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CFO Insights:
Foreign direct investment: How to successfully expand your global footprint

Around the world, emerging economies have generally recovered from the global financial crisis far quicker than more advanced economies. It should come as no surprise then that companies in the developed world are increasingly looking for opportunities to expand their footprint overseas. This search for new growth markets has shined a spotlight on foreign direct investment policies around the world.

While foreign direct investment is not a new topic in the boardroom, its levels declined sharply during the global financial crisis. But recently, this type of investment, which typically takes the form of cross-border mergers and acquisitions, has begun to rebound. According to the Organization for Economic Cooperation and Development (OECD), worldwide foreign direct investment inflows stabilized in 2010 after sharp declines in 2008 and 2009, and many countries are experiencing rising FDI inflows thus far in 2011.

As companies look overseas for new opportunities, chief financial officers need to consider taking a leadership role in examining the benefits and risks of cross-border merger and acquisition activity. By understanding how these investments have turned out in the past, CFOs can better plan for how new deals may play out in the future. This *CFO Insights* will explore how the foreign direct investment landscape has changed since the financial crisis; how different markets operate with different rules; and how the payoff from these investments can be measured.

Foreign Direct Investment's Changing Landscape

Historically most cross-border merger and acquisition activity has taken place from advanced country to advanced country. In recent years, however, that pattern has begun to shift as more activity is arising from and targeted at developing countries. While the United States continues to lead the world in foreign direct investment outflows, in some recent quarters investment inflows to China have exceeded those to the United States. This change is one sign of the diverging outlooks for developed and developing markets.

In developed markets, the outlook is for a slow-growth environment ahead as the hangover from the financial crisis persists. While the U.S. and other countries have emerged from recession, these recoveries have relied heavily on fiscal and monetary expansions. As governments withdraw these measures, there are concerns about how economies will function on their own. There are also looming questions about how Europe will tackle its sovereign-debt crisis, and how the U.S. plan to raise the federal debt ceiling will work out. Together, these unknowns cast a shadow of uncertainty over foreign direct investment activity in advanced countries.

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In developing markets, there is a very different picture. China and India continue to post the fastest GDP growth rates among major economies. Brazil and Russia also present tremendous growth opportunities for many businesses, along with more overlooked areas of the world such as sub-Saharan Africa. These opportunities are expanding at a time when the governments of many of these developing economies are taking steps to create a more welcoming environment for foreign direct investment.

CFOs are indeed recognizing the opportunity. According to the results of the first quarter Deloitte *CFO Signals* survey, finance leaders at some of America's largest companies said that nearly half of their companies' strategic focus is on revenue growth—substantially more than their 30 percent focus on cost reduction. And where is that growth going to come from? Some 68 percent of respondents expect foreign markets to generate more revenue and 40 percent expect revenue from recently or soon-to-be acquired entities to be higher within the next year than it was before the recession.

Different Rules for Different Markets

Although emerging markets present attractive opportunities for faster growth, they also present risks that CFOs need to keep in mind. Even in countries where foreign-investment rules are being relaxed, governments can be prone to make sudden shifts in policy. And in many emerging-market countries, policies and regulations relevant to foreign multinationals—ownership limits, bidding rules, local-competition rules—continue to be implemented unpredictably. CFOs can mitigate these uncertainties by understanding the intricacies of new markets before entering them and learning how government policies operate both in principle and in practice.

To do that, CFOs should consider initially consulting with specialists who understand host-country laws, regulations, and customs to evaluate the economic viability of a particular transaction. For example, CFOs should find out up front if the country permits—in law and in practice—the desired financial and ownership structure of the transaction. Beyond that, CFOs can play a critical role in determining whether, after the close of a transaction, the acquired business will thrive given the host country policies towards tax, competition, labor, and other business fundamentals. Ultimately, the CFO should be convinced that there is sufficient local-market knowledge and planning to ensure the transaction's return is high.

Despite the many differences in sectors and countries, some policies that pertain to cross-border M&A share a common bond: national priorities. For example, India currently forbids foreign companies from fully owning general merchandising retailers because of a perceived threat to the millions of homegrown jobs tied to small-scale retailers. These restrictions—which an Indian government panel recommended easing in July—have forced multinational companies to approach the Indian market differently from how they approach other foreign markets. Rather than establishing and expanding wholly-owned affiliates, these firms have had to seek local partners to establish a local-market presence.

Whenever a new market is identified, however, CFOs often come to face an important decision: do they take a country's policies as ironclad, and thus try to adapt to their constraints, or do they invest scarce time and resources trying to convince that country's government to change its policies? For many years, General Electric left its individual business segments to make their own inroads into emerging markets. Recently, however, the company has adopted a more holistic approach in which the company works with governments to build wide-ranging partnerships that take advantage of the company's full spectrum of products and capabilities. This is a reminder for CFOs about how thinking strategically instead of tactically about foreign direct investment can yield stronger results.

How Foreign Direct Investments Can Pay Off

In the end, analysts will judge the success of every cross-border merger and acquisition the same way: by measuring how it impacts a company's bottom-line. As CFOs advise on cross-border mergers and acquisitions, it is important to carefully weigh possible costs and benefits and clarify as much as possible the expected source(s) of increased profitability from the transaction.

For example, many multinational companies improve the performance of the businesses they acquire by applying their superior managerial experience and vast resources. In turn, acquired businesses often give larger companies important footholds in rapidly emerging economies. Other benefits are often achieved through synergies and cost savings, which can give multinational companies a much-needed opportunity to decrease costs and thereby boost cash flows.

More recently, some multinational companies are trying to benefit from emerging-market acquisitions in a new way: instead of exporting their knowledge and culture into acquired businesses, they are importing knowledge and creativity from emerging-market companies that excel in areas such as reverse innovation and disruptive technologies. By acquiring these innovative emerging-market companies, multinationals hope to reinvigorate themselves in ways that lead to greater growth. Similarly, corporations from emerging markets may choose to invest in developed market companies to acquire brand and expertise to boost efficiency in their own home markets.

In all these different cases, CFOs should remember a common caution: Bigger deals do not always lead to better results. While large acquisitions make larger splashes in the news, good publicity is no guarantee of good financial results. In fact, it can be just the opposite. Some academic research has documented that larger deals typically produce less economic value for shareholders. One explanation is that these deals are more motivated by corporate hubris than by clear-headed financial reasoning. Another explanation lies in problems of execution. As in all endeavors, the best-planned investments will not produce results without sound implementation. To realize efficiencies in large mergers and acquisitions, CFOs can play a critical role in convincing executives across the organization of the need to understand and implement the post-transaction strategy. Without this level of coordination, CFOs may not be able to translate the cost-savings they envision on paper into savings in practice.

Today, more than ever, companies need their CFOs to assume a leadership role in counseling on the costs and benefits of cross-border mergers and acquisitions. As CFOs rise to meet these new responsibilities, they should remember to ask themselves some key questions: What is the overall economic outlook for the new market? How open is the country to foreign direct investment in our industry? How will government policies impact our planned transaction? How exactly can this merger or acquisition improve our performance and bottom-line? And does our company have the capabilities to carry out the plan?

At a time when the world presents many opportunities for foreign direct investment, it is up to CFOs to ensure their companies make the right moves. By adapting strategies to varied policy environments to ensure wise investments in rapidly emerging markets today, companies can lay the foundation for faster growth tomorrow.

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