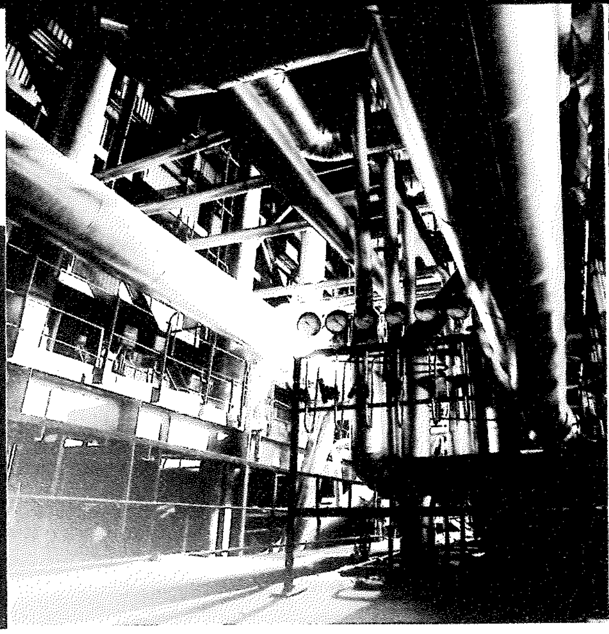
CHAPTER SIX

INVESTING ABROAD DIRECTLY



LEARNING OBJECTIVES

After studying this chapter, you should be able to

1 Understand the vocabulary associated with foreign direct investment (FDI)

2 Explain the OLI paradigm as an integrative framework

3 Explain why ownership advantages are necessary for firms to engage in FDI

4 Explain what location advantages attract foreign investors

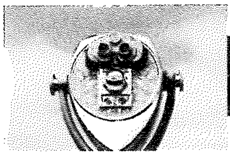
5 Explain and apply the concept on internalization advantages

6 Appreciate the benefits and costs of FDI to host and home countries

7 Explain how home and host country institutions affect FDI

8 Participate in three leading debates on FDI

9 Draw implications for action



OPENING CASE

Spanish MNEs enter the global stage

Spanish multinational enterprises (MNEs) have been relative latecomers to international business. Yet by 2010, Spain was among the top ten source and recipient countries for foreign direct investment (FDI). Foreign firms' stock of FDI in Spain grew from €201 billion in 2001 to €528 billion in December 2016, while Spanish firms owned €490 billion of FDI stock abroad, up from €264 billion in 2001.

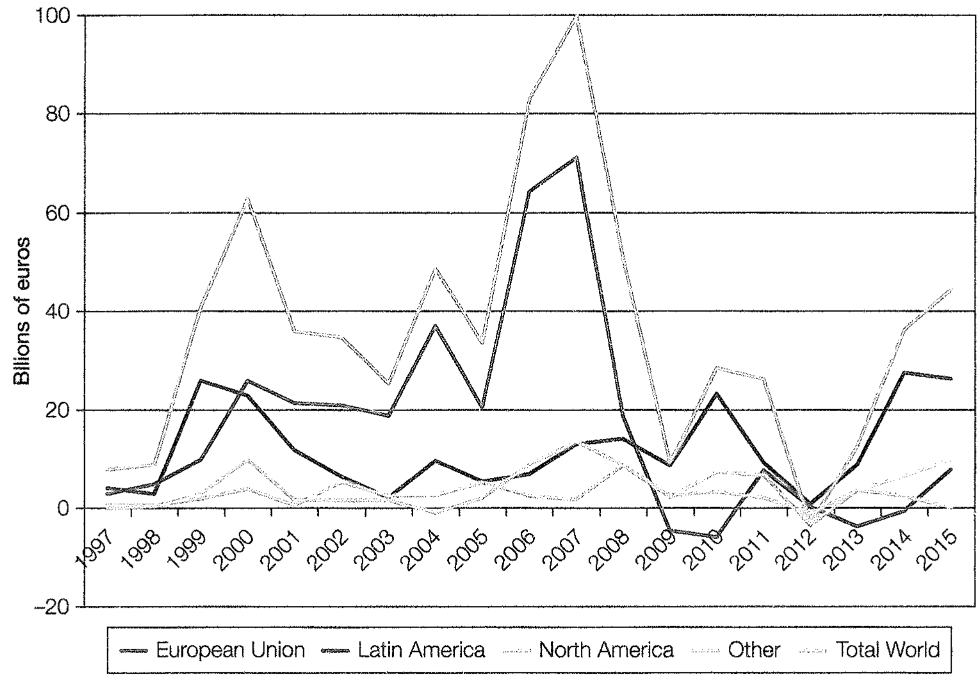
Since the early 1980s, liberalization and privatization not only increased competition from foreigners entering Spain but also propelled Spanish enterprises to compete abroad. EU membership in 1986, the EU common market in 1993 and the adoption of the euro in 1999 further levelled barriers to trade and investment.

In the 1990s, Spanish MNEs expanded abroad. Initially, many focused on Latin America, exploiting the similarities of language, culture and development processes. Moreover, Latin America was undergoing privatization and liberalization processes not unlike Spain's experience a decade earlier. Hence business leaders saw opportunities to enter new markets that were not too different from Spain and to contribute their experience and competence to the industrial development of their hosts. This drive into Latin America was led by six of the largest companies in Spain that accounted for over 90% of all Spanish FDI in that region: *Banco Santander* and *BBVA* in banking, *Endesa* and *Iberdola* in public utilities, *Repsol* in oil and gas, as well as *Telefónica*, Spain's main telephone operator. In 1999 and 2000, Spanish firms invested more than US firms in Latin America.

In the early 2000s, Spanish MNEs focused their attention on Western Europe, exploiting the opportunities of market integration in the eurozone. In particular, consumer goods and tourism businesses expanded from Spain to other parts of Europe. For example, entrepreneurs in the fashion industry, like *Inditex* (owner of *Mango* and *Zara*), successfully entered the international stage by pioneering new concepts of fast fashion, expanding first across Europe and then to other parts of the world. Thus the pattern of FDI from Spain became more geographically diversified (Figure 6.1).

The leading Spanish MNEs are concentrated in several industries. In banking, *BBVA* and *Santander* have become market leaders in many countries of Latin America. Starting in the 1990s, they became the largest foreign banks in Latin America through some 20 acquisitions. *Santander* also entered retail banking in the UK by acquiring *Abbey National* for €12.5 billion and acquired *Sovereign Bankcorp* to build a bridgehead in the USA. *Santander* escaped relatively unscathed from the financial crisis due to its geographic diversification and its prudent risk management. *Santander* even used the crisis to

Figure 6.1 Spanish outward FDI



Source: Authors' creation based on data from OECD and Banco de España.

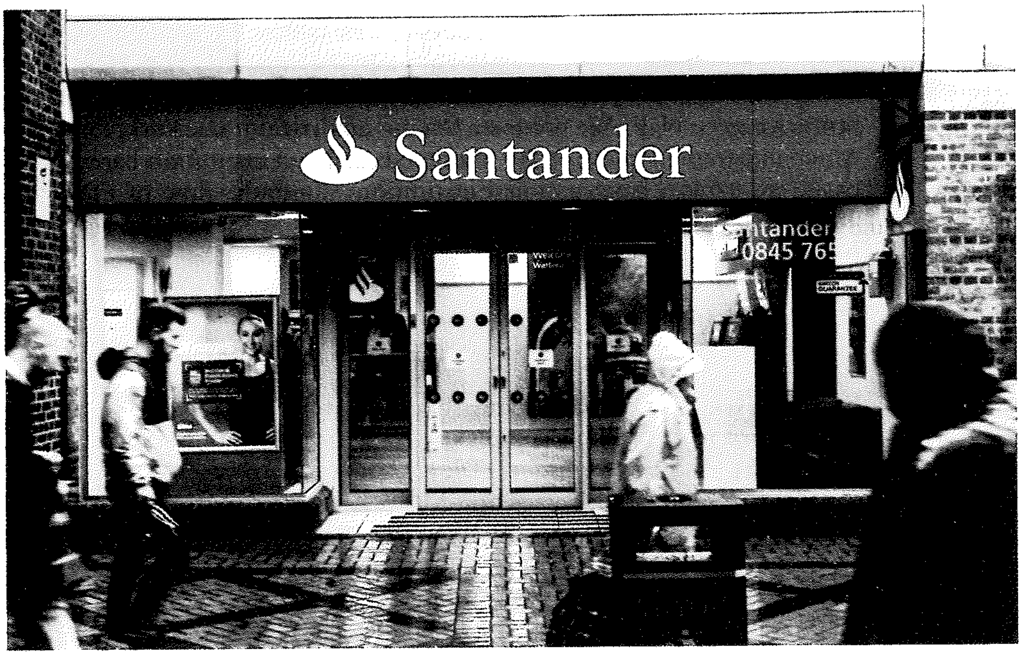
acquire assets from banks in financial difficulties, including *Banco Real* in Brazil from *ABN AMRO* and *Bank America*'s stake in *Serfin* in Mexico. In Poland, *Santander* acquired *Bank Zachodni*, the third-largest bank, from *Allied Irish Bank*. In the UK, *Santander* acquired two mortgage banks that faltered during the financial crisis and bought 318 branches of the then state-controlled *Royal Bank of Scotland*. *Santander* thus grew into the second-largest retail bank in the UK, with 11% market share serving 26 million customers through its 1400 branches.

In the utilities industry, privatized companies led the international expansion. Opportunities for acquisition in these sectors are often created by privatization. For example, *Endesa*, an electric utilities operator, started its international acquisition spree with a major investment in 1997 in Chile, which was the first Latin American country to create a legal framework for FDI that reduced business risk to acceptable levels. *Endesa* subsequently became the market leader in Chile, Argentina and Peru.

Similarly, telephone operator *Telefónica* began its internationalization by acquiring equity stakes in companies in Latin America. In 2010, it took full control of Brazilian phone operator *Brasilcel* by buying out minority shareholders for €8.5 billion, thus becoming the market leader. In Europe, *Telefónica* acquired *O2*, the mobile phone operator in the UK, Germany and Ireland for €26 billion. London later also became *Telefónica*'s hub for its digital economy operations. In China, *Telefónica* holds almost 10% in *China Netcom*, which in turn owns 1.7% of *Telefónica*.

In the construction sector, companies like *Ferrovial*, *ACS* and *Sacyr Vallehermoso* have grown on the back of the construction boom while expanding into the operations of infrastructure, such as motorways and airports, moving away from construction and into services. In the 2000s, *Ferrovial* embarked on a major acquisition drive with two objectives: (1) to reduce its dependence on the Spanish market and (2) to reduce the volatility of its revenues which previously were derived mainly from the very cyclical construction industry. Across Europe, *Ferrovial* acquired construction businesses such as *Amey* in the UK and *Budimex* in Poland, as well as airport operators such as *BAA* in the UK. Many UK airports, such as *Heathrow* and *Gatwick*, were thus owned by this Spanish MNE.

A major Spanish MNE was created with the merger of *British Airways* and *Iberia* in 2011. The International



How did Spanish bank Santander become a common sight on British high streets?

Consolidated Airlines Group (IAC) is registered in Madrid and hence is technically a Spanish MNE, but its operational headquarters are in London, and it is listed on the stock markets in both Madrid and London.

The financial crisis, however, also hit Spanish multinationals. Some divested projects overseas. For example, *Ferrovial* sold 10.6% of its *equity* in BAA to *Qatar Investment Authority*, a sovereign wealth fund. Others used their overseas affiliate to raise funds to channel money back to Spain. Hence in some years and for some countries, Spanish outward FDI was negative. In particular, affiliates in the Netherlands were used to raise capital to transfer to Spain, leading to a negative net outflow of FDI from Spain to the Netherlands over several years. For example, in 2012 Spanish MNEs withdrew more than €2 billion from *each* of Mexico, Switzerland, the USA and the UK. By 2013 however, the situation normalized, and Spanish MNEs continued their international growth.

Sources: (1) J. Galan, J. Gonzáles-Benito & J. Zuñiga, 2007, Factors determining the location decisions of Spanish MNEs, *JIBS*, 38: 975–997; (2) *The Economist*, 2007, Conquistadores on the beach, May 5; (3) P. Toral, 2008, The foreign direct investments of Spanish multinational enterprises in Latin America, *JLAS*, 40: 513–544; (4) N. Puig & P. Pérez, 2009, A silent revolution: The internationalization of large Spanish family firms, *BH*, 51: 462–483; (5) *The Economist*, 2009, Spanish companies in Latin America: A good bet? May 2; (6) A. Parker, M. Johnson & C. Hall, 2012, Qatar move illustrates attraction of BAA, *Financial Times*, August 21; (7) Bank of Spain website (www.bde.es, accessed February 2014); (8) www.bloomberg.com.

foreign direct investment (FDI)
Investment in, controlling and managing value-added activities in other countries.

multinational enterprise (MNE)
A firm that engages in foreign direct investment and operates in multiple countries.

Why are Spanish firms investing in FDI in Latin America and Europe? Is it because of the pull of low labour costs? Or is it lucrative markets abroad? Or both? Why do they choose direct investment rather than trade (Chapter 5) or financial investment (Chapter 7)? Why are these particular firms investing abroad while other domestically successful firms are not? Recall from Chapter 1 that foreign direct investment (FDI) is defined as directly investing in activities that control and manage value creation in other countries.[1] Also recall from Chapter 1 that firms that engage in FDI are known as multinational enterprises (MNEs). Focusing on FDI, this chapter builds on our analysis of international trade in Chapter 5. International trade and FDI are closely related. MNEs are not only trading with other firms, they also transfer goods and services internally, which creates intra-MNE international trade.

We start by clarifying the terms. Then we address a crucial question: 'Why do firms engage in FDI?' We present a famous analytical framework, the OLI paradigm, which integrates aspects of the resource-based and institution-based views. On this basis, we explore how national institutions affect the flow of FDI and how FDI impacts on host countries. Debates and implications for action follow.

LEARNING OBJECTIVE

1 Understand the vocabulary associated with foreign direct investment (FDI)

THE FDI VOCABULARY

Foreign investment comes in many shapes and forms. As a basis for systematic analysis, we need to reduce this complexity by setting the terms straight. Specifically, we will discuss (1) the key word in FDI, (2) horizontal versus vertical FDI, (3) FDI flow and stock and (4) MNE versus non-MNE.

foreign portfolio investment (FPI)
Investment in a portfolio of foreign securities such as stocks and bonds.

The key word is 'direct'

There are two primary kinds of international investment: FDI and foreign portfolio investment (FPI). FPI refers to investment in a portfolio of foreign financial assets, such as stocks and bonds, that do not entail the active management of foreign business