Ch. 17 Foreign Direct Investment

Topics

- Theory of Comparative Advantage
- Modes of FDI
- Motives for FDI

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Market Imperfections: Rationale for the MNE

- MNEs strive to take advantage of imperfections in national markets.
- These imperfections for products translate into market opportunities such as economies of scale, managerial or technological expertise, financial strength and product differentiation.

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Sustaining & Transferring Competitive Advantage

- In deciding whether to invest abroad, management must first determine whether the firm has a sustainable competitive advantage that enables it to compete effectively in the home market.
- In order to sustain a competitive advantage it must be:
  - Firm-specific
  - Transferable
  - Powerful enough to compensate the firm for the extra difficulties of operating abroad

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Sustaining & Transferring Competitive Advantage

- Some of the competitive advantages enjoyed by MNEs are:
  - Economies of scale and scope
  - Managerial and marketing expertise
  - Advanced technology
  - Financial strength
  - Differentiated products
  - Competitiveness of the their home market

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Where to Invest

- Two related behavioral theories behind FDI that are most popular are:

1. Behavioral Approach – Observation that firms tended to invest first in countries that were not too far from their country in psychic terms.
   - This included cultural, legal, and institutional environments similar to their own
2. International network theory – As MNEs grow they eventually become a network, or nodes that operate either in a centralized hierarchy or a decentralized one.
   - Each subsidiary competes for funds from the parent.
   - It is also a member of an international network based on its industry.
   - The firm becomes a transnational firm, one that is owned by a coalition of investors located in different countries.

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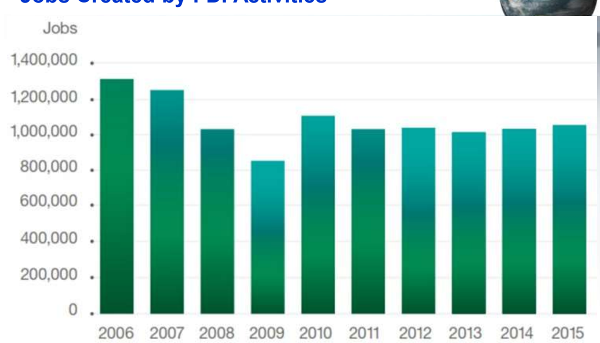
Jobs Created by FDI Activities



Source: Global Location Trends: 2016 Annual Report

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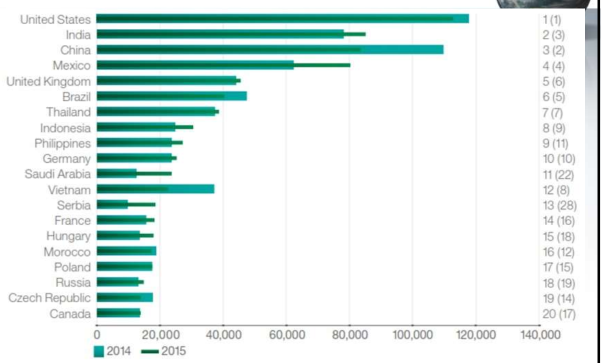
Top FDI Destination Countries by Jobs Created



Source: Global Location Trends: 2016 Annual Report

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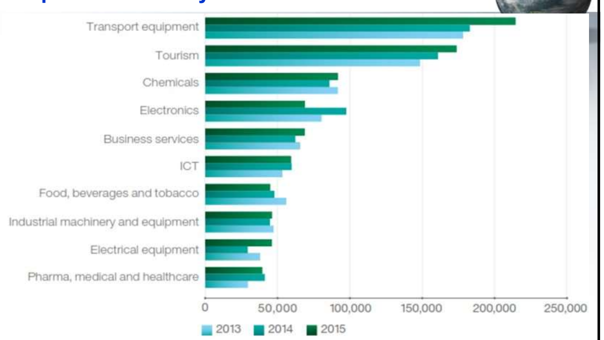
Top FDI Sectors by Jobs Created



Source: Global Location Trends: 2016 Annual Report

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Buy American?

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Where it's made

- Ford Fusion = Hermosillo, Sonora, Mexico
- Ford Taurus = Chicago, Illinois, USA
- Chevy Malibu = Fairfax, Kansas, USA
- Chevy Impala = Oshawa, Ontario, Canada
- Toyota Corolla = Cambridge, Ontario, Canada
- Toyota Camry = Georgetown, Kentucky, USA
- Honda Civic = East Liberty, Ohio
- Honda Accord = Marysville, Ohio, USA
- Hyundai Elantra = Ulsan, Korea
- Hyundai Sonata = Montgomery, Alabama, USA

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How to Invest Abroad: Modes of FDI

- Exporting vs. production abroad
  - Advantages of exporting are
    - None of the unique risks facing FDI, joint ventures, strategic alliances and licensing
    - Political risks are minimal
    - Agency costs and evaluating foreign units are avoided
  - Disadvantages are
    - Firm is not able to internalize and exploit its advantages
    - Risks losing market to imitators and global competitors

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How to Invest Abroad: Modes of FDI

- *Licensing* is a popular method for domestic firms to profit from foreign markets without the need to commit sizable funds.
- Disadvantages of licensing are
  - License fees are likely lower than FDI profits although ROI may be higher.
  - Possible loss of quality control.
  - Establishment of potential competitor.
  - Possible improvement of technology by local license which then enters firm's original home market.
  - Possible loss of opportunity to enter licensee's market with FDI later.
  - Risk that technology will be stolen.
  - High agency costs.

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How to Invest Abroad: Modes of FDI

- Joint ventures
  - A *joint venture* is a shared ownership in a foreign business.
  - This is a viable strategy if the MNE finds the right local partner
  - Some advantages include:
    - The local partner understands the market.
    - The local partner can provide competent management at all levels.
    - Some host countries require that foreign firms share ownership with local partner.
    - The local partner's contacts & reputation enhance access to host country's capital markets.
    - The local partner may possess technology that is appropriate for the local environment.
    - The public image of a firm that is partially locally owned may improve its position.

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How to Invest Abroad: Modes of FDI

- Joint ventures
  - Disadvantages of joint ventures
    - Political risk is increased if wrong partner is chosen.
    - Local and foreign partners have divergent views on strategy and financing issues.
    - Transfer pricing creates potential for conflict of interest.
    - Financial disclosure between local partner and firm.
    - Ability of a firm to rationalize production on a worldwide basis if that would put local partner at disadvantage.
    - Valuation of equity shares is difficult.

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How to Invest Abroad: Modes of FDI

- Wholly owned subsidiary: Greenfield investment versus acquisition
  - A *greenfield investment* is establishing a facility "starting from the ground up."
    - Usually require extended periods of physical construction and organizational development.
  - Here, a cross-border acquisition may be better because the physical assets already exist, shorter time frame and financing exposure.
    - However, problems with integration, paying too much for acquisition, post-merger management, and realization of synergies all exist

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How to Invest Abroad: Modes of FDI

- Strategic alliances can take several different forms
  - First is an exchange of ownership between two firms.
  - It can be a defensive strategy against a takeover.
  - In addition to exchanging shares, a separate joint venture can be developed.
  - Another level of cooperation may be a joint marketing or servicing agreement.

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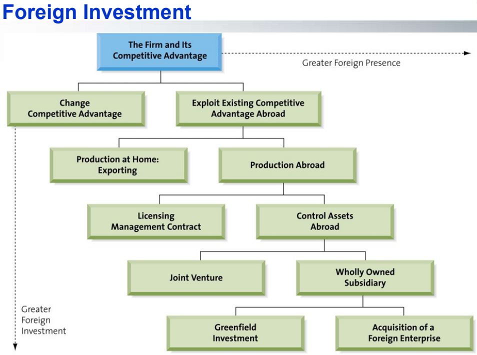
The FDI Sequence: Foreign Presence and Foreign Investment



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Strategies Employed by Emerging Market MNEs

- Taking brands global
- Engineering to innovation
- Leverage natural resources
- Export successful business model
- Acquire offshore assets
- Target a market niche

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Defining Political Risk

- In order for an MNE to identify, measure and manage its political risks, it needs to define and classify these risks:
  - Firm-specific risks
  - Country-specific risks
  - Global-specific risks

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Defining Political Risks

- **Firm-specific** are those risks that affect the MNE at the project or corporate level (governance risk due to the goal conflict between an MNE and its host government being the main political firm-specific political risk in chapter; business risk and FX risk are also in this category).
- **Country-specific** are those risks that also affect the MNE at the project or corporate level but originate at the country level (e.g. transfer risk, war risk, nepotism & corruption).
- **Global-specific** are those risks that affect the MNE at the project or corporate level but originate at the global level (e.g. terrorism, anti-globalization, poverty).

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Assessing Political Risk

- How can multinational firms anticipate government regulations that, from the firm's perspective, are discriminatory or wealth depriving?
  - At the macro level, firms attempt to assess a host country's political stability and attitude toward foreign investors.
  - At the micro level, firms analyze whether their firm-specific activities are likely to conflict with host-country goals as evidenced by existing regulations.
  - The most difficult task is to anticipate changes in host-country goal priorities.

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Firm-Specific Risks

- Governance Risk
  - This is the ability to exercise effective control over and MNE's operations within a country's legal and political environment.
  - For an MNE, however, governance is a subject similar in structure to consolidated profitability – it must be addressed for the individual business unit and subsidiary as well as for the MNE as a whole.

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Firm-Specific Risks

- Negotiating investment agreements
  - An **investment agreement** spells out the rights and responsibilities of both the foreign firm and the host government.
  - The presence of MNEs is as often sought by development-seeking host governments as a particular foreign location sought by an MNE.
- An investment agreement should include following policies:
  - Basis on which fund flows such as dividends, royalty fees and loan repayments may be remitted
  - Basis for setting transfer prices
  - The right to export to third-country markets
  - Obligations to build, or fund social and economic overhead projects such as schools and hospitals
  - Methods of taxation, including rate, type and means by which rate is determined

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Firm-Specific Risks

- An investment agreement should include following policies (continued):
  - Access to host country capital markets
  - Permission for 100% foreign ownership versus required local partner
  - Price controls, if any, applicable to sales in host country's markets
  - Requirements for local sourcing versus importation of materials
  - Permission to use expatriate managerial and technical personnel
  - Provision for arbitration of disputes
  - Provisions for planned divestment, indicating how the going concern will be valued (build-to-own or build-to-transfer)

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Managing Risks

- Managing cultural and institutional risks requires the MNE to understand the differences, take legal actions in host-country courts, support worldwide treaties to protect intellectual property rights, and support government efforts to create regional markets.
- The main global-specific risks are currently caused by terrorism and war, the anti-globalization movement, environmental concerns, poverty, and cyber attacks.
- In order to manage global-specific risks, MNEs should adopt a crisis plan to protect its employees and property. However, the main reliance remains on governments to protect its citizens and firms from these global-specific threats.

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