Chapter 17
Adjusting for Risk in Foreign Investment

Learning Objectives
- Define and classify foreign investment risks
- Analyze firm-specific risks
- Examine country-specific risks
- Identify global-specific risks

Defining Risk
- Risks associated with foreign investments are inherently subjective or qualitative and not quantitative
- Distinguishing risk as either one-sided or two-sided is one way of applying qualitative and quantitative measures of risk
- One-sided risk only emphasizes the potential for loss
  - These risks are typically expropriation risk, blocked funds, etc.
- Two-sided risk carries both loss and gain
  - A typical two-sided risk is foreign exchange risk
  - Risk measurement draws upon two distinct sets
    - Measures of risk from the market
    - Measures of risk from institutions

Defining Foreign Investment Risks
- In order for an MNE to identify, measure, and manage its foreign investment risk it is useful to define these risks as being
  - Firm-specific
  - Country-specific
  - Global-specific

Defining Foreign Investment Risks
- Firm-specific are those risks that affect the MNE at the project or corporate level (e.g. business risk, FX risk, governance risk)
- 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)
Defining Foreign Investment Risks

Firm-Specific Risks
- Business risks
- Foreign-exchange risks
- Governance risks

Country-Specific Risks
- Transfer risk
- War and ethnic strife
- Negotiation and corruption
- Defective economic and social infrastructure
- Macroeconomic disequilibrium
- Sovereign credit risk
- Cultural and religious heritage
- Intellectual property rights

Global-Specific Risks
- Terrorism
- Anti-globalization movement
- Cyber attacks
- Poverty
- Environmental safety

Measuring & Managing Foreign Investment Risks

Sensitivity Analysis
Mimimize Assets at Risk
- Simulating business plans
- Adjusting discount rates
- Adjusting cash flows

Diversification
- Plant location
- Source of debt & equity
- Currency of denomination
- Supply sources
- Sales locations

Insurance
- Hedging currency risk
- Risk-sharing agreement
- Country investment agreements
- Investment guarantees

Firm-Specific Risks: Measuring & Managing

Business Risks
- Forecasting errors
- Large & risky projects
- Portfolio risk

Foreign Exchange Risk
- Transaction exposure
- Operating exposure
- Accounting exposure

Governance Risk
- Transaction exposure
- Operating exposure
- Accounting exposure

- Goal conflict
- Ownership structure
- Human resources

Sensitivity Analysis
Diversification
Minimize Assets at Risk
Insurance

Firm-Specific Risks: Measuring & Managing

Business Risks are the risks that actual business results will be different than the estimates
- Sensitivity analysis: Project viewpoint measurement
  - Several “what if” scenarios are estimated
- Sensitivity analysis: Parent viewpoint measurement
  - Adjusting discount rates and/or cash flows
  - Difficulty in determining which to adjust and by how much
  - Also must consider portfolio risk management (why does the foreign subsidiary exist?)

Firm-Specific Risks: Measuring & Managing

- Negotiating investment agreements
  - An investment agreement spells out the rights and responsibilities of both the foreign firm and the host government
  - The agreement should include the following
    - 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
Firm-Specific Risks: Measuring & Managing

- Negotiating investment agreements
  - Methods of taxation, including rate, type and means by which rate is determined
  - 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

Firm-Specific Risks: Measuring & Managing

- Negotiating investment agreements
  - 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)

Firm-Specific Risks: Measuring & Managing

- Investment insurance and guarantees: OPIC
  - MNEs can sometimes transfer political risk through an investment insurance agency
  - The US investment insurance and guarantee program is managed by the Overseas Private Investment Corporation (OPIC)
  - It’s stated purpose is to mobilize and facilitate US private capital and skills in the economic development of less developed countries

Firm-Specific Risks: Measuring & Managing

- Investment insurance and guarantees: OPIC
  - OPIC offers coverage for four separate types of risk
    - Inconvertibility - risk that the investor will not be able to convert remittances into dollars
    - Expropriation – risk that the host government will seize the assets of the US investor without restitution payments
    - War, revolution & insurrection – covers damages to physical property of foreign subsidiary
    - Business income – coverage provides compensation for loss of income due to events from political violence that directly affect the company & its assets

Operating Strategies After the FDI Decision

- Although FDI creates obligations on the part of the foreign subsidiary and host government, conditions change and the MNE must be able to adapt
- There are several strategies that an MNE can undertake to anticipate changing conditions or host government’s future actions and negotiate these terms
  - Local sourcing – firms may be required to purchase raw materials from local producers
  - Facility location – facilities may be located to minimize risk

Operating Strategies After the FDI Decision

- Control of transportation – most important for oil and pipeline companies
- Control of technology – control of key patents and intellectual property
- Control of markets – common practice in order to enhance a firm’s bargaining position
- Brand name & trademark control – gives MNE ability to operate under a world brand name
- Thin equity base – foreign subsidiaries can be financed with a thin equity base and large proportion of local debt
- Multiple-source borrowing – firm can borrow from various banks and countries
Country-Specific Risks

These risks affect all firms, both domestic and foreign operating within the host country

Most typical risks are

- Transfer risk
- Cultural differences
- Host country protectionism

Transfer Risk

- Blocked funds
- Macroeconomic disequilibrium
- Economic infrastructure
- Sovereign credit risk

Cultural Differences

- Religion
- Nepotism and corruption
- Intellectual property rights

Protectionism

- Defense industry
- Agriculture
- Infant industry

Transfer risk are the limitations on the MNE’s ability to transfer funds into and out of a host country without restrictions

MNEs can react to potential transfer risk at three stages

- Prior to making the investment, a firm can analyze the effect of blocked funds
- During operations a firm can attempt to move funds through a variety of repositioning techniques
- Funds that cannot be moved must be reinvested in the local country to avoid deterioration in real value

An MNE has at least six strategies for transferring funds under restrictions

- Providing alternative conduits for repatriating funds
- Transfer pricing goods & services between subsidiaries
- Leading and lagging payments
- Using fronting loans
- Creating unrelated exports
- Obtaining special dispensation

Creating unrelated exports

- Because main reason for stringent exchange controls is a host country’s ability or inability to earn hard currency, anything an MNE can do to generate export sales helps the host country
- Some exports can be created from present productive capacity or through production of unrelated products and services for export

Special dispensation

- If the firm is in an important industry for the development of the host country, it may bargain for a special dispensation to repatriate some funds
Country-Specific Risks

- Other country-specific risks that may block funds are
  - Host country’s economic infrastructure
  - Sovereign credit risk
  - War & ethnic strife

Country-Specific Risks

- Cultural differences
  - Differences in allowable ownership structures
  - Differences in human resource norms
  - Differences in religious heritage
  - Nepotism and corruption in the host country
  - Protection of intellectual property rights
  - Infant industry
    - Defense
    - Agricultural

Global-Specific Risks

- These risks are currently at the forefront for MNEs and include
  - Terrorism
  - Anti-globalization movement
    - The role of international institutions such as the IMF and World Bank
  - Environmental concerns
  - Poverty
  - Cyber attacks

Summary of Learning Objectives

- Risk can be one-sided or two-sided
- Measures of risk stem from the marketplace and from institutional sources
- Foreign investment risks can be firm-specific, country-specific, or global-specific
- Business risks can be measured through sensitivity analysis from both the project and the parent point of view

Summary of Learning Objectives

- Goal conflict between the MNE and its host government creates a need for defensive firm strategies
- Corporate governance strategies include pre-investment agreements with the host country, investment insurance, operating strategies post investment, an appropriate ownership structure and a sensitive human resource policy
- Transfer risk can be contained by a pre-investment agreement and various strategies for moving blocked funds

Summary of Learning Objectives

- Other transfer risks include the danger of macroeconomic disequilibrium, weakness in the host country’s economic infrastructure, sovereign credit risk, and war and ethnic strife
- Other country-specific risks include cultural differences and host country protectionism
- Global-specific risks include terrorism, anti-globalization movement, environmental safety concerns, poverty and cyber attacks
Summary of Learning Objectives

- Managing global-specific risks is the task of national and international institutions; however, MNEs can help by supporting government efforts in countering the risks.