Department for International Development

INVESTOR PERSPECTIVES ON EMERGING MARKET INVESTMENTS

STAGE 2 REPORT

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CONTENTS

GRAPHICS:

Note:

We use the terms "OECD" and "Non-OECD" to differentiate between the major industrialised countries of Western Europe, North America and Japan and countries variously described as "emerging" or "frontier" markets.

We also use the term "MNE" to describe any corporate entity with activities in a number of different countries.

While other terms could be used in each case, these provide a convenient short hand reference for issues which occur throughout this study.

1. EXECUTIVE SUMMARY AND CONCLUSIONS

Overview

Stage 2 of our assignment involved structured interviews with 22 MNEs spread across 11 countries and 13 of the 39 Sectors defined in the fDi Markets database. They were conducted at parent company level with MNEs based in Western Europe or North America (OECD investors) or India, South Africa, Singapore and Malaysia (Non-OECD investors).

The combination of a small sample size (22 company interviews) and the spread of companies and head office locations led us to recognise from the outset that the outcome of the interviews would constitute a series of qualitative case studies rather than a statistically valid quantitative research study. However, we believe that the insights generated are likely to be of strong interest to DFID and other parties. The interviews address how executives who are responsible for foreign investments within large MNEs perceive investments in fragile states and emerging markets, what risks they encounter, how they manage those risks, what information sources they deem relevant and whether they use specific models and approaches to manage and limit those risks. We have extracted detailed comments from the interviews conducted and have summarised these in a number of the Appendices, which can also be read on a stand-alone basis.

The interviews revealed a high degree of consensus among both OECD and non-OECD MNEs on “knock-out” factors which would block consideration of investment in a new country. These include sanctions; high levels of political instability and civil unrest; poor security situations; extreme corruption; and a track record of poor behaviour by governments, including poor investor protection, breach of contract, unreliable legal systems and unreasonable changes in taxation. These are all issues which DFID addresses in its country programmes; significant change will normally only come as a result of sustained effort over a period of years.

They also confirmed that MNEs operating in the Extractive industry have a very different position vis-à-vis investments in Fragile and Conflict-Affected States (FCAS), which is directly linked to their need to identify and develop raw materials from lowest cost sources. The choice of geographical markets and diversification of production is limited for many Extractive MNEs, since few countries have the natural resources which they require. For these MNEs, investment risks associated with these markets are a given which needs to be managed and limited, but which cannot be avoided by choosing another location.

For Market seeking investments a similar process is applicable; here it is the size of the market in terms of population size and growth, disposable income, GDP growth etc. that serve as the “natural” endowments of a market.

In contrast, Efficiency seeking investments are characterized by a wider range of available locations and the process of selecting and identifying the most cost competitive and low risk location (from an initial longlist to a shortlist) can be seen as a pre-investment risk management process in which multiple risks are evaluated and quantified (to the extent possible).

In all cases, any examination of the investment decision process must take as its starting point the potential for generating additional profits for the MNE investor.

Only when potentially profitable investments (i.e. those which will generate additional revenues and/or reduce operating costs) are identified does the issue of risk move into focus. If profit potential is high, then MNEs will be likely to accept higher risks; conversely, if profit potential is low or non existent, then even the most positive investment climate will not attract an MNE's attention. Our view is that this factor is a major reason for the discrepancy between the indicated favourability of certain investment environments and the absence of increases in investment flows which is referred to in the Terms of Reference

The interviews produced some interesting perspectives on the differences between OECD and non-OECD investors, which are discussed at a number of points in this report.

The final section of the report (Section 13) sets our proposed approach for Stage 3 of the assignment. We have already had considerable discussions on our proposal to extend the scope of the desktop analysis required by our original Terms of Reference by using the data on the investments in the 9 FCAS countries from 2006 to 2012 for which we have details from our purchase of the fDi Markets database (original purchase of data for 6 countries plus 3 further ones). This is a rich source of data since it covers ca. 980 transactions over this period, each of which has also been classified under one of the four investment motivation headings.

Company selection approach

Our Stage 1 Report discussed Dunning's four primary motivations driving FDI decisions, namely:

- Extraction or Natural resource seeking;
- Market seeking;
- Efficiency seeking;
- Strategic asset seeking.

In selecting companies for interview, we initially attempted to identify clusters of companies in sectors corresponding to these four sets of motivations. In practice, it became clear that it would be difficult to identify statistically valid clusters of MNEs within the total limit of MNEs to be interviewed.

Our revised approach agreed with DFID involved expanding the initial list of six FCAS - Bangladesh, Myanmar, Nigeria, Sierra Leone, Uganda and Yemen – to nine, with the addition of Ethiopia, Kenya and Pakistan. This generated a list of ca. 1,350 investments by foreign companies in the 10 years between 2003 and 2012.

A number of filters (described in the next Section) were used to generate a long list of 47 interview candidates. A small number were deleted after further research; a number of companies stated that they were not prepared to be interviewed and some others simply failed to respond. 22 MNEs were in fact interviewed.

Findings from interviews

The interviews confirmed that the **Extractive sector** (companies interviewed were mainly oil and gas, but also included one cement and one metals company) has specific and different characteristics from other sectors. Company managements in this sector are used to working in "difficult" environments and commodities extracted are largely exported (though not invariably in the case of gas production). Operating as a global industry, there are internationally accepted models of investment agreements which have been developed over time between MNEs and governments of countries with exploitable resources; the larger oil majors also have developed Codes of Conduct which govern a wide range of their activities.

Extractive sector companies tend to invest in projects with much longer time horizons. For example, oil fields may have an economic life of 15 to 20 years or longer in many cases. Rio Tinto works on a 20 to 30 year horizon for its investments. The European cement company interviewed requires new quarries to have at least 50 years' reserves. New projects involve a number of years of capital investment before they become cash flow positive and the investor's negotiating position vis-à-vis the local Government has both strengths and weaknesses once an investment has been made.

Market seeking was cited as a motivating factor by 16 of the 22 companies interviewed to date. Bangladesh received the highest number of mentions (4), unsurprisingly given the 7 Indian MNEs interviewed, but 7 of the 9 FCAS were mentioned by interviewees, Sierra Leone and Yemen being the exceptions. Market seeking investments can cover a wide spectrum of activities, from setting up a sale warehouse for imported products to a full scale manufacturing operation producing products for the local market and perhaps also for export. As a result, levels of capital investment and payback periods may vary widely.

Strategic asset seeking was cited as a motivation by 7 interviewee companies, higher than might be expected given the specific characteristics of the FCAS. Examples given were mobile phone and port facilities, acquisition of local consumer brands and plans to establish regional hubs. All of the 7 MNEs which mentioned Strategic asset seeking also mentioned Market seeking, and we discuss in Section 5 linkages between Market seeking and Strategic asset seeking motivations; our hypothesis is that, in the general case of FCAS investments, the former factor may tend be the more dominant of the two factors.

A typical example of strategic asset seeking investment is a takeover of a (local) company by a MNE. The objective of the MNE is often to get access to proprietary technology, innovation or specific product or process innovation that the MNE does not own. These type of FDI projects often take place in developed market economies, but increasingly many MNEs see opportunities to adopt these strategies in emerging markets to get access to local distribution or supplier networks.

As might be expected given the specific characteristics of the FCAS, **Efficiency seeking** only received one mention. This was from Emami of India and referred to a low cost manufacturing base in Bangladesh. Companies which make Efficiency seeking investments typically rely on them to produce either goods or services which will be sold through other parts of the group. Since any disruption to these processes could be highly damaging, countries which are politically unstable, which are subject to conflicts and which have weak infrastructures tend to be excluded from the outset or screened out early in the process when potential locations are being considered.

OECD vs. non-OECD perspectives

When discussing FDI with the non-OECD interviewees, the discussion on approval processes revealed that they target, and have invested in, almost exclusively non-OECD markets. There may be a number of reasons for this:

- Most non-OECD MNEs will tend to be expanding in emerging markets adjacent to their home location.

- The challenges of operating successfully in these markets are of less concern because they are already familiar with similar issues in their home markets. They will be more comfortable with the business environment, security and cultural issues which may be seen as problematic by OECD MNEs.

- Non-OECD MNEs have a higher Weighted Average Cost of Capital (WACC) than their OECD counterparts, and therefore a higher hurdle rate for return on investment. FDI in higher risk countries is more likely to meet their return requirements than investment in OECD countries.

OECD MNEs are in a different position. For them, investment opportunities in frontier economies are a sub-set of global investment opportunities. Their investment appraisal process generally involves greater focus on a number of issues such as security, corruption and reputational risk, so projects will tend to require a higher return, either through an explicit higher hurdle rate for Return on Investment (RoI) or as a result of higher cost assumptions and contingencies.

It should be noted that OECD Extractive sector companies form a distinctive sub-group. Since many of them rely on FCAS or similar countries for high percentages of their reserves, they are constrained in the choices available to them in allocating capital between developed and emerging markets. Their corporate culture and international experience tends to be quite distinctive and is attuned to risks which OECD MNEs in other segments are able to choose to avoid.

Analytical and approval processes

A number of interviewees were willing to discuss aspects of their financial evaluation processes and to give examples of individual hurdle rates for specific FCAS, but none was willing to provide in-depth detail and many companies would not engage with this area of questioning at all. This is understandable given the commercial sensitivity of this subject.

However, from the limited number of responses, there is a clear differentiation between required RoI for Western Europe/North America and the non-OECD countries discussed during our interviews. Figures quoted for the former ranged between 5% and 8%, while the latter ranged between mid-teens and low twenties. Based on the small sample of interviewees who quoted actual numbers, it appears that the RoI premium for FCAS over Western Europe/North America is in the region of 10-15%.

We provide in Appendix 5 a projection and evaluation model which can be used by DFID to illustrate the factors considered by MNEs in investment appraisal analyses.

Investment incentives

Responses on the issue of investment incentives polarised quite strongly between OECD and non-OECD MNEs. The larger MNEs, especially those in the Extractive sector, tended to be dismissive of the need for incentives, while stating that they would obviously take advantage of them if they were available.

It is important to bear in mind that 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. The consequence is that, for a Market-seeking investment for example, some of the FCAS with small populations and/or very low GDP per capita may simply not reach the minimum hurdle for an MNE investor.

A further relevant factor is that any significant FDI involves commitment of senior management time, which is a scarce resource and which has a high opportunity cost. As a result, 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 less attractive.

While many of the larger MNEs interviewed were dismissive of investment incentives, they will be a factor for certain types of investment, especially those with a shorter payback period where the value of the incentive is correspondingly greater in NPV terms. They may also be necessary in order to achieve a level playing field where other candidate countries are offering similar programmes.

Actions that could be taken by Governments and/or IFIs/donors

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.

In terms of specific priorities, four issues identified by the majority of interviewees where Governments can intervene effectively were:

- Free movement of capital
- Robust and disciplined fiscal regime
- Workforce Skills and Education
- Appropriate investment incentives (non-OECD rather than OECD respondents)

In each of these areas, we would recommend that approaches which stand the best chance of increasing FDI in a specific FCAS in the short to medium term will involve:

- A realistic analysis of the sectors and investment opportunities which are most likely to be of interest to potential FDI investors;
- 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);
- A proactive approach in marketing investment opportunities to companies identified in the second stage;
- 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
- Supporting relevant Government ministries and departments to learn to understand the concerns of *existing* investors which are already operational in the respective country.

For donors and IFIs, the comments from OECD MNEs mostly amounted to supporting progress in the areas listed above. Interestingly, the non-OECD MNEs made almost no comment in response to this question, perhaps because there is no national counterpart to agencies such as DFID and therefore no tradition of working with them.

DFID financial subsidies for FDI projects

We would like to express a note of caution on negotiations with FDI investors (for example, on projects which do not meet hurdle rates of return) where some element of donor subsidy is requested.

One point which it is important to understand is that financial projections can easily be “reverse engineered” to produce a given result by flexing a number of the input assumptions. This may be of particular relevance when MNE representatives are discussing with DFID specific financial support required to achieve a given level of Return on Investment (RoI) or Internal Rate of Return (IRR).

Since we understand that many DFID field staff are not familiar with preparation of financial projections or use of RoI/IRR modelling, it would seem sensible for them to have access to this expertise at some central point in DFID, to ensure that any such negotiations are carried out on a level playing field.

DFID staff should also be conscious of the fact during such negotiations that the participation of official agencies may itself directly lower the political risk of the project, thus making the deal less risky than if the MNE had invested alone.

2. INTRODUCTION

This Stage 2 Report is the second deliverable under the contract between the Department for International Development (DFID) and GBRW Limited (GBRW) and Investment Consulting Associates (ICA) dated 24th December 2012.

The Stage 1 Report was submitted to DFID on 26th February and prompted considerable discussion of the selection criteria for the 25 multinational enterprises (MNEs) to be interviewed. The final selection criteria and long list of interviewee candidates were agreed on 21st March. The majority of the interviews took place between May and July 2013.

Basis for selection of MNEs

The Stage 1 Report discussed Dunning's four primary motivations driving FDI decisions, namely:

- ***Extraction or Natural resource seeking***, i.e. to gain access to specific natural resources available in the investee country;
- ***Market seeking***, i.e. to supply goods or services in the investee country and/or nearby markets;
- ***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;
- ***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.

In selecting companies for interview, we initially attempted to identify clusters of companies in sectors corresponding to these four sets of motivations. In practice, however, investors' motivations are not always clear cut – more than one objective may be applicable for some investments, while different divisions of the same MNE may make investments for different purposes[1]. It also became clear that it would be difficult to identify statistically valid clusters of MNEs within the limit of 25 MNEs to be interviewed.

The revised approach agreed with DFID involved expanding the initial list of six Fragile and Conflict-Affected States (FCAS) - Bangladesh, Myanmar, Nigeria, Sierra Leone, Uganda and Yemen – to nine, with the addition of Ethiopia, Kenya and Pakistan. This generated a list of ca. 1,350 investments by foreign companies in the 10 years between 2003 and 2012.

This list was then filtered as follows:

- Filter 1: Companies with investments in two or more of the countries. Rationale: to select companies which have invested in more than a single FCAS and therefore have a broader experience of the issues which are relevant to this research.

[1] For example, an oil major invested in Nigeria as part of its core extractive activities, while establishing a service centre in India as an efficiency seeking activity.

- Filter 2: Parent company based in Western Europe or North America (OECD investors) or India, S Africa, Singapore, Malaysia and the Gulf (Non-OECD investors). Rationale: To achieve a balance between OECD and non-OECD MNEs from as wide a spread of countries as possible within the constraints of the project budget.

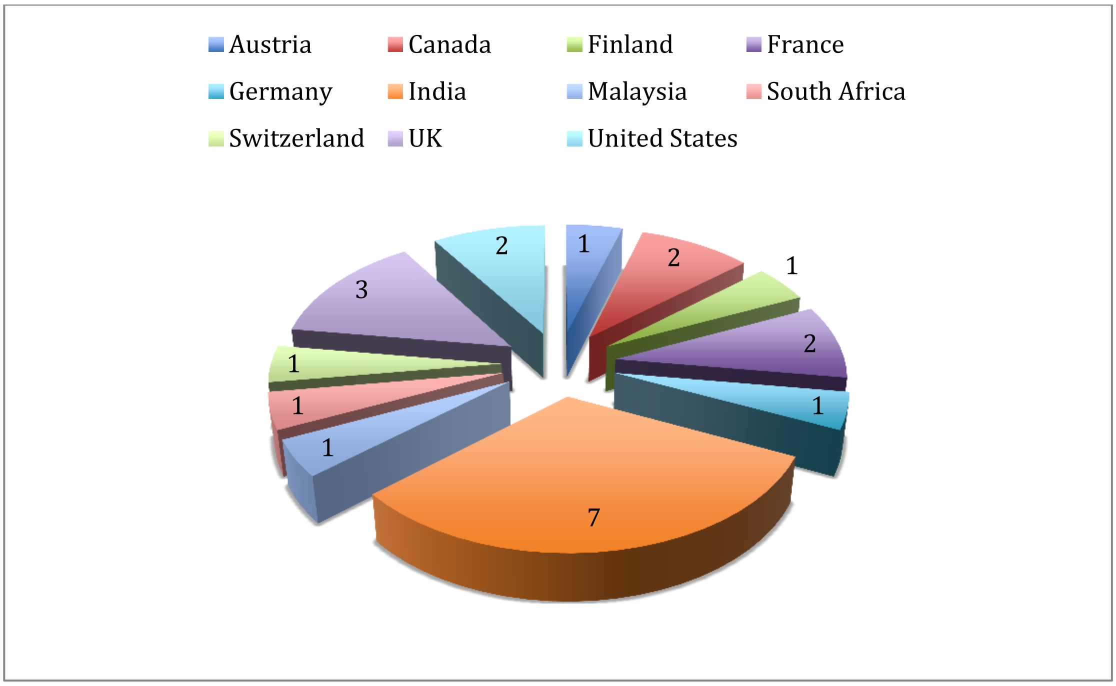
- Filter 3: At least one investment after January 2006. Rationale: to eliminate older investment decisions, for which the investment appraisal process might not be familiar to interviewees.

- Filter 4: Investment of $20 mn or greater. Rationale: to focus on the most significant investments and eliminate non-material transactions.

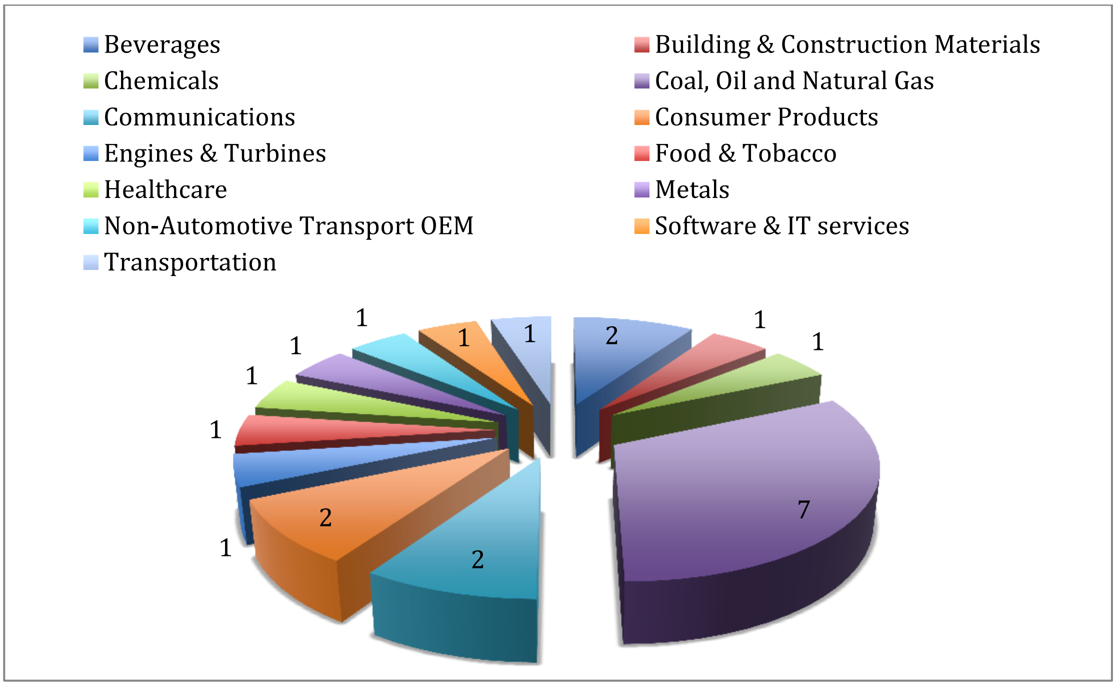
This generated a long list of 48 interview candidates which is attached as Appendix 1. Interviews were conducted using the structured Questionnaire developed during Stage 1, a copy of which is attached as Appendix 2.

Since some of the shortlisted names were disqualified after further research (see following section) or refused to be interviewed, the criteria were subsequently expanded by setting the minimum investment size at either of (a) $10 mn or (b) $5 mn plus at least 150 new jobs created. This generated a further 7 candidates, 1 of which was interviewed.

In the end 22 MNEs agreed to be interviewed; their head office locations and industry sectors shown in the following two charts:



Location of MNE head offices



Industry sectors of MNEs interviewed

Given the constraint on the number of company interviews and the spread of companies and head office locations, it was recognised that the outcome of the interviews would constitute a series of qualitative case studies rather than a statistically valid quantitative research study. However, we believe that the insights generated are likely to be of strong interest to DFID and other parties, given the previous lack of research of this type.

For this reason, we have extracted detailed comments from the interviews conducted and have summarised these in a number of Appendices, which are referred to at various points in this report. Each of these Appendices can also be read on a stand-alone basis.

3. METHODOLOGY AND APPROACH

The interview candidates were allocated between GBRW and ICA, with both companies contacting European-based MNEs, ICA handling approaches in North America, India and South Africa and GBRW handling approaches in the Gulf, Singapore, Hong Kong and Malaysia. Interview candidates were asked to take part in a structured interview lasting approximately an hour and a half, during which GBRW and ICA consultants used the structured Questionnaire. Actual interview times ranged from less than one hour to two and a half hours and the majority of the interviews were conducted face to face (which tends to produce more time with the interviewee and a more informative atmosphere).

Both consultants experienced a disappointing pattern of non-response to initial approaches. One of the causes was a “chicken and egg” problem of difficulty in identifying an initial point of contact who could then route the interview request to the appropriate person within the MNE. This slowed initial progress materially, though the situation changed rapidly after the DFID Growth and Resilience Department reached out to counterparts in other agencies for assistance in making introductions and identifying contact points. This is an important lesson to bear in mind for future exercise of this type.

With DFID’s assistance, the consultants were able to conduct interviews with 22 MNEs out of the target of 25, a response rate which reflects the sensitivity of the topic. Four companies on the long list of 48 were deleted after further research[2]; several companies on the long list stated that they were not prepared to be interviewed; others failed to respond despite a positive initial response following an introduction by a DFID counterpart; and others simply failed to respond at all, even after a number of follow up calls or e-mails.

It is important to bear in mind that this was not a random sample of firms, as there was almost certainly a degree of selection bias among the firms that were willing to respond to interviews. As a result, it is not possible to draw conclusions from these results about the whole population of 48 MNEs that passed the four filters. Even if it were, the conclusions could not be extrapolated to other types of MNE, for example those which have not yet invested in FCAS.

As such, the responses should not be regarded as conclusive results, but rather as generating hypotheses to be tested.

[2] Mercator Transport, Canada (too small, poor financial condition); Zain Mobile Telecommunication Company, Bahrain and Kuwait (had disposed of relevant investments); Al Futaim Group, Dubai (trading operation rather than FDI); InterContinental Hotels Group (IHG), UK (fDi Markets data incorrect, no relevant investments).

The list of 22 MNEs interviewed[3] and their business sectors[4] are as follows:

Company	Sector
Austria	
European oil company	Coal, Oil and Natural Gas
Canada	
Nexen	Coal, Oil and Natural Gas
Canadian oil company	Coal, Oil and Natural Gas
Finland	
Wärtsilä	Engines & Turbines
France	
European cement company	Building & Construction Materials
European oil major	Coal, Oil and Natural Gas
Germany	
BASF	Chemicals
India	
Apollo Hospitals Group	Healthcare
Bharti Group	Communications
Dabur India	Consumer Products
EMAMI	Consumer Products
Hero Cycles	Non-Automotive Transport OEM
NTPC Limited	Coal, Oil and Natural Gas
ONGC	Coal, Oil and Natural Gas
Malaysia	
Private Asian Group	Transportation
South Africa	
MTN Group	Communications
Switzerland	
Nestle	Food & Tobacco
UK	
Diageo	Beverages
SABMiller	Beverages
Rio Tinto	Metals
United States	
US oil major	Coal, Oil and Natural Gas
US Software/IT Group	Software & IT services

These cover 11 countries and 13 Sectors of the 39 in the fDi database (see Appendix 3 for the full listing):

[3] Note: In order to encourage as open a discussion as possible, interviews were held on the basis that "*All information will be held in strict confidence and the degree of detail discussed will be at your company's discretion*". Seven of the 22 companies asked for their identity to be withheld, so they appear described in generic terms in this report and its Appendices.
[4] Using the 39 sectors defined in the fDi database

- Beverages (2)
- Building & Construction Materials
- Chemicals
- Coal, Oil and Natural Gas (7)
- Communications (2)
- Consumer Products (2)
- Engines & Turbines
- Food & Tobacco
- Healthcare
- Metals
- Non-Automotive Transport
- Software & IT services
- Transportation

The US Software/IT Group was excluded from the analyses later in this report because, while its comments were highly relevant to the analytical approach for FCAS investments, the specific investment discussed had been made in Krakow in Poland. However, we summarise comments from the interview in a separate box in Section 5 to illustrate the way in which a large MNE can be motivated by a number of drivers in parallel, in this case Market seeking, Efficiency seeking and Strategic.

This leaves a core of 21 companies, which break down between OECD and non-OECD head offices[5] as follows:

Non-OECD	India, South Africa, Malaysia	9	43%
OECD	Austria, Canada, Finland, France, Germany, Switzerland, US, UK	12	57%

Interviews were conducted by senior members of GBRW's and ICA's management team[6], all of whom have experience of working with the management of large multinationals, and used the structured Questionnaire referred to above. Almost all of our interlocutors were members of the company's senior management team and were able to comment on the questions from a company-wide perspective. Not all the interviewees were able, or willing, to respond to every aspect of the Questionnaire. However, the majority of the interviews gave helpful (and in some cases) unexpected insights into operational and policy issues.

In most cases, it was possible to discuss all sections of the Questionnaire, but the level of details covered under each section varied for a number of reasons, including:

- One of the main reasons not all topics could be addressed equally by the respondents during the interviews is the fact that FDI decisions within a company are often managed and delivered in teams, bringing together staff from different functions within the company, all of which might be relevant for the FDI project.

[5] We questioned whether the Africa Division of SABMiller should be considered as a non-OECD multinational in its own right, given its business scope and the parent company's South African origin. For consistency, it has been classified as an OECD MNE given its UK head office and incorporation.
[6] From GBRW, Paul Rex and Johnny Rizq (London) and Martin Edwards (Singapore); from ICA, Douglas van den Berghe and Matthijs Weeink (Amsterdam), Chris Steele (US) and Kavan Bhandary (India)

A typical FDI team within a MNE consists of a project manager, Chief Financial Officer (or tax/finance director), a staff person from HR, an engineer, head of supply chain, legal counsel and head of asset or real estate within the company.

- Most respondents set a time limit for the discussion. Our initial approach said that the interview would last from one and a half to two hours, but in practice some interlocutors had time constraints and were only willing to be interviewed for a shorter period than this.
- Most respondents focused in the early part of the interview on the factors which drove specific investments (responding to the first six questions in Section 1 of the Questionnaire[7]). When discussing the specific risk factors covered in sections 3 to 8 of the Questionnaire, some respondents felt that it was not meaningful to rank specific factors in order of importance (either commenting "all of these", or rating some as significant in certain situations but not in others). In some cases, respondents commented that discussions under section 3[8] had already covered all of the relevant issues, particularly when the interview was subject to time constraints.
- Some respondents were unable to comment on specific areas (for example, the relevance of the publications listed in section 2) or were unwilling to discuss areas considered as commercially confidential.

Our view is that it was important to prioritise the key factors driving specific investments, since this is the starting point for any MNE to consider an investment in a FCAS. The key factor is the expected profitability of investment; a focus on investment climate issues alone may miss the fundamental rationale for any FDI by an MNE.

Based on experience of working with MNEs, the primary motivator for MNE FDI is an opportunity for generating additional profits. Only when potentially profitable investments (i.e. those which will generate additional revenues and/or reduce operating costs) are identified does the issue of risk move into focus. If profit potential is high, then MNEs will be likely to accept a range of higher risk factors; conversely, if profit potential is low or non existent, then even the most positive investment climate will not attract an MNE's attention. One relevant example is Finland, which scores very highly on all investment climate criteria, but does not attract substantial levels of FDI because the profit opportunities are small.

The corollary of this position is that FCAS seeking to attract MNE investors should first evaluate which aspects of their economy and/or natural resources are most likely to attract MNE investors motivated by one or more of the four factors listed above. This will then determine which aspects of their investment climates are likely to be relevant to the target investor group(s) and which incentives or disincentives will be of greatest importance.

[7] 1.1 Why would your company invest in a new country?; 1.2 Can you describe your company's approach to evaluating and approving an investment in a new country?; 1.3 Which parts of the company are involved in this process?; 1.4 Are there any countries which you would not/have decided not to invest in because they are considered too risky?; 1.5 If yes, are you able to discuss what risk issues were involved?; 1.6 Are there any business risks associated with foreign expansion/investment which would be considered as totally unacceptable (knock out factors)? If so, what are they?

[8] 3.1 Can we talk about your investment(s) in [specific FCAS country]? Can you talk me through the investment decision process?

4. ANALYSIS OF QUESTIONNAIRE RESULTS

Headings 1, 2 and 10 of the Questionnaire deal with general approaches and issues; Headings 3 to 9 focus on a specific investment in one of the FCAS identified through our fDi Markets data. In practice, discussion in sections 3 to 9 ranged more widely at times, while in a small number of cases the interviewee did not have enough information, so chose a different investment to discuss.

The following sections summarise interviewee comments following the order of the ten subject headings[9] in the Questionnaire.

- General approach to FDI (Section 5)
- Country perspectives (general) (Section 6)
- Investment in specific Fragile and Conflict Affected States (Section 7)
- Investment related factors (Section 8):
    - Business environment
    - Social and demographic factors
    - Geographic factors
    - Economic and policy environment
    - Investment incentives
    - Political risk insurance
- Actions that could be taken by governments of "difficult" countries and/or IFIs/donors (Section 9)

In order to capture as much of the flavour of interviewees' responses, which were very revealing in many cases, we have extracted comments from the interviews and summarised these in a number of Appendices to allow for ease of comparison.

[9] Since there was (intentionally) duplication between some sections of the Questionnaire, we have reorganised some of the responses under the relevant subject headings.

5. GENERAL APPROACH TO FDI

Motivation

The motivating factors mentioned for each of the interviewees were as follows:

Company	Sector	Extraction	Market seeking	Strategic	Efficiency
Apollo Hospitals	Healthcare		✔		
BASF	Chemicals		✔		
Bharti Group	Communications		✔		
US oil major	Coal, Oil and Natural Gas	✔			
Dabur India	Consumer Products		✔	✔	✔
Diageo	Beverages		✔	✔	
Emami	Consumer Products		✔	✔	
Hero Cycles	Non-Automotive Transport		✔	✔	
European cement company	Building/Construction Materials	✔	✔		
MTN Group	Communications		✔	✔	
Nestle	Food & Tobacco		✔		
Nexen	Coal, Oil and Natural Gas	✔			
NTPC Limited	Coal, Oil and Natural Gas	✔	✔	✔	
European oil company	Coal, Oil and Natural Gas	✔			
ONGC	Coal, Oil and Natural Gas	✔			
Rio Tinto	Metals	✔			
SABMiller	Beverages		✔		
Canadian oil company	Coal, Oil and Natural Gas	✔			
Private Asian Group	Transportation		✔	✔	
European oil major	Coal, Oil and Natural Gas	✔			
Wärtsilä	Engines & Turbines		✔		
Totals		9	14	7	1

It can be seen that a number of interviewees mentioned multiple factors.

Companies focused on Consumer Products, Food & Tobacco and Beverages (5 of the 21 interviewees) cited **Market seeking** as their main motivation, as did those in sectors such as Chemicals, Healthcare and Non-Automotive Transport (3).

Unsurprisingly, companies in the Coal, Oil and Natural Gas sector were highly focused on **Extraction**, which was the sole factor cited for 6 of the 7 MNEs in this category. However, it is important to bear in mind that approaches can vary within this sector; for example while crude oil tends to be sold primarily into export markets, the cost and logistics issues involved in transporting natural gas often mean that local sales opportunities are also important.

Companies in the Metals and Building/Construction Materials sectors also cited Extraction as a motivating factor. In the case of the latter, high transport costs for low value cement products mean that identification of producing quarries goes hand in hand with opening of new markets, so Market seeking and Extraction go hand in hand.

As discussed earlier, given the specific characteristics of the FCAS, **Efficiency seeking** only received one mention. This was from Emami (India) and referred to a low cost manufacturing base in Bangladesh.

Interestingly, **Strategic asset seeking** was cited as a motivation by 7 interviewee companies, higher than might be expected given the specific characteristics of the FCAS. Interestingly, all of these were non-OECD MNEs. Specific examples were:

- MTN and the Asian transportation group. In both cases, networks (of mobile phone installations and port facilities) are the USP for the business, so it can be argued that Market seeking and Strategic asset seeking motivations are interlinked.
- Emami and Dabur (both Indian groups) cited acquisition of local brands to add to their portfolios as a major factor.
- Hero Cycles talked of plans to establish regional hubs.
- Diageo described their motivations as Market Seeking linked with Strategic asset seeking (the latter described as "filling gaps" in Diageo's extensive African network).
- NPTC's reference was to buying Strategic assets in the form of coking and thermal coal reserves, which could arguably be classified under Extractive.

As we said in the Stage 1 report: *"... [Strategic] asset-seeking FDI relates to FDI aimed at acquiring assets of foreign firms to promote the long-term strategic objectives of the acquiring firm, sustaining and advancing the firm's international competitiveness. It is driven by the need of firms to acquire specific technological capabilities, management or marketing expertise. More recently this form of FDI is typified by the search for talent and highly-skilled workforces as a reason for FDI by MNEs. This type of strategic asset FDI makes use of local competence levels that are very often created by local or national governments.... It is not always easy to separate the four motives for FDI."*

Given the specific characteristics of FCAS, specific technological capabilities, management or marketing expertise may be relatively sparse. It is also notable that all of the 7 MNEs which mentioned Strategic asset seeking also mentioned Market seeking, suggesting that the many non-OECD investors see FDI in neighbouring markets as linking both drivers.

Knock out factors

There was a high degree of agreement between both OECD and non-OECD interviewees on the principal factors which would deter an investment from being considered at all ("Knockout factors"):

Issue	Mentions	% of respondents
1. A poor security situation	14	67%
2. High levels of political instability and civil unrest	9	43%
3. Track record of poor behaviour by governments, including poor investor protection, breach of contract, unreliable legal systems and unreasonable changes in taxation.	7	33%
4. Sanctions	6	29%
5. Corruption	6	29%

All of these are of course issues addressed by DFID in its country programmes, although material changes tend to require long periods of sustained effort.

It should be noted that larger companies in the extractive sector usually have formalised Codes of Conduct governing their activities, which will capture points 1, 2, 4 and 5. Countries where the provisions of the Code of Conduct cannot be met were said to be non-starters for new FDI.

It was clear from the context of discussions that the references to corruption involved extreme situations at senior political levels. Sensitivity towards corruption has been heightened for OECD MNEs by the fact that many OECD governments have now passed legislation making corrupt payments a criminal offence[10]. However, many interviewees acknowledged (although in many cases, not explicitly) that low level corruption is a fact of life in many countries such as the FCAS and its effects on costs and efficiencies are taken into account as part of a wider range of business risks.

Knock-out factors cited by individual respondents were as follows:

Company	Knockout factors
Apollo Hospitals	Political instability and regions with crime or terrorism affected areas
BASF	Security and political risks as well as corruption
Bharti Group	High civil unrest, history of bad investor protection cases, political instability and perennial disaster prone regions.
US oil major	Sanctions imposed by the US Government in countries such as Iran and North Korea.
Dabur India	Major political instability, civil unrest or threats related to terrorism. Higher taxation would be an impediment too.
Diageo	Two preconditions for any investment are (1) acceptable security situation and (2) ability to operate in accordance with Diageo values. Corruption cited re (2)
Emami	Major political instability, civil unrest or threats related to terrorism
Hero Cycles	Civil unrest and political instability

[10] For example, the UK Bribery Act, which was passed on 8 April 2010 and came into force on 1 July 2011

Company	**Knockout factors**
European cement company	High levels of corruption and unsatisfactory legal systems.
MTN Group	A small market that is heavily penetrated already with existing service providers.
Nestlé	Security, corruption. Note that poor security environments also tend to correlate to weak demand for Nestlé products
Nexen	Security Sanctions Argentina because the fiscal regime cannot be trusted over the long term.
NTPC Limited	Highly politically volatile regions, history of breach of contracts/payments and lack of measures for employee safety.
European oil company	Political instability (but this is kept under review) Other issues will tend to be project specific and will be linked to size of investment and payback period. Issues are set out in XYZ policy document, but "no two projects are the same".
ONGC	War, terrorism related crimes, extreme political volatility
Rio Tinto	Safety and security issues; sanctions
SABMiller	Corruption has inhibited investment in countries with strong "Mafias" – Azerbaijan, Armenia and Italy (!) cited. Countries subject to sanctions Muslim countries where alcohol sales not permitted[11]
Canadian oil company	Expropriations / Nationalizations Civil War Sanctions
Private Asian Group	Following are key : Property title, ability to get necessary licences, Financial stability (repatriation of dividends), rule of law
European oil major	Security Any situation where ABC could not implement its Code of Conduct. However, "*we can solve most problems*" and "*we are already in most difficult countries*".
Wärtsilä	The only "off limits" countries are those subject to EU, UN or US sanctions, or countries where Wärtsilä would be unwilling to send its own people because of high personal security risks e.g. Afghanistan and Somalia. There are other countries in which Wärtsilä does not make investments for the time being because of the prevalence of corruption and the inability do business without using corrupt practices.

[11] Although this could also be considered as a market related factor

OECD vs. non-OECD perspectives

Non-OECD

When discussing FDI with the non-OECD interviewees, the discussion on approval processes revealed that they target, and have invested in, almost exclusively non-OECD markets – see below:

Company	Approaches to Established v Emerging Markets	Specific countries discussed[12]
Apollo Hospitals	Have only invested in emerging markets (but including Gulf)	Nigeria *Sri Lanka, Bangladesh*
Bharti Group	Have only invested in emerging markets	*18 countries in Africa through Zain acquisition, including Chad, Democratic Republic of Congo, Malawi, Republic of Congo*
Dabur India	Higher hurdle rates are a major impediment when dealing with established markets while competition from major brands is significantly less in emerging markets	Nigeria, Nepal *Future greenfield facility in Africa*
Emami	Have not established any production facility in established markets	Egypt, Bangladesh
Hero Cycles	The competitive landscape would be of primary concern when we compare mature and emerging markets as we would need to push much more in building a brand compare to established global peers present in an established market. We would generally use an emerging country to manufacture rather than set up a production facility in an established country.	At the moment we are exporting to a few countries in Latin America, Central America, a few countries in Africa, Sri Lanka, Nepal and Bangladesh
MTN Group	MTN is focused on emerging markets and tends to avoid established markets.	Myanmar
NTPC Limited	We haven't invested in an established market but do pursue opportunities by bidding in EPC projects in Power. We also look at extraction and or buyout opportunities for thermal coal in established countries.	Bangladesh *Sri Lanka, Bhutan, Nepal, Nigeria, Kenya*
ONGC	We have not invested in established markets like the US but are looking to buyout natural gas blocks of a large exploration firm. For emerging markets we typically look at acquiring blocks from the respective government.	*OVL has a presence in 27 projects in 14 countries:* *Myanmar | Russia | Vietnam* *Iraq | Syria | Libya | Nigeria* *Sudan and South Sudan | Brazil | Colombia | Cuba | Venezuela | Kazakhstan*
Private Asian Group	Completely different. When investing in a mature, established market one can have a 'Western approach' and rely on published data (corporate, Government …). For an Emerging Market investment decision, one has to rely on one's own contacts	Myanmar (Hotel in Yangon) *N Korea (lack of local contact!), Laos (lack of commercial opportunity) Pakistan (instability of government).*

[12] Main country(ies). Other countries referred to shown in italics

There may be a number of reasons for this:

- Most non-OECD MNEs will tend to be expanding in emerging markets adjacent to their home location, for example MTN and SABMiller[13] in Africa or Emami or NTPC in Bangladesh. In addition, MNEs from these emerging non-OECD markets tend to be more opportunistic in their FDI decisions and have less experience with managing FDI decisions (including risks) than their OECD counterparts. They are also often family owned, which reduces shareholder pressures for a more structured approach.

- The challenges of operating successfully in these markets are of less concern because they are already familiar with similar issues in their home markets. They will be more comfortable with the business environment, low level security and cultural issues which may be seen as problematic by OECD MNEs.

- New FDI in higher risk countries will tend to produce high potential returns for non-OECD MNEs. These companies will have a higher Weighted Average Cost of Capital (WACC), a measure which reflects their cost of equity (the return expected by their shareholders) and their cost of funding (the availability of debt and the margin required by lenders). In some cases, FDI in mature OECD markets will only produce returns which fall below their WACC hurdles. As can be seen from the comments above, both reasons are cited.

It is important to note that there will be non-OECD exceptions to these comments, for example Sovereign Wealth Funds, which have a very different investment perspective, and privately held companies, which may have greater leeway as earnings and specific RoI targets in any given year are of less short term relevance to their owners. The final company cited (Private Asian Group) falls partly into this latter category.

OECD

OECD MNEs are in a different position. For them, investment opportunities in frontier economies are a sub-set of investment opportunities globally. Their investment appraisal process generally involves greater focus on a number of issues such as security, corruption and reputational risk and projects in emerging markets in general, and FCAS in particular, will tend to require a higher return, either through an explicit higher hurdle rate for Return on Investment (RoI) or through higher cost assumptions and contingencies. In addition, MNEs from OECD countries are often listed on the stock exchange and their investment decisions and reputation are more subject to shareholder and public scrutiny.

[13] Although SABMiller, originally a South African company, is now incorporated in the UK, its corporate culture shows many of the characteristics of a non-OECD MNE.

Extractive sector

It should be noted that OECD Extractive sector companies form a distinctive sub-group. Since many of them rely on FCAS or similar countries for high percentages of their reserves, they are constrained in the choices available to them in allocating capital between developed and emerging markets.

Because of the significance of their investments to some investee countries, the larger players are also able to dictate the terms on which they will invest, negotiate specific concessions and resist corruption pressures[14].

As a result, the corporate culture and international experience of many of the major extractive companies is quite distinctive and is attuned to risks which OECD MNEs in other segments are able to choose to avoid.

Comments from US global Software/IT Group

In order to illustrate the way in which a large MNE can be motivated by a number of drivers in parallel, in this case Market seeking, Efficiency seeking and Strategic, we set out overleaf a number of general comments from the US Software/IT Group which discussed its specific investment in Krakow in Poland.

[14] Which does not mean that they always do so

Comments from US Software/IT Group on its approach to FDI planning

- Starts on different fronts. Have to start with what the company does. The reasons for FDI are primarily:
  - Revenue growth and sales
  - Acquisition and integration
  - Agnostic – could have been positioned anywhere, but which carry their own location drivers:
    - Local, nearshore, offshore
    - Local - has to be in a specific location due to client
    - Nearshore – has to be in time zone but otherwise fine
    - Offshore – Truly location agnostic
- Prioritisation:
  - Overall corporate and business strategies
  - Global workforce plan is next
    - Where is this talent
    - Engineering, ops, administration can be where the talent is
    - Business context and then the business problem
  - Core, noncore critical, noncore noncritical
    - Two globalization centres: San Jose and Bangalore
    - Customer hubs
    - Then the talent pool locations – noncore critical. There for a specific purpose
    - Noncore non critical – Sales and acquisitions
- Every country has a risk, so how do you manage risk?
  - Two primary risks
    - Safety and security
      - Crime, terrorism, general health, geo political climate, infrastructure (and natural hazard resilience), ability to extricate, off/on grid,
      - Downtime of networks, options, regulations, both for the office and for the home
    - Information technology
  - If there's an extreme risk, we will take it off the list
- Workplace resources team is specifically responsible for identifying location:
  - Businesses are the drivers for the people needs through their business requirements
  - Legal, HR, and others are pulled in for consultation
- For the location agnostic work, we make no conscious decision between developed and emerging markets:
  - Don't want to drop anything prematurely
  - We will assess every county within those areas as we go
  - Research collected for projects results in a list of good location for other projects
  - Once we have the information going forward, we can rely on similar process but leverage some of our earlier work
- What data sources:
  - HR team provides labour info
  - IT department provides the infrastructure info
  - Safety/security group gets geopolitical and crime data
  - Leverage the functional area that knows that area most intimately to make them responsible for collecting the data.
  - Real estate and associated data is specialised team
  - These groups occasionally will go outside for additional data

6. APPROVAL PROCESSES

Some companies were prepared to discuss aspects of their investment evaluation process, while others simply commented that this was confidential to the company. Differences in approach may reflect the fact that OECD MNEs are subject to a higher degree of scrutiny from their shareholders and are therefore more accustomed to disclosing information on strategy and performance in meetings with investment analysts and in their Annual Reports.

It is noteworthy that all 7 Indian MNEs were unwilling to engage with discussions on RoI or hurdle rates, while 8 of the remaining 15 interviewees were willing to make some comment.

Appendix 4 summarises the response from each company interviewed under two headings:

- Approval process; and
- RoI/Hurdle rates.

Approvals committees

In all cases, companies interviewed had in place committee structures to review and approve investments.

In most cases, larger investments require Board or Executive Committee approval while smaller investments can be approved at divisional management level. In many cases, a separate committee will have analysed proposals before presentation to the decision making body, integrating inputs from various parts of the MNE, including (depending on the nature of the business and of the investment):

- Divisional or line management (who would normally initiate the proposal)
- Product lines
- Strategy
- Corporate finance
- Financial management and insurance
- Security
- HR
- Legal
- Agriculture
- Geology

It is important to bear in mind that the investment approval represents only one point in an evaluation and implementation process which may stretch over a period of moths to years. Each individual FDI project involves a complex internal investment decision making process that will have multiple (cross disciplinary) corporate stakeholders.

Two typical Approval Committee structures

European Cement Company
New investments (historically above €20-30 mn, but now above €10 mn) are approved by an Investment Committee, whose membership would include:

- CEO
- CFO
- EVP Strategy & Development
- EVP, Operations
- Head of Region

An investment in a new country would also involve a Risk Committee, whose membership includes the Legal Department (dealing with foreign legal issues and judicial systems) and the Security and Safety Department.

Diageo

For smaller investments, Regional President, Africa and FD Africa

For larger investments, CEO, CFO and Board, with inputs from:

- Corporate Finance/M&A team (both global and locally embedded units
- Security Division (including external resources if required)
- Legal

Follow on investments

There was almost complete unanimity that follow-on investments were much easier to approve than a first investment (assuming that the first had been a success).

Even though the evaluation and approval process may have been the same, the players involved would have a greater familiarity with the situation in the relevant country and therefore a greater comfort level in considering the follow-on proposal.

Investment appraisal models

A number of interviewees were willing to discuss aspects of their financial evaluation processes and to give examples of individual hurdle rates for specific FCAS (see overleaf), but none was willing to provide more detail and many companies declined to engage with this area of questioning at all. This is understandable given the commercial confidentiality of this subject.

However, from the limited number of responses, there is a clear differentiation between the required RoI for investments in Western Europe/North America compared with non-OECD countries. Figures quoted for the former ranged between 5% and 8%, while the latter ranged between mid-teens and low twenties.

Comments from a number of respondents are summarised in the box below. Based on the small sample of interviewees who quoted actual numbers, the required RoI premium over Western Europe/North America for emerging market risk is in the region of 10-15%.

Comments from specific MNEs

- **Diageo:** maintains an internal scale of required RoI by country, which covers a wide range within Africa. Investment opportunities globally are evaluated against different hurdle rates. Examples given of W Europe at 5-6% vs. Ethiopia at >20%.
- **European cement company:** uses a range of IRR hurdles for different countries. The baseline WACC rate for US and Europe is in the region of 8%, while emerging market rates would be in the region of 16-18%. An IRR which is too high (say, high 20%s) would normally raise question marks, since production processes are relatively consistent throughout the world and the key variables in each country are similar for the major players.
- **US oil major:** Every single project manager worldwide will be using the same management process, but there will be exceptions to the standard process reflecting strategic (political) considerations to the standard process.

  What is risk?: Cost x Time x People. In high risk countries the price for 1 barrel of oil will be discounted to factor in specific local risks. In higher risk countries we will be seeking higher returns on investment – several digits higher.
- **SABMiller**: has a RoI hurdle rate for each of its countries of operation (available to senior management and Corporate Finance group, but not generally available in company so that people cannot game the system). Examples given were:
  - UK: 8%
  - Uganda: mid-teens
  - S Sudan: 25-30% (this may be actual return rather than hurdle rate)
- **Nestlé:** Described a very systematic approach involving multiple inputs from Business Zones, Business leader for product lines, Function leaders from Environment; Agriculture; Consumer; Security; and "numerous others") which enables different investment opportunities to be ranked against each other.
- **Rio Tinto:** has an IRR figure for each country which is a potential candidate for investment (available internally, but not publicly). Sensitivity modelling includes a range of assumptions on initial investment, commodity prices, tax rates, etc. The cashflow projections will include a "base case" of operating cost estimates. The risk premium reflects the levels of uncertainty of those estimates.

Comments also indicated that there are at least two ways of approaching RoI calculations:

- The first involves using a standardised approach to project revenues and costs, then setting higher RoI hurdles for investments in riskier countries;
- The second involves using a common hurdle rate, but adding higher contingency levels onto projected costs to reflect the additional risks of operating in riskier countries.

Both approaches incorporate similar elements to require a higher gross return for increased risk, but the former gives a more explicit picture of the higher rates which are required on a country by country basis.

Investment Projection/Evaluation Model

We have discussed with DFID whether it would be possible to produce an investment hurdle rate model which can be applied across a range of countries for a hypothetical investment. The central problem is that such a model will not – and in fact cannot - capture the revenue and profit generating aspects of the investment, which are very much company-specific. For this reason, there are no indices which can be used as inputs to the model, in contrast to the data available on cost and risk issues.

In the absence of examples provided by any of the interviewees, we attach as Appendix 5 an investment projection/evaluation model which includes an Excel workbook and a detailed narrative explaining how a business case is built up for new FDI and what factors go into the business projections. We also show examples of ways in which local risk factors can impact on different types of businesses. The workbook is a dynamic model in which the impact of changes in various assumptions can be modelled.

We understand that this area is one in which most DFID country officers have little or no experience and we would be happy to address this topic as part of the Stage 3 workshop with DFID and other interested parties.

One point which it is important to understand is that financial projections can easily be “reverse engineered” to produce a given result by flexing a number of the input assumptions. This may be of particular relevance when MNE representatives are discussing with DFID specific financial support required to achieve a given level of Return on Investment (RoI) or Internal Rate of Return (IRR).

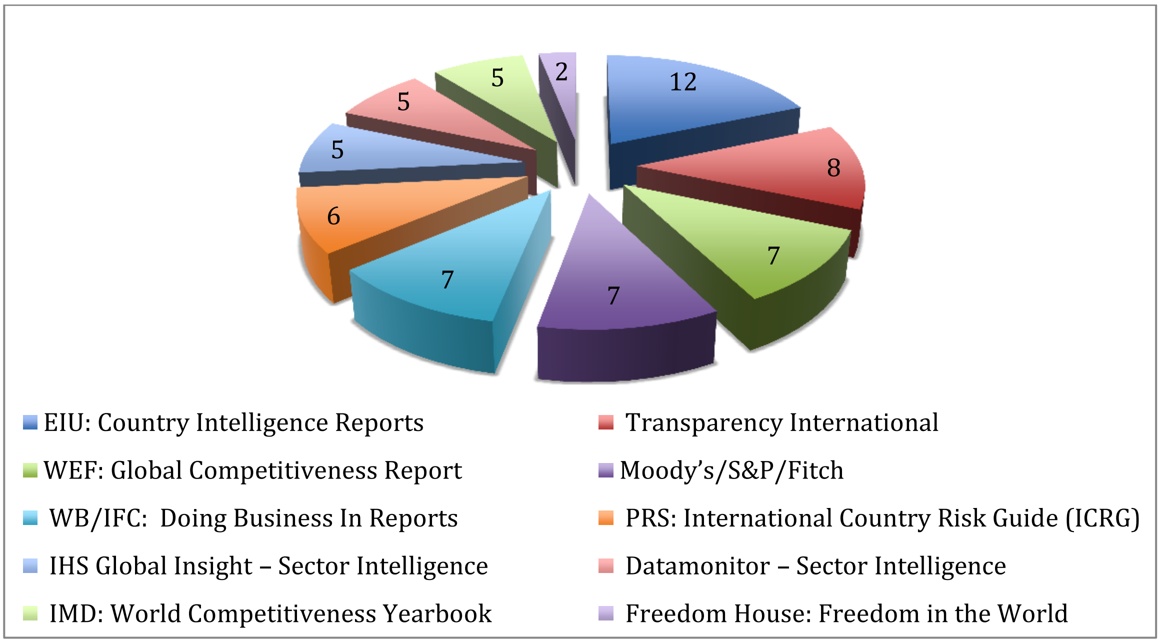
7. COUNTRY PERSPECTIVES (GENERAL)

Data sources

Appendix 6 summarises the feedback from interviewees on data sources used for reference during FDI evaluations. Of the 21 companies interviewed, all of the Indian companies mentioned only one or two of the publications listed below and in two cases, none at all. The privately held Asian Group responded that it referred to none of them, "*since these organisations come to us for information*"!

It is important to bear in mind that the responses of interviewees did not necessarily represent a corporate position, since many answered from a personal (rather than a corporate) perspective.

The ranking of positive responses was:



Data sources cited

One other publicly available country source cited by several interviewees is the CIA World Factbook. Other sources referred to (in most cases, only once or twice) were:

- Euromonitor, Wood MacKenzie, PSC, Platt's Energy reports, Global power sector reports, ADB reports;
- Country specific publications and services;
- Industry journals;
- Main information source is own experience over long term plus knowledge sharing with partners with experience in relevant country;
- External consultants (Control Risks, McKinsey, HIS, Eurasia Group, Embassies and NGOs) for more detailed studies;

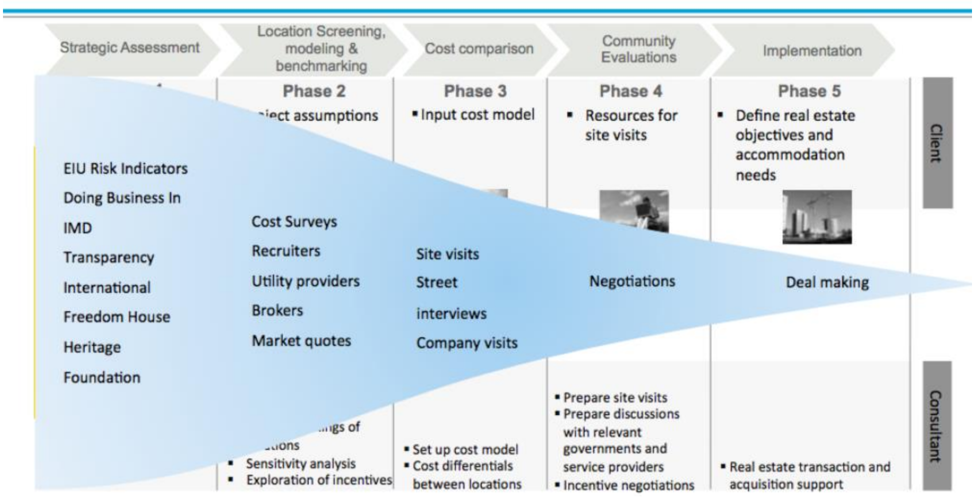
Other comments on the reference sources mentioned in the Questionnaire are as follows:

Publication	Comments
EIU: Country Intelligence Reports	Relevant content and timely updates
Transparency International	Valuable for e.g. Board reporting
WEF: Global Competitiveness Report	For high level country analysis only
Moody's/S&P/Fitch	Reference point only
WB/IFC: Doing Business In Reports	General background rather than directly relevant
PRS: International Country Risk Guide (ICRG)	Proprietary source – pay per view system
IHS Global Insight – Sector Intelligence	Proprietary source with detailed and timely reports
Datamonitor – Sector Intelligence	Geographical as well as sector focus
IMD: World Competitiveness Yearbook	Sample of countries is 60, limited number of FCAS countries
Freedom House: Freedom in the World	For high level country analysis only

The issue of information sources was highlighted by DFID as an area where feedback from interviewees is of strong interest. However, we should point out that this information is generally only considered relevant at the first of the five stages in the MNE FDI decision process.

In our Stage 1 Report, we emphasised that the steps companies take before actually starting up their operations in a new location follow a specific path in which they assess the opportunities and risks that a location/country offers. This process starts with building a strategy, desk research (including modelling) and moves towards actual site visits in which the facts are challenged by perceptions and how it actually 'feels' to operate in a specific country and city.

The initial risk mapping often starts with more general institutional risks captured in data provided by organizations such as those listed above. During a later stage of the project more industry-specific and project-related risks are explored and mapped. These risks are more related to the operational process of the firm. The figure of the Corporate Investment Roadmap below (taken from Section 3 of the Stage 1 Report) illustrates this process:



Corporate Investment Roadmap

The entire process involves balancing opportunities against costs and building upon the availability of information ranging from hard facts to interviews with firms that already have operations in the specific country.

In many cases companies may find that the necessary data to make a well-balanced investment decision is simply not available for countries such as the FCAS countries. Companies also understand that some risks are manageable (e.g. crime in cities) but others (political instability) are not. The entire investment decision making process can perhaps best be qualified as “risk mitigation” rather than total risk management.

8. INVESTMENT IN SPECIFIC FRAGILE AND CONFLICT AFFECTED STATES

Of the nine FCAS reviewed in the study, interviewees cited specific investments in the following[15]:

Myanmar	3
Nigeria	3
Bangladesh	2
Kenya	2
Pakistan	2
Uganda	2
Ethiopia	1
Sierra Leone	1
Yemen	1

Risk issues

Detailed responses from interviewees who commented on risk issues are summarised below.

Comments from interviewees varied widely, which was not surprising given the range of sectors involved and the number of countries. In general (with the exception of security for company staff on the ground), most comments related to specific commercial issues affecting the investment project. In many cases, these had a political dimension because of the role played by the government of the country concerned in relation to the investment, but other concerns focused on labour, transportation, relationships with local investors and dealing with bureaucratic issues with a strong potential to delay project timing.

Company	Sector	Countries discussed[16]	Main risks in countries discussed
Apollo Hospitals	Healthcare	Nigeria *Sri Lanka, Bangladesh*	Development of private medical sector and poor regulation
US oil major	Coal, Oil and Natural Gas	Nigeria	Immature legal base, civil unrest and difficulties with security on the ground.
Dabur India	Consumer Products	Nigeria, Nepal *Future greenfield facility in Africa*	Nigeria: Some cultural integration issues initially with labour unions. Power. Nepal: Labour unrest caused by Maoist influence

[15] These total 17, as some interviewees were unable to discuss specific FCAS investments
[16] Main country(ies). Other countries referred to shown in italics

Company	Sector	Countries discussed[16]	Main risks in countries discussed
Diageo	Beverages	Ethiopia	Risks described as macroeconomic rather than political. Also: • Environmental (compliance requirements) • Cultural: strong tradition of over-compliance leading to lack of decision taking and initiative • Drought • Availability of currency and raw materials • General "shocks"
European cement company	Building/Construction Materials	Uganda, Kenya	The major risk involved the logistics (and potential cost overruns) associated with transporting plant and machinery to location in SW Uganda.
MTN Group	Communications	Myanmar	The main issue was understanding the further commitments required by the government and whether MTN could meet these obligations.
Nexen	Coal, Oil and Natural Gas	Yemen	Above ground risk is the main one: are the people safe. Other risk is educating the government how the industry works. Corruption and transparency are also important as well as repatriation of profits.
NTPC Limited	Coal, Oil and Natural Gas	Bangladesh *Sri Lanka, Bhutan, Nepal, Nigeria, Kenya*	The major risk we faced was political rifts between the ruling and the opposition parties which did cause delay in going ahead with the project.
European oil company	Coal, Oil and Natural Gas	Pakistan	Changes in Government. Gas is sold into domestic Pakistan market, therefore currency risk on profits. Fields are technically very challenging. Security was not an issue until post 2001. Initially 40 expats with families in Pakistan, now only 5 expats as workforce is almost 100% Pakistani
Rio Tinto	Metals	Mozambique *Mongolia*	Safety and security Tenure of mining concessions Corruption/stability Transportation

Company	Sector	Countries discussed[16]	Main risks in countries discussed
SABMiller	Beverages	Uganda, Kenya	Major business risk was going in as a minority investor without control. Another factor was the defensive attitude of majority investor (strongly affected by experiences of nationalisation/ expropriation in preceding decades) which tended to emphasise repatriation of profits rather than long term capex.
Canadian oil company	Coal, Oil and Natural Gas	Sierra Leone *Iraq, Mexico*	No legislative framework for oil and gas companies. Changing laws and regulations and unclear rules.
Private Asian Group	Transportation	Myanmar (Hotel in Yangon)	Stresses extremely high level of 'local understanding' that is necessary given the complexity of the country. You need to know who to talk to and involve in order to get licences issued, title transferred etc. The whole investment process revolves around personal contacts. (NB: not bribery, just knowing who to approach to get what done. Extremely bureaucratic system. Need to keep on moving files from bottom to top of pile).
European oil major	Coal, Oil and Natural Gas	Myanmar	In financial terms, RoI has been robust. However, company has suffered strong reputational damage. X points out that company's investment pre-dated the sanctions in the early 2000s, but the company engaged with its critics too late and did not communicate effectively.
Wärtsilä	Engines & Turbines	Pakistan	The main risk would be an unsatisfactory regulatory and contractual framework. It avoided this risk by playing a role in advising the Government on that framework. Wärtsilä also recognised that electricity off-takers would be poor payers and that the IPPs would at times be sitting on a lot of receivables. Therefore the strength of government undertakings and guarantees was paramount.

9. OTHER INVESTMENT RELATED FACTORS

This section discusses feedback from interviewees under sections 4 to 8 of the Questionnaire on issues not already incorporated into the earlier Sections of this report. We list below the more significant comments made under each heading. Areas where significant differences of position can be seen are highlighted in light blue.

As a general caveat, responses in some cases may have reflected personal views of the individual interviewees and cannot necessarily be extrapolated as representing corporate policy positions.

Business environment

In the early stage of the evaluation process, business environment factors such as a reliable court system, political stability, stable fiscal and tax rules as well as corruption are considered more important than operational factors such as stable supplies, transportation, and availability and reliability of energy sources.

The table overleaf summarises the responses from interviewees on the factors listed under the "Business Environment" heading. Where respondents listed issues in order of relevance, the top four factors have been recorded; where they rated them High, Medium or Low, the High responses have been selected[17].

[17] In a small number of case, Medium response have also been included where other comments in the interview supported this

	Apollo Hospitals	BASF	Bharti Group	US oil major	Dabur India	Diageo	Emami	Hero Cycles	European cement co	MTN Group	Nestle	Nexen	NTPC Limited	European oil company	ONGC	Rio Tinto	SABMiller	Canadian oil company	Private Asian Group	European oil major	Wärtsilä	TOTALS	TOTALS %	Non-OECD	OECD	Non-OECD %	OECD %
OECD (Y) or Non-OECD (N)	N	Y	N	Y	N	Y	N	N	Y	N	Y	Y	N	Y	N	Y	Y	Y	N	Y	Y			OECD/Non-OECD			
Question 4																											
Political stability	1	1	1		1	1	1	1	1			1	1	1	1		1		1			14	67%	8	6	89%	50%
Corruption		1		1		1			1	1				1		1	1			1	1	10	48%	1	9	11%	75%
Court System		1		1					1	1				1					1	1	1	8	38%	2	6	22%	50%
Transport infrastructure			1	1	1		1	1							1	1		1				8	38%	5	3	56%	25%
Taxation				1			1	1	1				1					1			1	7	33%	3	4	33%	33%
Reliable Energy	1		1		1		1	1	1													6	29%	5	1	56%	8%
Policy making	1		1									1	1		1							5	24%	4	1	44%	8%
Trade policy	1				1								1		1							4	19%	4	0	44%	0%
Quality of institutions (Ministries/Regulators)										1				1		1					1	4	19%	1	3	11%	25%
Employment Policy														1		1						2	10%	0	2	0%	17%
Totals																						**68**		**33**	**35**		

One additional factor, "Quality of institutions", was added to reflect the feedback from MTN and Wärtsilä on the importance of regulators and from two Energy companies on the importance of institutional capability in their counterpart Energy Ministries.

The first and second rankings of Political stability and Corruption reflect the importance attached to these as knockout factors (see above). While Court system ranked as the joint third most important factor, two of the oil companies pointed out that International Arbitration is in fact the forum normally used for oil/gas industry contract disputes.

Analysing the responses between OECD and non-OECD interviewees, it can be seen that OECD MNEs placed high ratings on Corruption (75% vs. 11%) and Court System (50% vs. 22%), while non-OECD interviewees rated Political stability (89% vs. 50%)and Transport infrastructure (56% vs. 25%) more highly.

Analysing the responses between the Extractive (oil, gas, metals and cement, 9 companies in total) and Non-Extractive (12 companies), some interesting differences in position can be seen:

Question 4	Extractive	Non-Extractive	Extractive %	Non-Extractive %
Political stability	5	9	56%	75%
Corruption	5	5	56%	42%
Court System	4	4	44%	33%
Transport infrastructure	4	4	44%	33%
Taxation	4	3	44%	25%
Reliable Energy	1	5	11%	42%
Policy making	3	2	33%	17%
Trade policy	2	2	22%	17%
Quality of institutions (Ministries/Regulators)	2	2	22%	17%
Employment Policy	2	0	22%	0%
Totals	**32**	**36**		

Extractive companies appear generally less concerned with Political stability (56% vs. 75%) than the Non-Extractive group. This is perhaps unsurprising given that companies in the Extractive sector are used to working in "difficult" environments, where commodities extracted are largely exported and where only a subset of the wider risks in the business environment is relevant to their activity. In this sector it is not a matter of comparing countries for one investment project which might be made in a number of locations), but rather different investment projects are benchmarked and ranked according the magnitude of the opportunity and its commercial feasibility in relation to the business environment risk profile.

The lower concern with Reliable Energy (11% vs. 42%) reflects the fact that many larger extractive projects will (or can if necessary) generate their own power.

Detailed responses are summarised in Appendix 7, which lists the features identified by each interviewee and their comments on their assessment approaches.

Social and demographic factors

The next table summarises the responses from interviewees on the factors listed under the "Social and Demographic Factors" heading. The same scoring system has been used, except that only the top three factors have been recorded where response were ranked in order. Detailed responses are summarised in Appendix 8.

	Apollo Hospitals	BASF	Bharti Group	US oil major	Dabur India	Diageo	Emami	Hero Cycles	European cement co	MTN Group	Nestle	Nexen	NTPC Limited	European oil company	ONGC	Rio Tinto	SABMiller	Canadian oil company	Private Asian Group	European oil major	Wärtsilä	TOTALS	TOTALS %	Non-OECD	OECD	Non-OECD %	OECD %
OECD (Y) or Non-OECD (N)	N	Y	N	Y	N	Y	N	N	Y	N	Y	Y	N	Y	N	Y	Y	Y	N	Y	Y			OECD/Non-OECD			
Question 5																											
Large and/ or Growing Population	1		1		1	1	1	1	1	1			1				1		1		1	12	57%	8	4	89%	33%
Workforce Skills and	1			1					1	1		1		1		1	1	1		1		10	48%	2	8	22%	67%

	Apollo Hospitals	BASF	Bharti Group	US oil major	Dabur India	Diageo	Emami	Hero Cycles	European cement co	MTN Group	Nestle	Nexen	NTPC Limited	European oil company	ONGC	Rio Tinto	SABMiller	Canadian oil company	Private Asian Group	European oil major	Wärtsilä	TOTALS	TOTALS %	Non-OECD	OECD	Non-OECD %	OECD %
OECD (Y) or Non-OECD (N)	N	Y	N	Y	N	Y	N	N	Y	N	Y	Y	N	Y	N	Y	Y	Y	N	Y	Y			OECD/Non-OECD			
Education																											
Threat of Crime and/ or Terrorism		1	1	1		1							1	1	1		1					8	38%	3	5	33%	42%
Labour Stability				1		1	1	1						1								5	24%	2	3	22%	25%
Lifestyle and Cost of Living Factors	1				1				1													3	14%	2	1	22%	8%
Cultural Integration																						0	0%	0	0	0%	0%
Totals																						**47**		**24**	**23**		

For Market seeking investors, social and demographic factors weigh much more heavily in the investment appraisal process, as these feed directly into market opportunities (see below). As can be seen from the responses on Large and/ or Growing Population, this element was considered a key factor by almost all respondents apart from those in the Extractive sector.

Social and demographic factors also have a influence on labour and other operating costs, shortage of qualified labour will lead to structurally rising labour costs for specific job functions or the need for hiring (costly) expatriates. This is a particular factor for OECD MNEs where expatriate costs can be extremely high and is reflected in the 67% response from this group vs. only 22% for the non-OECD MNEs.

Crime/Terrorism was also highly rated, consistent with the appearance of those topics in the Knockout factors responses. The additional measures to protect company staff against crime or threats of terrorism are translated into costs and as such incorporated in the financial business model.

The very different positions of the Extractive vs. Non-Extractive sectors can be seen in the following breakdown:

	Extractive	Non-Extractive	Extractive %	Non-Extractive %
Large and/ or Growing Population	2	10	22%	83%
Workforce Skills and Education	7	3	78%	25%
Threat of Crime and/ or Terrorism	4	4	44%	33%
Labour Stability	2	3	22%	25%
Lifestyle and Cost of Living Factors	1	2	11%	17%
Cultural Integration	0	0	0%	0%
Totals	**19**	**28**		

For Extractive MNEs who are exporting oil, gas, ore and other commodities, size of local population is of little relevance to market demand. On the other hand, the emphasis on Workforce Skills and Education reflects the high cost of using expatriates and the preference to replace these with local staff where this is feasible[18].

[18] See for example the comment from the European oil company, which had 40 expats with families in Pakistan 12 years ago but now only 5

Market opportunities

With the exception of Extractive MNEs, analysis of a country's economic and demographic development is also a key element of the investment case. For example:

- Diageo's investment analysis process starts with an assessment of the market fundamentals, based on population size, demographics and economic growth rates. As a general statement, markets across Africa tend to have low consumption levels and to be relatively unsophisticated, but that lack of sophistication can represent an entry opportunity.

- For a European cement company, the economic analysis of markets in new or existing countries takes as its starting point economic growth, which correlates strongly to construction expenditure. GDP/head and per capita consumption figures are used as key indicators. Construction expenditure is broadly divided between infrastructure (normally the first to materialise in a developing country) then housing and other. Other relevant factors are which materials are traditionally used in housing construction (for example, brick and/or wood in Ethiopia and Pakistan).

- BASF primarily invests in another country due to market potential for its products. It uses specific models from other markets in order to better understand and address the distribution of the consumer base in the target market. "*Where is the customer?*" is one of the main drivers for its foreign expansion strategies.

- When evaluating and approving an investment in a new country, Hero Cycles looks at the size of the two wheeler market, growth of the two wheeler market industry, the competitive landscape, middle class clusters, demographics and the presence of a vendor ecosystem

Employment issues

A number of the larger MNEs increasingly use local employees in national or regional management positions. For example:

- SABMiller has expatriates and local management ("lopats") and is increasingly developing a third group which is a cadre of "African nationals". There are currently 120 people in this category (one third women) and they are rotated between the company's operations in different countries, taking them out of their comfort zones in their home country environments.
- A European oil company with extensive activities in Pakistan initially had 40 expatriates with their families in the country, but now has only 5 expatriates as their workforce is almost 100% Pakistani.

For OECD MNEs, the cost of expatriate staff is a strong motivating factor for increasing the percentage of local management (with security issues an additional factor, as in the example of Pakistan above.

At the other extreme is the example cited by one oil company of some Chinese companies which bring in an entire management team and workforce for new investments (including the construction team). As a result, there is almost no knowledge transfer taking place and job creation potential for the host economy is marginal. This approach is increasingly causing debate and controversy and in response more and more governments dictate a “minimum” percentage of locally sourced workers.

Geographic factors

Geographic factors are highly relevant to MNEs’ consideration of FDI, but manifest themselves in different ways depending on the specific country and industry. Some examples:

- For both OECD and non-OECD MNEs, proximity to an existing operation will make an investment easier to consider, since management resources are close at hand and regional knowledge will be greater.
- For non-OECD MNEs, proximity to the Head office will be a strong positive factor.
- Extractive sites which are remote from port facilities may present elevated risks of transport problems (limited resources, rainy season issues). One interviewee commented that contingencies for cost overruns on investments could run at around 10-12% in developed markets, 15-20% in medium risk countries and 30-40% in Sub-Saharan Africa. Conversely, some offshore oil and gas facilities may be virtually insulated from these issues.
- Companies in the Food and Beverages sectors rely on local suppliers for manufacturing inputs (grains and vegetables for Nestlé[19], barley, sorghum and maize for Diageo and SABMiller) as well as dependable supplies of water.
- In the cement industry, transportation costs make up a high percentage of the product cost, so investors look for markets with strong growth potential coupled with suitable quarries for extraction nearby. In countries with few or no limestone quarries, cement market prices will be significantly higher since all producers face similar constraints. The higher prices support additional transport costs and/or use of lower grade quarries whose limestone is more difficult to process.

[19] Under Nestlé’s “Farmer Connect” approach, some plants use in excess of 85% of local ingredients

Economic and policy environment

The next table summarises the responses from interviewees on the factors listed under the "Economic and Policy Environment" heading. The same scoring system has been used with the top three factors recorded where response were ranked in order. Detailed responses are summarised in Appendix 9.

	Apollo Hospitals	BASF	Bharti Group	US oil major	Dabur India	Diageo	Emami	Hero Cycles	European cement co	MTN Group	Nestle	Nexen	NTPC Limited	European oil company	ONGC	Rio Tinto	SABMiller	Canadian oil company	Private Asian Group	European oil major	Wärtsilä	TOTALS	TOTALS %	Non-OECD	OECD	Non-OECD %	OECD %
OECD (Y) or Non-OECD (N)	N	Y	N	Y	N	Y	N	N	Y	N	Y	Y	N	Y	N	Y	Y	Y	N	Y	Y			OECD/Non-OECD			
Question 7																											
Free movement of capital	1		1	1	1	1	1	1	1	1			1	1	1	1	1	1	1	1		17	81%	9	8	100%	67%
Robust and disciplined fiscal regime	1		1	1	1	1	1	1	1				1		1	1	1	1	1	1		15	71%	8	7	89%	58%
Free trade policy/ trade bloc integration	1					1	1	1	1									1		1		7	33%	3	4	33%	33%
Convertible and fair floating currency					1	1								1			1	1	1			6	29%	2	4	22%	33%
Predictable and competent monetary policy			1			1							1	1	1			1				6	29%	3	3	33%	25%
Totals																						**51**		**25**	**26**		

The key economic and policy environment factor that is important for all types of FDI is Free movement of capital (identified by 17 out of 21 respondents – 100% of non-OECD MNEs and 71% of OECD). This is of course a key issue for any foreign investor who will need to repatriate profits at some point - to quote one of the oil and gas companies "*When you are not allowed to repatriate your capital outside the country, that is bad…that's a real bad sign*".

Second ranked was a Robust and disciplined fiscal regime which was cited as a critical location factor by 71% of the interviewees. A small percentage change in the corporate income tax, royalty or dividends tax rate can result in a unforeseen and significant financial losses. A number of respondents commented that unpredictable changes are considered the biggest risk, and companies seem to prefer a (slightly) higher but more predictable fiscal regime over a lower yet less predictable one.

The responses of Extractive MNEs on these two points did not differ materially from those of Non-Extractive companies.

For resource seeking companies Trade blocs are considered less important, given the fact that in most cases all outputs are exported onto the global markets. The share of intermediate or final products that is sold locally is traditionally very small. Only in the case of large consumer markets such as Nigeria and Bangladesh were there some local market sales activities reported.

Currency convertibility is an important issue for MNEs. The low response of 29% may be explained by the fact that MNEs, especially those with large export sales, have a number of opportunities to generate usable foreign exchange.

Investment incentives

The final table, overleaf, shows responses to questions on the issue of “Investment incentives.”

	Apollo Hospitals	BASF	Bharti Group	US oil major	Dabur India	Diageo	Emami	Hero Cycles	European cement co	MTN Group	Nestle	Nexen	NTPC Limited	European oil company	ONGC	Rio Tinto	SABMiller	Canadian oil company	Private Asian Group	European oil major	Wärtsilä	TOTALS	TOTALS %	Non-OECD	OECD	Non-OECD %	OECD %
OECD (Y) or Non-OECD (N)	N	Y	N	Y	N	Y	N	N	Y	N	Y	Y	N	Y	N	Y	Y	Y	N	Y	Y			OECD/Non-OECD			
Question 8																											
Tax incentives	1			1	1		1			1			1		1							7	33%	6	1	67%	8%
Land & Utility subsidies	1				1	1	1						1									5	24%	4	1	44%	8%
Rebates	1			1	1		1						1									5	24%	4	1	44%	8%
Export free zones/ Special Economic zones					1		1								1							3	14%	3	0	33%	0%
Cluster development projects					1		1						1									3	14%	3	0	33%	0%
Other tax benefits				1									1									2	10%	1	1	11%	8%
Duty free imports on capital equipment										1					1							2	10%	2	0	22%	0%
Value chain development projects					1																	1	5%	1	0	11%	0%
Other private sector development projects	1																					1	5%	1	0	11%	0%
Totals																						**29**		**25**	**4**		

An additional factor, "Duty free imports on capital equipment", was added to reflect comments from MTN and OGNC.

Responses on the issue of investment incentives polarised quite strongly between OECD and non-OECD MNEs[20] (the latter providing 86% of responses, while making up only 43% of interviewees). Most of the former listed a number of factors as being relevant as shown above, while non-OECD MNEs companies indicated that they would take advantage of any investment incentives available, but commented very firmly that

[20] Although the responses of Extractive MNEs did not differ materially from those of Non-Extractive companies

any investment project which had to rely on subsidies from the investee country was unlikely to be economically viable in the first place. (Especially in the case of countries with unstable policies, incentives are easily provided but also easily revoked. This causes uncertainty and is therefore considered a business risk. In other words incentives can become a barrier to foreign investment rather than facilitating it.)

The differences in response may be explained by a number of factors:

- Indian MNEs make up 7 of the 9 non-MNE respondents and may consider these types of incentive as normal in their home market.
- Extractive sector companies work with much longer time horizons than the other groups and the impact of subsidies is therefore proportionately smaller on financial projections and RoI calculations.
- Many of the non-Extractive OECD MNEs have strong brands and low WACC and may see these competitive advantages eroded by new entrants whose short-term perspectives are distorted by the prospect of a package of subsidies.

Political risk insurance

While putting in place normal commercial insurances, few of the companies interviewed considered it necessary to take political risk insurance against risks such as currency transfer restrictions, expropriation, war and civil disobedience, breach of contract and non-honouring of sovereign financial obligations. Rio Tinto pointed out that adequate levels of cover would probably not be available for very large projects in very small FCAS, mentioning Mongolia as a relevant example.

A number of those with capital intensive investments utilised export credit finance packages, typically providing credit risk insurance to the lenders.

10.ACTIONS THAT COULD BE TAKEN BY GOVERNMENTS AND/OR IFIS/DONORS

Reviewing the feedback from the MNEs interviewed, the following observations can be made.

Business environment

Issues of highest relevance were Political stability (67% of responses); Corruption (48%), an effective Court System[21] (38%) and Transport infrastructure (38%). There was little differentiation between the views of OECD and non-OECD MNEs on the first and third of these points, but only 1 non-OECD respondent cited Corruption as a high priority issue as against 9 OECD respondents.

The high response from OECD MNEs almost certainly reflects legislation in many OECD countries criminalising corrupt payment; we would also caution against projecting a wider non-OECD view onto the responses from the 9 interviewees, 7 of whom were Indian MNEs.

Weaknesses in all four of these areas tend to be characteristics of FCAS, so it is difficult to identify additional specific short-term actions by Governments, donors or IFIs which could have an impact on these over and above existing and long standing programmes.

Social and demographic factors

Large and/ or Growing Population and Workforce Skills and Education were cited by 57% and 48% of the respondents respectively. The former factor is important from the perspective of Market seeking investors, where a larger population size represents greater market opportunities and responses between OECD and non-OECD interviewees were evenly balanced.

Workforce Skills and Education are a particular issue for OECD MNEs, who are receptive to using local staff to replace expensive expats here this is practicable. Of the 10 responses, 8 were from OECD MNEs while only 2 were from non-OECD companies. This requirement is an issue across the board for all four categories of investors, suggesting that Governments and donors could focus on this as a priority area. An indispensable first step, though, is to identify what kinds of investors (both by motivation and by sector) will be attracted to a specific country, so as to ensure that training resources are targeted at developing appropriate skills.

Threat of Crime and/or Terrorism ranked as the third factor, cited by 38% of respondents. Weaknesses in these two areas tend to be characteristics of FCAS. This is an area where DFID is already investing through security and justice programmes in a number of countries.

Economic and policy environment

The issues of Free movement of capital and Robust and disciplined fiscal regime produced the highest responses (81 % and 71% respectively) to any question. Any

[21] Although, as discussed above, national courts are of less relevance for investors in areas such as Extraction, where International Arbitration is the agreed forum for dispute resolution.

foreign investor will need the ability to repatriate profits at some point, so this is clearly a key issue for MNEs considering alternative FDI options in a number of countries.

On fiscal issues, a number of interviewees stressed the problems which can be caused by sudden and/or arbitrary changes in tax rates; while corporation tax on company profits is one point of sensitivity, changes in taxes on oil revenues or excise duties on alcohol sales can have a much greater impact on absolute levels of profitability.

Investment incentives

Responses on the issue of investment incentives polarised quite strongly between OECD and non-OECD MNEs - in fact, non-OECD MNEs made up 86% of total mentions. The larger MNEs, especially those in the Extractive sector, tended to be dismissive of the need for incentives, while stating that they would obviously take advantage of them if they were available.

It is important to bear in mind that the investment case takes as its starting point the potential to generate revenues. 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. The consequence is that some of the FCAS with small populations and/or very low GDP per capita may simply not reach the minimum hurdle for many MNE investors.

A further relevant factor is that any significant FDI involves commitment of senior management time[22], which is a scarce resource and which has a high opportunity cost. As a result, investments which show the highest potential for generating additional revenues will get the greatest management attention, while weak business cases which require a subsidy element will be seen as less attractive.

Investments in “difficult” countries may also present a high degree of reputational risk for the investing company (and, internally, for the individual(s) involved in sponsoring the investment[23].

However, while many of the larger MNEs interviewed were dismissive of investment incentives, they will be a factor for certain types of investment, especially those with a shorter payback period where the value of the incentive is correspondingly greater in NPV terms. They may also be required to achieve a level playing field where other candidate countries are offering similar programmes.

The lesson from this is that FCAS may need to offer certain incentives to preserve a level playing field with competitor countries. However, it is important to carry out a realistic analysis of the competitive strengths and weaknesses of a country planning to offer such incentives, so as to ensure that they are targeted at investors who are likely to have a genuine interest in FDI. It is also important to ensure that incentives are not more generous than they need to be to achieve their desired effect.

[22] For example, Diageo stated “*One non-financial factor is the potential call on senior management time – considered a scarce resource – which is an issue when prioritising competing investment opportunities.*”

[23] For example, a European oil major said of its gas producing investment in Myanmar that in financial terms, RoI has been robust. However, the company has suffered strong reputational damage, even though its investment pre-dated the sanctions in the early 2000s.

ICA's experience is that many countries operate investment incentive programmes which are not properly tailored to the industries which they are intended to attract and, in many cases, more generous than they need to be to achieve their objectives. We would therefore recommend that a country's analysis of its attractiveness to specific types of investor should include a review of what incentives (if any) are appropriate for the target industry sectors.

Other Governmental actions

Comments from interviewees are summarised in Appendix 10. While some reflect specific concerns of individual companies, there was a high degree of consensus that the most important actions that can be taken are those which create an enabling environment for normal business activity, as can be seen from the following verbatim references from the interviews.

Responses to the question "What tangible actions could be taken by Governments of "difficult" countries which would have the biggest positive impact on the investment case?"

- *"Streamlining tax codes, accessing WTO, ratifying oil and gas laws, investment laws"*
- *"Consistency of regulatory landscape and regulatory environment"*
- *"Faster project clearances, transparency with issues dealing with investor protection"*
- *"Transparency of economic policy and inward investment approach"*
- *"Government policies transparent, clearly stated and published (so change of government does not lead to loss of continuity). Monitoring and dissemination of actual performance against stated objectives".*
- *"Political and policy commitment towards building the power sector, easier acquisition of land for large power projects, firm control on red tape, corruption and investor protection"*

Other areas mentioned a number of times were:

- Transport infrastructure (38%)
- Strengthening of capacity in the relevant Ministries to deal with project approval and related issues such as taxation. This was a particular factor for companies in the extractive sector (mentioned by two of the seven oil companies interviewed).
- Active participation at Ministerial level in overseas trips by Government delegations. This was cited both positively (Ethiopia) and negatively (Libyan participation in international conference where Ministers sent substitutes and there were disagreements between representatives during discussions).
- Active and professional follow up by the investee country Ambassador with investor's Head Office

- Avoidance of sudden policy changes (for example, anti-alcohol stances in Turkey or Botswana).

Donors and IFIs

The comments from OECD MNEs mostly amounted to supporting progress in the areas listed above. Two interviewees also mentioned the key role played by their country's Embassy in facilitating initial contacts between their senior management and the Ministers of the country concerned.

Interestingly, the non-OECD MNEs made almost no comment in response to this question, perhaps because there is no national counterpart to agencies such as DFID and therefore no tradition of working with them. There may also have been a degree of selection bias amongst the OECD MNEs, since several of them had established relationships with DFID or its counterpart agencies in their own countries.

Wärtsilä was extremely positive about the role played by the IFC through its willingness to invest directly in independent power plant (IPP) projects in Pakistan, thereby creating a more reassuring environment for private investors.

Conclusions from interviewees' responses

Most interviewees made reference to issues such as sanctions, political instability and civil unrest, poor security and corruption as factors which would act as major impediments to a positive investment decision.

Most interviewees also mentioned infrastructure (especially power and transportation) as a key issue in preparing the investment analysis. The degree of importance depends on the characteristics of the particular investment and industry; some companies will include generating capacity as part of the project investment and others (at one extreme, offshore oil and gas producers) are not affected by poor transportation links.

The general theme which emerges from interviewees' responses is that the factors which are most likely to be conducive to promoting FDI are those which are institutional rather than financial: transparency of investment and tax policies; consistency of legislation, regulatory approach and fiscal policies; active promotion of the country to potential foreign investors; and an efficient government apparatus staffed by individuals who have the relevant expertise to deal with foreign investors in general and, where applicable, specific sectors such as oil and gas production. The majority of these are already being addressed by donors and IFIs, with varying degrees of success.

While these factors are easy to specify, many of the characteristics of FCAS are likely to act as a drag on their achievement, especially over a sustained period.

In terms of specific priorities, four issues identified by the majority of interviewees were:

- Robust and disciplined fiscal regime
- Free movement of capital
- Workforce Skills and Education
- Appropriate investment incentives

In each of these areas, we would recommend that approaches which have the best chance of increasing FDI in a specific FCAS in the short to medium term will involve:

- A realistic analysis of the country's attributes which are most likely to be of interest to potential FDI investors (for example, natural resources, domestic market opportunities, strategic linkages).
- 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).
- A proactive approach in marketing investment opportunities to companies identified in the second stage. This is an area where external support will almost certainly be required, partly for cost effectiveness and partly to help ensure that the promotional exercise hits the right points from the recipient's perspective.
- 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.

11.STAGE 3

The Terms of Reference for Stage 3 state:

"Stage 3 will involve testing the model. This will involve:

- *A desktop exercise comparing actual MNE investment in three of the Focus Countries, analysing actual investments made against (1) the findings from the Stage 2 MNE interviews and (2) the apparent attractiveness of certain investment environments according to indicators such as the World Bank's Doing Business Indicators.*
- *Meetings with a sample of the MNEs interviewed in Stage 2, to test the conclusions from the structured interviews and to explore additional questions arising from the outputs from Stage 2 and the comparison of actual investment referred to in the bullet point above.*
- *The output from Stage 3 will consist of a detailed report and one or more workshops with DFID and other interested parties.*

The consultant will also be required to present (or assist in presenting) a paper at the World Bank's ABCDE in June 2013. A draft paper or a two-page proposal will be required by the end of January 2013."

We have proposed a number of amendments to the ToR to reflect findings from Stages 1 and 2 of the assignment:

- The ABCDE submission was not accepted for presentation, so this part of the ToR falls away.
- Secondly, we question whether we need to have follow-up meetings with the companies interviewed, as in most cases the information already given has been quite comprehensive.
- Thirdly, we have discussed and agreed with DFID that it makes sense to move one of the Stage 2 deliverables (Policy brief for DFID: How to assess investment attractiveness of individual FCAS for different types of MNEs; what actions can be taken by Governments, donors and IFIs to make a material impact on the investment case) to Stage 3, so as to incorporate additional findings from this stage.
- Fourthly, the abridged version of our report for distribution to the MNEs interviewed will form an additional deliverable.

We have already had considerable discussions on our proposal to extend the scope of the desktop analysis referred to above by using the data on the investments in the 9 FCAS countries from 2006 to 2012 for which we have details from the fDi Markets database (original purchase of data for 6 countries plus 3 further ones).

This is a rich source of data since it covers ca. 980 transactions over this period, each of which has also been classified under one of the four investment motivation headings. Our proposal for the scope of this part of the Stage 3 report is attached as Appendix 11.

The proposal suggests testing a number of hypotheses as follows:

Hypotheses to be tested against database

- *Extractive companies form a class of FDI investors with specific characteristics. Investment is driven by commodity prices and the costs of extraction from alternative locations rather than by the characteristics of the country where the natural resources are located.*

  This will be tested by comparing Extractive investments over the 2006 to 2012 period against investments in the other three categories.

- *Market seeking companies will focus on FCAS with larger population sizes [“Investment Potential” factor]*

  This will be tested by comparing Market seeking investments against population size, i.e. do countries with larger populations get more investments than the average for the FCAS?

- *Market seeking companies will focus on FCAS with a certain level of disposable income [“Investment Potential” factor]*

  This will be tested by comparing Market seeking investments against an index combining GDP per capita + GDP growth rates, i.e. do countries with higher GDP/GDP growth get more investments than the FCAS average?

- *Market seeking, Efficiency seeking and Strategic asset seeking firms will all be responsive to the investment climate in the relevant FCAS [“Investment Risk” factors]*

  This will be tested by comparing Market seeking Efficiency seeking and Strategic asset seeking investments for each FCAS against a composite index, based on the Doing Business In…, Global Competiveness, Freedom in the World and Corruption Perceptions indices for each country. A spider chart for each country will illustrate specific characteristics.

  The rationale is that a low score in each index represents a less favourable investment environment and vice versa.

- *FCAS with poor investment climate indicators will not tend to discourage Extractive sector FDI*

  This will be tested by analysing patterns of Extractive sector FDI against Investment Risk indices.

- *Factors such as sanctions, high levels of civil unrest or military conflict and extreme arbitrary behaviour by governments will act as a knockout factor for most MNE FDI*

  There is already a very clear illustration in the example of impact of sanctions in case of Myanmar. In the case of Yemen and Pakistan, data may also support the impact of conflict issues and civil unrest.

Hypotheses for commentary

- *Companies with a high ratio of sales to capital investment will be more willing to invest in FCAS with poor investment climates*
- *OECD MNEs will tend to invest in regions where they have a presence*
- *Non-OECD MNEs will tend to invest in non-OECD markets*
- *Non-OECD MNEs will tend to invest in neighbouring countries*
- *Non-OECD investors are less responsive to higher risk criteria than OECD investors- in particular corruption indices*
- *Efficiency seeking investors will tend to avoid FCAS, since stability, efficiency and predictability are key factors for such investors*

Our report on these hypotheses will also indicate issues arising from the analyses described above where further statistical analysis with input from DFID statistician is recommended. This analysis would be beyond the scope of the Terms of Reference for the assignment, but we have already provided DFID with a soft copy of the fDi Markets database which we are using. Delivery of the remaining two elements of the Stage 3 deliverables (Policy brief for DFID and abridged version of our report for distribution to the MNEs interviewed) will follow completion of the analyses described above.

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