requirement is closely linked to the fact that CND projects imply the establishment of a new culture of cooperation both among enterprises and between enterprises and other players in their institutional environment. The period of intervention must therefore be sufficiently long for internal dynamics within the cluster to change. As a general rule this will not be possible in less than three years.

The decision in favour of the CND approach is therefore a strategic one demanding a longer-term donor commitment. Otherwise the impact can fade quickly.

#### **Economic sense and methodology**

CND interventions must have a clear business orientation. Networking must aim at visible improvements in the economic situation and prospects of the participating MSMEs, and the networking must grant the group a new comparative advantage, which the MSME can not secure alone.

Typical incentives for the entrepreneurs are crisis and market opportunities. Within the CND approach, the emphasis of the activities must be on growth constraints. As these growth constraints are variable, the CND interventions must have a demand orientation. In UNIDO's experience, project strategies must be flexible and vary from network to network and cluster to cluster, depending on the nature of the constraints/objectives of the client base.

For networks to display their full potential, it is necessary to develop strategic projects. This points to the importance of process and project innovation, and structural improvement, as opposed to, for instance, an increase in sales resulting from occasional participation in a

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<sup>24</sup> Russo, F. (2002), p.21

<sup>25</sup> see Ceglie and Dini (1999), p. 19 et. sqq., Russo (2002), p. 18 et. sqq., Ceglie (ed.), Dawson. and Paris (2003), p. 23 et. sqq.

trade fair. The step to strategic projects does not occur by itself, but needs sufficient support from the broker.

### **Capacity development on the part of the brokers**

In UNIDO's experience, the best incentives for performance improvement on the part of the brokers have been training, learning forums and study tours to mature networks and clusters. This has proved to be a successful incentive, especially amongst young professionals. A framework for network brokers to work together is also important.

Transfer of knowledge should rely heavily on concrete cases of successful networks and clusters. To this end, UNIDO has developed the concept of "Joint Learning Programmes" aimed at giving first-hand exposure to cluster and network agents from developing countries.

### **Financing**

A combination of public and private investment appears to be the best way to finance network development services. As the private partner also invests resources, sustainability increases.

The introduction of fees to be paid by the beneficiaries should be pursued as early as possible to secure sustainability. Progressively increasing the share of costs that enterprises have to cover is one way to support self-management capacities.

### **Relationship between networks and clusters**

Cluster and network developments are complementary and occasionally sequential. Networks promotion can be pursued as part of cluster development and, on some occasions, the initiation of network activities has, with intensification of this approach, led to cluster development.

Whether formalised networks or informal networks are preferable depends on the i) task at hand ii) the investment capacity of the potential participants iii) the extent of competition among the participants; and iv) the expected rate of return.

### **Working with support institutions**

The territorial or cluster dimension emerges with the involvement of BDS providers, business associations and governmental institutions.

All projects emphasize the importance of a healthy BDS market.

The role of the cluster or network broker has to be clearly defined in relation to the BDS providers. Particularly if the latter are weak, incentives arise to draw in the possible services of the former to get the project moving ahead. There has to be a good balance between so doing and slowing the pace by supporting capacity building on the part of the BDS providers.

To pay attention to the surrounding support services is a good pathway to greater local ownership and, ultimately, process sustainability.

Business associations can be a starting point for CND, but the creation of networks can also lead to the formation of business associations.

It has repeatedly been proved that the cluster development approach is an effective complement to the efforts of other MSME support initiatives e.g. BDS, finance, public-private partnership.

### **III.1.3 European example “Innoregio” and the follow-up “Unternehmen Region”**

A strength of GTZ from the viewpoint of partner countries is that they have insight into European experiences and, in particular, are close to the transition process in the new Federal States. The goal of the program Innoregio and the follow-up “Unternehmen Region” is the initiation of innovative processes that will lead to the development of new and competitive products. This is also an interesting topic for middle income countries. The example of Innoregio and the follow-up “Unternehmen Region” is therefore presented here.

The programme InnoRegio started at the end of 1999. Restricted to the new German federal states, it was designed to initiate regional networking between enterprises, research institutions and other local stakeholders for the development of new innovative products and processes. As incentive a fund of € 230.5 million was set up. Selected networks could get their projects co-financed. The following is based on the relevant literature and a background interview with the person in charge of the programme.<sup>26</sup>

The programme started with a bottom-up approach to mobilising potentially innovative people, institutions, and enterprises in the regions. The programme representatives went on a road show to present the initiative. The road shows were also advertised through other avenues than the normal private sector communication channels, such as chambers of commerce or business associations, e.g by inviting church representatives. Their aim was to initiate broad, and in some cases, unusual coalitions.

Based on this mobilisation, 444 regional initiatives applied for the funds. For application they had to hand in a rough outline proposal. Because of the broad mobilization process the number of applicants was very large. Many of the proposals did not really have an idea that seemed to promise economic sustainability. From these 444 regional initiatives, a jury selected 25 InnoRegios in November 1999, which entered into the development phase. Within the development phase, the regional initiatives could claim up to €150.000 for the specification of their concepts. The development process was followed every step of the way by facilitators. In October 2000, 19 InnoRegios entered into the funding phase, and 4 more in June 2001. Two InnoRegios did not manage at all to meet the quality requirements for the

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<sup>26</sup> Regionale Innovationsinitiativen; Neue Länder at Bundesministerium für Bildung und Forschung (BMBF); BMBF (2005) and BMBF (2004)

funding phase. The funding phase started in November 2000 and will continue until the end of 2006. Funding consists of two components:

- Constitution of a regional office. The regional office co-ordinates the activities of the regional network members and assists in the selection of joint projects. For the first two years all of the regional office costs were covered; after this period cost-sharing between networks and the programme began.
- Cost-sharing funding of the regional network projects within their given budgets. The individual projects needed the approval of the programme coordinator Projektträger Jülich PTJ

1044 regional network projects were funded (May 2005). The majority of them deal with the development of innovative products or processes.

The step from project ideas to project concepts qualified for funding was a difficult one; it was April 2001 before the first projects were able to start. This was due to the lack of applicant experience, problems in coming up with the required guarantees of financial stability on the part of the enterprises involved, and internal coordination problems within the InnoRegios. The start-up difficulties were overcome in most of the InnoRegios by 2002.

The experience with InnoRegio led to the design of the program "Unternehmen Region" with several modules. Each of the modules developed since 2001 aims at a specific step of the value chain in the creation of innovative products.

The modules *Zentren für Innovationskompetenz* and *InnoProfile* support activities at universities as a first step in the value chain for innovative products.

The module *Innovationsforen* supports regional networks at the early stage. Regional incentives get funding for the organization of a two-day conference. The conference is supposed to have a thematic focus related to the competitive advantages of the region. The participants are entrepreneurs, researchers and other local stakeholders. The conference is supposed to lay the foundation for further concrete network activities. Since 2001, 50 conferences have been supported. Out of the *Innovationsforen*, ideas for *Innovative Regionale Wachstumskerne* can evolve.

The *Innovative Regionale Wachstumskerne* consists of enterprises and their research partners. They are supposed to develop innovative products or processes together and to establish them successfully in the market.

The application process for funding is standardised and supports the elaboration of the business plan. The support consists of a series of standardized and facilitated workshops, a guide business plan and the opportunity to take advantage of consultancy support (cost-sharing) if necessary.

After this preparation phase, which can last up to one year, the business plan is presented in an assessment centre. Successful networks receive cost-sharing funding for the

development of the innovative products or processes. Since 2001, 17 initiatives have managed to reach the funding phase<sup>27</sup>. The module Innovative Regionale Wachstumskerne is accompanied by research into the success factors of the individual initiatives by the Malik Managementzentrum St. Gallen.<sup>28</sup>

The program InnoRegio was accompanied by research into the effects of the funding,<sup>29</sup> which was co-ordinated by DIW Berlin. We will concentrate on the major findings:

1. The program InnoRegio managed to initiate regional innovative actions. A significant number of network members are planning further collaborative activities after the funding comes to an end. Whether the specific funded InnoRegios will continue in the current form cannot yet be judged. The funding phase will last until 2006.
2. The specific InnoRegios have met with varying levels of success. The following success factors were identified:
  - Regions with a good basis of competitive and innovative enterprises and research institutions have shown better results, and the prospects for sustainability on the part of the collaborative actions are larger. The conclusion derived from the research is that, for the network approach to be successful, a minimum ex-ante potential within the region is required.
  - The individual benefit for the involved enterprises and research institutions has to be sufficiently great. Within the programme InnoRegio, an initial benefit was given by the funding, but the potential of the cooperation to succeed beyond the funding phase must also be demonstrable. Within this context, time is a decisive factor. The networking must result in quick gains in the initial phase. With increasing experience of the cooperation mechanism and of positive results, the willingness of the parties to stick with the process will increase.
  - If the regional potential and the individual benefit of the involved parties are granted, the third success factor becomes decisive: Professional network management.

### III.1.4 Conclusion

Considering the pro-poor growth objective, one might say that the lessons learnt by “Innoregio” and the modules of “Unternehmen Region” are not relevant in the quest for the development of an instrument to foster collaborative business linkages with a pro-poor objective. The interesting fact is that the lessons learnt show strong similarities with the lessons learnt by UNIDO, and an additional insight has been gained: the integration of universities as modules of “Unternehmen Region”. This could be adapted for middle income

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<sup>27</sup> also see [www.unternehmen-region.de](http://www.unternehmen-region.de)

<sup>28</sup> First results see Unternehmen Region 03/2005

<sup>29</sup> BMBF (2005)

countries in the form of the integration of technical schools and universities. The following similarities in the lessons learnt can be stated:

1. Sequencing of instruments: Analysing Innoregio and the modules of “Unternehmen Region”, it becomes clear that the initiation of regional collaborative business linkages is closely related to the sequence in which instruments are employed. This has already been mentioned in the context of the lessons learnt by UNIDO. Their experience was that cluster development sometimes emerged out of network activities, and, in other cases, the converse was true: cluster development led to network activities. It is therefore important to find out, as a first step, which network or cluster activities already have taken place, which persons or groups have been promoting collaborative actions, and to support the already existing motivation.

2. Benefit at the level of the enterprises: In both examples the importance of benefit at the level of the enterprises is highlighted. This arises from the costs of networking. Lessons learnt by UNIDO also highlight the necessity of a clear business orientation, and that the networks must rise up to the level of strategic projects which substantially improve the competitiveness of the involved enterprises. This will only lead to results if there is sufficient market potential for the branch or, as the case may be, the improved products.

3. Potential within the region: Cluster development and networks may be not the best instruments for disadvantaged regions, as the collaborative approach needs favourable conditions to unleash its potential. This should be carefully considered. It may be wise with respect to marginal, in particular remote, areas to concede that growth potential does not exist or to concentrate first on infrastructure measures e.g. roads.

4. Professional network management: The quality of cluster and network management is of crucial importance. This is the justification for supporting the capacity development in respect of this point, and for setting the focus on facilitators/brokers. Within this context, the focused BDS support will also be emphasized. As analysed above, market potential is central to success. For the identification of market potential, consultants should be used - firstly, because they contribute a different point of view and a set of professional methodologies, and, secondly, this saves time and reduces frustration on the part of the network or cluster members.

## **III.2 Public Private Partnership**

A relatively new and innovative approach within development concepts is the public private partnership. Here we will outline the British approach with the Business Linkages Challenge Fund (BLCF) and the German approach with the PPP Facility and integrated PPP. PPP Facility and BLCF are cost-sharing grants covering up to 50 percent of the total costs of the private partner within a joint development project.

### **III.2.1 Business Linkages Challenge Fond / DFID**

The Business Linkages Challenges Fund (BLCF) has been in existence since 2001. It provides companies in targeted developing countries with cost-sharing grants of between 50.000 and 1 million pounds sterling<sup>30</sup>. The focus is on the establishment of business linkages. The BLCF is financed by the British Government's Department for International Development (DFID), and managed by the Emerging Markets Group (EMG), with support from Deloitte offices in BCLF target countries, Enterplan Limited, and Project North East.

By sharing the risk associated with getting involved with the establishment of business linkages, the BCLF is supposed to boost the capacity of private sector to contribute to growth and to poverty reduction.

The following mechanisms are in place: applications to the BLCF must be spearheaded by a for-profit private sector enterprise; bids must involve two or more private sector entities, although it is the lead entity that completes the application formalities and becomes the contracting party when projects are funded; third parties can be involved in the implementation. For example, government agencies or NGOs can be linkages partners and support the implementation of the project. The BLCF is focused on 19 countries in Southern Africa and the Caribbean.

The BCLF is a competitive procedure and, in each bidding round, applications will be ranked according to the following criteria

- likely sustainability of project
- enhancement of the competitiveness and viability of participating enterprises so as to improve employment opportunities and increase exports of domestic sales
- improvement of the incomes and livelihoods of poor people
- extent of new private sector resources mobilised
- potential replicability of project
- degree of innovation in the project approach

An independent Assessment Panel makes the funding decisions. There is a broad range of projects that has been funded by BCLF. The last bidding round finished in March 2005.

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<sup>30</sup> Also see [www.businesslinkageschallengefund.org](http://www.businesslinkageschallengefund.org)

## Lessons learnt

A mid-term review of BLCF was conducted in 2005<sup>31</sup>. The following highlights the major findings. The general impression of the mid-term review was that the fund concept is relevant as a means of engaging with the private sector as a partner in development issues.

**Impact:** It has to be noted that 30 out of the 53 projects are still ongoing. Therefore impact can only be judged to a limited extent.

- It is expected that the purpose of contributing to business competitiveness will largely be achieved.
- The aim of strengthening the links between micro-enterprises (benefits of globalisation to be secured for, and by, the poor) and the BLCF projects is only likely to be achieved to a limited extent.
- Two projects have already managed at this early stage to have an overall impact by making an impression beyond the confines of the project<sup>32</sup>. This can be judged a success, as the overall impact can regularly take a long time to become clear.

Bearing in mind necessary preconditions concerning size, management capacity and the technological level of local SMEs linking to TNEs (see chapter 2.4 and 2.5), the findings with respect to micro-enterprises do not come as a surprise.

**Demand for the funds:** It is worth noting that, by 2005, only 8.1 million pounds out of a total of 15.1 million had been disbursed, although approximately 14.9 million pounds sterling had been committed.

- This is, in the first instance, partly attributable to flaws in the design and in the performance of fund managers
- It may also be indicative of absorptive capacity in the target countries
- The fund proved to be particularly effective where full-time, dedicated resources were available and a pro-active approach prevailed. The pro-active approach increased significantly the quality and volume of applications<sup>33</sup>.

It can therefore be concluded that a fund approach should have pro-active representation in the target countries.

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<sup>31</sup> Engelhardt, A. (2005). The mid-term review was carried out in February and March 2005.

<sup>32</sup> In Mozambique the Mocit Citrus project initiated linkages between government and the wider business community beyond project level and the Thandi Fruit project in South Africa scaled up its operations from the Cape Province to the national level.

<sup>33</sup> For this discussion see also Deloitte Emerging Markets Group (2004), p.11 et sqq.

**Finance:** At 1:1.33, the average leverage ratio was good. The overall leverage ratio was impressive, with private sector investment totalling 34.5 million pounds sterling. This is a clear sign that private funding can be generated.

### III.2.2 PPP / Germany

The BMZ set up a PPP facility in 1999 to encourage cooperation between German and European investors and business associations and development agencies in developing and transition countries. PPP projects are planned, financed and implemented jointly by the private and the public partners. Two preconditions for financing PPP are the project's sustainability after the cost-sharing phase and its impact on development goals. PPP projects today cover a wide range of topics from environment to public health. Unlike the BLCF, the facility is not specialised. The PPP facility is financed by a special fund within the German federal budget.

The second PPP instrument is the so-called integrated PPP. This is a cooperation between domestic or international enterprises and GTZ projects in the developing country. This opportunity is open to all enterprises independent of nationality. The funds for integrated PPP are part of the GTZ project or program's budget.

GTZ experience with PPP has revealed the following pattern:

- The role of the donor tends to be that of a facilitator.
- GTZ can match the relevant partners (enterprise, public entity, other stakeholders) and is respected because of its neutral position.
- GTZ, besides its neutral position, should be the advocate of the development goals e.g. poverty reduction, and gender and environmental issues.
- GTZ personnel is highly regarded by the private partners, as far as the facilitator role and communication abilities are concerned. The trust of the local stakeholders and the intimate knowledge of local conditions are also important assets.
- Successful public private partnerships regularly have a long preparation phase. Within this preparation phase, the local GTZ personnel are of paramount importance because of their co-ordinating role, which can be very time-consuming.
- Upon the start of the implementation phase, the role of GTZ should be, and is, very restricted. The private partner has the leading role and the responsibility, and the role of GTZ is limited to overall co-ordination, conflict management, and monitoring and evaluation.
- Enterprises anticipate economic advantages. Otherwise they do not get involved in the public private partnerships.

- PPPs support sustainability because the private partner will only be willing to bear part of the costs if he expects returns beyond the project phase. This has a positive effect on the detailed design of projects and increases overall impact.

### **III.2.3 Conclusion**

Public private partnership is a relevant tool to support the establishment of collaborative business linkages, especially as far as joint actions with large enterprises are concerned. As the latter act also out of self-interest – and this should be a precondition for ensuring sustainability – they are open to cost-sharing approaches. The role of the donor is primarily one of facilitator and matchmaker.

## **III.3 Databanks and matchmaking**

### **III.3.1 Overview**

Instruments presented thus far aim at establishing collaborative business linkages. Databanks and matchmaking simply lead in the first instance to business contact and market transaction.

Internet-based databanks open up a search path either for potential buyers or sellers. In the simple version, they basically function like the yellow pages. MSMEs fill in their company profiles and what products or services they have to offer. The quality of the databank depends on the directory. It is advisable to have search functions differentiated into branch, products, regions and size of enterprises. The maintenance of a databank can be a labour-intensive task for the hosting institution. Firstly, MSMEs have to be encouraged to become listed in the databank. Secondly, a regulation has to ensure that the information about the MSMEs is up-to-date e.g. contact data, enterprise profiles, or that defunct MSMEs are deleted.

An additional feature is the establishment of a market place. Within the market place, enterprises fill in a concrete search request for products or services they are looking for or that they have to offer. Such an Internet platform has been developed by German Chambers of Commerce Abroad (AHKs) and GTZ in cooperation with several further partners.<sup>34</sup>

The main advantage of databanks is that they enhance transparency within markets and therefore reduce the search costs. They can be especially valuable in regions where enterprises have limited sources of information about possible business partners within their region, and can also enable first contact to take place between possible business partners across long distances.

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<sup>34</sup> [www.e-trade-center.com](http://www.e-trade-center.com)

They are a good basic initial instrument, but it has to be noted that databanks are no stand-alone solution. Evolving trust within business linkages is mainly based on face-to-face contact and personal experience. Their combination with face-to-face events focusing on common topics of interest or branch-specific issues can therefore be an option.

The reputation of the listed MSMEs can be enhanced by means of some kind of audit prior to admittance. This could be linked to qualification measures, although it has to be noted that such a procedure can lead to market barriers and is therefore problematic.

Databanks can be embedded into business linkages programmes connecting local suppliers with large enterprises and are used e.g. by SBP<sup>35</sup> within the private sector initiative (Psi) in Tanzania or as a component element of the BP Enterprise Centre in Azerbaijan.<sup>36</sup>

An interesting approach is the combination of the potential of the Internet with matchmaking procedures. The matchmaking institution schedules a date for a matchmaking event focused on a specific topic, e.g. public tender construction issues. The interested MSMEs register on the Internet platform with the products or services they have to offer, and the matchmaking institution makes appointments with potential buyers. The appointments take place at the matchmaking event, and the attending MSMEs present their offers face-to-face. At such a matchmaking event, the participating MSMEs can have anywhere between 3 and 10 appointments. The advantage is that these dialogues take place well directed. Such a matchmaking approach is followed by U.S. Small Business Administration, SCORE Counsellors to America's Small Business, in cooperation with Hewlett Packard. They combine this service with additional training with respect to general business issues such as marketing.<sup>37</sup>

A similar approach is pursued by the "Rueda de Negocios". GTZ developed this matchmaking procedure in Honduras in 2003 . 140 enterprises took part and 1.200 contracts were sealed. In 2005, a local institution (Consejo Hondureno de la Empresa Privada) was selected by tender. They will offer this service for MSMEs in the future. The matchmaking procedure consists of the following:

- a two day face-to-face event in which enterprises searching for suppliers and vice versa take part
- each participant identifies in advance which other participants they wish to meet, basing their decision on the attendance list
- participating enterprises are prepared in advance and can also take advantage of training with respect to presentation and negotiation

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<sup>35</sup> SBP (originally the Small Business Project) is registered in South Africa as a section 21 not for profit company. Together with BP Tanzania they applied for funds from the Business Linkages Challenge Fund.

<sup>36</sup> Deloitte Touche Tohmatsu Emerging Markets (2004), p. 18

<sup>37</sup> [www.businessmatchmaking.com](http://www.businessmatchmaking.com)

- software optimising the time schedule of the participating enterprises
- integration of institutions on the meso-level.

These matchmaking procedures can, and should, also be integrated into fairs. This is for example a standard procedure for supporting evolving partnerships in the context of cluster development in Europe.<sup>38</sup>

### **III.3.2 Conclusion**

Databanks and matchmaking are a good supplement to collaborative business linkages. Their main advantage is the reduction of information and searching costs and therefore the opening up of opportunity for MSMEs. They cannot, however, replace the systematic approach of collaborative business linkages. Contracts through databanks and matchmaking evolve by chance. This can be a starting point for long-term relationships between the business partners. The hit rate of databanks and matchmaking procedure can be increased by focusing on branches or themes e.g. public tender.

## **III.4 Group Counselling**

### **III.4.1 Overview**

The success of horizontal or vertical networks depends on the implementation of upgrading processes within the enterprises involved. This can be done by a combination of group counselling and, on certain occasions, individual support. Group counselling has several advantages:

- Members learn from each other.
- It is cost-effective.
- Networking is supported, as, with successful group counselling, the advantages of joint actions can be experienced. This contributes to the build-up of social capital.
- The facilitator / counsellor of existing groups can invite specialists, which, on a group basis, is affordable.

Three distinct formats have to be distinguished:

1. Comprehensive training along the lines of the emerging topics. Existing formats: Manual for the Nucleus and Business Bridge Manual.
2. Process upgrading within a given market strategy. Existing format: Small Business Competitiveness Club

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<sup>38</sup> For example search with the combination “matchmaking” and “bio” in google.

3. Tools for the development of a market strategy. Existing format: Tool box of Cefe

### **Nucleus Approach<sup>39</sup>**

An incentive for the development of the nucleus approach was the previous experience that the supply of services by business association and chambers did not meet the requirements of the SMEs. The underlying assumption is that the communication process between SMEs and the support institutions must be improved through the development of communication mechanisms, and that the SMEs need a forum where they can not only express their demands but also benefit from immediate action. These fora are the nuclei. The nucleus is facilitated by a counsellor. As the counsellors are employees of either a business association or the chamber, the nucleus approach also makes a contribution to the organisational development of these institutions. This is because of the intensive communication processes initiated between the nuclei-members, the counsellor and his institution.

The enterprises of the nuclei can either come out of the same sector or meet on the basis of a topic of common interest. Starting numbers should be around 7 to 12 SMEs, and, in the long run, it should be more than 10 members. The counsellor facilitates the learning process and links the nuclei to the regional know-how sources, for example, specialised trainers. The extensive experience with the nucleus approach (start of development 1991) led to the elaboration of a manual of the current project in Sri Lanka. This manual covers the whole range of optional activities from, for example, discussion of price arrangements over a business dinner to training activities or lobby activities, and gives concrete recommendations on how to facilitate these activities.<sup>40</sup> It can also be a helpful source of ideas for the facilitation of horizontal networks especially as far as the trust building issue is concerned. It also has to be noted that the aim of the nucleus approach is different. The initiation of horizontal networks requires distinct phases to be described in chapter 6.3.

### **Business Bridge**

Another example of comprehensive group counselling is a format called Business Bridge developed by SBP in South Africa. SBP, as quoted above, is active within the arena of business linkages between large enterprises and MSMEs. The key mechanism used here is a series of peer group sessions, where entrepreneurs are exposed to new and different ways of doing things, can help each other to solve problems, share experiences, develop their inter-firm networks and improve their management capacity. An interesting tool within this format is the market place: Each peer group session starts with an exchange of information about business opportunities the members have heard of.<sup>41</sup>

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<sup>39</sup> <http://www.nucleussl.com/ESSP/Start.htm>

<sup>40</sup> [http://www.nucleussl.com/ESSP/Nucleus/Work\\_with\\_Nucleus/N%20Manual.htm](http://www.nucleussl.com/ESSP/Nucleus/Work_with_Nucleus/N%20Manual.htm)

<sup>41</sup> The business bridge manual is not yet on-hand. Work in progress.

### **Small Business Competitiveness Club<sup>42</sup>**

This is an excellent approach once the market strategy of the attending MSMEs is clear. It is therefore well suited for vertical linkages, where process upgrading is the issue, or within horizontal networks during the implementation phase. The format is based on the Balanced Score Card. The BSC is a controlling device, and the specific quality is the introduction of four perspectives: (1) Learning and capability growth perspective, (2) (work) process perspective, (3) customer value perspective and (4) financial perspective. For each perspective, benchmarks are defined from the customers' point of view. This only works out when the market requirements i.e. the preferences of the customers are clear. For example, if the customer places high value on the total accuracy of the parts supplied by the vendor, this will inform the search for benchmarks. Club members define together their relevant benchmarks and, within this process of definition, awareness of the critical success factors in their business increases. In the follow up period they meet on a regular basis, compare their benchmarks and discuss upgrading measures for their individual firms. This induces a very effective learning cycle with respect to the internal processes. Members should come from the same branch.

### **Relevance of Cefe**

Cefe contains tools to develop a market strategy for a horizontal network. In particular the Boston matrix, SWOT-analysis or five forces method have to be mentioned. These tools can be used to structure the strategic workshops. As already mentioned in chapter 4.1.4, it is advisable to integrate consulting services in advance to deliver the necessary market analysis, both because they bring in a different and broader perspective and also to prevent excessive demands on the participating enterprises.

### **III.4.2 Conclusion**

Group counselling methods are a necessary supplement to collaborative business linkages. This is due to the fact that regularly upgrading processes within the involved enterprises have to be supported. Several formats are at hand. They have been described above. Selection criterion for the fitting group counselling format is the purpose of the upgrading process within the involved enterprises.

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<sup>42</sup> Lawson (2005). The instrument evolved from work done in South Africa, mostly for GTZ interventions in the fields of Industry Sector Technology & Innovation Development, Local Economic Development and Active Labour Strategies

## **Part II: TOOL FOR PROMOTING BUSINESS LINKAGES**

## IV. Framework for promoting Business Linkages

### IV.1 Business Linkages within the products of PSD

As analysed in the preceding chapters the support of cluster and network management is of decisive importance for the successful promotion of business linkages. Therefore cluster and network management is the core of the business linkages approach.

Cluster and network management has interdependencies with other instruments and modules of PSD. The following graph gives an overview of the range of products of GTZ by September 2005. It has to be noted that the design of range of products for private sector development is work in progress. The relationships of products and modules or the titles change as the discussion progresses. The blue coloured modules are those with special importance for the business linkages approach as proposed by Kappel and Dornberger. We agree that these are the modules with relevance for the business linkages approach. The proposed instrument “promotion of cluster and network management” corresponds with the module “promotion of networks and stakeholder fora”.

**Graphic 8: Range of GTZ's PSD products with potential for business linkage approach**

Products PSD	MODULES WITH IMPACT ON				
	SME				MSME
<b>Trade</b>	Reduction of trade barriers and monitoring	Standards of trade / appraisal of conformity	Interregional trade promotion	<b>Export- and FDI*</b>	
<b>Business and investment climate</b>	Analysis and benchmarking of the investment climate	Formulation and implementation of laws and standards	SME policy and strategies of SME promotion	<b>Promotion of chambers and business associations</b>	Integration of the private sector into the PRSP implementation
<b>BDS / Services for enterprises</b>	Analysis and development of BDS markets	Capacity Building	Tools for BDS financing	<b>Specific BDS services</b>	Information and consulting services for poor groups
<b>Local and regional economic development</b>	Strategy and marketing for locations	Support of communal institutions for PSD	<b>Promotion of cluster</b>	<b>Promotion of networks and stakeholder fora</b>	<b>Analysis and development of local markets<sup>43</sup></b>

Source: Kappel und Dornberger (2005), p. 63

<sup>43</sup> Kappel and Dornberger use the term service markets instead of local markets.

The following interdependencies with the other products and modules are of special relevance:

### **Trade**

Recruitment of foreign direct investment (FDI):

1. Once the investor has built up his supplier base, it is more difficult to increase the proportion of local suppliers. This is due to additional search and risk costs incurred by the change of suppliers. Local content should therefore be a topic within the negotiation. At this point the willingness of the investor to contribute to the upgrading of local suppliers is greater, and potential for PPP can be put into effect.
2. The recruitment of FDI should be embedded into the private sector development strategy with its defined focus on certain sectors. With FDI, missing links or bottlenecks within the value chain can be tackled and the upgrading of the value chain supported.

Reduction of trade barriers and monitoring:

1. Some developing countries are on the verge of WTO membership; the example of Vietnam was quoted in chapter 2. In this example, the FDI engagement is used to upgrade suppliers with the aim of increasing the competitiveness of the suppliers sufficiently to withstand any future competitive pressure created by membership of the WTO. In addition to assisting their local suppliers to fulfil the buyers' requirements, Metro Cash & Carry Vietnam – together with the GTZ SME Development Program – is assisting the Ministry of Trade in developing policies and an adequate legislative and regulatory framework that will help to establish a modern distribution network.
2. Kappel and Dornberger suggest the implementation of a duty draw back system in favour of local content. This is the advent of a new trade barrier and leads to the distortion of markets. Therefore it has problematic aspects.

### **Business and investment climate:**

1. Business and investment climate are the framework of economic activity. If there are significant hindrances regarding the framework e.g. corruption the business linkages approach will unleash its potential with only minor impact.
2. Public authorities are an important potential customer for MSMEs. Whether MSMEs can successfully negotiate public tender procedures depends on the regulations of these tender procedures. One example is whether collaborative applications by MSMEs are made possible by the precise conditions of the tender procedure.<sup>44</sup>

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<sup>44</sup> Also see Kappel und Dornberger (2005), p. 71

### **BDS/services for enterprises:**

There are close relationships which should be considered between the functioning of the BDS supplier markets, the financial sector and the upgrading of MSMEs through the business linkages approach. This has been discussed above and also group counselling methodologies have been presented.

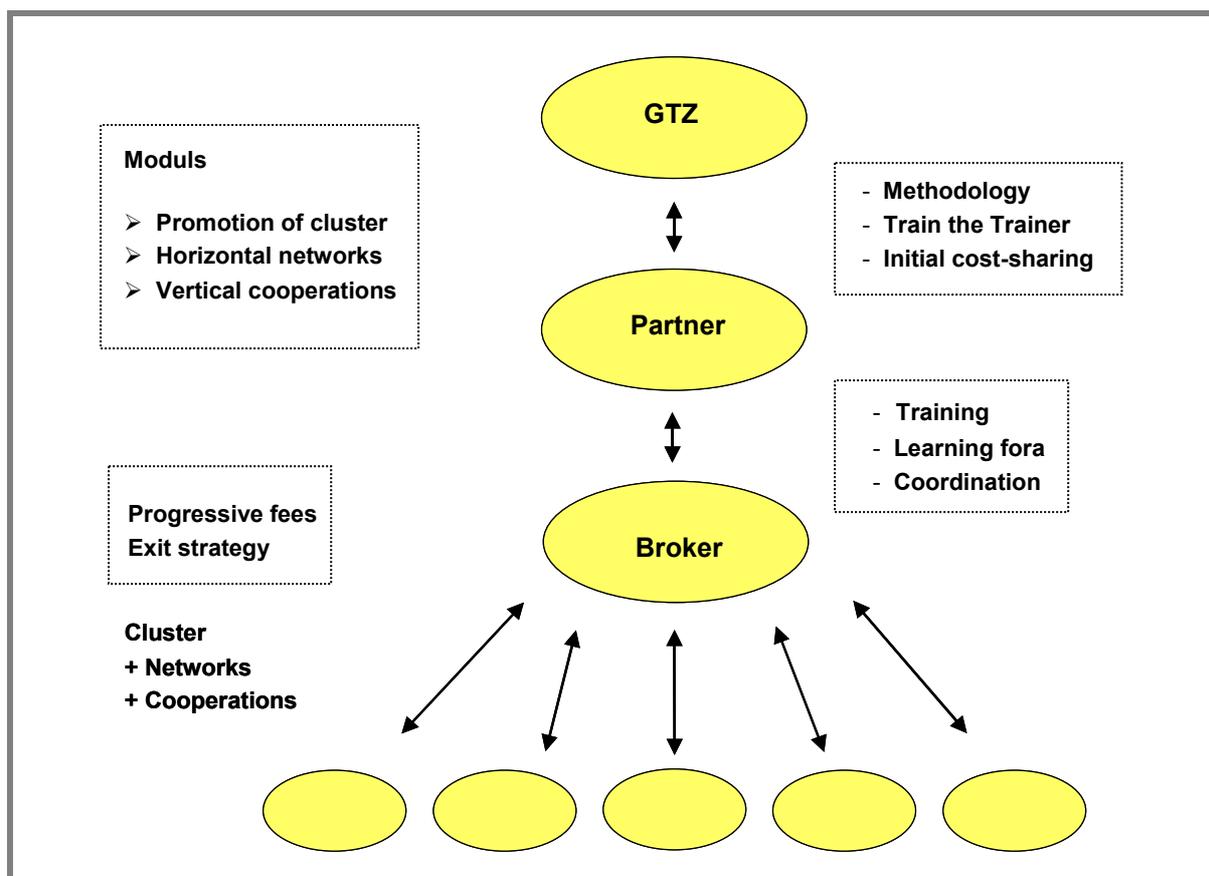
### **Local and regional economic development:**

1. Currently, LRED programmes and projects are in the implementation phase in several priority partner countries. The collaborative business linkages approach is an ideal complement. For example, the GTZ SME Development Program in Vietnam is cooperating with international buyers of aquaculture products to assist local fish farmers and processing companies fulfil their requirements. This is taking place within the framework of the programme's local economic development approach in An Giang province.
2. Chapters 2 and 3 present the analysis that there are limits to linking micro- and small-sized enterprises of the informal sector directly to domestic and global value chains of the modern sector. But these MSMEs of the informal sector can profit from the rising consumer demands of the employees in these value chains. This is the topic of the module "analysis and development of local markets".

## **IV.2 Focus tool application on priority partner countries**

Brokers are central for the effective management of cluster and networks. On questions of sustainability, these brokers should be local consultants. The institution taking over the coordination and training role regarding the brokers must also be a local institution. It can be a business association, NGO or chamber of commerce depending on the concrete situation in the country or region.

**Graphic 9: Role of GTZ within the collaborative business linkages approach**



The role of the GTZ is restricted to co-financing the initial phase and to the dissemination of methodology and the idea of networks and cluster. This involves the concept of training to train. Considering the criteria sustainability and impact this cannot be done sufficiently with one project here or there but needs a significant commitment in the selected countries. It should be embedded in

- the dissemination of the advantages of clusters and networks at national and regional level (e.g. government officials, business associations, support institutions)
- the awareness on the part of the support institutions (e.g. BDS, finance) of their role in supporting cluster and networks
- the local institution concerned with the training, further qualification and networking activities for the brokers, which needs a minimum number of brokers
- learning fora for the brokers. This exchange of experiences requires a certain number of network and cluster development activities
- study tours within the country and abroad

It is conducive to the collaborative business linkages approach for the advantages of clusters and networks to be widely spread among donors. Therefore it can be an ideal field of action for joint activities with other donors.

The business linkages approach can be appropriate both for LDCs and MICs. But it has to be considered that the cluster and network approach needs certain preconditions e.g. sufficient number of potentially competitive MSMEs, regional proximity of these MSMEs, potentially capable BDS suppliers and a promising domestic or international market perspective for the sectors involved.

Within MICs and also LDCs regional income disparity exists. The cluster and network approach can contribute to pro-poor growth in rural areas but it will not be suitable for remote areas with low population density, a small number of enterprises and poor connections to markets because of e.g. lack of roads.

### **IV.3 Integrating business linkage promotion in national PSD strategy**

The business linkages approach should be incorporated into the PSD strategy of the individual country. This is in order to unleash the full potential of this approach. Generally within the definition of a private sector development strategy, an analysis of the potential of the sectors is conducted. The potential of the sectors is judged by certain criteria e.g. comparative advantage of the region / nation, relevance of the sector, technological and managerial level of the MSMEs within the sector. This leads to a focus on certain sectors within the private sector development strategy of a given country or region. This focus should be considered by the concrete selection of target groups for the business linkages approach.

In addition to this classic way of identifying potential clusters or value chains to be supported by a programme, spontaneous opportunity seeking or opportunity grabbing becomes more and more relevant. By this we mean initiating a cooperation with for example a buyer interested in improving its local supplier base, even though the programme might not have planned to work in the specific sector. But the impact on jobs and income generation of this spontaneous cooperation might be substantial.

Special emphasis should be placed on the market potential of the individual cluster, value chain, or network. The experience with the collaborative business linkages approach clearly indicates that the market potential is decisive for sustainability.

The following describes the target groups of the business linkage approach. The recommendation is based on the analysis in chapter 2 and the considerations in chapter 3. It is important to emphasize that PSD with a pro-poor perspective can be directed both at opening up employment opportunities for poor people and/or business opportunities for poor entrepreneurs.

- Linking local SMEs to the global value chains of the TNE. The TNEs serve markets with mass production. The main pro-poor impact is the opening up of employment

opportunities. Poor entrepreneurs can profit from the indirect effects through rising consumer demands of the employees to be met by the informal sector.

- Upgrading of domestic value chains with mass production directed at domestic markets. The main pro-poor impact is the opening up of employment opportunities, even though the likelihood of integration of smaller enterprises may be increased. Functional upgrading i.e. conducting of branding, design and marketing is an integral part. Poor entrepreneurs can profit from the indirect effects through rising consumer demands of the employees to be met by the informal sector.
- Fostering horizontal business linkages directed at specific small market segments. The competitive advantages of micro and small enterprises i.e. flexibility and high proportion of handmade components is relevant. Poor groups can benefit either as entrepreneurs or through employment.
- Fostering of agricultural value chains and rural markets. This is because the majority of the poor lives in rural areas and earns its living from agriculture.

The implementation of the business linkages approach should also be monitored with a pro-poor perspective. Upgrading of cluster and value chains can have winners and losers. Particularly vulnerable groups e.g. unskilled workers, woman or ethnic minorities can be left behind during this process. Therefore the effects on the poor should be monitored by mapping the bottlenecks and designing customized approaches to integrate them. These will probably be instruments from other fields like education, health or infrastructure.

#### **IV.4 Principles of financing**

The principles of financing have several aspects:

1. Co-financing by the local institution in charge of the coordination, training and networking of the brokers

GTZ shares its professional experience in the form of technical advice, methodology and co-financing. The benefiting institution also should invest its own resources. Sustainability is the main argument. The proportion of co-financing should be based on the institution's business plan. Income can be generated through fees for the training programmes, learning fora and study tours. It can also apply for money from of the national budget. The institution's financial contribution should increase progressively as that of donor's decreases.

An open question is the status of the brokers. They could be local consultants working totally on their own account, which may have the consequence that they only concentrate on easy collaborative business linkages. On the other hand they have a strong incentive to be successful. A combination of basic income earned by the institution and fees would also be possible. In this case, fees from the benefiting

MSMEs belong at least partly to the institution. An exchange of experience with UNIDO should take place with reference to this question.

2. Linking local SMEs to the global value chains of TNE

Engagement with the support of these business linkages should have a clear demand orientation. Only if the concrete TNE / TNEs are really interested in these business linkages will sustainability be achievable. This is expressed by the willingness for a cost-sharing approach. It should be considered whether the PPP facility can be opened up to foreign enterprises.

This opening up of the PPP facility is mentioned here with reference to the business linkages between TNE and SME. It may also be relevant on a case by case basis as far as the other target groups are concerned.

3. Fees paid by the MSMEs within horizontal networks aiming either at domestic mass markets or at specific market segments

An important precondition for an exit strategy of the brokers is the design of the fee structure. The MSMEs involved should pay progressive fees for the coordination role of the broker. An exit time frame should be agreed upon in the business plan. Whether there is an initial phase without even minor fees should be left to the concrete circumstances. It is possible that, especially within incipient clusters with a high portion of poor entrepreneurs, a flexible approach is necessary. In the latter case it should be considered whether a voucher system (entailing a free choice of broker) is practical.

4. Fees for group counselling or individual consulting

Training measures are key to the upgrading within horizontal or vertical networks. The benefiting SMEs should pay at least cost-sharing fees.

## **IV.5 Competitive advantage of the GTZ**

The GTZ has a high reputation regarding its competencies as process coordinator and facilitator. Additionally, a whole set of tools relevant for the network and cluster approach already exists. They have been developed e.g. for the LRED approach, for the upgrading of agricultural value chains and within CEFE. The previously existing experience with PPP is also an asset, since a growing network of GTZ to international business partners brings with it a huge potential for involving them in initiatives to upgrade local suppliers. Most other donors still lack this linkage to the international business community as partner and lack the experience in involving them in project activities.

The elaboration of these tools to a consistent set of methodologies in cluster and network development has a solid foundation. This could be done as pilot e.g. within existing LRED activities.

## V. Methodology for promoting Business Linkages

The methodologies for building up the three types of business linkages are distinct and require distinct phases and tools. All elements outlined below need to be adapted to local conditions.

### V.1 Module vertical cooperation

Vertical cooperation takes place between enterprises along the value chain. Three target groups are relevant:

- (1) Linking SMEs to the global value chains of TNEs and also foreign SMEs
- (2) Fostering the cooperation along the value chain between enterprises aiming at domestic markets.
- (3) Upgrading of agricultural value chains.<sup>45</sup>

Generally the initiative is with the buyer in the value chain. Their motivation is decisive. The client enterprise defines the possible products and services to be purchased on the regional market. In advance this buyer must have defined his market and the specific quality requirements derived from there. As far as TNEs are concerned this is not a development aid topic. The development of domestic value chains is a different case. The definition of promising markets is a question dealt with within the module horizontal networks because the initiative for market definition primarily lies with the players of horizontal networks.

Vertical cooperation is part of implementation of a given market strategy of the buyer.

The basic institutional arrangement within vertical cooperation is contracts between the buyer and the supplier regarding price and quality specifications.

The following phases can be distinguished:

1. Selection and motivation of buyer
2. Design training
3. Training and consulting
4. Follow-up

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<sup>45</sup> Agricultural value chains are named separate because of their relevance for pro-poor growth. Otherwise they could be subsumed on global or domestic value chains.

Selection and motivation is a topic of linking SME to global agricultural and non-agricultural value chains. The phases from design training onward are also relevant for upgrading domestic value chains.

### **Phase 1: Selection and motivation of buyer**

This is the critical point. The module has two basic assumptions:

- (1) That there is considerably more potential for doing business between local SMEs and the TNEs, than is currently being put into practice.<sup>46</sup>
- (2) That public effort is necessary to fill the gap between existing qualification of SMEs and quality requirements.

Especially the first assumption must be considered carefully at the concrete location. If there are no value adding manufacturing and processing activities of TNEs the approach will fail because of lack of demand. This is exactly the reason why the BLCF in Ghana had to be closed down prematurely.<sup>47</sup>

If value adding manufacturing and processing activities of TNEs exist, timing becomes important. Once the buyer has installed his supplier bases changes occur only sporadically. Therefore the topic of local content must be integrated into the strategy of FDI acquisition. This leads to two further topics:

- (1) Sector specific focus
- (2) Integration of the topic at institutional level

Sector specific focus: Motivations for FDI on the part of enterprises are the labour costs, the existing skills within the workforce, the proximity to potentially effective suppliers, existence of scarce raw materials and the future attractiveness of domestic markets<sup>48</sup>. This leads to sector specific pattern of FDI and push to enforce local content should follow these market forces. It can be supposed that the FDI-focus is closely related to the sector focus defined in the PSD as the sector specific focus of PSD should reflect competitive advantages of the location.

Integration of the topic at institutional level: The topic should be integrated systematically into the institutions concerned with the acquisition and the negotiations regarding FDI. This is the linkage to the buyer. The institution could be e.g. a one-stop-agency for investors. The question at stake is whether also a systematic linkage to the SMEs or, as the case may be, the potential suppliers, is necessary. Buyers generally select suppliers on their own behalf.

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<sup>46</sup> Russo (2002), p. 15

<sup>47</sup> Elliott, D. (2004), p.7

<sup>48</sup> e.g. conducive environment or general conditions regarding infrastructure are Also important. But these are general criteria not really related to distinct sectors

But within this process linkages to sector-specific business associations can be supportive because of their access to the SMEs. Also the selection process can be supported by commercial purchasing agents, brokers with detailed information on the enterprises producing the searched products and the institutions involved with the training.

Selection criteria buyer: demand and local supply match, openness to cost-sharing (PPP), long-term commitment to region

Selection criteria SME: potential to meet quality requirements, openness to further improvement, readiness to pay cost-sharing fees for the training and consulting

### **Phase 2: Design training**

Again the initiative is with the buyer as the buyer defines the quality requirements. Also it can be supposed that the technical staff of the buyer will be involved with the training measures. Further on the training institutions and their professional expertise for the design of the measures are important.

The comparison of the quality requirements and the necessary changes within the potential suppliers takes place. This can be facilitated by one-on-one interviews and round table discussions. The process can be facilitated by a neutral institution. This could be done by brokers.

### **Phase 3: Training and consulting**

Typical training measures are shop floor assistance, classroom training or study tours. An example can be found in chapter 2.4.2. Also benchmarking through group counselling (see small business competitiveness club chapter 4.4) is a good option.

### **Phase 4: Follow-up buyer and suppliers**

The satisfaction of the buyers should be monitored. This can be done by one-on-one interviews by the brokers. Relevant topics are the satisfaction with the suppliers, with the design of the training programmes and with the performance of the training institution. Also a follow-up with the suppliers in a mixture of one-on-one interview and focus group discussion should take place.

The follow-up can lead to adjusting activities regarding the concerned business linkages and also in general to lessons learnt for future activities for the establishment of business linkages.

### **Outlook: State of the art within GTZ and next steps**

Currently activities regarding vertical linkages are underway at several sites e.g. Vietnam, Brazil, Sri Lanka (Core Groups) or Ghana. In some cases, GTZ staff are directly involved with identifying potential buyers. This is a valuable approach for acquiring experience about

the implementation concerning vertical linkages and the practical problems involved regarding the qualification process of the SMEs and regarding the problems of bundling lot size at SME level. Lessons learnt will be elaborated.

The question at stake is how to institutionalise the identification of potential buyers. Investment promotion agencies might be the most suitable institutional structure for sustainable match-making.

In Sri Lanka experience currently is being gained with the 'Core Group' approach. This is a fora bringing together all stakeholders of a particular value chain. This facilitates the communication of the stakeholders and can lead to joint activities to tackle common problems. Such Core Groups, once established, can also be a body facilitating additional business linkages.

## **V.2 Module horizontal networks**

Horizontal networks are cooperations of MSMEs at the same level of the value chain. The following three target groups are relevant:

- (1) Upgrading of domestic value chains with mass production directed at domestic markets
- (2) Fostering horizontal business linkages directed at specific market segments
- (3) Fostering of agricultural value chains

Crisis or market opportunities are the catalyst for horizontal networking. The attempt to cooperate will only be sustainable if the benefit on the individual level exceeds the costs of cooperating. Hence this module focuses on the opening up of market potential by means of horizontal networks.

**Essential for horizontal networks is the elaboration of a promising market strategy.**

The definition of this target market and the elaboration of the business plan give direction to the horizontal network. Horizontal networks will generally have a legal status e.g. association. This is due to the long-term perspective and the intensity of cooperation. The development of horizontal networks consists of the following phases:

1. Selection and promotion
2. Pilot projects - Elaboration business plan
3. Strategic projects – Elaboration business plan
4. Implementation business plan
5. Self management and exit broker

These phases will only be conducted successfully if professional facilitation by a broker is given.

### **Phase 1: Selection and promotion**

Horizontal networking is particularly suitable for handicraft, manufacturing, tourism and agriculture.

Within services it is of minor importance because the benefits are not convincing. Jointly purchasing inputs is hardly relevant because service companies' main input is labour and collaborative marketing is unlikely because joint development of products is rarely relevant. Moreover the establishment of an umbrella brand name is difficult especially for simple services which do not have individual features and are interchangeable.

In the trading sector purchasing associations could be an interesting approach to empower small retailers. Main costs for retailers are the costs for goods for resale. Therefore bundling purchase and utilising economies of scale are very attractive options. But this approach is also bound to certain preconditions. Joint purchase needs the security of proper payment by the members. Also the small retailers need to be a certain distance apart from each other so that they are not directly competing. In addition, communication infrastructure and financing infrastructure need to be at a certain level. The promotion of trade purchasing associations is suitable for MICs with medium to high population density.

The focus of this module is on the establishment of horizontal networks in handicraft, manufacturing, tourism and agriculture. The entrepreneurs should be active in priority sectors of PSD and the sector should be on the agenda of cluster development. Besides the concentration on potentially competitive branches the following factors facilitate the establishment of horizontal networks:

- entrepreneurs with the willingness to cooperate
- regional proximity of entrepreneurs
- sufficient number of entrepreneurs with the same branch focus.

The factor – willingness to cooperate – is critical. If this willingness is not existent the module horizontal networks should not be applied. Indicators in favour would be the existence of a critical mass of entrepreneurs expressing interest and willingness to mobilize other colleagues.

Open group discussions are suitable for spreading information about the potential of horizontal networks and for promoting the formation of new horizontal networks. These open group discussion should be facilitated by the brokers.

Successful examples of horizontal networks should be presented at this event. The best option would be the presentation by a member of a successful horizontal network. This

person should also talk about the obstacles during formation and how these obstacles have been tackled successfully.

### **Phase 2 and 3: Pilot projects and strategic projects - Elaboration business plan**

Each member of the horizontal network needs to develop trust in the reliability of the other members and in the benefit of joint actions. Trust is based on knowledge of each other and concrete experiences. In the beginning members will only be willing to invest limited resources. Typical short-term activities (pilot projects) include joint visits to fairs, joint training or joint purchase of inputs. The trust building phase can be facilitated by some of the workshop formats documented in the Manual for the Nucleus (e.g. dinner of fraternization, discussion of problems and objectives, meeting in the workshop of an entrepreneur).

Typical long-term activities (strategic projects) touch upon activities for product and process upgrading including branding activities with the purpose of opening up new markets. These can be export markets or domestic markets.

A latent conflict is that pilot projects only have limited impact on the well-being of the entrepreneurs and that the significant economic benefit only evolves once the strategic projects are in the implementation phase. Therefore this time-lag should be offset by a promising perspective. Experts should be asked to conduct market analyses, to present their findings and to outline possible market directions. Also successful horizontal networks with similar initial situations could be invited again.

The elaboration of the business plan of the horizontal network is done in a series of workshops. For question of continuous motivation the facilitator should ensure that each session leads to a follow-up action and therefore to some kind of benefit for those attending. Within the workshops the following steps based on the guide business plan (appendix) will be taken:

- analysis of common opportunities and problems
- development of short-term goals
- development of strategic goals
- common work plan
- budget
- organizational structure of the group
- criteria evaluation

Key to success is the definition of the right market focus. To give additional insight into the necessary steps the most relevant tools for the definition of the market focus are briefly

described in the appendix although they are already well documented elsewhere<sup>49</sup>. The relevant tools are:

- SWOT-Analysis
- Five Forces Analysis
- Boston Matrix
- Diversification and Risk

These tools can be used to structure the workshops and will also be applied by the specifically selected experts.

Implementation of the defined market strategy will require changes within the enterprises and regarding the ways they work together. These changes will be documented in the work plan. Market strategy, work plan, budget and the rules of interaction within the network form the business plan. The business plan should be documented in a proper way.

The rules of interaction within the network cover topics like legal status, obligations and rights of the individual entrepreneur and rules for conflict settlement. Also there should be agreement on indicators for the performance of the network. These indicators should cover the economic outcome and the way of interaction within the network.

Finally the business plan should contain a time frame of the exit of the broker. Also agreement on progressive fees broker should be included.

#### **Phase 4: Implementation business plan**

For the implementation several points will be emphasized:

- (1) Generally process and product upgrading will be necessary within the enterprises. This must be supported by training and consulting measures. An adequate group method is the above presented "Small Business Competitiveness Clubs". It works with the Balanced Score Card and an effective learning cycle will be installed by using the bench marks derived from there.
- (2) Joint activities e.g. establishment of a common shop to sell products need to be monitored and evaluated according to the indicators agreed upon.
- (3) Periodical reflection on whether members are satisfied with the manner of interaction within the network should be performed.
- (4) Application of the rules for conflicts. If necessary exclusion of free-riders.

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<sup>49</sup> see Cefe or PACA or Tools LRED

- (5) Successes should be celebrated
- (6) Integration of the BDS suppliers and other stakeholders by the broker.

### **Phase 5: Self management and exit of the broker**

Two preconditions are important to increase the probability of successful self management and exit of the broker:

- (1) The horizontal network is economically successful. Growth expectations were realistic. This emphasizes the need to select the right branches and to limit the network approach to cases of sufficient potential at MSME-level.
- (2) From first day on broker pursues an exit strategy. Elements of the exit strategy are the progressive fees, agreed-on time frame for the exit and teaching of self-management techniques for meetings.

Regularly successful networks will employ a professional for the follow-up of the coordination of activities.

### **Outlook: State of the art within GTZ and next steps**

Currently activities regarding horizontal linkages are being implemented or thought about at several sites e.g. Vietnam, South Africa, Philippines and Ghana. Lessons learnt will be very interesting. As far as is known horizontal networks with emphasis on market potential are not currently being implemented systematically yet. This could be done as pilots within existing LRED-projects. The thereby methodology elaborated in further detail could be documented as a guide complemented by lessons learnt. The report outlines the necessary components:

## **V.3 Module cluster development**

Cluster development supports the upgrading of the sector specific focus of a given region. The main focus is the linkages to the involved support institutions e.g. business associations, regional government, BDS providers within a cluster, horizontal and vertical linkages are of relevance. Cluster development consists of the following phases:

- 1. Identification of cluster
- 2. Development of a common vision and mission by the stakeholders
- 3. Common work plan
- 4. Implementation
- 5. Evaluation
- 6. Exit broker

Professional cluster management by brokers during the process of cluster development is decisive. Cluster development financed by donors should end up with a coordinating institution. This umbrella organisation (e.g. NGO, regional agency) coordinates the diverse actions of the cluster and can be financed by a combination of public money and contributions from the benefiting enterprises.

GTZ disposes over a whole tool set to identify and develop promising clusters. Therefore the methodology of the module is here not described in detail. Instead a short overview of existing tools is given.

Principally a top-down or bottom-up approach to identify promising clusters and to develop the common vision can be distinguished. Generally a mixture is advisable. The advantage of the top-down approach is the professional analysis of the given sector and the inclusion of the views of a third party. This analysis can be supported by a guidebook developed by GTZ. The guidebook is rounded off with three case studies from South East Europe (Bulgaria, Macedonia and Serbia) and also gives an insight into the concepts within the EU.<sup>50</sup> The advantage of the bottom-up approach is the ownership of the involved stakeholders. This contributes to sustainability. For this task the toolset of PACA is on-hand.<sup>51</sup> PACA combines the methodology of Rapid Rural Appraisal with the concepts mainly of Porter and with a series of workshop formats. The use is widespread within LRED programmes of GTZ and is therefore based on already extensive experience.

### **Outlook: State of the art within GTZ and next steps**

For cluster development the required methodologies are on hand. Experience with implementation (best practice) will be documented with the progression of the existing LRED programmes. These methodologies and the best practices can be used for a training manual for brokers.

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<sup>50</sup> Schwanitz, S., Müller, R., Will, M. (2002). See: [www2.gtz.de/wbf/doc/Wettbewerbsfähigkeit.zip](http://www2.gtz.de/wbf/doc/Wettbewerbsfähigkeit.zip)

<sup>51</sup> Meyer-Stamer, J. (2003). See [www2.gtz.de](http://www2.gtz.de).

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## Appendix

### I. Business Plan for Horizontal Networks

#### I.1 Initial situation

##### Products

Which products / product groups are currently produced?

Prominence of the products / product groups by turnover?

- increasing, stable, decreasing prominence over the last three years
- reasons

##### Customers

Who are the customers? Characteristics regarding age, income, region or size of enterprise etc.?

- increasing, stable, decreasing demand of the customer groups in the last three years?
- reasons
- estimated future demand of the customer groups? Reasons

Why do the customers buy the product? Benefit customer? Which characteristics of the product they appreciate the most?

Which potential customers cannot be reached at the moment due to quality requirements? Reasons? Potential actions?

Which further problems do the customers have with the enterprises of the horizontal network? Reasons? Potential actions?

##### Competitors

Who are the competitors? Strengths and weaknesses? New competitors?

##### Sales channel and marketing

Sales channel? Constraints?

Marketing message existent?

Marketing devices applied?

### **Inputs**

Main inputs for the production? (percentage expenses, relevance own product quality)

Problems regarding availability regarding punctual delivery and quality?

Who are the suppliers? Competitive market as several suppliers exist?

### **Technology and skills**

How are the products produced?

Skills, problems and constraints?

Improvements with low financial investment?

## **I.2 Analysis of potential markets**

Bearing in mind the potential of producing modified products based on the existing products, technologies and skills:

- Identification of potential domestic or foreign customer groups. Description relevant characteristics like age, income, preferences
- Influencing factors on future demand
- Estimation of tendencies demand: increasing, stable, decreasing
- What is the unique selling point? Description of wanted characteristics product

Potential sales channels? Advantages and constraints

Competitors? Strength and weaknesses?

## **I.3 Strategic goals**

### **Products and customer**

Definition of products / product groups and target customers

- Characteristics product
- Design and branding
- Unique selling point (perspective customer!)

**Technology, skills and inputs**

Changes in the technology process

Necessary skills improvement

Changes input

Financial investment?

**Sales channel and marketing**

What is the main message to get across? A) final customer B) sales channel

How will the customers be reached? Direct marketing, sales persons, stores ...

Which marketing devices will be used? Fairs, Flyers, Internet ...

**I.4 Workplan**

Who, what, until when and how

Indicators success

**I.5 Formal organisation**

Which formal organisation will the horizontal network have?

Obligations and rights of the individual entrepreneur?

Rules for conflict settlement?

Who will undertake the day to day management activities?

**I.6 Budget**

## II. Tools for the elaboration of the strategy

### II.1 Basic Instrument: SWOT-Analysis

The SWOT-analysis structures the analysis in a sensible way into four aspects:

<p><b>Strength Horizontal Network</b></p> <p>e.g.:</p> <ul style="list-style-type: none"> <li>• mastery certain production skills</li> <li>• ability to produce a certain amount</li> <li>• reputation for certain tradition</li> </ul>	<p><b>Weakness Horizontal Network</b></p> <p>e.g.:</p> <ul style="list-style-type: none"> <li>• distribution channel lacking</li> <li>• poor marketing</li> </ul>
<p><b>Opportunities Environment</b></p> <p>e.g.:</p> <ul style="list-style-type: none"> <li>• growing purchasing power urban „middle class“</li> </ul>	<p><b>Threats Environment</b></p> <p>e.g.:</p> <ul style="list-style-type: none"> <li>• customs duties will be lowered; new competitors</li> </ul>

Often the difference between strength and weaknesses and opportunities and threats are misunderstood. Strength and weaknesses are within the sphere of influence of the network or enterprise while opportunities and threats are outside the sphere of influence of the network or enterprises.

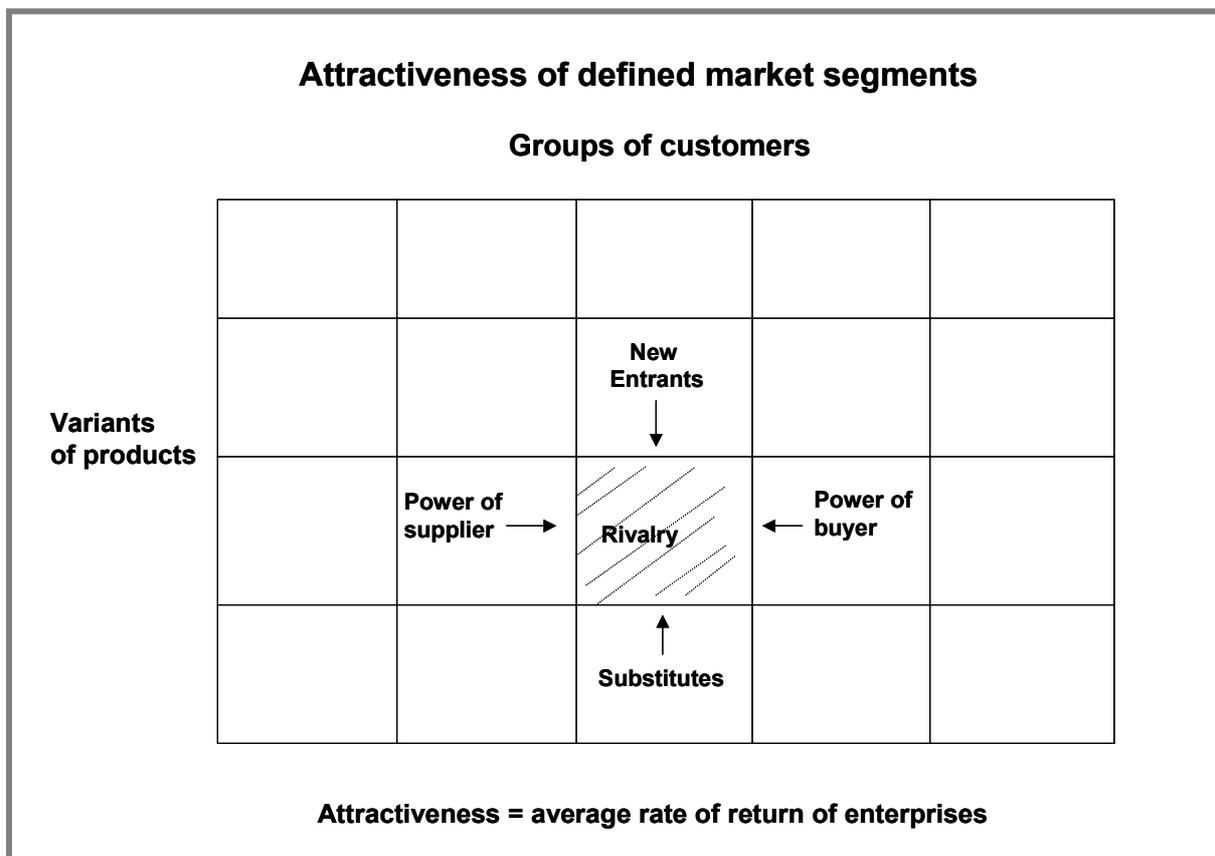
**Benefit of application: Network members get a general idea of current status. Systematisation**

### II.2 Five Forces Analysis

The Five Forces Analysis was developed by Porter. He distinguishes between 5 forces defining the attractiveness of a specific market segment:

1. Bargaining power of suppliers: The bargaining power of the suppliers depends on the competition in their market. Therefore how many suppliers exist, are there substitutes and how critical is the input for the production?

2. Bargaining power of customers: The bargaining power of the customers depends on their number and sizes. If there are only a few buyers against a numerous number of suppliers they can set the conditions.
3. Threat of substitutes: Will there be in the future or near future an alternative for the product due to technical innovation?
4. Threat of new entrants: Will new competitors enter the market and which competitive advantages will they have?
5. Rivalry among existing enterprises: Are there numerous enterprises offering the same interchangeable product? Does the product have something unique for the customer group?



Porter states that the attractiveness of a market can be measured by the average rate of return of the enterprises serving the specific market segment.

The tool Five Forces Analysis can be used in two directions:

1. Evaluation of the point of departure.
2. Initiation of the search process for defining a more attractive market segment.

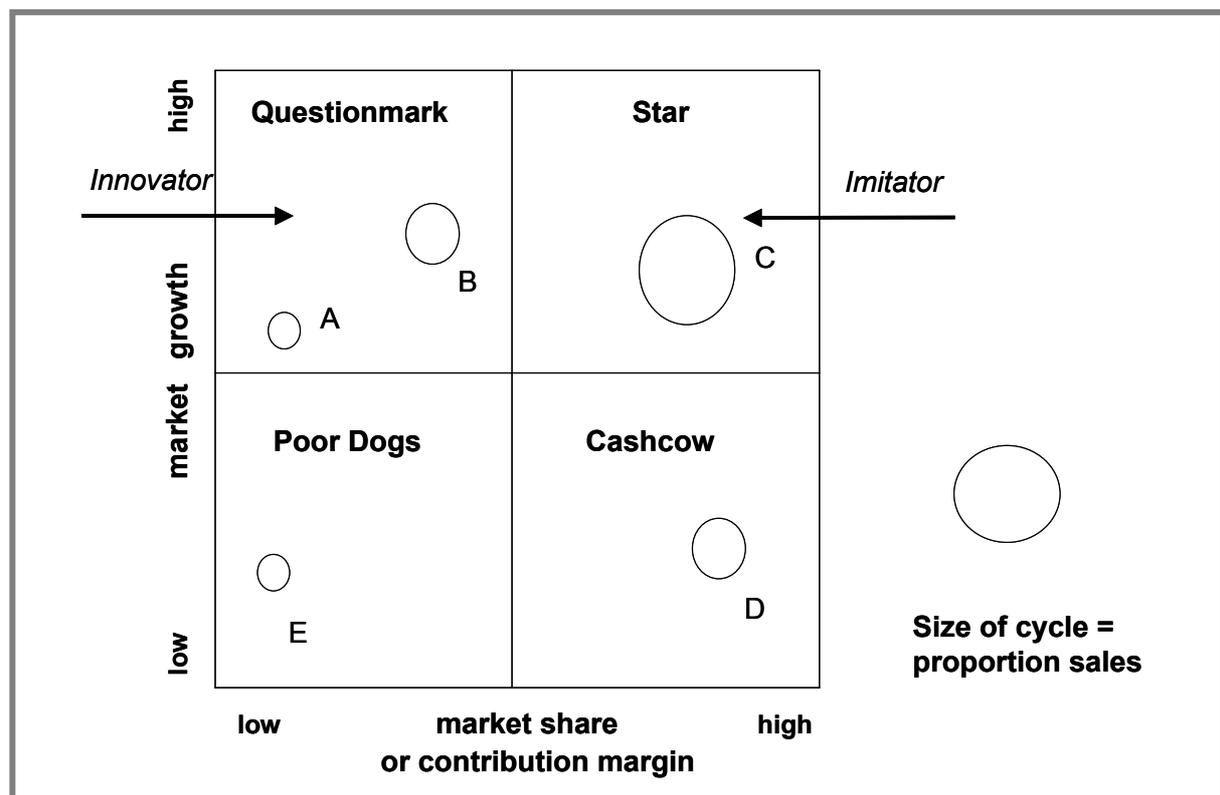
Example of more attractive market segment: Producing no frills cars for a certain income group in MICs or ecologically produced hammocks for a certain customer group in developed countries or production and export of fruits entering the target market in a season in which they are not available from domestic production.

This search process must be accompanied by market research about the preferences of the customer groups and whether new customer groups segmentation can be done e.g. no frills flights, not thought of yet. This should be done by expert research.

Benefit of application: New look in the sector. Search for unique selling point starts.

### II.3 Boston Matrix

The Boston Matrix in its original version sets market growth<sup>52</sup> in relation to market share. It was developed for large companies who have the data to measure their market share and the power to realize a significant market share.



<sup>52</sup> Behind market growth is the concept of life cycle of products. Innovators invent a product, then a slow demand is kicked off by early users, followed by fast increasing sales because the product becomes main stream, then satiation is reached followed by declining sales as new innovative substitutes take over the market.

The underlying concept for the use of market share is that enterprises with a large market share have lower costs because of economies of scale and also because of organizational and production innovation due to learning processes. This gives them advantages against competitors. A methodical alternative for application with SMEs is to plot their products using the contribution margin. Generally the contribution margin within a given SME varies due to the differences in effectiveness of production within the given product portfolio.

The products of the network are then plotted into the matrix based on the estimation of market growth and contribution margin. Within the Boston Matrix concept norm strategies for each of the four categories (question marks, stars, cash cows and dogs) exist. We will not discuss them here but instead emphasize the following points:

1. The visualisation of the existing product portfolio within the Boston Matrix has immediate awareness effects. As example, if none of the current products is serving growing markets call for action is evident.
2. Products within the field question marks (high market growth and low effectiveness of production) should be carefully analysed. If there is no potential for better effectiveness they should be eliminated as they regularly have negative contribution margins and therefore produce losses.
3. The Boston Matrix is a tool for investment decision. In which product should the network or enterprise invest. For cash to become available from own resources it is necessary to have a product in the field cash cow.

**Benefit of application: Awareness of the relevance of market growth. Basis for investment decision in a product.**

## II.4 Diversification and risk

This is simple tool for the assessment of risk. It graphically depicts that four different market strategies of increasing order of risk can be followed:

		<b>Customer</b>	
		<b>old</b>	<b>new</b>
<b>Product</b>	<b>old</b>	<b>Further Penetration of Market</b>  <i>Lowest Risk</i>	<b>New Customer</b>  <i>Growing Risk</i>
	<b>new</b>	<b>New Product</b>  <i>Growing Risk</i>	<b>Diversifikation</b>  <i>Highest Risk</i>

- Penetrating a given market with an existing product. Low risk as preferences of customers are known and the production process also.
- Supplying new customers with a given product. The new customer group e.g. could be in a new country. Increasing risk as intimate knowledge of the new customer group does not exist.
- Serving familiar customers with a new product. Increasing risk because of the new product.
- Launching a new product at a not yet served market. Highest risk.

Benefit of application: Awareness of risk level. Generally increasing risks call for increasing cushion in terms of time and cash to tackle unanticipated obstacles.

Deutsche Gesellschaft für  
Technische Zusammenarbeit (GTZ) GmbH

Dag-Hammarskjöld-Weg 1-5  
65760 Eschborn/Germany  
T +49 61 96 79-0  
F +49 61 96 79-11 15  
E [info@gtz.de](mailto:info@gtz.de)  
I [www.gtz.de](http://www.gtz.de)

