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FDI 101 | An Overview of Foreign Direct Investment

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Abstract

FDI 101 is intended to serve as a primer on foreign direct investment for professionals working in the investments and development fields; a brief explanation of FDI, the value created by foreign subsidiaries as well as the impact such firms have on state economies, workforces, and communities. Fundamental concepts relating to identifying, capturing, and growing FDI are explored. Approaches for integrating FDI into one's business development strategies are also proposed. The overview focuses on and speaks to the practitioner: professionals working to advance economic development at the state and local levels.

What is Foreign Direct Investment

Foreign direct investment (FDI) is an area of economic study concerned with the means a country, state, or locality acquires technologies, skills, and access to international markets, by attracting subsidiary operations of multinational corporations[i]. An easy-to-understand approach to FDI begins by asking: *How do companies based in one country develop a tangible presence in other countries?* Assuming the reader is a U.S.-based professional, one might start considering the methods by which companies from Canada, Germany, Sweden, or Greece could create an actual physical presence domestically.

Several business strategies allow foreign companies to conduct business in the U.S., but to be considered FDI, the foreign company must create a physical entity— a subsidiary, with accountability to the parent company[ii]. The degree of accountability, or *ownership*, allows companies to be classified as an *affiliate* or a *majority-owned affiliate*. Economists classify entities with at least 10 percent foreign-owned equity or control as affiliates. When the percentage of ownership or control exceeds 50 percent, companies are thought to be majority-owned affiliates. [iii]

Figure 1: Standards for classifying foreign-owned subsidiaries as defined by US Bureau of Economic Analysis

FDI is often conflated with other measures of global economic activities. But FDI is specific: a *direct investment*. A foreign company must develop an actual presence in another country through subsidiary operations. *Indirect investments* by foreign corporations, what economists might term *portfolio investments,* might include companies advancing money into assets of other companies or governments, such as buying stocks, securities, or bonds. Foreign direct investment is an active investment in a country, state, or locality. The resulting subsidiary produces tangible outcomes for its host location. Foreign subsidiaries contribute to the local economy by expanding employment, providing business and partnership opportunities for existing companies, and creating economic and intrinsic value. FDI contributes to the long-term growth of host locations. This recognition has led states to launch new strategies and approaches for attracting FDI.

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Realizing FDI: Three Approaches

FDI is realized by three methods:

1. Greenfield,
2. by acquisition, and
3. through mergers.

The Greenfield FDI is defined by the U.S. Bureau of Economic Analysis (BEA) as investments to either establish a new affiliate or to expand an existing affiliate in another country. The name paints an easy-to-understand picture of this approach to FDI. Imagine an empty field of green grass in which a new facility can be easily built. For example, Revision Military Inc (Canada) took the Greenfield approach when entering New Hampshire by building a new facility in Portsmouth, NH.

Figure 2 Approaches to FDI developmentcan include new projects, mergers, and acquisitions

FDI through acquisition refers to the purchase of a controlling stake in a foreign company.[iv] A recent example of acquisition FDI in New Hampshire is the purchase of Stonyfield (Londonderry, NH) by the French diary multinational, Lactalis, from another French food product company, Group Danone, in 2017.[v] In contrast to acquisitions, FDI achieved through mergers is consolidation by two or more companies from different countries; the organizations recognize the synergies and impact gained from merging into a larger entity. Again, in New Hampshire, an example of this type of FDI is when Citizens Financial Group, Inc. (whose parent company is the Royal Bank of Scotland) merged with the First NH Bank (whose parent company is Bank of Ireland) to create New England's (then) third-largest banking business, Citizens New Hampshire, in 1996.[vi]

The most direct and easy way to recognize FDI is through Greenfield when foreign companies enter a location by creating new facilities and operational programs. But FDI can also be realized through the combination of two or more companies in the form of a merger or acquisition. Business development professionals are likely to focus on greenfield approaches, but high-value FDI can also be created when executives identify and pursue mergers and acquisitions.

FDI Activity: Horizontal and Vertical

A final concept fundamental to understanding FDI is what economists call *FDI activities*, the strategic decisions, actions and associated outcomes, a subsidiary does to grow in its host location. Increased FDI activity indicates increased value for the host country, state, or locality. FDI activity is rationed by two well-accepted models: the horizontal and vertical. These approaches help one better understand the opportunities and impediments present in a location[vii].

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The Horizontal FDI Model[viii] predicts a positive relationship between the market potential of locations where the affiliates reside and the FDI activities. Empirical evidence supporting the model suggests market-seeking investors are drawn to larger economies with significant market potential. In contrast, the Vertical FDI Model predicts an adverse effect of the host market size on FDI activities[ix]. Again, empirical data leads one to think multinational enterprises headquartered in skill-intensive countries (e.g., the U.S., Europe, and Japan) tend to invest and produce goods in regions where unskilled labor is relatively cheap and then re-import a large portion of the products back to the home country or export them to other countries.

Regardless of the model - vertical or horizontal, FDI activities contribute to the growth of host economies in several ways. First, FDI activities create and retain jobs, providing employment activities to local residents. These jobs are thought consistent and stable, even during economic downturns. The pay levels of FDI produced jobs are typically higher than domestic jobs. FDI activities also boost the efficiency of local markets as the subsidiaries represent increased competition. High degrees of FDI activities bring innovation to the local markets. Subsidiaries foster the development of new and cutting-edge processes and technologies, advancing the skills of local workforce. The advanced training and investment in efficient and innovative technologies create positive technological spillovers to domestic firms[x].

FDI represents a long-term commitment by a foreign multinational company. Subsidiaries created in host-locations require extended investments and a commitment to developing a distinct presence complementary to a location. In layman's terms: *these companies are in it for the long haul*. New firms are intended to grow and be sustainable. FDI is thus valuable today, tomorrow, and the foreseeable future. FDI results in physical facilities and infrastructures that not only benefit the company itself during its operations but also support the local economy. Even if an FDI exits a location in a shorter-than-expected timeframe, the infrastructure those subsidiary firms brought to the location, or built in order to attract FDI (such as the Foreign Trade Zones in the US, the Free Trade Zones in China, etc.) are available for new firms, domestic or foreign.[xi]

Attracting FDI: Becoming the Navigator

State and local business development executives' recognition of the significant rewards and returns associated with FDI have led many to ask: *How can I better facilitate FDI in my location?* The first step is becoming comfortable with the concepts of FDI and honing one's understanding of the long-term nature of such investments. Economists and professionals working to increase FDI regularly talk about the *triad of FDI partners*. Driving the model is the understanding that the most successful foreign subsidiaries came to fruition through the cooperation of people and partners from the business, government, and academic sectors of a host-location. The insights and capabilities found

Figure 3: The interaction and support of partners from across the business, academic, and government sectors

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within each sector regularly create synergies that effectively move FDI from a multinational company's first inquiry regarding a location to the arrival of a new business entity, and its long-term growth and development in the host location.

Perhaps the most significant capabilities of business development professionals are those that support long-term FDI prospects. There are no universal frameworks and timelines for managing a multinational company's entry to a new host-country or state. Each FDI journey is unique. Across countless case studies of positive FDI activities, and in conversations with professionals who have experienced the FDI process, a key theme is revealed: *the process requires a navigator*. The process of building a presence in a new country, state, or location is complex, necessitating access to a myriad of people, partners, and resources. Business development professionals are well-suited to be navigators of FDI. The greater one's network and their ability to connect the most appropriate people at various points in the progression of FDI, the more likely a multinational company can best enter a host-location. Across the FDI timeline, the business development professional is well-suited to recognize opportunities or impediments and link the many members of the triad to solve problems and offer unique support and solutions. One's knowledge of the multinational company's plans, access to resources throughout the locality, and the ability to connect the most appropriate people when necessary is the key to attracting and developing FDI.

Foreign companies require guidance; who better to help navigate the FDI journey than the business development professional?

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[i] Lall, Sanjaya, Narula, Rajneesh. Understanding FDI-Assisted Economic Development. [VitalSource Bookshelf]. Retrieved from https://bookshelf.vitalsource.com/#/books/9781136876790/

[ii] The definition of FDI in this paper is consistent with the one used by the US Bureau of Economic Analysis. See for example: https://www.bea.gov/news/2019/new-foreign-direct-investment-united-states-2018.

[iii] The definition of FDI in this paper is consistent with the one used by the US Bureau of Economic Analysis. See for example: https://www.bea.gov/news/2019/new-foreign-direct-investment-united-states-2018.

[iv] There is a lack of consensus among researchers and professionals regarding the methods in which FDI is realized. This paper combines content from Investopedia.com and corporatefinanceinstitute.com.

[v] Kowitt, Beth. 2017. Danone's Stonyfield Sale Is the Latest Twist in the Yogurt Wars. *Fortune*. Retrieved on October 7, 2019 from https://fortune.com/2017/07/05/danone-sells-stonyfield-lactalis/.

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[vii] Rogers, C. L. and C. Wu. 2012. Employment by Foreign Firms in the U.S.: Do state incentives matter? *Regional Science and Urban Economics*, 42(4): 664-680.

[viii] Markusen, J.R., 1984. Multinationals, multi-plant economies and the gains from trade. *Journal of International Economics* 16, 205–226.

[ix] Helpman, E., and P. R. Krugman. 1985. Market structure and foreign trade. MIT Press, Cambridge, MA.

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[xi] Wu, C., and G. Burge. 2018. Competing for Foreign Direct Investment: The Case of Local Governments in China. *Public Finance Review*, 46(6): 1044-1068.

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