Foreign Direct Investment

Chapter 8

January 22, 2019

Agenda

- Some recent M&A news
- Foreign market entry modes
- What is foreign direct investment (FDI)
- Trends in FDI
  - Key trends
- FDI theories
- Benefits and costs of FDI
  - Benefits and costs of FDI to home and host nations
  - Policy instruments and FDI
- Managerial implications

Some Recent International M&A News

- Konecranes of Finland acquired the material handling and port solutions business of Terex Corporation of USA for 1.1 billion euro
- Newmount, a U.S. goldmining company, agreed to buy its Canadian rival, Goldcorp for $10 billion, making it the world's largest goldminer
- Singapore Technologies Telemedia acquired a 74% stake in India's Tata Communications Data Center Private Limited for $616 million
- Apple paid $300 million to license U.K.'s Dialog Semiconductor's IP and another $300 million to acquire a portion of its chipmaking business and about 300 staff who were already working on Apple's business
- Do the acquirers face any risks?
- How does the host country benefit? And disadvantages?

Foreign Market Entry Modes

- Non-equity modes
  - Exporting/importing
  - Licensing/franchising
- Equity modes
  - Foreign direct investment → Today's topic
    - Wholly owned
    - Partly owned
- **Key Issue**: Given that it is so costly and risky to invest abroad, why do companies make FDI?
  - FDI theories attempt to provide an answer

What is FDI?

- When a firm invests directly in facilities to do R&D, produce, and/or market a product in a foreign country
  - FDI involves a *significant* equity stake in a foreign company – allowing the investor at least some *control* over the operations of the foreign entity
- FDI vs. FPI (Foreign Portfolio Investment)
- Forms of FDI
  - Greenfield vs. acquisition
  - Horizontal vs. vertical
  - Wholly owned vs. partly owned

The Language of FDI

- The flow of FDI refers to the amount of FDI undertaken in a given time period
- The stock of FDI is the total accumulated value of foreign owned assets in a country at a given time
- The outward FDI is the flow of FDI out of a country
- The inward FDI is the flow of FDI into a country
- Horizontal vs. vertical FDI
- FDI vs. FPI (Foreign Portfolio Investment)

Horizontal vs. Vertical FDI

- Horizontal FDI
  - FDI in the same industry abroad in which the company operates at home
  - Typically involves acquiring, or joint venturing with, a competitor overseas, or making a greenfield investment in the same industry overseas
- Vertical FDI
  - Backward vertical FDI is investment in an industry abroad that provides inputs for a firm's domestic operations
  - Forward vertical FDI occurs when a company invests in a customer overseas (e.g., a foreign distributor)

FDI Trends

- Rapid rise in FDI, compared to trade and global output (GDP), during the previous three-four decades
- Historically, the **TRIAD** countries (USA + Japan + Western Europe) had accounted for the bulk of inward and outward FDI, though emerging markets (e.g., the BRIC nations) have lately been receiving (and making) increasing amounts of FDI
- The United States has been the largest foreign-direct investor nation in the world for a long time and the largest recipient of FDI

FDI Trends, contd.

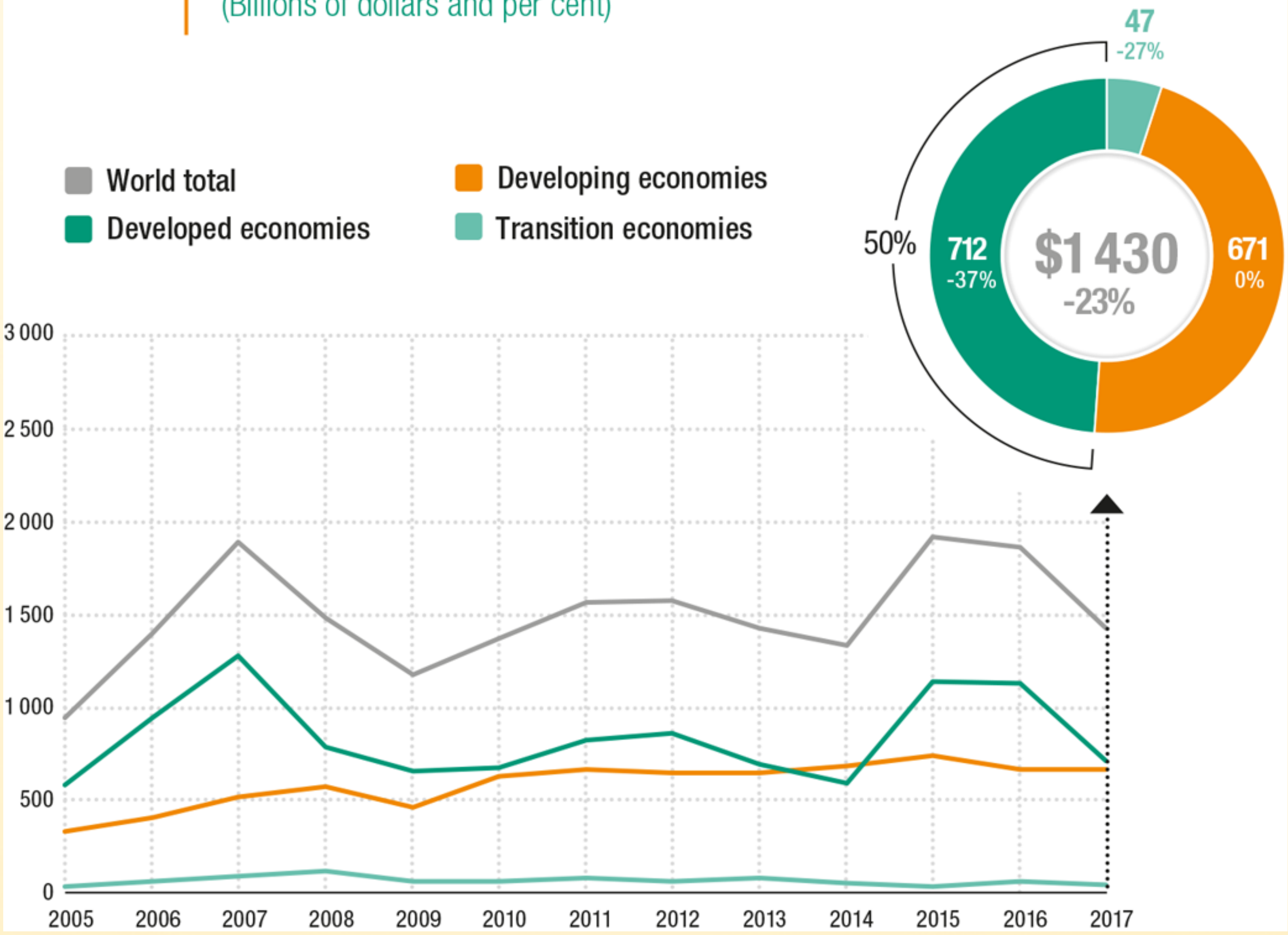
- Both the flow and stock of FDI have increased over the last three-four decades
  - Most FDI is still targeted towards developed nations
    - United States, Japan, and the EU
  - but, other destinations are emerging
    - South, East, and South East Asia, especially China and India
    - Latin America
- However, huge decline in FDI from 2016 to 2017 – mostly in the highly developed economies of Europe and North America

Sharp Decline in Global FDI, 2016-2017

https://unctad.org/en/PublicationsLibrary/wir2018_en.pdf

Figure 1. FDI inflows, global and by group of economies, 2005–2017

(Billions of dollars and per cent)



https://worldinvestmentreport.unctad.org/world-investment-report-2018/chapter-1-global-prospects-and-trends/#Global-FDI-flows-fell-sharply

Figure 2. | FDI inflows, by region, 2016–2017 (Billions of dollars and per cent)

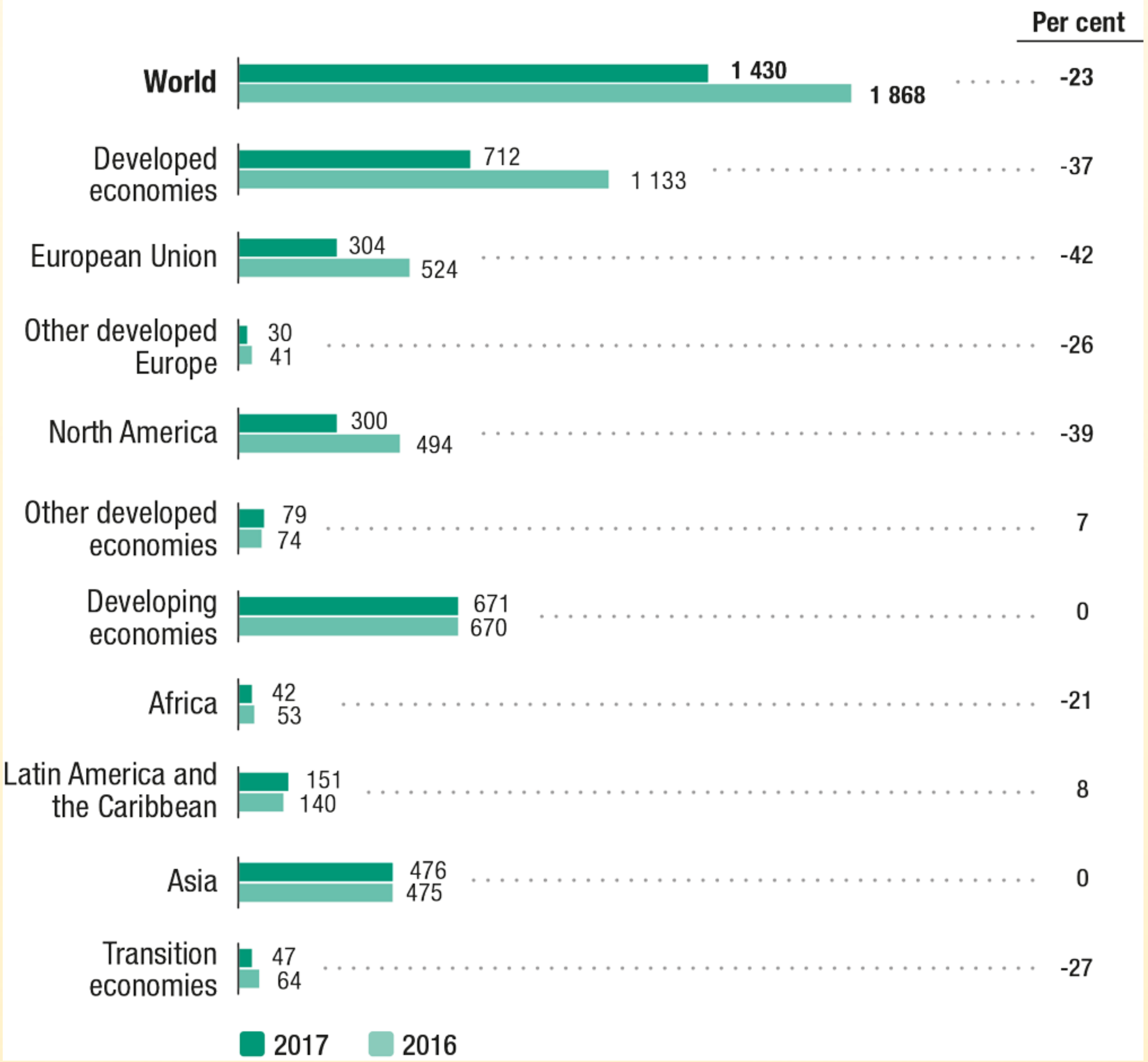


Figure 3. FDI inflows, top 20 host economies, 2016 and 2017
(Billions of dollars)

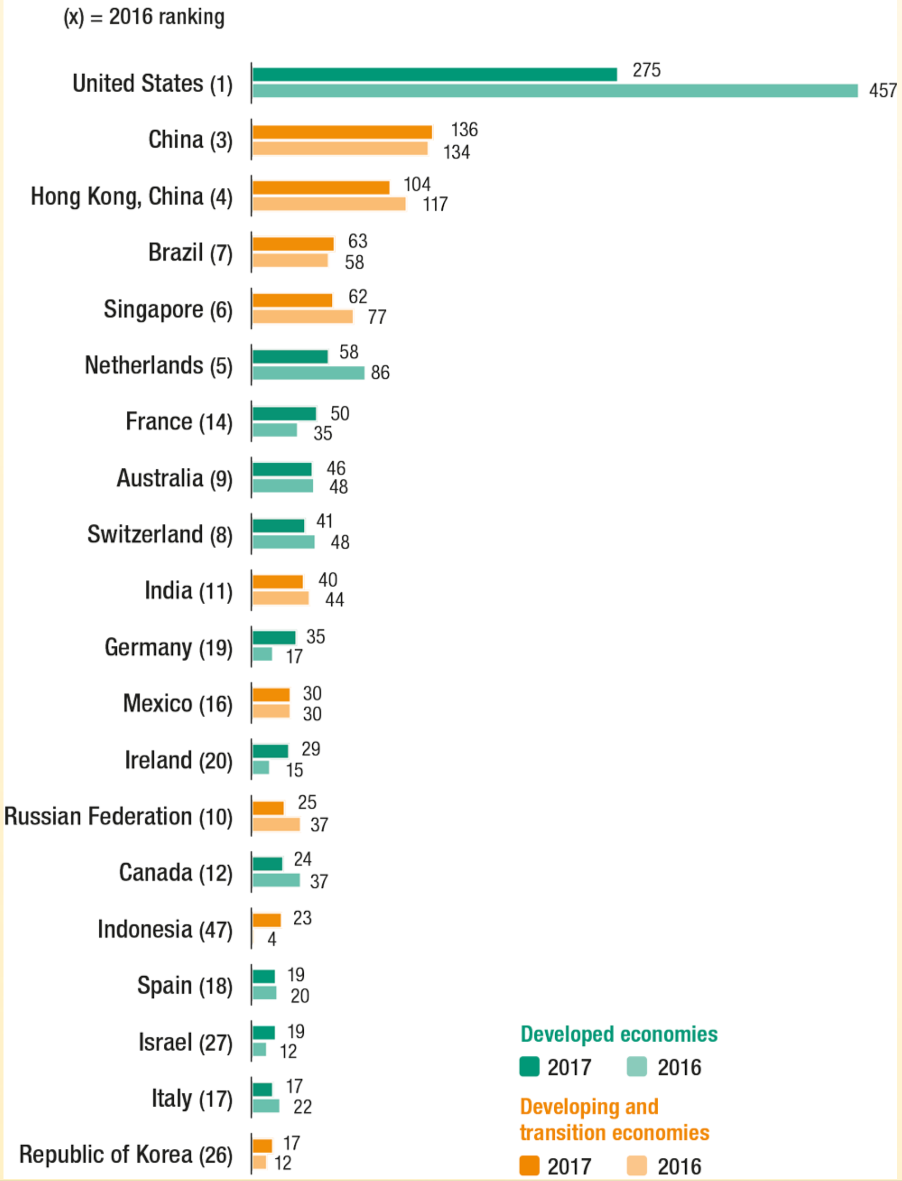
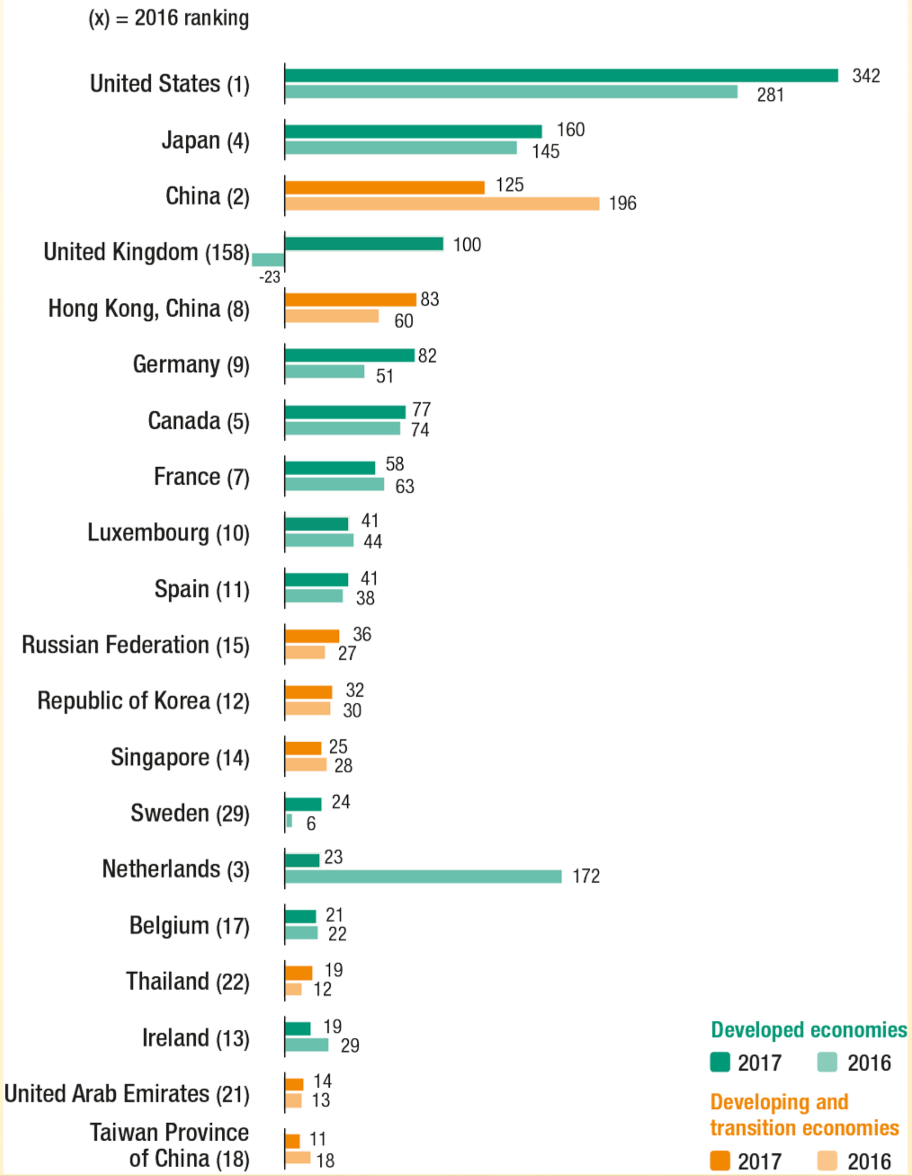


Figure 4. FDI outflows, top 20 home economies, 2016 and 2017
(Billions of dollars)



FDI Trends, contd. (WIR, 2018)

- Global FDI flows declined by 23% from 2016 to 2017
  - Value of net cross-border M&As declined by 22%
  - Value of greenfield investments declined by 14%
  - Continuing decline in rate of return for FDI over the last five years
- The share of developed economies in global outward FDI flows in total worldwide flows was relatively stable at 71%
  - a decline of only 3% from 2016 to 2017
- China's outward FDI declined for the first time in 15 years – by 36%
- While FDI flows to developing Asia remained steady from 2016 to 2017, FDI into Africa reached its lowest level in ten years
- A modest decline in FDI flows to Latin America and the Caribbean
- FDI to transition economies declined significantly

https://worldinvestmentreport.unctad.org/world-investment-report-2018/chapter-1-global-prospects-and-trends/#Global-FDI-flows-fell-sharply

The Shift to Services

FDI flows into services had been rising for over a decade:

- The general move in most developed economies from manufacturing to services
  - Services account for almost 80% of the U.S. economy, 75% of EU economy
- Many countries have liberalized their FDI policies related to services, partly a result of WTO successes
- The rise of Internet-based global telecommunications networks has allowed many service enterprises to locate some of their value-creating activities to different nations to take advantage of favorable factors, as well as offshoring

However, FDI into services declined significantly in 2017

FDI Growth is Driven By

- Globalization of the world economy
  - Globalization of markets
    - Declining barriers to trade and investment
  - Globalization of production
  - Favorable business climate
  - Fear of protectionism in host markets
- Technological developments
  - Global supply chains
  - Reduced transaction costs
- Growth of emerging markets
  - Political and economic changes
- Deregulation and privatization

FDI – An Important Source of Capital

- Gross fixed capital formation - the total amount of capital invested in factories, stores, office buildings, and the like
  - the greater the capital investment in an economy, the more favorable its future prospects are likely to be
- So, FDI is an important source of capital investment and a determinant of the future growth rate of an economy
- Since World War II, the U.S. has been the world's largest foreign-direct investor
  - the United Kingdom, the Netherlands, France, Germany, and Japan are other important source countries
  - together, these countries account for 60% of all FDI outflows from 1998-2011

Acquisitions vs. Greenfield Investments

Acquisitions

- Acquisitions are more popular than greenfield investments, especially in developed economies
  - 70-80% of all FDI is through M&A
- Rationale:
  - Quicker to execute; less risky
  - Target firms often have valuable resources
  - Lesser threat of retaliation from incumbents
- Some challenges:
  - Merging the two companies' systems, cultures, … (post-merger integration)
  - Growing protectionism, especially in Europe and Latin America
    - And USA?

An Example

General Motors in Poland, 2005

1992 Started selling GM cars in Poland

1994 Started SKD assembly in Warsaw in a JV with FSO

JV ended in 2000, FSO went to Daewoo

GM decides to make greenfield investment in Poland

1996 Construction begins for OPEL plant in Katowice Special Economic Zone

1998 OPEL production begins

2005 OPEL plant capacity: 180,000 cars

(As of 2005, GM also had other investments in Poland, including a 50:50 JV with Fiat to make diesel engines)

Why did GM invest in Katowice (and not elsewhere in Poland)?

- The region's industrial tradition
- Two of the largest technical universities in the country are in nearby Gliwice and Krakow; no difficulty in finding technically qualified employees
- Large market size (population: 40 million); export possibilities, since Poland was to eventually join the EU
- Low labor costs
- Incentives offered by the Katowice SEZ
- The City's and the region's decision to invest in infrastructure (e.g., A4); good rail system; good IT and power infrastructure
- Reviewed the City's offer and how the City was managed

Theories of FDI

Theories of Horizontal FDI

- **Key Issue**: Given that it is so costly and risky to invest abroad, why do companies make FDI?
- Ideally, to exploit a foreign market, a firm should export or license its products/technology there – the least costly and least risky alternatives
- However, certain **market imperfections** may make exporting and licensing unattractive/infeasible

Why choose FDI over exporting/licensing?

- Why exporting might not be attractive or feasible:
  - Barriers to trade
  - Competitive advantages of incumbents (e.g., brand names, proprietary knowledge, location, relationships, etc.)
  - Low value-to-weight ratio of the product
- Why licensing might not be feasible:
  - Know-how is difficult to articulate and codify
  - Difficulties in the valuation and sale of know-how
  - Risk of creating a new competitor

Theories of Horizontal FDI

- FDI theories:
  - Firms' strategic behavior
  - The eclectic paradigm
  - Other possible explanations

Strategic Behavior

- Why do firms in the same industry undertake FDI at about the same time and to the same locations?
- Knickerbocker - FDI flows are a reflection of strategic rivalry between firms in oligopolies in the global marketplace
  - Oligopolies – Interdependence between major firms can lead to imitative behavior
    - When one company goes to a new foreign market, others may follow it
  - A case of multipoint competition - when a multinational enterprise encounters the same competitors in different national or regional markets around the world

The Eclectic Paradigm
(John Dunning, 1977, 1988)

- A theory of why firms set up manufacturing facilities overseas, combining ideas from several previous theories
- For a firm to undertake international production, it must have:
  - Ownership advantage (O)
  - Location advantage (L)
  - Internalization advantage (I)

  The O-L-I Paradigm

The O-L-I Paradigm

- Ownership Advantage: A firm must have some core competence which can be leveraged in a foreign market
  - e.g., brand, technology, FMCG marketing, etc.
- Location Advantage: The host market for FDI must offer some advantages for foreign firms to invest there
  - e.g., attractive factors of production, markets, incentives, etc.
- Internalization Advantage: It must make sense for a firm to use the FDI mode of entry (i.e., to set up its own operations in the foreign market) than other entry modes (e.g., exporting or licensing)

Other Explanations for FDI

- Following customers
- FDI as a reaction to trade barriers
  - Japanese auto companies' investments in the U.S.
- FDI as a reaction to changes in taxation rates and exchange rates

Benefits and Costs of FDI

Benefits and Costs of FDI

Host Country Benefits

- The resource-transfer effects
- The employment effects
- The balance-of-payments effects
- Effects on competition and economic growth

Benefits of FDI to Host Country

Resource-Transfer Effects

- FDI can make a positive contribution to a host economy by supplying capital, technology, and management resources that may otherwise not be available locally or may be in short supply, and which may "spill out" to the other firms in the economy

Employment Effects

- FDI can bring jobs to a host country that may otherwise not be created there
  - Direct and indirect job creation, e.g., by foreign automakers in the U.S.

Host Country Benefits of FDI – contd.

Balance-of-Payments Effects

- A country's balance-of-payments account is a record of its payments to and receipts from other countries
  - The **current account** is a record of a country's export and import of goods and services; governments typically prefer to see a current account surplus rather than a deficit
- FDI can help a country achieve a current account surplus:
  - if the FDI is a substitute for imports of goods and services
  - if the MNE uses a foreign subsidiary to export goods and services from the host to other countries

Host Country Benefits of FDI – contd.

Effect on Competition and Economic Growth

- FDI in the form of greenfield investment increases the level of competition in a market, driving down prices and improving consumer welfare
- Increased competition can lead to increased productivity growth, improved product and process innovation, and greater economic growth in the host market

Costs of FDI to Host Countries

- The possible adverse effects of FDI on competition within the host nation
- The perceived loss of national sovereignty and autonomy
- Adverse effects on the balance of payments

Costs of FDI to Host Countries

Adverse Effects on Competition

Host governments worry that the subsidiaries of foreign MNEs operating in their country may have greater economic power than indigenous competitors because they may be part of a larger international organization

National Sovereignty and Autonomy

- Some host governments worry that FDI is accompanied by some loss of economic independence
- The concern is that key decisions that can affect the host country's economy will be made by a foreign parent that has no real commitment to the host country, and over which the host country's government has no real control

Costs of FDI to Host Countries – contd.

Adverse Effects on the Balance of Payments

- With the initial capital inflows that come with FDI there is usually a subsequent outflow of capital as the foreign subsidiary repatriates earnings to its parent country
- When a foreign subsidiary imports a substantial number of its inputs from abroad (intra-company trade), there is a debit on the current account of the host country's balance of payments account

Benefits of FDI to Home Countries

- A positive effect on the current account of the home country's balance of payments from the inward flow of foreign earnings
- The employment effects that arise from outward FDI
- The gains from learning valuable skills from foreign markets that can subsequently be transferred back to the home country

Costs of FDI to Home Countries

- Employment effects
- Balance of payments effects

Government Policy Instruments and FDI
Home Country Policies

- **Encouraging Outward FDI**
  - Many investor nations now have government-backed insurance programs to cover major types of foreign investment risk (expropriation, war losses, inability to repatriate capital or earnings to home country)
- **Restricting Outward FDI**
  - Virtually all investor countries, including the United States, have exercised some control over outward FDI from time to time, e.g., foreign investments involving sensitive technologies
    - China has lately been restricting outward FDI

Policy Instruments and FDI:
Home Country Policies

Encouraging Outward FDI

- Insurance against foreign investment risks
- Loans to firms investing in foreign markets
- Double-taxation treaties
- Influencing foreign countries

Restricting Outward FDI

- Exchange-control regulations
- Tax rules to encourage companies to invest at home
- Political reasons
- Security reasons

Government Policy Instruments and FDI
Host Country Policies

Encouraging Inward FDI

- Incentives to foreign firms to invest in their countries – motivated by a desire to gain from the resource-transfer and employment effects of FDI, and to capture FDI away from other potential host countries

Restricting Inward FDI

- Ownership restraints and performance requirements
- The rationale underlying ownership restraints:
  - Foreign firms are often excluded from certain sectors on the grounds of national security or competition
  - Ownership restraints seem to be based on a belief that local owners can help to maximize the resource transfer and employment benefits of FDI for the host country

Policy Instruments and FDI: Host Country Policies

Encouraging Inward FDI

- Incentives for inward FDI
- "Investment" visas

Restricting Inward FDI

- Ownership restrictions
  - Excluded from certain industries/sectors
  - Equity restrictions
- Performance requirements
  - Local content; exports; technology transfer
  - Local participation in top management

Implications for Business

- Exporting is preferable to licensing and FDI if:
  - Transportation costs are minor
  - Trade barriers are minimal
- If exporting is not feasible, choose licensing over FDI
- However, FDI is the best alternative when:
  - Exporting and licensing are not feasible or advisable
  - The firm has valuable know-how which cannot be adequately protected by a licensing contract
  - The firm needs tight control over the foreign entity
  - The firm's skills and know-how are not amenable to licensing

Implications for Business (Contd.)

- Firms for which licensing is not a good option tend to be in these industries:
  - High-technology industries where protecting the firm's proprietary know-how is most important
  - Global oligopolies, where firms must maintain tight control over foreign operations (e.g., to launch coordinated attacks against global competitors)
  - Industries with intense cost pressures, which also require firms to maintain tight control over foreign operations, and to derive economies of scale in manufacturing and other operations