

International Business Strategy

Lecture Six

Foreign Direct Investment (FDI)

Introduction to Lecture Six

In our lecture five we looked at the strategy formulation process, why we noted is part of the how question. In this topic we will focus on one of the options an international business has to enter foreign countries.

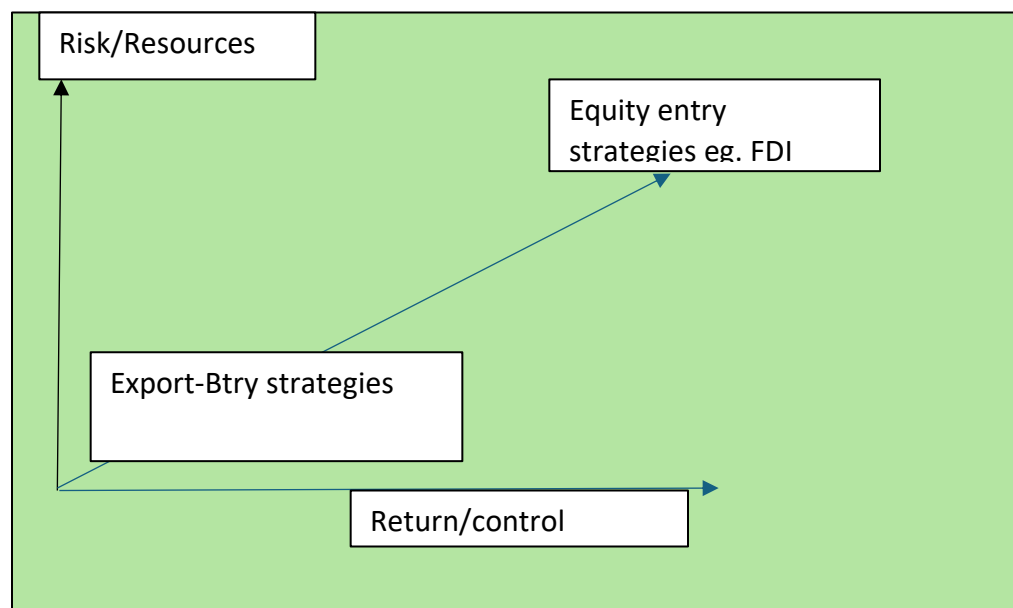
Learning Outcomes

1. Examine what constitutes FDI
2. Differentiate different forms of FDI
3. Pinpoint factors encouraging FDI as an entry strategy
4. Debate on impacts of FDI to host countries

What constitutes FDI?

In our lecture two we looked at foreign entry theories and we defined what foreign direct investment is. Just to recap on this, FDI means that a firm owns a part or whole of an operation in another country. We noted the threshold of at least 10% as given by the World Bank was critical. Another important aspect to remember about this ownership is intended to give the firm management control. Comparing FDI with all the other entry strategies, it represents the deepest level of engagement a firm can have. This means that the firm will have to commit most resources when pursuing this type of entry strategy. Consequently, the **risk** is high, and the expected **returns** are also high. This relationship is depicted in the two dimensions graph **1**, FDI falls under equity entry strategies.

Graph 1. Risk-Return Relationship in Entry Strategies



Forms of FDI

When a firm decides to use FDI to enter a market, it has three major options to achieve this; Greenfield or Mergers and Acquisitions. In the next section we look at each of these options

1. **Greenfield**- In this option of FDI, a firm starts from scratch. It identifies the land to establish its factory/plant and offices on, acquire it or lease it, develops the blueprint of its buildings, go ahead and construct them. Then recruit personnel (local and foreign) to work in those plants and offices and start the operations. Some of the benefits of this form of FDI is that the firm has control of every aspect from how the Artcurial of the building to the caliber of people it recruits. It also gives the firm ownership of every stage. On the flip side, this option is slightly slow as it takes time before the firm can start production. Often this takes the form of wholly owned subsidiaries. This strategy is applicable under the following circumstances: when a market is emerging, meaning it has significant growth potential, a market with unique characteristics whereby customization and localization will be required; where there are no suitable target for acquisition; where the goverment is offering very attractive incentives for direct investment; and where the firm want to avoid legacy issues that comes with acquiring an existing firm.

The strategy is not without its drawbacks; It is costly in term of the initial investment that need to be committed. The strategy takes time before a firm can hit the market with its products. It is not without regulatory hurdles stemming from obtaining such things as business permits, different licenses to do construction, in some countries this is a process that is full of red tape. It is also a very risky investment especially when you do not have the knowledge of the local markets and cultures.

2. **Joint Venture-** This is whereby two or more parent firms join hands to create a separate firm where they share ownership. The new firm operates in a foreign country/market. In markets where the host government is not so receptive to foreign businesses, this method is common whereby a local firm and a foreign firm may establish a separate firm to overcome this challenge. The advantage with this strategy includes; shared risk, the cost is also shared, it may increase the time to market if one of the partners is a local firm, there is synergy as firms combine their strengths, and it offer a flexible and pre-determined exit strategy. This strategy is mostly applicable under the following conditions; A market with complex legal framework, when the cost and risk of setting up in a foreign market is too high, when you want to leverage the complementary resources of your partners, and when you want to mitigate the political risk. The drawback of the strategy is that there is shared control which complicates decision-making as consensus must be sought. Parties have very limited control over each other's action outside the venture, coming up with the venture requires strict scrutiny and legal framework. Often than not there are issues of intellectual property rights and finally, any damage to venture brand name could have negative impact on the parents' one.

3. **Mergers and Acquisitions (MA)-** The third alternative for a firm interested in venture into a foreign market using FDI is MA. These constitute two strategies though often mergers and acquisitions are used interchangeably. Mergers signify the coming together of equal parties. This can be the vehicle that a firm uses to get into a foreign market. It would entail a foreign firm joining hand with a local existing firm to start operations in that very local market immediately. In this case the two parties are likely to have equal shares and control of the operations of the business. The second and common strategy here is **acquisition**, which entails a foreign firm acquiring a local firm (usually weaker compared to the foreign one) this could be 100% acquisition or a stake that would give the acquirer control over the local firm.

Advantages of acquisitions

- This gives the foreign firm immediate control and access to the local market. This is one of the advantages of acquisition, in that the acquirer reduces the time to market,
- Also, the foreign firm has a ready workforce and access to existing distribution channels and suppliers.
- Use of acquisition helps the firm to ride on the existing goodwill and brand equity that the local firm has built over time.
- It may have an upsurge in the firm's product uptake if the foreign firm has global brand recognition.
- The strategy allows the foreign firm to overcome what we referred to as *market imperfections* or trade barriers that may be present in the country in our lecture two.

Disadvantages of acquisitions

- The acquirer may have to deal with any negative associations with the local firm's brand or products.
- The strategy does not also allow the firm much flexibility in the immediate future, in as far as changes of the facilities, workforce and product.
- There is still ample time and diligence needed before the take over

Factors Encouraging FDI

There are several factors that can be said to encourage FDI in any given country and international business managers must be alert to their presence.

- Trade barriers- This is what we termed as market imperfections. Where say import duties are exorbitant a firm interested in a market may try to go round such via foreign direct investment
- Government incentives- if the local/host government has offered incentives to foreign companies such as tax breaks, this may witness a surge in foreign investment
- Developed infrastructures- If a country has well developed infrastructure such as road, rail, telecommunication, banking, and insurance among others. It may act as a heaven for foreign investment.
- Available raw materials supply- If the key raw materials of the foreign firm's products are readily available in the host country and say at a reasonable cost, this may encourage foreign firm to choose FDI as an entry strategy

- Customer knowledge- At times a firm could pursue this strategy in its bid to get a deeper understanding of its customers in each market. This is where the local presence will help the firm gain valuable knowledge.
- Following customers- A firm may opt for FDI when its client moves to a foreign country. If a firm's main client who they supply moves to a foreign country, they may not have much of an option but to follow them.
- Mimicking main rivals- There are instances where firm tend to follow its rivals in the game of power, this may include if the rival establishes themselves in a foreign market the firm follows suit.
- In search of cost reductions- at times it may make economic sense to produce or locate your production facilities in a foreign country where the factors of production may be cheaper.

The factors above were classified by Cavusgil et al (2012) into three categories;

1. *Market-seeking motives*: This is whereby a firm may be experiencing unfavorable market conditions in its domestic market or there are market opportunities in the foreign market. Or the firm could be following its customers or rivals.
2. *Efficiency-seeking motives*: In this category the desire to increase efficiency by reducing raw materials or production costs that may be derived from cheap inputs and cheap labor are the key drivers. The presence of market imperfections are the ones that push a firm to pursue FDI.
3. *Resource/asset-seeking motives*: Some firms may venture into a foreign market to purely gain new knowledge, managerial know-how, assets, raw materials or technology.

Impacts of FDI on Host countries

If you recall in our lecture two, we looked at why the government may be concerned with FDI and thereby intervening. The following are some of both positive and negative impacts of FDI on host country;

- Capital flow- this is beneficial to a country as investors bring in financial resources into the country and this helps in balance of payment.
- Technology and managerial know-how transfer- as new facilities are set up locals are likely to learn new things including how to operate the production technology
- Heightened competition- Any time a new firm enters an industry, the competition is likely to be stirred up and this may in effect be beneficial to consumers with possible lower prices.

- Import substitution- when a foreign firm sets up a production facility in the local market it means what they were importing will now be produced locally. This from a balance of payment perspective is good for the country
- Increased export earnings- With production happening locally, it is possible that the firm will be exporting its products. Where this is the case, it will earn the country some export earnings.
- Cultural erosion- At times, multinational may erode the heritage of a nation if they are highly entrenched in the economic activities of a country
- Political interference- At times the multinational expansion could serve political motives of their masters in the countries they establish themselves in.

Management Issues in the FDI Decision

Engaging in FDI requires some important decisions to be made regarding the management of the company and its market. Here are three such decisions;

1. Control

As we pointed out earlier firms are always looking for control of activities that happen in the local markets. This is why most companies would seek up to 100 % control with the belief that it will give them greater control. However as Wild, Wild and Han (2010) noted this may not always be the case. The host government may have some requirements that would erode such control. For instance, some governments have requirements that you must employ a certain percentage of the locals, others may require goods produced be exported to reduce competition with local industries. It is good to note that most countries now are not so controlling because they appreciate the role that multinationals play in their economy.

2. Purchase or build decision

Another key decision managers will have to make is whether to buy an existing business or to build their subsidiary from scratch. The former is what we call acquisitions while the latter is what we call greenfield investment. Each of these approaches has its advantages and disadvantages. Management must consider the context, where there is an existing business that matches what the foreign firm is seeking to do then acquisition would be a good choice, besides it will be a quicker way to enter the market. In some instances, there may be no match of an existing business or the technology in the country could be absolute, in such a case the multinational may have no option but to pursue green field investment.

3. Production Costs

When considering the local market, it is important to look at all aspects of cost and not just the tax and cost of land. There are labor costs that the firm will have to bear, questions such as; what are the minimum wages in a country? what other benefits that labor laws may require the firm to pay? What training will be required to bring the workforce to production level? How are all these components projected to rise? All these need to be looked at as they may erode the cost advantage of a country.

Topic Recap

In this topic we have looked at what constitutes FDI, with an emphasis on control as the bottom line. We have also explored different forms of FDI and their application. Next, we have looked at factors that are encouraging FDI as well as the impact this strategy has on the host country. Finally, we have looked at management issues in FDI. In the next topic, we will look at international alliances which also help us answer *how*.

References

- Cavusgil, S.T., Knight, G., Riesenberger, J.R. (2012). **International Business**. New Jersey: Pearson. Second Edition
- Wild, J., Wild, K., & Han, J. (2010). **International Business** (5th ed.). Pearson Education, Inc.