**Foreign Direct Investment**

Multinational corporations frequently capitalize on foreign business opportunities by engaging in direct foreign investment FDI, which is investment in real assets (such as land, building, or even existing plants) in foreign countries.

Multinational corporations engage in joint ventures with foreign firms acquire foreign firms and form new foreign subsidiaries. Financial managers must understand the potential return and risk associated with DFI so that they can make investment decisions that minimize the MNC’s value.

Because the motive of DFI is always to increase profits of the organization and to increase the value of the shareholders equity.

**Motives for Direct Foreign Investment**

Whenever any multinational corporation is engaged in Direct Foreign Investment the firm always has some motives behind their decisions. the most common motives of Direct Foreign Investment by multinational organizations are as follows.

* Improve their profitability
* Enhance shareholders wealth
* Boosting Revenue
* Reducing Cost

**Revenue Related Motives**

The most common motive for multinational organizations to go for a DFI is always a boost in its income the most common revenue related motives which a multinational organizations always wants to achieve with its Direct Foreign Investment are as followed.

* Attract New Sources Of Demand
* Enter Profitable Markets
* Exploit Monopolistic Advantages
* React To Trade Restrictions
* Diversify internationally

**Attract New Sources of Demand**

Multinational corporations commonly pursue DFI in countries experiencing economic growth so that they can benefit from the increased demand for products and services there. The increased demand is typically driven by local resident’s higher income levels. Higher income allows for higher consumption, local residents higher consumption within the country results in higher income. Many developing countries, such as Argentina, Chile, Mexico, Hungry and China have been perceived as attractive source of new demand Many MNC’s have penetrated these countries since barriers have been removed.

**Example**

Intel is the world’s leading semiconductor company. It is headquartered in the U.S. and its products include microprocessors, motherboard chipsets, network cards, etc. In 2009, Intel employed 79,800 people and its sales were $35.1 billion. Besides the U.S., Intel has factories in Barbados, China, Costa Rica, Ireland, Israel, Malaysia, the Philippines, and soon also in Vietnam. Intel is mainly engaged in vertical FDI. While the skilled-labor-intensive part of the production process (e.g. wafer production) is located in developed countries, the unskilled-labor intensive part (e.g. assembly and testing) is located in developing countries. All production facilities are fully owned by Intel

**2-Enter Profitable Markets**

When an MNC notices that other corporations in its particular industry are generating high earnings in a particular country, it may decide to sell its own products in those markets. if it believes that its competitors are charging high prices in a particular country. It may penetrate that markets and understand those prices. A typical problem with this strategy is that previously established sellers in a new market may prevent a new competitor from taking away their business by lowering their prices just when the new competitors attempts to break into the market.

**Exploit Monopolistic Advantages**

Firms may become internationalized if they possess resources or skills not available to competing firms. If a firm possesses advanced technology and has exploited this advantage successfully in local markets, then the firm may attempt to exploit it internationally as well. In fact the firm may have a more distinct advantage in markets that have less advanced technology.

**Example**

In The 1996 Intel, the world’s largest semiconductor company announced, that it would construct a new us$300 million assembly and test plant in Costa Rica aroused considerable interest in the foreign investor community. With annual revenues of more than us$20 billion, Intel’s gross sales were approaching two times the GDP of tiny Costa Rica, which had a population of only 3.5 million. Intel’s plan called for the establishment of a campus that could accommodate up to four plants employing 3,500 over time, eventually reaching an estimated Us$500 million in total investment. The aim is to overcome the market.

**React To Trade Restrictions**

In some cases, MNC use DFI as a defensive rather than an aggressive strategy. Specifically, MNC’s may pursue DFI to circumvent trade barriers.

**Example**

Japanese automobile manufactures established plants in the United States in anticipation that their exports to the United States would be subject to more stringent trade restrictions. Japanese companies recognized that trade barriers could be established that would limit or prohibit their exports. By producing automobiles in the United States, Japanese manufacturers could circumvent those barriers.

**Diversify Internationally**

Since economic of countries do not move perfectly In tandem over time, net cash flow from sales of the products in a single country. By diversifying sales ( and possibly even production) internationally, a firm can make its net cash flows less volatile

**Example**

Nike is the world’s leading supplier of athletic shoes and apparel and a major manufacturer of sports equipment. It is headquartered in the U.S. and its brands include Nike, Umbra, Converse, etc. In 2009, Nike employed 34,300 people and its sales were $18.36 billion. Nike has contracted with more than 700 factories around the world and has offices in 45 countries outside the U.S. this was because the Nike want to diversify its business.

**Cost Related Motives**

MNC’s also engage in DFI in an effort to reduce costs. The following are typical motives of MNC;s that are trying to cut costs.

* React to exchange rate movement
* Fully benefit from economies of scale
* Use foreign factors of production
* Use foreign technology
* Use foreign raw materials

**Fully Benefits From Economies of Scale**

A corporation that attempts to sell its primary products in new markets may increase its earnings and shareholders wealth due to economies of scale (lower average cost per unit resulting from increased production). Firm that utilize much machinery are most likely to benefit from economies of scale.

**Use Foreign Factors of Production**

Labor and land costs can vary dramatically among countries. Multinational corporations often attempt to set up production in locations where land and labor are cheap. Because of market imperfections such as imperfect information, relocation transactions costs and barriers to industry entry, specific labor cost are seldom equal among markets.

**Example**

Asia continues to be the world's top recipient region of foreign direct investment (FDI), accounting for nearly 30 per cent of global FDI inflows, UNCTAD’s World Investment Report 20141 reveals. Total inflows to developing Asia (excluding West Asia) amounted to $382 billion in 2013, 4 per cent higher than in 2012 this increase Is due to the low cost of labor and material in these countries..

**3-Use of Foreign Raw Materials**

Because of transportation costs, a corporation may attempt to avoid importing raw materials from a given country, especially when it plans to sell the finished products back to consumers in that country. Under such circumstances, a more feasible solution may be to develop the product in the country where raw material is located.

**Use of Foreign Technology**

Corporations are increasingly establishing overseas plants or acquiring exiting overseas plants to learn about unique technologies in foreign countries. This technology is then used to improve their own production process and increases production efficiency at all subsidiary plants around the world

**Example**

Cisco recently planned a $1 billion investment in Russia to create innovative business idea. Cisco has previously invested heavily in India and other markets to tap into unique technologies and innovation.

**React To Exchange Rate Movement**

When a form perceives that a foreign currency is undervalued. The firm may consider DFI in that country because the initial outlay should be relatively low.

**Example**

Inflows to the Republic of Korea reached $12 billion, the highest level since the mid-2000s, and those to Taiwan, Province of China rose to $4 billion. Hong Kong, Special Administrative Region of China, – the region's other high-income economy and the second largest FDI recipient in East Asia – experienced only 2 per cent growth in FDI inflows to $77 billion. In March 2014, the Chinese Government decided to move the headquarter of CITIC Group to Hong Kong, Special Administrative Region of China, which is likely to help enhance its competitive advantages for attracting investment from leading transnational companies (TNCs), including those from mainland China.

**Comparing Benefits of DFI among Countries**

The potential benefits from DFI vary with the country. Countries in Western Europe have well established markets where the demand for most products and services is large. Thus, these countries may appeal to MNC’s that want to penetrate markets because they have better products than those already being offered.

**Example**

McDonald’s is the world’s leading foodservice retailer. It is headquartered in the U.S. and its brands include McDonald’s, Pret A Manger, etc. In 2009, McDonald’s employed 400,000 people and its sales were $22.34 billion (McDonald’s corporation only). There are more than 31,000 McDonald’s restaurants located in 118 countries.

**Comparing Benefits of DFI among Countries**

|  |  |
| --- | --- |
| **BENEFITS** | **MEANS OF USING DFI TO ACHIVE THIS BENEFIT** |
| **Revenue Related Motives** |  |
| Attract new sources of demand | Establish a subsidiary or acquire a competitor in a new market. |
| Enter markets where superior profits are possible | Acquire a competitor that has controlled its local market. |
| Exploit monopolistic advantages | Establish a subsidiary in a market where competitors are unable to produce the identical product sell products in that market. |
| React to trade restrictions | Establish a subsidiary in a market where tougher trade resurrections will adversely affect the firms export volume. |
| Diversify Internationally | Establish subsidiaries in markets whose business cycles differ from those where existing subsidiaries are based. |
| **Cost Related Motives** |  |
| Fully benefit from economies of scale | Establish a subsidiary in a new market that can sell products produced elsewhere this allow for increased production and possibly greater production efficiency |
| Use foreign factors of production | Establish a subsidiary in a market that has relatively low costs of labor or land sell the finished product to countries where the cost of production is higher. |
| Use foreign raw material | Establish a subsidiary in a market where raw material is cheap and accessible: sell the finished product to countries where the raw materials are more expensive. |
| Use foreign technology | Participate in a joint venture in order to learn about a production process or other operations |
| React to exchange rate movements | Establish a subsidiary in a new market where the local currency is weak but is expected strengthen over time. |

**Steps Taken By MNC TO Determine Whether to Pursue DFI**

The following are the steps taken by multinational corporations to determine whether they should pursue Direct Foreign Investment or not

* Identify Motives
* Capital Budgeting
* International Corporate Control
* Country Risk Analysis
* Capital Structure
* Long Term Financing

**Benefits of International Diversification**

These are they following benefits which normally every organization seek whenever they are planning to do international diversification.

* It reduces firms overall risks
* To generate more stable return
* It reduces variability of projects

**Example**

Toyota is the world’s leading auto maker. It is headquartered in Japan and its brands include Toyota, Lexus, Scion, etc. In 2009, Toyota employed 320,800 people and its sales were ¥20.529 trillion. Toyota has factories all over the world and sells cars in more than 140 countries. This is because is because in the poor countries it will enjoy the benefits of cheap labor and raw material and in the rich countries it will enjoy the benefits of high price which will improve the profitability of the business if used properly.

**4-Diversification Analysis of International Projects**

MNC with investments positioned around the world is concerned with the risk and return characteristics of the investments. The portfolio of all investments reflects the MNC in aggregate.

Tools of Analyses

1. Comparing Portfolios along the Frontier
2. Comparing Frontier among MNC’s

**Host Government Views of FDI**

Each government must weigh the advantages and disadvantages of DFI in its country. The most frequently cited advantage is that direct foreign investment will create local jobs and thereby reduce the unemployment rate.

Host Government Views of FDI

* Incentives to Encourage DFI
* Barriers to DFI
* Government Imposed Conditions on Engaging In DFI

**Incentives to Encourage DFI**

The ideal DFI solves problems such as unemployment and lack of technology without taking business away from local firms

**Example**

Beijing, July 16, 2010 - China has been successful in mobilizing inward Foreign Direct Investment (FDI). Attracted by the country’s investment opportunities and by its sheer size and growing domestic market, China received about 20 percent of all FDI to developing countries over the last 10 years and over $100 billion in 2008 because of its FDI friendly conditions.In terms of share of GDP and investment, FDI accounted for some 2.5 percent of GDP on average over the last five years. While this may appear to be low it can be easily explained by the overall size of the economy: China is the third largest economy of the world, just behind Japan and the United States of America.

**Barriers to DFI**

These are the following barriers of Direct Foreign Investment for the Multinational Corporations.

* Political instability
* Ethical differences
* Regulatory barriers
* Environmental barriers
* Industry barriers
* Red Tape barriers
* Protective barriers

**Protective Barriers**

When MNC’s consider engaging in DFI by acquiring a foreign company, they may face various barriers imposed by host government agencies. All countries have one or more government agencies that monitor mergers and acquisitions.

**5-Red Tape Barriers**

An implicit barrier to DFI in some countries is the ‘Red Tape Barrier’ involved, such as procedural and documentation requirements. An MNC pursuing DFI is subject to a different set of requirements in each country. Therefore, it is difficult for an MNC to become proficient at the process unless it concentrates on DFI.

**Industry Barriers**

The local firms of some industries in certain countries have substantial influence on the government and will likely use their influence to prevent competition from Mac’s that attempts DFI.

**Environmental Barriers**

Each Country enforces its own environmental constrains. Some countries may enforce more of their rustications on a subsidiary whose parent is based in a different country. Building codes, disposal of production waste materials, and pollution controls are examples of restrictions of that force subsidiaries to incur additional costs.

**Regulatory Barriers**

Each country also enforces its own regulatory constraints pertaining to taxes, currency convertibility, earning remittance, employee rights, and other policies that can affect cash flows of a subsidiary established there.

**Ethical Differences**

A business practice that is perceived to be unethical in one country may be considered totally ethical in another.

**Political Instability**

If a country is susceptible to abrupt changes in government and political conflicts, the feasibility of DFI may depend on the outcome.

**Government Imposes Conditions on Engaging in DFI**

Government imposed conditions do not necessarily prevent on MNC from pursuing DFI in a specific foreign country, but they can be costly.

**Example**

Mexico requires that a specific minimum proportion of parts used to produce automobiles there be made in Mexico. The proportion is lower for automobiles that are to be exported. Spain’s government allowed Ford Motor co to set up production facilities in Spain only if it would abide by certain provisions. This included limiting Ford’s local sales volume to 10 percent of the previous year’s local automobile sales. In addition, two thirds of the total volume of automobiles produced by Ford in Spain must be exported. The idea behind these provisions was to create jobs for workers in Spain without seriously affecting local competitors. Allowing a subsidiary that primarily exports its product achieved this objective.

**Summary**

MNC’s may be motivated to initiate direct foreign investment in order to attract new sources of demand or to enter markets where superior profits are possible. These two motives are normally based on opportunities to generate more revenues in foreign markets. Other motives for using DFI are typically related to cost efficiency, such as using foreign factors of production, raw materials, or technology. In addition MNC’s may engage in DFI to protect their foreign market share, to react to exchange rate movements, or to avoid trade restrictions.