



## **Evaluation of FDIs: Principles, Actualities and Possibilities**

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## **Abstract**

When companies consider making foreign direct investments (FDIs), as increasing numbers necessarily do, they have to evaluate those propositions. This paper forms part of the output from a study whose aim was to answer the question: “how should FDIs be evaluated or assessed: what kind of models are/should be employed in this process?”

*A priori* considerations, and a subsequent survey of UK top 250 listed companies, produced a set of six major ‘contextual’ factors which it is argued should be evaluated in conjunction with the core financial appraisal which will undoubtedly take place for any given project or proposal. The paper examines each of the six factors in turn, describing: its fundamental importance to the overall process; how the sample companies actually treated it; and how one could, or should, assess it. This structure gives rise to the wording of the title. The paper concludes with a section which discusses how the factors might be put together, along with the financial appraisal, to best inform ultimate corporate decision makers.

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# On Evaluation of FDIs: Principles, Actualities and Possibilities

## Introduction

In an earlier paper, Foster (1998), we explained in some detail why we conducted an empirical enquiry into the current practices of a sample of large UK companies in the matter of evaluating their Foreign Direct Investments (FDIs). Essentially, the reason for the empirical work was the sparse nature of the literature positing an holistic, evaluative approach to the assessment of FDIs. More precisely, the study aimed to answer the question:

“how should (such) FDIs be evaluated or assessed: what kind of models are/should be employed in [this] evaluation process?”

A semi-structured questionnaire was sent to a sample of 65 of the FTSE-250 companies, chosen to reflect breadth of industrial content<sup>1</sup>, and likely participation in FDI. From the 24 responses, there were 16 fully usable replies, of which eight were supported by later, detailed interviews.

In brief, the responses showed a pattern of fairly thorough financial appraisal, within limits, but very little formal modelling of other complementary issues which were proposed as being relevant on *a priori* grounds: infrastructure adequacy, labour adequacy, power availability (a special case of infrastructure); and cultural aspects of the projected host country. The (initially) non-financial issues which most respondents did consider were market potential and country risk. The former inevitably becomes embedded in the cash flow projections of the financial aspects of appraisal but the latter may not, depending on the company's point of view.

The aim of this paper is to make a systematic ‘tour’ of these potentially relevant factors for FDIs, describing for each one: why it seems to be of importance in the first place (principles); how our sample, in particular the eight firms who afforded follow-up interviews, actually handled/modelled it (actualities); and, how one could (or should?) model and hence assess the features (possibilities). We then examine the question of how to look at them as a whole. It is thereby hoped to provide insights into the underlying processes which should arguably feed through into and make more effective the ‘primary’ financial assessment on which companies focus.

In order to provide a route-map to the paper, we reiterate the factors (Fi) identified as:

- F1: Infrastructure Adequacy
- F2: Power Availability (a special case of F1)
- F3: Labour Adequacy
- F4: Cultural Aspects of Projected Host
- F5: Market Potential
- F6: Country Risk

These, and the process of their synthesis into an overall framework, index the sections which follow.

Many of the illustrative examples in this paper relate to the East/South East Asian area. There are two reasons for this. First, as we explained in some detail in Foster (1998), this

region of the globe has been, since the mid-1980s, and is likely to remain, after the developed economies of Europe and the US, one of the main sink areas for FDI, with China leading the way. Consistent with that, the great majority of our survey respondents had invested to some degree in the region recently. The second, rather prosaic, reason is that it is an area about which the author is knowledgeable.

## **Infrastructure Adequacy (F1)**

Quite simply, infrastructure is important because of its potential to impede legitimate business activity if it is not there.

Although none of our sample had a composite formal infrastructure modelling process, all dealt with some aspects of it. The elements which were identified as important varied widely with industry. For example, an energy company observed, “we provide infrastructure” but found that the railway transport logistics in India, at a co-ordination level, posed non-trivial problems. By contrast, a building materials company noted wharfside handling capabilities as critical and built locational cost variations carefully into the cash flow projections developed for projects.

For others, the softer end of the infrastructure was more important, eg education. A comment made by more than one respondent here, was that basic education levels for the bulk workforce tend not to be a problem; rather it is at management level that problems occur. Even there, perceptions of a particular country could vary, as we discuss further in the section on labour adequacy. Interestingly, in this context, a recent report on the Thai economy identified poor standards of education in that nation, and hence weak productivity, as a big factor underlying the nation’s lack of competitiveness - in contra-distinction to laying the blame simplistically on “high wages” (*Bangkok Post*, 1999). This is quite a contrast for one of the recently vaunted ‘New Tigers’ of Asia.

This latter point gives a hint of a recurring theme to emerge in this paper: that such perceptual variations suggest that internally designed and administered assessment instruments may be the way forward, even if some theoreticians may regard such instruments (or their output) as ‘non-validated’ (or therefore unreliable). Our argument is that, in areas of decision-making where significant judgement is required, internal empathy may be more valuable than externally judged ‘validity’.

Some respondents suggested that appraisal of infrastructure (along with Factors F2-F5) might usefully be seen more in terms of a pre-appraisal screening or initial sieve, than as an element of the final appraisal. While the notion of its use as a screening device seems sensible, we shall propose later that such evaluations as are conducted might also usefully be recorded to provide a contextualising profile to sit alongside the detailed financial appraisal at decision making time.

Another recurring theme will be the suggestion that, since formal schemes for measurement of adequacy of variables are not so commonly agreed and used, simple, subjective scoring templates may be the best way to record and highlight the ‘best guess’ view of the company’s management; including the professionally enhanced perceptions of managers or advisers on the ground in target investment locations.

One rather obvious suggestion, but one which not all actors immediately recognise, is that it is important to assess a given infrastructure factor as it will apply to you. Thus, looking up compendia which give (admittedly generally interesting) national statistics such as numbers

of telephones per thousand population may be a very poor guide in say China, Thailand or Pakistan, if your business will be dealing exclusively in the big cities such as Shanghai, Bangkok or Lahore; poor road surfaces may be unimportant if you are a power generator located in a port hinterland with sea-borne feedstock. En route to, for example, a subjective scoring system, harder data may of course be collected to inform those ratings.

The variables likely to be included in any such scheme include:

- ◆ availability of road access
- ◆ availability of rail access
- ◆ port handling capabilities (air and sea)
- ◆ availability of land for factories and/or warehousing
- ◆ availability and reliability of telephone and other communications systems
- ◆ educational provision: schools (for workers); universities (for management)
- ◆ availability of quality banking services and capital access
- ◆ friendliness of legal system: are key aspects codified; are such laws as exist effectively implemented; tax regime (including import duties on inbound goods and withholding taxes on profits)
- ◆ attitude of host government to foreign investors.

Such a set of variables could be ranked on Likert type scales from a negative (unfavourable) score through to a positive one or, for reasons of composite comparison (see later), perhaps better on a scale of affirmation from 1-10.

## **Power Availability (F2)**

This variable was one of two infrastructure special cases (the other being labour) separated out. The rather obvious reason was that power, normally electricity, is a pre-requisite for almost any business, provided in some form or another. An airport or port uses electricity all the time, not least in developed economies, for goods tracking systems, be the goods people, containers or vessels. A media group whose computers and automatic presses are not 'alive' is not an active company; and any manufacturer/processor ceases to do so as power is denied. Even a power company consumes its own product as it works to deliver service to others.

Not only do all these types of companies need power to operate; to run efficiently they require continuity of supply at a consistent voltage. Again, therefore, we were not surprised that 6 out of 16 respondents noted explicit appraisal of power supply, 4 of the 6 being in the 8 more detailed responses.

From there the picture varied, some manufacturers/producers would make provision for their own, on-site generating capacity, if it could not be bought reliably and at a fair price from the local grid - this included the sugar producer, the power company, the tobacco company and the heavy building materials group. The capital, as well as the otherwise recurrent costs of power, as a COG clearly then has to be factored into estimated cash flows. For others, the matter was "not an issue" (a leisure company) and "not relevant" (a media group), essentially because they only operated in developed economies - Europe and the US; Hong Kong in Asia. Yet others responded that while such a matter did not appear in HO planning appraisal as such, others may have done so earlier, as one interviewee put it: "operating companies

might do that sort of thing [quantified appraisal] but by the time it comes to HO it is part of a more discursive/debative approach” (the engineering conglomerate).

Moving on to its appraisal, this variable could perhaps be scored again on a set of variables, such as listed, with either a dichotomous score, or a scaled ranking as appropriate:

- ◆ power supply available: yes/no
- ◆ power supply reliability
- ◆ power rating reliability
- ◆ availability of feedstock if own generation required
- ◆ access to standard tariff, where a drawn-down supply: yes/no

The last dichotomous variable highlights the need to investigate the terms on which power is supplied. For example, in China different industrial sectors pay different rates, let alone the private versus corporate trade-off (Foster, 1997b).

The final point to make regarding power is one about enterprise size. All the companies in our sample were by definition ‘large’. As such, they felt able, where necessary, to invest in the provision of their own primary, or in some cases reserve, generator(s). A recent UNCTAD report, UNCTAD (1998), talks bullishly of the potential of SMEs to be foreign investors, especially in Asia. Small scale manufacturers may well invest in other countries, a Macanese SME in South China or a Thai SME in SW China. As small firms they may feel being self-sufficient for power is beyond them, maybe just too costly. For such firms then the issues of price per kwh and continuity of supply may be critical, for as we know, the high attrition rate in small firms is often due to cash flow management problems rather than an inherently unprofitable project or business (Keasey and Watson, 1993, ch.6); and one might note here that there is no reason to suppose that matters differ across world regions in this matter.

### **Labour Adequacy (F3)**

Like power, the availability and adequacy of local labour are crucial to the success of foreign investments. If competent ‘shop floor’ workers cannot be found a ‘good idea’ can turn in to a costly nightmare or, if not that, a less profitable venture than had been hoped (Foster, 1997).

In the questionnaire responses, only one firm (a media group) nominated any specific criteria against which to assess labour adequacy - wage rates and legislation, which are allied to but not exactly descriptors of intrinsic adequacy. The commonest view was broadly judgmental around use of contacts “being there”, and relying on joint venture partners. The sugar producer noted: “there’s usually plenty of it [labour]; we just train it if necessary”. That is fine given a basic intent to “enter unless there are pressing reasons not to”. It is less helpful if one is looking at a set of projects from which only a selection will be possible. Also, SMEs may again find poorly educated potential workers a more binding constraint.

What the follow-up interviews revealed was a sense that where real problems arose it was much more likely to be with local management rather than with the general workforce. This is highly significant, since most also aspired to a largely indigenous management in any given country.

Perhaps the most damning assessment came from the trader/distributor. As their planning director put it; “what we need is international managers of products [for global brands] not local or non-local managers”; but of their JV partners (as required by law) in Thailand he

observed: “[they] typically have no idea when it comes to the sort of management input required to run an international business. They just take a view that different things are important”.

One might speculate whether this is in part due to how discretionary the spending on a firm’s product is. In sophisticated global markets, breadth of management vision may be required but, in businesses which operate much more on a basis of national or regional service and responsiveness, ‘suitable’ managers may be easier to locate. For example, the sugar producer noted Thailand as an easy place to do business.

The notion of an international manager could have another interpretation, viz, people who adapt and cope and succeed wherever they go. Such people may not be one’s own nationals was what the tobacco company noted; they located members of their elite, mobile force of international managers in their European subsidiaries and in Brazil, as well as the UK. They believe the profile to succeed is happily married men with families, good language skills and an independent streak. This is in sharp contrast to how a Japanese or Chinese FDI might be managed - in that case Japanese and Chinese senior managers feature prominently.

Overall then how might one assess and/or score labour adequacy? A possible set of variables might be the:

- ◆ availability of:
  - elementary educated workers
  - high school educated
  - relevant graduates (engineers, accountants etc)
- ◆ perceived willingness to learn/adapt on job
  - workers
  - managers
- ◆ degree managers willing to be responsible for decisions
- ◆ diligence of workforce
- ◆ honesty of workforce (all levels)
- ◆ degree of unionisation and/or willingness for flexibility
- ◆ attitudes to foreigners (eg UK ‘masters’ or third party customers).

## **Cultural Aspects of Host (F4)**

There is little doubt that investing in locations with markedly different ambient cultures poses challenges to the investor. Some claim almost that culture is the prime variable to be handled (Franke *et al*, 1991) where others, including ourselves, counsel a more moderate approach. However, we do recognise the potential downside from failure to accept and work with differing attitudes and perceptions in host countries.

An often noted example (Hutton,1988, ch.6), at one remove from the immediate business setting, is the unhappiness of accompanying spouses who fail to adjust to a new environment. A tense home setting can rapidly reduce the effectiveness of an otherwise happy and adjusted worker. The archetypal ‘adjustor’ identified by our tobacco company

(see above) is in tune with this thought. Moreover, before any liberated women demand to know why the example has the male as worker, the answer is of course that some cultures are intrinsically patriarchal. We may or may not approve but, if we go as guests to that country, it behoves us to observe the proprieties. To do otherwise is, pragmatically, to court failure.

To succeed in a new environment, one key requirement is to communicate effectively. This may amount to more than saying clearly what I/we want/think. For example, in some Asian countries the key may be to listen more for what is not said than to what is affirmed. Many Asians find overt refusal difficult, with the result that 'replies' to direct questions are laced with circumlocutory niceties while being devoid of concrete response. Such circumlocution, irritating perhaps to the American or Brit, is their way of saying 'no'. I recall being shamed by a Chinese friend who, in response to the charge that I had been left in the dark about some arrangements, said: "but I told you, I was sure you understood!" When I re-ran the previous week's mental tape I realised that she was right but she had told me as "an honorary Chinese": my mistake, her belief in my ability to understand was intended as no mean compliment.

Our own position would be that in a whole host of ways, vaulting the cultural barriers is best achieved when both parties compromise. A lovely example of this was an observation I made in the 1980s on, for me, an early trip to Thailand. I became aware that the conversation at an adjacent dining room table was in English, but surely these were not English speakers. They were not, but their own languages (Thai and Japanese was my educated guess) were very different. Hence, both compromised, and they used English - archetypal, effective trans-cultural dealing.

Given the importance of cultural differences as a barrier to commerce, it was surprising that none of our sample made any explicit attempt to model the issue at the appraisal stage.

However, several noted that they made attempts to offer training for those likely to be posted and/or look for 'cultural fit' at posting. Another suggested that the matter was handled by the fact they employed local managers. Certainly, this means that company management may be able to handle local systems: it leaves open a potential gap between those local managers and HO. Yet another noted: "we would be wary of situations where corruption is common". On a slightly different tack but still in the area of dishonesty, the engineering company noted that problems are not just in the well known "difficult" places, such as Nigeria and Indonesia, they have a big problem in Spain and Italy with their plants being used by the staff "out of hours" to run a "black shift". The problem was noted as follows: "if you try to clamp down, management walks out..." In other words, not only does the problem exist, but it is orchestrated by the company's own managers.

In a slightly different direction, but still part of the cultural milieu, the power company noted that plant safety is non-negotiable and absolute, whatever else may "give".

Turning to the issue of how one might usefully model this area, we hope it would be clear from the foregoing that our suggestion is to model 'cultural distance', as the size of the potential task to finding the common ground which breeds success. Hence, we would argue that the important thing for an investor is to set themselves as a baseline or 'origin' in the mapping process and then measure such aspects of culture as that organisation sees to be of importance on subjective rating scales which measure 'perceived distance from home expectation'.

Thus, if one included say five aspects, each rated on a 1-to-10 scale, an aggregate score of 5 would indicate total expected harmony with domestic norms and 50 would represent the ultimate challenge.

This leaves the issue of whose model to adopt/amend or what variables to employ. In the literature on the impact of culture on business, as it is transacted across countries, the two best known names are arguably Hofstede (1980) and Trompenaars (1993). Our own view tends to be that Hofstede may be much criticised, but no-one has demonstrated that they have an overtly superior, operational model. I heard it suggested recently at a seminar that Trompenaars' model was "obviously superior" because it was "empirically validated". Within its context of development, I would suggest the Hofstede model is similarly 'valid' and Trompenaars' is itself confounded by the initial laying down of his perceptions and prejudices in the starting propositions. Our own criticism of Hofstede's model is not that the variables are not very important, but that the scores one sees attributed are difficult to understand. For example, Hong Kong is a place of extreme uncertainty avoidance for most workers. An elite cadre of managers may be tolerant of uncertainty but not the average clerk, as anyone with real Hong Kong experience would know.

What companies need is a device which makes obvious sense to them. We propose, therefore, an embryonic model in which Hofstede's four dimensions appear, together with a variable suggested by our confectionery company, namely the attitude to foreigners or degree of potential hostility thereto. One could argue for inclusion of a corruption variable, but on balance we have decided to leave this to factor F6. Thus the posited variables are:

- ◆ power distance
- ◆ masculinity (/femininity)
- ◆ uncertainty avoidance propensity
- ◆ collectivism (or individuality) propensity
- ◆ hostility to foreigners.

On measuring these we reiterate the proposition is to rank for similarity (score 1) through to dissimilarity (score 10) from home base, which may even be home-company base. Thus, Shell (HK) and HSBC (HK) may come up with different profiles for China, whereas Hofstede would have placed HK and China uniquely in Euclidian 4-space. In short, it is perceived cultural distance which is paramount not some abstract truth. People manage as they feel.

## **Market Potential (F5)**

In a way, this is obviously the least problematic of our six factors, since any financial appraisal necessarily requires, at a minimum, the potential value of the market servable from an FDI. The words are carefully chosen because, if the project is, at least in part, export oriented, then it is not the host country market potential alone which is to be assessed. Thus, at a minimum an estimate of minimum total market units to be served is *necessary*.

For some this will be easier than others. If, for example, a developer/power generator takes on a power plant project on B-O-T terms, prudent negotiation will ensure that the host's grid agrees a minimum fixed off-take of design capability. Assuming that is favourable (say >70%) then profitability of the project will depend on feedstock costs and, perhaps crucially, exchange rates if the project's finance were denominated in currency other than the host's. It is on the latter 'rock' that several Asian power projects have foundered since *les evènements de 1997*.

For Unilever on the other hand, selling Wall's ice cream is, we suggest, much harder to predict. No-one actually needs an ice cream be it Wall's or Haagen-Daz.

However, the suggestion we wish to make here is that where, at least in part, the host economy is part of the target market, a general model representing the complexity/difficulty thereof, or otherwise, would be helpful.

In his major book on foreign trading, Porter (1990) proposed his so-called Diamond as a means to understand what makes originating economies, and their component industries, successful. He argued that if a country were favourably positioned on the Diamond in its domestic economy it would be more likely to be able to "launch itself" successfully at other markets overseas. Our suggestion here is that the directional logic can be turned on its head and the same intrinsic economic variables at the corners of the Diamond can be used to assess target economies, taking care to interpret the nodal variables carefully.

Porter argued that, to be able to leave the domestic launch-pad successfully in any industry, one requires strength in at least two of the four corners, preferably three and ideally in all four. A similar clustering of strength would be required in this modified version.

As with previous factors, if we adopt a set of simple rating scales of perceived weakness through to strength, a summary statistic can be achieved by adding the four scores together, although the profile will also be important; for, (5,5,5,5) would give the same aggregate score as (2,8,2,8) but some might argue the overt strength of the 8s was preferable to the mediocrity of the 5s across the board. Either way, making the profile and total explicit should help the quality of debate amongst ultimate decision makers, as we shall argue out in the last section.

To recap the four corners of the Porter Diamond, suitably amended for inward/target market usage are:

- ◆ Factor Conditions in Host Country
- ◆ Structure of and Rivalry in our Industry in Host Country
- ◆ Aggregate Demand Conditions in Host Country
- ◆ Prowess of Related and Supporting Industries in Host Country.

Furthermore, this Inward Diamond could be modified so that some or all of its corners would reflect activity in a region as distinct from a single country, if desired. Thus, if ICI decided to build a paint plant in Vietnam, they might also be interested in the demand conditions for paint and the industry structure in neighbouring Laos and Kampuchea (Cambodia).

## **Country Risk (F6)**

The evaluation of country risk is widely agreed to be an important element of FDI study, especially since it will usually be imported into the key financial appraisal. On the other hand, it is also recognised as difficult and complex, not least because there may not be easy agreement between parties where the boundary between business risk and country risk is located, a matter evidenced from our own sample.

A more subtle point, and certainly not one well-understood in practice in our experience, is the question of whether the same country will have similar risks for all industries. This, in some ways, parallels our requested emphasis on company specific perceptions in the area of cultural distance. Thus, consider the influence of the military in X as a component of X's risk

(this is a commonly included sub-factor). Most schemes suggest that, where high scores indicate increasing risk, a strong military presence in government, makes the country riskier (Howell *et al*, 1993). However, true as this may be in the long term, such influence helps arms companies sell arms even if it makes people like our tobacco company nervous (Iraq has for some years been one of their few 'no-go' countries). Thailand spends far more on hi-tech weapons for its armed forces than could possibly be justified by any threat from Laos, Kampuchea and Burma (Myanmar) - and if China attacked one suspects it would be an unequal fight. One suspects that this spending is the ex-generals in government keeping their former colleagues happy with a continuing supply of 'new toys'. Up until the early 90s Gulf War, the West were happily selling arms to Iraq, especially as the mullahs in Iran were seen as more of a threat than Saddam at that time.

In the sample, we found quite strong support concerning the risk splitting issue, for the view expressed by an independent consultant (formerly in the oil industry) whose views we summarised as follows (Foster, 1998):

“Whenever possible, variability in input factors should be handled by utilising a range of forecasts of cash flow elements of a proposed investment; factors which cannot be obviously incorporated into cash flow forecasts should then be handled by an appropriate uplift in hurdle rates applied to proposed investments.” (\*)

Even there, the power company differed. The Planning Director's point was not that he intrinsically disagreed, but he felt that an alternative approach led to more transparent discussion by ultimate decision makers and it was better to have them knowingly agree, as a group, to a decision than to exercise judgement partially, with some elements having an apparently black-box quality. He also argued that overall sensitivity analyses are always necessary. The approach is summarised as:

“[We make] separate evaluation of each investment, building up from a risk-free rate, using risk scoring for each category of risk - business, operational, political, etc. The built up rate is then used to estimate the NPV.”

One of the benefits of this approach is that the dividing line between 'business' and 'wild' is not at issue. However, at a recent conference, a finance expert became quite exercised at the mere idea that such an approach be adopted: it wasn't 'correct'! What he clearly failed to appreciate was that, in a company, not everyone on the Board is an expert in finance theory but they are, in principle, co-equal partners in the ultimate decisions made. The Planning Director at the company quoted was an accountant by trade but, to our mind, also had a good grasp of the principles of collective decision-making. He lived ultimately in the world of the realistically possible, not the theoretically pure.

Moving back to the consultant's synoptic view, one still has the issue what is and what is not to be included in 'wild risk'. For example, the *Economist's* model of (country) political risk - perhaps more accurately political and social risk (*Economist*, 1986) - includes a variable labelled 'corruption'. Now clearly, handling corruption within an amorphous model and 'adding in its price' by upping the hurdle rate, could be said to work in that the matter is included. However, might it not be that, in terms of (\*), it would be better to put a figure on the likely cost of corruption and factor it into the cash flows? The problem, of course, is that one is then arguably seen to be agreeing that you will, along with others, act corruptly; and most companies, including those who do 'pay off', have an official policy of 'no corrupt payments'. What could be done to avoid this dilemma is to simply note that various cost

elements 'seem to be higher' in Nigeria than in the US, let us say, and use accurate total cost estimates.

We suspect, however, that leaving corruption quietly buried in the political risk profile, and as some amorphous consultant's fees in the books (perhaps unconnected to any specific project), may be a preferred face-saving approach. Of course, there is always the option of just refusing to pay: some big companies may even have the clout to be able to do that. Shell is an example of a company letting itself be seen to try to bite that bullet recently, with the very public sacking of a number of employees throughout its empire (*The Daily Telegraph*, April 1998). For small companies, the requirement may be moral courage - we were told recently of a small IT company in Hong Kong which has just that. The company is run by Christians who are simply trying to practise what they preach, and have had some success with the approach.

It is well known that there are various agencies specialising in country/political risk assessment, for example, PRS and BERI. It is also true that other people, such as the *Economist* (1986), have models which seem sensible and useful and are in the public domain. We describe the *Economist* model briefly here as an example of evident, robust good sense.

The model attaches implicit weights to the component variables by scoring them on different length scales as follows:

Political:

bad neighbours	3 points	
authoritarianism	7 points	
staleness (of government)	5 points	
illegitimacy	9 points	
generals in power	6 points	
war/armed insurrection	20 points	sub-total = 50

Social:

pace of urbanisation	3 points	
islamic fundamentalism	4 points	
corruption	6 points	
ethnic tension	4 points	sub-total = 17

Total = 67

Within this model, the obvious potential problems are: first that the variables are not orthogonal (for example, one would expect authoritarianism and generals in power to be correlated), and second, that it is not altogether clear why one has the relative weights posited. It may be that they are the outcome of a factor analysis but this is not clear. However, the point here seems to be, that it may not matter overmuch about the internal fine tuning of such models because the current methods for incorporating their output into the hurdle rate for project evaluation are pretty subjective. A key feature, again on the plus side, is the transparency using such a model within a company can bring. If groups of managers decision makers are each called on to set out their views and these are then reconciled and synthesised, then the outcome will be a profile which has credence in that organisation. When final decisions are made, one hopes that a degree of both consensus and commitment may be achieved which would otherwise be lacking - see again the power company example. As one interviewee pertinently noted, the best reference point for a given company in a particular market may well be its own database of past experience in that market.

The key issue here is, and is likely to remain, “by how much should [we] raise the hurdle rate given a particular agreed level of riskiness, by [our] agreed rating method?” There is no easy answer or manifestly, theoretically correct answer to this question. That being so, we are in the world of empirical benchmarking and our earlier comments on local derivation, or at least local to a particular ordered pair of (country, industry) apply, in our opinion.

There are two more points to be made in this section, both of an arguably ‘what not to do’ variety: these may help to reinforce the proposals we have made.

First, the finance expert referred to earlier was again outraged at the notion that, as we definitively determined, some companies were effectively assessing country (/political) risk by reference to the country’s sovereign debt rating as established by Moody’s or Standard and Poor, and then adding a pre-set percentage to the hurdle rate depending on the rating band. Now, the argument that one is essentially using a cost of one type of capital inappropriately to price another may be technically accurate, but it is not too hard to see why people may do it. If we forget that S&P are rating sovereign debt and just think of a general sense of a country’s economic standing, the exercise may seem less inappropriate. That is how we would interpret the observed companies’ actions. What seems more worrying is the notion that the same hurdle adjustment is made for different industries/product groups - see the earlier discussion.

The second point is that many risk assessments which are raised and then used (be they S&P’s ratings, a recent *Economist* rating or whatever) tend to be ‘current’ in focus. The complementary statement is that they lack future focus; they are not really forecasts of expected future risk, which is what should be used in project evaluations. An illustration of this is the failure of both Moody’s and S&P to forecast the East Asian meltdown, with the result that their major downgrading of South Korea, Thailand and Indonesia took place in December 1997, once the crisis was deeply in train! (Foster, 1998). At the same time, December 1997, Moody’ only eased their Malaysia rating from A1 to A2 and S&P held them on A+. However, while we were certainly arguing that Malaysia’s problems were at least as serious as, say South Korea’s, S&P had South Korea at BBB-. From a future orientation, Malaysia’s problems seem likely to persist until their government ends its process of ‘denial’ of self responsibility.

In an otherwise interesting discussion of an application of the *Economist* model to SE Asian nations, Howell *et al* (1993) appear to fall a little into the same trap. Their empirical ratings suggest ‘improved’ prospects, or reduced risk, for the SE Asian countries generally, bar Burma. In particular, Malaysia’s ‘tradition of democracy’ was noted as an underpinning reason for its very positive assessment, second only in their group of ten countries to Singapore. Staleness and ethnic disharmony are noted as the downside elements of their picture but there is no real hint of suggestion of the constitutional disquiet which is pressing negatively on Malaysia’s possible economic recovery just five years later (ie well within the probable investment appraisal timeframe of any appraisals being conducted back in 1993).

## **Synthesis and Conclusion**

The fundamental point that we would wish to make is that decisions based on an appraisal which explicitly includes both the financial calculations which all firms (in their various ways) conduct, and the profile of factors discussed in this paper (F1-F6), are likely to be better informed and hence more robust decisions than those made on a partial basis.

Second, even if some elements of the set of attributes F1-F6 are indeed incorporated somehow into the financial calculations (F5 and F6 are almost bound to be), we recommend that the firm's own formal appraisal of each of the Fi is also presented to the eventual decision makers as part of a final data set. The method of formal assessment may be subjective, but that a factor should be and has been formally assessed is the key point.

Third, one could consider whether it is better to conjoin the assessments of the Fi into a single, composite utility function (ie build a MAUT type model) to sit as a partner to the financial numbers, or to present the information on a profiling basis. At the outset, we were minded to suggest the former but the process of constructing this paper has caused a change of mind - the reason is transparency. We have argued at various points that the objective must be to carry all the decision makers with the process. That being so, it seems possible that this is most likely to occur if additional layers of modelling complexity are not allowed to, or perceived to, obscure the underlying picture. Hence, a profile of the key financial measures (including appropriate sensitivity analyses) and the factor assessments should be presented to the final decision makers.

Fourth, it is suggested that the factors listed be assessed by the sort of transparent rating processes outlined in each of the factor description sections. It is further recommended that the ratings actually developed are, at least in part, based on internal knowledge and perceptions - as well as possible external, expert assessment. There are two reasons for this, on the one hand it should help to breed commitment to eventual decisions, on the other, however expert experts are, they do not have the immediate feel for a sense of a company which those inside it possess. There is also another potential assessment check built in here; if external experts and internal raters produce significantly different assessments, one can and should explore the reasons for the divergence.

**Note**

The eight detailed follow-up cases included: a power developer/generator; a tobacco company; a heavy building materials company; a sugar and foodstuffs producer; a trader/distributor; a confectionery/soft drinks group; a diversified engineering conglomerate; and a specialised building products group dealing with relatively sophisticated building approaches.

The other respondents ranged widely from another energy company to media groups, via a telecomms business and a transport hub management group.

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