POLICY BRIEF: MULTINATIONAL INVESTOR PERSPECTIVES ON FRAGILE AND CONFLICT-AFFECTED STATE INVESTMENTS

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Based on findings from DFID commissioned GBRW/ICA study 2014
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Introduction

1) DFID commissioned original research to look at how country risk affects foreign investment decisions in fragile states. This research intended to look at how investors think about risk; what the differences are in risk perceptions between firms; and what development partners could do about this. The findings and some recommendations are summarised in this note. This note synthesises some of the conclusions from GBRW and Investment Consulting Associates’ research which was carried out over 2013/2014.¹

The nature of FDI in developing countries

2) Developing countries attract a low amount of FDI and that much of it is concentrated in the extractives sector. As we can see below developing countries account for a large proportion of global primary goods FDI but an exceptionally small proportion of global manufacturing or services FDI. Even within manufacturing, the bulk of FDI in LDCs relates to extractives refinement.

³ Global FDI is increasingly coming from other developing economies. FDI from developing countries now represents around a third of global FDI and is growing – much of it going to other developing economies.

¹ See Stage 1, 2 and 3 reports for more detail
4) **The literature offers some explanations as to why we might see the above trends.** Theory suggests that foreign investment will occur when the returns to investment outweigh the costs to the project, after adjusting for risk. As we know, many of DFID’s countries are not only costly places to operate but unpredictable due to significant political uncertainty, weak institutions and poor logistical connections. This uncertainty itself carries a significant cost which investors take account of when deciding whether, where and when to invest.

5) **However a short literature review DFID commissioned also found a relatively mixed picture on exactly what risks matter the most in influencing investor decision making**\(^2\). This is a critical issue, as without understanding what reforms matter the most policy makers will struggle to encourage investment. The literature on institutions and risk is fraught with challenges – with institutions being relatively challenging to measure, and causality with investment difficult to verify. Much of the literature explores the determination of aggregate FDI flows, but the limited literature that goes beyond trying to explain total FDI suggests there could be a significant difference in how different types of firms perceive risk.

6) **Therefore in order to understand and unpack these FDI trends we commissioned some research.** In order to build on and expand the available literature on the topic our study focused around understanding the commonalities and differences between investors aggregated by:

1) Area of investment
2) Originating country of FDI
3) Investment size

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\(^2\) Ref GBRW/ICA literature review
Methodology for research

7) We took a unique dataset of greenfield FDI announcement to 9 fragile DFID partner countries from 2003-2013. These data are based on public announcements by firms, rather than official sources. The sample contains around 1500 investment announcements. The dataset contains rich information on sector, location and source country/firm, although we have some concerns on the information, we believe it is the best available dataset on foreign investment in FCAS.

8) The first use of the dataset was to select 22 firms representing a cross-section of the investors in the 9 countries for interview. Our qualitative research involved in-depth interviews with senior staff. The 22 were selected from a sub-group of investors who we expected would give the most informative responses e.g. they had to have at least 2 investments in the 9 countries over the 10 years. While they did account for a cross-section of both OECD and non-OECD countries, and the key sectors of investment, this does not represent the typical investor and should be seen as a way of generating hypotheses for further investigation rather than conclusive.

9) Our quantitative research involved reviewing any statistical relationships between what type of investment took place in a given country and year, and indicators of market potential and risk. We assigned each investment to the country-year in which it was announced, and for each country-year took indicators from the World Governance Indicators, World Development Indicators and Global Competitiveness Index that interview respondents reported as relevant. We then divided the investments on a series of criteria: by the 4 investor types/motives identified below. OECD/non-OECD, large/small investments and compared the average values to see if there were any clear patterns and if they were consistent with what was reported in interviews. While this is a descriptive exercise and can only begin to corroborate/contradict the interview findings, we do derive some clear results for certain areas, in particular extractives investment.

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3 This data was from the FT FDI database – covering all declared FDI investments from 2003-2013 in Ethiopia, Nigeria, Pakistan, Kenya, Burma, Sierra Leone, Uganda, Yemen, Bangladesh. Countries were selected as they covered a range of Asian and African countries which DFID lists as Fragile states, and also a mix of resource rich, and non-resource rich
How do firms think about risk and return in new investments?

10) **Investors focus around three key areas when considering new opportunities:**

1. How high is the return relative to the cost of investment?
2. How predictable are these costs and risks?
3. Are there other strategic reasons for this investment?

Looking at two projects with the same costs and returns, investors will choose the more predictable project. Risk therefore has a cost which investors will factor in to the investment decision.

In the case of some investors (point 3), the immediate return may not explain the investment but rather the investor is thinking strategically – the investment being a first-step into a market seen as having longer term potential.

In principle, these three factors can be included in an investment appraisal model to estimate the expected value of the investment / rate of return.

11) **The investor decision making process can be broken down into having 5 stages.**

This begins with an assessment of potential returns and this is balanced with some weighting of the risk environment. On weighing up alternative business opportunities with equally high returns, risk indices can prove useful. Information sources, such as the Economist Intelligence Unit, Political Risk services, and IHS Global are helpful for broad perspectives on country risk. From the firms we interviewed very few listed the Doing Business Indicators or World Enterprise Surveys as important sources of information in this regard.

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**Investment Consulting Associates**

1. Define project, goals and business requirements
   - Project definition and understanding of strategy
     - Determine geographic scope
     - Selection of location factors
     - Weighting of location criteria

2. Project assumptions
   - Analysis & comparison of locations
     - Data gathering
     - Build model for location analysis
     - Rank locations
     - Sensitivity analysis
     - Explore incentives

3. Input cost model
   - Comparison of costs
     - Set up cost model
     - Analyse cost differentials between locations

4. Resources for site visits
   - Site visits
     - Prepare site visits
     - Discussions with relevant governments and service providers
     - Incentive negotiations

5. Define Real Estate objectives and accommodation needs
   - Real Estate support
     - Real estate negotiation and acquisition support
12) **There are knock-out criteria for investors in even considering the returns of investments.** Over 2/3rd of the firms we spoke to say a poor security situation would be a deal breaker. Almost half also felt civil unrest or political instability would stop an investment decision being considered.

13) **Once countries are considered on the long list they may be compared using a simple cost-benefit analysis.** Depending on the risk threshold of the company they may decide which country, or group of countries, they are comfortable with. The simple heuristic below shows that Chile here has high risks (ranked as low on Cost indicator – may include political instability, logistics etc), but may have significant market opportunity (high on the Benefits indicator) – while Cambodia on the other side represents lower benefits, but also significantly lower costs. Often firms will be considering an investment as it relates to their portfolio, and the performance of other investments will affect their own risk appetite.

14) **At the third and fourth stage of the business development process, we can see that in-country knowledge becomes critical.** While risk indices can provide some markers, the information for many DFID countries is quite poor and the countries are far from homogeneous. A number of companies we talked to raised the difficulty of accessing good information from country governments. In order to conduct a detailed cost model the firms need to carry out their own on-ground analysis.

15) **Getting down to a further level of granularity on costing models allows for more detailed assessment of the ideal location.** These bench-markings are sometimes between countries and also between areas within countries. The standard approach is creating a Profit and Loss account projection which can be compared across investments⁴. To illustrate below we summarise a range of potential business opportunities:

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⁴ See Stage 3 report for a more detailed account of how these P&L projections are created
16) **The Profit and Loss can be affected in a range of ways.** Risks are often added to “operational expenses” and can be calculated via rules of thumb/or more scientific approaches. For example one cement company we spoke to predicted as much as a 30% increase in contingencies for developing versus developed countries. Aside from risks there are also incentives (e.g. tax holidays, grant support), which can increase the profits/likelihood of investments.
How is the investment decision affected by the sector/motivation?

17) We found that differing investors profiled countries in significantly different ways. For the purposes of this research we classified investments using Dunning’s 4 drivers:

a. **Extraction or Natural resource seeking**, i.e. to gain access to specific natural resources available in the investee country;

b. **Market seeking**, i.e. to supply goods or services in the investee country and/or nearby markets;

c. **Efficiency seeking**, i.e. seeking plentiful supplies of cheap and well-motivated unskilled or semi-skilled labour, or access to other competitively priced inputs (e.g. energy, land, port facilities etc.) or advantageous tax or regulatory regimes;

d. **Strategic asset seeking** i.e. driven by the need of firms to acquire specific technological capabilities and/or management or marketing expertise, to promote the long-term strategic objectives of the acquiring firm.

We looked to see if the interview responses and quantitative data supported the idea that these were distinct “types” of investor who were influenced by different types of risk in different ways.

**Resource seeking investment**

18) **The most important factor behind resource-seeking investment is the price of the resource.** High global commodity prices mean good returns on extractives investments so often these will be exploited, regardless of where they are discovered.

19) **Nevertheless due to long lead times in investment, we found that these firms are highly sophisticated consumers of risk data, and factor these into investment decisions.** The majority of the respondents had 20-30 year long time horizons on investment, therefore political instability, weak regulatory regimes and conflict are significant concerns. One oil major shared with us their process of evaluation whereby they will rank operational risks from 1-5:

<table>
<thead>
<tr>
<th>Risk score</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Low complexity, limited engineering and interfaces, low stakeholder simple well tying, relation issues, simple facility modification and change</td>
</tr>
<tr>
<td>5</td>
<td>New technology, typically complex interfaces to manage, substantial health and safety environment, operation integrity and stakeholder issues, scheduled delays may include substantial penalties</td>
</tr>
</tbody>
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20) **A key part of the risk environment for extractives investment is the issue of policy certainty.** As one respondent told us, following major resource discoveries once major investments have been made and extracted commodities come on stream

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countries often change their fiscal regime to get a larger share of the returns. Firms therefore have to take higher risks in weaker governance environments – due to the potential of fluctuating policies.

21) Due to the significant institutional and political risks, weak emerging markets have significantly higher risk premia attached to them than developed markets. Of the interviewees who responded to this question, they reported, on average, a risk premium of between 10% and 15% attached to more fragile countries.

22) Where high returns in high risk environments depend on government tax relief or subsidy, this can make investors suspicious. Governments in exceptionally weak institutional environments often will provide significant subsidies, tax breaks or low tax rates to attract investors – but for some this in itself can be a deterrent. As one respondent explained if the “fiscal regime is too generous we get suspicious it may change over time. The government is better off putting a regime in place in which both sides get an equal share and return. The regime may be high but at least it is a regime which the government can live with over the next twenty years.”

23) In addition to the above, the majority of companies we spoke to had a “code of conduct” which investments would have to uphold, and reputational damage was a key concern. One company described their experience in Myanmar where a long running investment with high ROI, had very negative impact on their reputation despite the fact their investment was pre-sanctions. The CEO said, “[we] would not have invested if [we] had known the reputational damage.”

24) The quantitative analysis suggests a significant difference between resource-seeking investors and investors of other types. Resource-seeking investments took place in country-years that scored significantly lower on most risk indicators, including regulatory quality, government effectiveness and voice and accountability.

25) So, while resource seeking investors are not indifferent to risk we see them operating in high risk environments because this is where the lowest cost natural resources tend to be. Moreover, extractives investments often follow an exclave model where activity is concentrated in one area and largely disconnected from the domestic economy. This is relatively easy to protect from general institutional and political weakness by doing a deal with government. What is clear from the interviews is that the risk environment directly affects the bottom line of the extractives firms, and also affects the returns governments can expect from their resources.

Market seeking investment

26) Market seeking investors are motivated chiefly by consumer demand in the target country. Almost all of the market seeking firms raised “large population” as a key factor influencing investment decision making. As one firm explained, the first stage in any investment appraisal process is looking at the population size, the available income and also the competition.

27) This is then weighed against risk concerns such as logistics, policy certainty, corruption and political instability. Unlike resource-seeking investors, these firms often have to link in to established logistical chains, be it power or road infrastructure, and therefore are more exposed to this type of risk. As in extractives

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6 i.e. they would require an expected annual rate of return 10%-15% higher in a fragile state relative to a stable country to be persuaded to invest. In practice the estimation of this premium includes a large element of subjectivity and can change regularly.
a risk premium would be seen on emerging market investors. One brewing company told us they have a hurdle rate of over 20% for an investment in Ethiopia; versus Western Europe where they would expect 5-6%. Another compared their UK investments where they expect 8% with Uganda which would be in the mid-teens, and South Sudan where expectations would be between 25-30%.

28) **This type of investment is a common feature in many of our countries already.** With rising populations and growing incomes, some of our countries are offering significant market opportunities – most countries are now home to at least one brewery. Sometimes the returns in these markets are sufficiently high to compensate for even quite significant risks – particularly when costs can be passed on to consumers.

**Efficiency seeking investment**

29) **Most developing countries struggle to source efficiency seeking investment.** Efficiency seeking investment occurs where the location can produce a good, like textiles or electronics, cheaper than elsewhere. While manufacturing and services account for the bulk of global FDI, they account for only a third in developing countries; consistent with this only a third of investments in our sample were classified as “efficiency seeking”.

30) **The doorstep condition for efficiency seeking investment is often good human capital, some significant regulatory stability and good logistics.** Many of which are lacking in many of our countries. We interviewed one US efficiency seeking investor who explained that around 50% of their investment decision relates to the quality of human capital, the remainder being on logistics and the investment climate. Our statistical analysis confirmed this, with decent efficiency of exports supply of labour, and good infrastructure being common characteristics of countries who receive investment.

31) **When we look at Africa in particular it is clear that it has some significant work to do on attracting this kind of investment.** Due to the relatively low skill base, often high labour costs, and unstable regulatory environment many efficiency seeking investors will not take Africa seriously. This is changing in some countries (for example Ethiopia), but it is far from the norm.

**Strategic asset seeking investment**

32) **Strategic asset seeking FDI is often bounded up with other drivers of investment and is not possible to relate to proximate risk or return factors.** These investments often involve much longer-term calculations about the reactions of rivals, and can be thought of as complementary investments, underpinning the returns to the other three. Seven of the firms we interviewed felt their investment choice was partly strategic, as well as linked to one of the other drivers. This shows that business decisions are not entirely motivated by immediate returns but are also part of wider strategic decisions – perhaps strengthening a network or adding new products or services as well as generating additional sales in the target country.

**Does the originating country of FDI affect the investment?**

33) **Qualitatively we have found that non-OECD investors may perceive our countries as “less risky” than OECD investors.** Corruption and political stability was cited as a significant hurdle for OECD firms, most OECD investors interviewed raised the issue of the UK Bribery Act, or its equivalent, as being a key concern in investment
decision making. The non-OECD investors felt this was less of a concern – with very few highlighting it as an issue.

34) Interestingly none of the firms interviewed from non-OECD countries had invested in OECD countries. This is for, we believe, several reasons – one relates to the cultural similarities between many non-OECD countries in terms of business practice, and also proximity to each other. Furthermore we found that the firms interviewed often had a higher cost of credit than OECD firms – which drove them towards higher return business opportunities. Lastly many business services provided by non-OECD investors may be catered for developing countries, as appose to OECD countries.

Does the size of the investment affect the perception?

35) Qualitatively we found a significant difference in responses from larger to smaller firms. Large firms talked about the “red carpet treatment” which allowed them to operate in challenging environments because of deals they may have negotiated directly with government. Furthermore larger firms are also more capable of sourcing financing for riskier environments. Smaller firms seemed to be more subject to the risk environment and therefore more vulnerable.
Where should development partners intervene?

36) **Many of the interviewees, especially the larger and stronger OECD MNEs, commented that the most important actions that can be taken are those which create an enabling environment for normal business activity.** Aside from the fundamental knock out criteria relating to political stability and freedom from conflict - four issues identified by the majority of interviewees where intervention is needed were:

   a. Encouraging free movement of capital
   b. Supporting a robust and disciplined fiscal regime
   c. Improving workforce Skills and Education

37) **A number of Non-OECD investors also encouraged the use of “appropriate incentives” however it’s important to treat the idea of donor subsidies with some caution.** Without sustainable revenues, it is impossible to achieve the stream of profits which constitute the “Return” element of the RoI calculation. If a business case is fundamentally weak or unsound, no amount of subsidy can transform it into a strong one on a sustainable basis. Since most FDI involves commitment of significant amounts of senior management time, which is a scarce resource and which has a high opportunity cost, investments which show the highest potential for generating additional revenues will get the greatest management attention, while weak business cases which require a subsidy in order to be viable will be seen as much less attractive. As one investor commented to us, grant support cannot improve a bad investment, though grants would of course be utilised if available.

Conclusions

38) **It’s clear that an investment promotion and investment climate strategy should be based on the potential of the country.** While sweeping investment climate reform strategies have their place, focus is needed to ensure countries can target the appropriate investors. A short-medium term strategy for promoting investment in a specific FCAS should involve:

   d. A realistic analysis of the sectors and investment opportunities which are most likely to be of interest to potential investors;
   e. Based on this first stage analysis, a second stage which identifies which foreign investors are most likely to consider FDI in the relevant sector(s);
   f. A proactive approach in marketing investment opportunities to companies identified in the second stage;
   g. Training and technical support for selected individuals or departments in the relevant Government ministries to ensure that they have the necessary expertise to deal with potential foreign investors and to appreciate their concerns and perspectives; and
   h. Supporting relevant Government ministries and departments to learn to understand the concerns of existing investors which are already operational in the respective country.

39) **Subsidising credit for firms should be treated with some caution.** While “buying down” risk may be a useful way of increasing investment in high-risk markets in the short-run, donors could waste money by subsidising investments that would have taken place anyway.
40) Development Partners have a clear role to play in encouraging an improved institutional and regulatory environment. All firms said the regulatory and institutional environment was a critical issue when considering investment. But the enabling environment means more than just business regulation: it includes market size (population, income levels, consumption), stability of the government (predictable and peaceful handovers of power), conflict risk, labour force (size of working-age population, education and skill levels, location) and infrastructure. A broader understanding of what a good investment environment is—could be a useful area for future research.