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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Lessons for Development from London Business School's Centre for New and Emerging Markets (CNEM) Research Project
"Investment in Emerging Markets"

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Key Messages

1. The nature of the institutional and policy environment is critical for Foreign Direct Investment (FDI), especially the quality of the legal framework and the predictability of government policy.
2. FDI is also affected by the quality of locally available resources, notably human capital, supplier industries and infrastructure.
3. The availability of acquisition opportunities is important for the scale of both inflows and spillover benefits. Privatisation and liberalisation policies pave the way for foreign entry as does the existence of a competitive domestic sector.

The views and opinions expressed in this study are those of the author and do not necessarily correspond to the views or policies of the Department for International Development (DFID), UK.

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Introduction

1. This paper summarises the findings of a major CNEM (the Centre for New and Emerging Markets) research project on the determinants of FDI in Egypt, India, South Africa and Vietnam from 1991 to 2000. A number of complementary research methods were employed, including 12 case studies and a survey covering between 5 and 15% of the population of foreign subsidiaries in the four countries¹. The sectoral distribution firms in the survey are reported in Table 1, and of the cases in Table 2 (see Appendix). The material has been written up as a book (Estrin and Meyer (2004) and in a number of technical papers (e.g. Meyer, Estrin and Bhaumik (2003)). In this summary, we outline the main policy conclusions and explain how they have been derived. Throughout the text the main findings of the work are highlighted in italics. We commence with the foreign investors perspectives, and then discuss pertinent aspects of the institutional environment. Later we discuss local firms and the project dynamics.

Global Strategy – Local Entry

2. Any explanation of foreign investment must start from an understanding of the global strategies pushing multinational companies (MNCs) into emerging markets, including impact of institutional changes at the global level such as World Trade Organisation (WTO) memberships and regional integration. Most investors in our study focus on a particular industry aiming for global leadership in their chosen segment. FDI in developing countries can serve this objective by providing a global supply base, or by extending market reach.

3. It could be expected that much FDI into developing countries would take the form of outsourcing manufacture to low cost suppliers and investing to exploit location - specific assets, for example, natural resources. Such investments would primarily lead to enhanced exports and balance of payments benefits. The survey reveals that this is not an accurate description of FDI into our four sample economies. Around three quarters of FDI is “market-seeking” (that is, aimed at supplying the domestic market in the host country), except in Vietnam where the proportion is around 50%. Moreover, the survey reveals that most foreign direct investments are small; the

median number of workers in each country at the start of operations was 40 in Egypt, 30 in India, 76 in South Africa and 85 in Vietnam.²

4. However, global sourcing strategies lead to the transfer of supplier relationships. Manufacturing companies often prefer to use the same suppliers worldwide, especially in the automotive industry. Thus, Honda's investment in motorcycle assembly in Vietnam triggered further investment by its Japanese suppliers, while Behr moved to South Africa to supply the new overseas operations of its German customers.

5. In recent years, many MNCs have shed peripheral product lines and expanded their core businesses, often by acquisition. They increasingly serve worldwide markets and reorganise their supply chain to take advantage of locational advantages worldwide (see Meyer, 2003). For example, among our cases, Heinz changed its strategy by refocusing on a narrower product line but with a large international presence, including in Egypt. For companies aiming to become global leaders in their market segment, competitive interaction with global rivals may induce early entry in emerging economies to reap first or second-mover advantages. This appears to be the motivation for Carlsberg acting soon after Heineken entered Vietnam, and NGK Ceramics following competitor Corning into South Africa. On the other hand, some firms have divested selected emerging market operations as part of a global restructuring, including ABN Amro.

6. One can infer some important lessons for policy makers. Although many developing economies could provide low cost settings for western firms, very few succeed in attracting significant numbers. The investment that occurs often generates little local employment, and primarily focuses to meeting the needs of domestic markets, and therefore is concentrated in large or fast growing economies. Hence, even in countries like those in our sample, with quite significant FDI flows, *policymakers should not look to FDI primarily as a source of employment creation: the main benefits instead must derive from spillovers that improve competitiveness.* Moreover, policy-makers need to create an infrastructure, such that investing firms can with limited risk take up the opportunities offered by the comparative advantage of potential host economies, for example relatively cheap labour or raw materials.

7. Moreover, policy makers need to be aware of evolving strategies of MNCs to identify the factors driving FDI decisions. Regressions also indicate that prior business familiarity with the host country and experience of the FDI projects in other developing countries is associated with the decision to invest. Moreover, many investors originate within the region in the case of Egypt and Vietnam, and regional trade and integration policies as well as global ones often influence location decisions. This suggests benefits to the co-ordinating of FDI policies at regional level by policy makers in different countries.

The Institutional and Policy Environment

(i) The National Institutional Framework

8. In the survey, we explored managers' perceptions of the evolution of the host country's institutional environment from the start of operations to 2001. Using Lickert scales, we find managers' evaluation of many aspects of the business environment to range from "satisfactory" to "good". For example, in all four countries, local labour quality and availability in four skill categories, from skilled manual workers to executives, is evaluated as good, as is the quality of most local inputs, for example, of raw materials, machinery, professional services and of utilities. Moreover, there is a marked improvement in the evaluation of these inputs in the period up to 2001 in Egypt, India and Vietnam but not in South Africa. Given that these countries consistently received reasonably significant FDI flows over this period, the data suggest that ensuring the supply of a reasonable quality of inputs is a prerequisite for FDI to developing countries, and that policies with respect to labour skills and infrastructure, particularly of roads, electricity and telecommunications are critical.

9. However, the survey reveals that managers' evaluation of the host economy's institutional environment often remains poor. Thus the general legal framework is on average regarded as unsatisfactory, as is the predictability of government policy. Central governments are regarded as failing to follow policies conducive to FDI, and the evaluation of provincial and local governments is even worse. Thus, foreign investors do not regard governments as business friendly, even in countries that have prioritised FDI, and the situation is not seen as having improved greatly outside

Vietnam up to 2001. The survey suggests that institutional problems are concentrated in the public sector itself, and relate to unpredictability of policy, legal frameworks and complexity of the business environment. The survey only covers firms that have chosen to invest, many of which have managerial experience in similar business environments that has probably enabled them to develop mechanisms to cope with weak institutions. It seems likely that firms which are not able to manage the risks of operating in such environments instead choose not to invest.

10. We obtained further insights on the importance of institutions on FDI from the case studies. Complaints about general issues such as bureaucracy or corruption were common, but firms that had entered had found ways to address these problems. The institutional problems that had an impact on business were instead very specific to the industry if not the firm. However, the cases do point to a variety of aspects of the general legal framework that are of major concern to investors. For instance, in Egypt and India labour law was frequently described as problematic. Restrictive labour law inhibits FDI by acquisition as it inhibits the post-acquisition restructuring and modernisation of production processes. Bureaucracy in Egypt is still very difficult for foreign firms to manoeuvre around (El Mikawy and Handoussa, 2002), and this creates a need for a local partner. In South Africa, visa and immigration regulations have been frequently mentioned as an obstacle.

11. On the positive side, wider policies of liberalisation affecting industry facilitate FDI, and in many cases crucially influenced the timing of entry. Liberalisation also changes the competitive environment for local firms who have as a result sought foreign partners to help deal with the anticipated increase in competition. At the same time, with liberalisation often incomplete, foreign investors can be interested in partnering with local firms that contribute location-specific capabilities, especially for those concerned with establishing positions in local markets (for example, the cases of Packaging, SEAB, Bacardi-Martini, Heinz).

(ii) Industry Specific Institutions

12. The cases frequently refer to industry-specific regulatory institutions. Examples include industrial policy in the automotive sector, regulation of the banking sector, licensing and pricing of pharmaceutical products. The case of the South African automotive industry represents a positive influence of industrial policy. In fact, Black and Gelb (2004) consider policy as ‘absolutely critical’ for the establishment of the export-oriented automotive components industry. A key element has been a tariff regime for imports of cars and components based on local content with import-export complementarity. Local content is measured on a ‘net foreign exchange usage’ basis, which allows export revenues to be deducted from the value of imports on which tariffs were to be paid. The policy attracted foreign investors such as NGK Ceramics and Behr and created an automotive (supplier) cluster in South Africa. Local content requirements have also encouraged the development of the local supplier network serving Honda’s motorcycle manufacture in Vietnam, where Japanese foreign investors have established some key suppliers.

13. Other industry specific policy influences arise from the removal of barriers to business. In particular, the timing of entry and the acceleration of resource commitments has been determined by changes in the regulatory conditions and the liberalisation of the industry. Where local firms control industry-specific ‘rights’ such as operating licences, these institutional arrangements can induce foreign investors to choose joint venture (JV) or acquisition as the entry mode. Path dependency then can lead to the continued operation of businesses set up during a particular policy approach. In Egypt, for example, GSK established local manufacturing in part to ease access to the local pharmacy market and to protect international patents through a local presence. As intellectual property rights were strengthened and the market was liberalised³, there were fears that local production would be reduced. However, in the case of GSK, the opposite happened; the firms’ global strategy led to the operation being upgraded to become a regional supply hub. In the case of banking, the step-wise liberalisation of the banking sector in South Africa and India created business opportunities for ABN Amro. Industry-specific regulation also affects the mode of entry, as remaining restrictions on foreign ownership are often limited to industries considered politically sensitive. In India, this includes alcoholic beverages, as

illustrated by the Bacardi-Martini case where foreign ownership has been limited to 74%. Liberalisation of such industries would see new entrants establish wholly owned affiliates, while an existing JV may, possibly after a lag, be converted to full foreign ownership.

(iii) Regional Policies and Institutions

14 In setting up operations, however, investors closely evaluate institutions at the specific investment locations. Industrial policy may intentionally favour investment in special industrial zones by providing incentives such as tax and tariff exemptions, as in Egypt (El-Mikawy and Handoussa, 2002)⁴. The Indian and Vietnamese cases illustrate the importance of sub-national institutions at the level of states or provinces, but because Egypt and South Africa are administratively more centralised, this issue has had less prominence. The Bacardi-Martini case illustrates the obstacles for businesses that operate nationwide, if regulatory regimes and/or pertinent tax legislation vary within a country. The case also points to the potentially detrimental effects of sub-national competition for FDI. For foreign investors, complex and regionally divergent regulation create obstacles to FDI, increases the costs of information gathering and negotiations, and increases the need for local partners that help with these tasks.

15. In Vietnam, we found a clear pattern of provinces that are more progressive in implementing liberalisation and establishing effective law enforcement also attracting more FDI, particularly in the form of greenfield projects (Meyer and Nguyen, 2003). In this process, informal institutions at the local level have become more important, including FDI promotion, promotion of market institutions and access to industrial real estate. In Vietnam, it appears that local governments taking a more accelerated approach to reform have helped facilitate foreign investment. Thus reform programmes should encourage local authorities to act in the spirit of liberalisation, and to act entrepreneurially in fostering local business development.

Supply Side Constraints: Capital Markets and Local Businesses

16. In developed countries, acquisitions account for 90% of all FDI capital (UNCTAD, 2003), which generates the greater technological spillovers as well as via skill transfers and in the supply chain (UNCTAD, 2002). However, outside South Africa, acquisitions are rare. In fact, the dominant entry modes were greenfield and joint venture, each of which may offer weaker spillover benefits for the rest of the economy. Our study suggests that this can be related to both capital market development and the 'quality' of local firms.

17. Capital markets are a key facilitator of mergers and acquisitions. Companies are far more likely to pursue acquisition-based growth strategies where capital market institutions are developed. The difference in entry patterns that we observe between South Africa and the other countries in our study can in part be related to the larger and more developed capital market institutions. Capital markets can be the location of FDI projects if equity is acquired prior to the launch of a full bid. This did not happen in our South African cases, yet they appear to be indirectly facilitated by several capital market-related institutions:

- (i) Stock markets provide benchmark prices for the valuation of corporate assets and firms.
- (ii) Information is more readily available if accounting standards are sophisticated, and specialist intermediaries provide the required services, notably independent auditing.
- (iii) Specialist intermediaries, such as investment banks, stockbrokers and consultancies experienced with mergers and acquisitions are available to provide support services.

18. Liquidity of markets for corporate control moreover depends on owners of firms being interested in selling their businesses to foreign investors. Yet, in emerging economies, a significant proportion of firms tend to be owned by the state, or by domestic family-controlled business groups as in India. Hence, the availability of firms for possible acquisition depends on privatisation policy and on business groups' corporate strategies.

19. Privatisation has played a substantive role in all four countries, although not on the scale of Eastern Europe in the 1990s. For instance, in Egypt the privatisation of telecommunications has been crucial for the establishment of ECMS and the take-over of mobile services from the state-owned service provider. In India, privatisation was officially initiated in 1991 but implementation has been slow. Where there has been privatisation, local Indian business groups have participated as the main bidders, so that few FDI projects, and none of our cases, have been linked to privatisation. Private ownership of local industry facilitates acquisitions, as foreign investors can negotiate directly with the owners without the need to involve government authorities, as is illustrated in the Ziton, GSK and Packaging cases. However, private ownership is no guarantee that local owners will be interested in selling to foreign investors. For instance, many family-owned Indian business groups remain largely uninterested in selling, although the Packaging case illustrates that the divestment from peripheral operations can create opportunities for inward FDI.

20. In Vietnam, state-owned firms continue to dominate the local economy and foreign investors until recently were dependent on cooperating with them to get access to resources, such as real estate and export licences, or legitimacy with local authorities. Government policy recently encouraged state-owned firms to seek foreign partners, facilitating the creation of joint ventures in Vietnam in the 1990s. There has been some privatisation, but not in forms that would allow foreign investors to acquire firms. However, the ABB Transformers case illustrates how a foreign investor can attain control over an existing operation in ways that resemble a partial acquisition.

21. The shortage of appropriate acquisition targets and the weakness of capital markets means that such investment as does take place has characteristics not well suited to maximise spillovers to the host economy. Thus, ironically, in order to encourage FDI, policy-makers need to develop a vibrant domestic private enterprise sector, thereby creating the acquisition targets as vehicles for skill, technology and management transfers to the wider economy.

Project Dynamics

22. The complexity of adapting entry strategies to the local context is illustrated by our case studies. Many cases show foreign investors contributing technology and global marketing and management knowledge, while local partners contribute knowledge and network access related to the local business environment. The local contributions vary across industries, with most investors setting up manufacturing operations citing human capital relevant to their particular type of operations as the principal attraction for the location selected. Where the operation is export oriented, foreign firms mostly contribute access to export markets - especially to other units of the same MNE- with their global brand and distribution network. An exception is Heinz, where the El Kharafi group as regional partner facilitates access to other Arab markets.

23. The Carlsberg and ABB cases illustrate the resources sought from the host economy. Carlsberg had several turnkey projects prior to establishing the joint venture in 1993. The chosen partner, Halimex, had demonstrated good political standing and an ability to adapt and apply received technology. ABB chose a partner with a track record of production and innovation in the industry, including experience in reverse engineering. The firm was technologically advanced by local standards, and commanded a substantial market share. Within a few years, both joint ventures had come to compete primarily on the basis of the foreign investor's technology, though at the outset, the technological competence of the local partners was crucial for establishing the joint venture and for the ability to transfer technology locally. The cases illustrate that *absorptive capacity is crucial for technology transfer within joint ventures*. Levels of education of individual employees, as well as organisational structures and cultures promoting learning, innovation, and flexibility enhance technological progress in the acquired business or joint venture.

24. The role of local partners in the joint ventures varies greatly, as illustrated by the three Vietnamese cases. In the case of Honda, the local firm appears to play a largely passive role, helping to provide legitimacy and land. In the case of ABB Transformers, the local co-owner has transferred all its operations to the newly created joint venture and remained as a shell-firm, owning equity in the JV. ABB has

effectively taken over the existing operation and the local state-owned co-owner provides a means through which the ministry aims to influence an otherwise privately run firm, while facilitating access to other state entities that are important customers. SEAB/Carlsberg is structured as a traditional joint venture where both partners contribute resources and share control. Carlsberg Breweries of Denmark maintains control indirectly through its brand name and by having a Danish financial investor as a partner.

25. Most foreign investors engaging in a partial acquisition aim at eventually attaining full control. Foreign partners in the Egyptian and Indian cases increased their equity stake. These changes are sometimes planned, but also occur in response to changes in the environment, notably regulation of FDI. In the Packaging case, lack of financial resources of the local partner was the trigger for change of ownership, though both partners considered full acquisition early on. Similarly, GSK gradually increased its ownership in the Egyptian operation over a long period. In the Bacardi-Martini case, capital needs were met by issuing non-voting preference shares that kept the local ownership stake at the legally required minimum of 26%. However, Bacardi-Martini would increase its equity stake if it were permitted to do so. Hence, policy ought not to be overly concerned with the initial set-up of an FDI project, but with the form that it will take in the long run under the influence of both the investor's global strategy and the local business environment.

Conclusion from the Project

26. FDI comprises a large number of relatively small projects by entrepreneurial, regional and multinational firms, as well as a few large investments by MNE's. Changes in global strategies and the evaluation of the policy environment are the prime drivers of investment into emerging markets. In particular, as MNE's shift from conglomerate strategies to a favoured single industry strategy ("global focussing"), they aim to be market leaders and optimise their supply chains on a global basis. This pushes them into emerging markets with efficiency-seeking investments.

27. Many FDI projects in our sample are greenfield investments, especially those aiming to exploit factor cost advantages. Joint ventures and partial

acquisitions are more common for market-seeking investors who require access to local resources such as distribution channels and “political capital”. Acquisitions are rare, except in South Africa where local firms offer some attractive strategic assets and capital markets function better. Foreign investment projects evolve over time as resource transfers, ownership states and the roles of partners change. In some cases, this is already anticipated by the investors at the time of entry. In other cases, this occurs as a reaction to a changing business environment and leads to phenomena like staggered brownfield acquisitions. Effective capital markets, in terms of institutional development and the “supply-side”, that is, of firms available for acquisition, are crucial for facilitating FDI by acquisition. The supply-side is often determined by privatisation policies or by domestic conglomerates restructuring their operations.

28. Liberalisation has created many opportunities for FDI, and has affected investors’ choice of timing, equity stake and locations, including intra-country location choices. In decentralised countries like India and Vietnam, the institutions at the state or province level are often also crucial. Industry specific policies are often more important than broad FDI policies. They may be actively promoting FDI in a sector, as in the South-African car industry; neutrally regulating an industry, as in financial sector; or inhibiting FDI by over-regulation, as in the Indian alcoholic beverages industry. The presence of FDI may itself create pressures on both local firms to upgrade their technologies and on local institutions to accommodate the needs of a market economy.

Conclusion

In conclusion we summarise the policy implications of our study as follows:

Institutions as Location Advantages

- (i) Foreign Direct Investment (FDI) to developing countries is commonly facilitated or hindered by the institutional and policy environment. Of particular concern are the legal framework, the predictability of government policy and

the overall extent to which the policy is conducive to FDI at both provincial and local as well as central government levels.

- (ii) FDI is also affected by the quality of locally available resources, notably human capital, supplier industries and infrastructure.

Institutional Barriers to FDI

- (i) Regulatory barriers to FDI, especially of ownership forms, remain a major problem. Many regulatory regimes that affect foreign investors operate at the level of the particular region, for example, regional development policies, or industrial sector, for example, licensing procedures.
- (ii) Privatisation and liberalisation policies play a central role in reducing barriers to FDI. Privatisation helps to create a private sector, and therefore acquisition opportunities. Liberalisation paves the way for foreign entry, especially in key sectors such as banking and finance.
- (iii) The development of capital markets and associated regulatory institutions and specialist intermediaries is important to attract FDI in form of acquisitions.
- (iv) Regulatory constraints on corporate change, for example labour laws in India, remain a major impediment to FDI, and acquisitions in particular.

Domestic Private Sector as Barrier to FDI

- (i) FDI to developing countries is limited in scale and can take forms that do not maximise spillover benefits because of the weakness of the domestic private sector. Where the supply of domestic acquisition targets is limited, entry is disproportionately on a greenfield basis and does not attract larger FDI-related capital inflows.
- (ii) Privatisation of state-owned firms or the restructuring of domestic conglomerates enhances the 'supply' of firms available for acquisition.
- (iii) The absorptive capacity of local firms, that is their ability to adopt and apply transferred technology, is crucial for successful technology transfer and thus for firms' attractiveness for foreign partners and for their ability to attract spillovers.

- (iv) Thus, policies aimed at enhancing competitiveness of local firms also make an industry more attractive for foreign investors.

Appendix

Table 1: Sectoral Distribution of Case Studies

	Egypt	India	South Africa	Vietnam
Services	ECMS (telecom)	ABN Amro (banking)	ABN Amro (banking)	---
Food & beverages	Heinz (ketchup)	Bacardi-Martini (spirits)	---	SEAB / Carlsberg (brewing)
Manufacturing, intermediate products	---	Packaging (packaging)	NGK / Behr (automotive suppliers)	ABB (Electrical components)
Manufacturing, final products	GlaxoSmithKline (pharmaceuticals)	---	EST (electrical equipment)	Honda (motorcycles)

Table 2: Distribution of Affiliates by Sector (percent of affiliates)

Sector	Egypt	India	South Africa	Vietnam
Primary	3	3	3	4
Basic consumer goods	13	12	13	36
Intermediate goods	15	16	14	27
Machinery and equipment	10	26	19	8
Infrastructure and construction	18	6	12	2
Trade, tourism and recreation	15	1	5	13
Financial and business services	18	13	21	7
IT	5	19	8	1
Pharmaceuticals	3	5	5	2
Total	100	100	100	100

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Notes

¹ The project surveyed around 600 firms; 150 from Egypt, 141 from India, 144 from South Africa and 166 from Vietnam. All surveyed firms had been established between 1991 and 2000, had at least 10 employees, and foreign equity participation of more than 10%.

² This conclusion applies to all sectors. In our survey, manufacturing accounts for 41% of FDI entry into Egypt. 59% in India, 51% in South Africa and 75% in Vietnam. Financial and business services plus tourism account for 35, 26, and 20% of FDI entrants respectively.

³ In the context of Egypt's association with the WTO

⁴ Industrial parks providing infrastructure have been attributed a pivotal role in the development of software clusters in India, Brazil and Israel (Commander (2004).