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RISK ASSESSMENT AND MANAGEMENT IN FDI's. A CASE STUDY IN THE BALKANS

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Abstract

The Foreign Direct Investment (FDI) decision-making process tends to emphasise strategic analysis over financial analysis. The priority given to strategic analysis is a major theme to emerge from the case study reported in this paper. Specifically, the foreign direct investment decision-making process of a Greek company in the Balkans is examined. The focus of interest lies in how risk was assessed and managed during the FDI decision process. Executives found political risk to be an important element to the decision, but were unable to express it numerically. The reason for this is that the financial expression of risk was not seen to offer an adequate understanding of the concept. Previous findings, which suggest that risk is an important element of FDI's and is considered separately from the financial analysis, were endorsed. In practice, risk was considered during the first steps of the process and is expressed mainly qualitatively. The case study organisation reported here tried to reduce risk through gradual expansion strategies and by enrolling the participation of local partners and venture capital investors. Risk assessment and management are not studied separately, but as two inter-related tasks. These findings suggest that the focus for companies undertaking FDI's may be more on managing risk than attempting to make a sophisticated calculation of risk for inclusion in financial appraisals of FDI projects.

Key words: Foreign Direct Investments, Risk, Case Study, Balkans.

JEL Classification: F21, G31.

I. Introduction

Capital investments in the real world are not risk free; therefore appraising techniques have to take risk into consideration. In DCF methods the discount rate should be adjusted for risk, reducing the present value of future cash flows from risky projects (Brealey & Myers, 1991). Other possible methods for assessing risky capital investments are, simulation, sensitivity analysis and game theory (Northcott, 1992). Surveys of large US and UK firms have observed that the use of more sophisticated techniques and formalised routines in investment practices has considerably increased in the last decade, but a wide variety of methods and approaches is being used (Pike & Wolfe, 1988; Marsh *et al.*, 1988; Klammer *et al.*, 1991; Farragher *et al.*, 1999; Arnold & Hatzopoulos, 2000). The use of formal risk analysis has been increased due to the changing environment within which companies are forced to make capital expenditure decisions (Klammer *et al.*, 1991).

Still, quantitative methods for dealing with uncertainty are often inadequate to express the problem of risk (Pinches, 1982). In reality many companies rely more on qualitative expressions of risk, or apply the payback method in order to tackle it (Farragher *et al.*, 1999). It was found that risk assessment takes place during the initial phase of identification of an investment project where some form of early screening occurs, acting as a pre-evaluation stage of various ideas based on elementary data (King, 1975; Farragher *et al.*, 1999). This means that unlike the theory's suggestions, risk assessment is rather dealt separately from the subsequent detailed financial analysis. The difficulty of conceiving the concept of uncertainty again illustrates the shortcomings of traditional capital investment theory. The degree of uncertainty is affected by environmental and organisational factors such as the nature of the business and of the project, as well as the personal characteristics of the decision-maker. The subjectivity of how methods are applied does not justify expressed optimism (Pike & Wolfe, 1988) about a reduction in the gap between theory and practice.

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It is reasonable to suggest that these remarks on the use of risk analysis should characterise foreign direct investment decisions as well.

Foreign Direct Investment (FDI) has differences from, as well as similarities to, investing in a home country. Under the FDI process more inter-country factors have to be taken into consideration, which means that the decision-making may be a more complex activity (Aharoni, 1966). In addition to the usual business and financial risk characterising a capital investment project, investing abroad entails other specific risks related to the targeted country (political or country risk) and the international economic environment. The information available to the firm is limited and often fails to capture all the variables in the foreign investment process. On the other hand, some studies have pointed out the high degree of similarity between the two processes (Robbins & Stobaugh, 1973). The differences may lie in the importance of some factors considered in the process, rather than the process itself (Pike & Dobbins, 1981). It has been suggested that the FDI process is less sophisticated than the domestic equivalent (Piper, 1971) because the FDI process emphasises strategic analysis over financial analysis. The FDI decision process is therefore less likely to follow the normative model of decision-making (Kelly, 1981). It is not based on economic criteria only, but is significantly influenced by behavioural factors (e.g. perceptions, needs, and goals).

This paper emphasises the issue of risk, which is a major issue in the process. Specifically, the way foreign risk is measured, assessed and finally tackled will be discussed. Risk assessment and management is an integral part of the FDI decision-process. Since it is suggested that risk is an important element of the foreign expansion strategy, this paper adopts the adaptive view of strategy (Mintzberg, 1978, 1987; Pennings, 1985) in order to show that in the FDI process risk assessment and risk management should not be seen independently. On the contrary, risk assessment affects risk management and vice versa. The research approach selected is the case study method that allows the in-depth examination of how and why capital investment practice evolves (Abdel-Kader & Dugdale, 1998). Specifically, the FDI decision-making process of a Greek industrial firm that chose to invest in the Balkans during the 1990s was studied.

II. Empirical findings on the international Capital Investment process

Until recently, the literature on FDI return and risk has been predominately theoretical and in the finance domain, lacking empirical findings and neglecting the organisational context in which financial techniques are used (Wilson, 1990). Some studies have taken place mainly in the US with the use of questionnaires for collecting data. The first major study of FDIs (Stonehill & Nathanson, 1968) found that the larger the project is, the more important strategy was in the decision process and consequently the less important the financial analysis became. Daniels (1971) found that mainly market evaluation criteria, such as market potential and ROI, were applied in FDI projects. Similarly, in Taiwanese FDIs in China, the most used financial method was return on sales and political risk analysis was applied (Wei & Christodoulou, 1997). Usually the decision is either to go or not go to a foreign country (Daniels, 1971). Projects were rarely found to be ranked based on financial criteria. Baker and Beardsley (1973) found a limited understanding of the concepts of risk and return, which affected the use of the relevant techniques in FDI decision-making. Oblack and Helm (1980) noted the steadily increasing use of DCF techniques, but still risk was not expressed through these calculations. The failure of current theoretical models to incorporate risk sufficiently was stated by Bavish (1981) as well. Finally, Kelly & Philippatos (1982) have shown that risk is handled in a subjective way. The conclusion in general is that there is a trend towards the use of more sophisticated techniques (Kim & Crick, 1984) especially in the bigger firms (Stanley & Block, 1983). Still, no adequate explanations are given concerning the conceptual framework of risk and return and the way they are considered in an organisational decision-making process. Wide discrepancies appear to exist between the actual use of techniques and what capital investment theory suggests (Mills, 1986).

Unfortunately questionnaires fail to show how or why the various techniques are used and thus cannot offer in-depth information about the decision-making process, since it is clear that complex organisational factors may affect the use of financial techniques applied to investment decision-making. Case studies try to relate the financial techniques applied within the organisational context in which the decision process was taking place. Market and strategic considerations

prevailed in decisions regarding foreign expansion followed by the goal of risk diversification. These considerations are examined during the early stages of identification and screening, which will determine the final outcome of the foreign investment (King, 1975; Wilson, 1990). During these stages, crucial information about the investment is collected and goals are set.

Risk, being an important element of FDIs is considered separately from the financial analysis, during the first steps of the process and is expressed mainly qualitatively (Wilson, 1990). Political risk was usually interpreted subjectively rather than included in cash flow adjustments. Executives found political risk to be an important element to the decision, but were unable to express it numerically (Wilson, 1990). Managers are not always familiar with the use of sophisticated techniques so there is a preference to see risk and return as two separate concepts because of the inability to fully express risk through the use of quantitative analysis techniques. In practice it is observed that managers apply descriptive and qualitative methods, as well as drawing on their personal network of information, for anticipating risk when making investment decisions (Prakash Sethi & Luther, 1986). The focus in companies undertaking FDIs appears to be more on managing risk than trying to make a sophisticated calculation of risk (Wilson, 1990).

Most models of strategic investments decision-making (Buckley, 1996) suggest that risk assessment takes place during the strategy formation, while risk management concerns the implementation of the investment decision. In studying the process of making strategic investments decisions, such as FDIs, the "implicit" or adaptive view of strategy (Pennings, 1985) seems most relevant (Sykianakis, 2002; Sykianakis & Bellas, 2005). The adaptive view suggests that strategy is formed incrementally, as a stream of actions-decisions responding to perceived changes in the company's environment (Mintzberg, 1978). By adopting the adaptive mode of strategy instead of the planned one the dichotomy between formulation and implementation becomes obsolete. "Strategy formation then becomes a learning process, whereby so-called implementation feeds back to formulation and intentions get modified en-route, resulting in an emergent strategy" (Mintzberg, 1978, p. 946). Applying this view in study FDI risk, it could be said that risk assessment shapes risk management, but also managing with risk reforms the understanding and the conception of risk. Also, it determines the attitude towards risk in the future.

III. Methodology

Viewing the FDI decision process as a social practice, the research method to be used is the case study approach since it provides an in-depth analysis of the investing company and allows the researcher the opportunity to study in detail organisational practices and the decision-making process. Case studies have already been used in the domain of management accounting, providing useful explanations about practice (see for example: Hirst & Baxter, 1993; Jones & Dugdale, 1994; Scapens, 1990; Larimo, 1995; Miller & O' Leary, 1997). The case study approach used for this research is mainly descriptive. The current study aimed at describing the decision-making process (referring particularly to risk assessment and management) in the foreign direct investment activity of a Greek company in relation to the capital investment literature, as well as depicting the applied accounting practices.

Normative capital investment decision-making theory is a relatively well developed area. However, case studies in this area could offer knowledge about practice and help to shape some parts of the theory. Since FDI decision-making in the context of the Balkans has not yet been explored, a critical case is required to provide such knowledge. It is suggested that 'critical' cases with expected rich data should be preferred (Pettigrew, 1995). The selected case is a big company, among the few Greek companies that have a substantial presence in the Balkans. Its experience provides a useful subject of study since the company has undertaken substantial investment projects abroad that allow the researcher to observe the evolution of the FDI process under various conditions.

The case study company, Delphi is a leader in the Greek ice cream market. The company's first investment abroad, in Bulgaria, was ready in 1993. Subsequent investment projects in Romania and Yugoslavia were completed during late 1990s. These three main FDI projects form the main focus for this study. Multiple ways were applied for collecting evidence. During the case study thirty-seven (37) open-ended interviews were performed during the three research-visits to the research site. Another important source of evidence was documents and archival analysis. The

advantages of documentation are its ready availability and the fact that it records the real time events, while interviews may be flawed by time and subjective perceptions. Its disadvantages include a degree of irretrievability or bias, and its inability to give a full account of events described (Yin, 1994). Documents provide 'facts' (Pettigrew, 1995), but on the other hand it is rare that decision-making can be fully depicted on paper (Mintzberg & Waters, 1990).

To achieve construct validity (Yin, 1984) in this study, multiple sources of evidence (triangulation) were used during data collection. Also, multiple interviewing about the same subject was used as a way of overcoming any single respondent's bias. Internal validity was achieved with the use of theory and existing literature to explain patterns from the case study.

IV. Eastern Europe: Economies in Transition

The Eastern European countries have been, since the early 1990s, in a state of transition, moving from a centrally programmed economy towards an open market economy (Paliwoda, 1995; Nsouli, 1999). This transition gave the opportunity to western companies to enter growing markets with unsatisfied demand, in order to reduce production costs, and build strong position in markets with low competition. Though Eastern Europe offers many attractions to foreign investors, still the potential investor may face some disadvantages and risks (Paliwoda, 1995; Nsouli, 1999).

Greek firms during the 1990s considered expansion to the Balkans as a way to their further development (Labrianidis, 1996). The Balkans seem much less appealing and more risky compared to the central-eastern European markets, but for certain reasons such as past experience, geographical and cultural proximity, and the existence of 50 million potential consumers, Greek companies were willing to invest there (Labrianidis, 1997, 1999; Hope, 1998). Though Labrianidis (2000) presents a good account of the experience of Greek FDI in Eastern Europe, he does not examine these FDI at a micro-level. The present study aims to examine the FDI decision-making process, addressing in particular the issues of risk assessment and risk management, by using a case study of a large Greek dairy company during the last ten years.

V. Risk analysis in the Decision-Making Process

Mintzberg *et al.* (1976) viewed any decision-making process in three major phases: identification of an idea, its development, and selection that includes the authorisation given for that idea. Unlike other decision-making models, Mintzberg *et al.* do not imply that any decision process is a linear one, but rather a cyclical one. This approach has been used among others in explaining the capital investment decision process (Pinches, 1982; Larimo, 1995; Sykianakis, 2002). The first stage of the investment decision process is the identification of the investment opportunity (triggering), during which a risk profile for the investment is formed (King, 1975). In Delphi's experience, the FDI identification stage concerns mainly macro-elements in the analysis that have to do first with political risk and then with the country's overall demand for the product, as determined from the market size and the national income. Also at that stage, the company makes the first contacts with partners or agents from abroad. The then junior business analyst (JBA) comments:

"...The parent company receives many proposals for partnership from abroad.

Having local connections is vital for a foreign multinational company in order to survive in a hostile and risky environment and cope with red-tape and illegitimate trading."

This phase of investigation and data collection is perhaps the most important stage of this decision process because this information is key to the decision (King, 1975). Information about the economic, political and market environment, as well as prospective partnerships, is important in order to examine whether a project fits the corporate strategy for expansion and to estimate future demand for the company's products. At this phase risk assessment and management are taking place simultaneously.

Risk analysis is an important element in making any strategic investment decision. Political risk is a key determinant of undertaking any FDI investment, and for that reason, it is often examined separately and before the financial analysis takes place (Wilson, 1990). Risk is often

expressed qualitatively (Farragher *et al.*, 1999), perceived subjectively (Prakash Sethi & Luther, 1986) and considered at the identification or early development phase and not at the selection stage as the normative capital investment theory implies. In Delphi, information gained during screening and investigation was crucial in order to decide whether the project would continue. Country risk (political and economic) was a major element of FDI decision-making, particularly in south-eastern European countries where poor economic conditions, political tensions and instability had resulted from the transition from socialist to open market economic system. These made investing in production far more risky since, in the event of an open political conflict or an economic crisis and closure of the company, a great part of the fixed assets could not be used elsewhere.

Delphi assessed and reported qualitatively political risk in its business plans. The political and economic conditions in each country were first examined and described in the initial business plan. Basic information about the country, helped to analyse the issue of country risk. Delphi received information from various companies and agencies, but it mainly relied on its managers' understanding and perceptions of risk, which was based on their experience in the foreign markets.

VI. The role of financial analysis in the FDI decision process

It became clear that risk analysis in Delphi took place in the early stages of the FDI decision process and was mainly descriptive. It rests to see what the connection is between risk assessment and financial analysis applied. The company applied the NPV method. The BDD said of Delphi's early FDI projects:

"...The country risk did not have any quantitative expression and was not incorporated in the NPV analysis. It is clearly subjective trying to represent country risk as a premium in the discount factor. The discount rate applied in FDI decision-making was the same for every business Delphi undertakes."

Applying to FDI projects the same required rate of return (RRR), used in the rest of Delphi's investments, it is unlikely that any FDI would be found with negative NPV. The application of an identical RRR for all investment projects, regardless of the underlying risk profile is against theoretical prescriptions (Northcott, 1992).

The company's treasurer, who has that responsibility for the financial analysis, concludes:

"In reality, the decision to invest is made prior to any formal business plan presentation and NPV computation."

For the decision a feasibility study is presented containing many gross facts and figures. In the calculation of the future cash-flows exists an important degree of uncertainty." As the treasurer says:

"If relying only on NPV no investment would have take place in the Balkans. Greek entrepreneurs make FDI decisions with their instinct. Delphi chose to expand in the Balkans because there were not considerable competition there and thus it would have great advantages in the future being the first to enter the market. Any decision for investing relied on market and strategic criteria".

The above statement shows that the application of the NPV method is not a critical factor in determining the investment decision. Perceptions about country risk, investment opportunities and economic climate matter more than the calculated NPV or risk adjusted required rate of return (Eiteman *et al.*, 1991). According to research findings on Taiwanese companies, a limited number undertook formal and long run planning procedures for FDI assessment and it was found that the main information collected was about regulations and laws in the host country (Wei & Christodoulou, 1997). The various financial techniques (NPV in particular) may be useful analytical tools, but are generally not the main determinants for the investment decision. Often, they are used to justify a decision already taken (Aharoni, 1966; King, 1975; Wilson, 1990). According to the BDD:

"Judging under rational decision criteria, any investment would have been rejected. Consequently, the FDI decision was based mainly on

hunches and feelings rather than on numbers. Projections of sales and cash-flows were mere hypothesis and subjective assumptions about the future."

From other interview findings it appears that break-even analysis is a substantial indication for Delphi, being calculated in the initial phases of a business plan. An approximate result may derive from sales estimates, since Delphi considers demographic and market conditions at an early stage, and basic investment costs could also be known. Other studies have also found that the economic viability of a CI project is judged at a relatively early stage often using simple calculations and prior to any detail investment analysis (Jones & Dugdale, 1994). In Delphi, break-even analysis is used as a reassurance that the project would yield a minimum amount of sales and profits. Since future sales is the most sensitive and unknown figure, risk analysis focuses on sales figures and techniques such as break-even point or sensitivity analysis, applied under various sales scenarios. The discussion at the end summarises the role of the financial analysis in Delphi's FDI decision-making process.

VII. Risk Management

Until now it became obvious how Delphi assessed risk in its FDI projects. Though risk was found to be existent and despite being a material issue, the company chose to move forward since it was thought that foreign risk could be dealt with. Therefore, risk assessment should always be seen together with how risk could be managed. Ways for limiting FDI risk has been part of Delphi's foreign expansion strategy. Delphi usually preferred to search for local partners. Their contribution was thought to be vital in providing knowledge on the host market and country, as well as in combating red-tape and resistance from local competitors. A joint venture with a local partner is often a less risky option and offers a better knowledge of the marketplace, but it should be preferred only when it allows synergies and control of the venture to the foreign investor (Paliwoda, 1995).

Delphi initially considered acquiring an existing plant or entering into a joint venture for local production in order to reduce time and resources spent as well as risk. Delphi would form a partnership only under specific terms. These terms included having management control and control of the majority of share capital. As a way to reduce exposure to risk in its initial FDI projects, Delphi contributed second-hand fixed assets (trucks, refrigerators, machinery) to the joint-venture's share capital, plus working capital, rather than providing huge amounts of capital. Delphi's rule was that when investing in a high-risk country, the investment should grow gradually in order to reduce risk, gain experience and manage self-financing expansion through existing cash-flows. Of course, the approach to establishing production bases abroad was different in Delphi's three target countries. In Bulgaria, Delphi formed a joint venture with a local producer and thus obtained an existing factory with satisfactory production standards in which they brought about some improvements. In Romania a trade partner existed, but the negotiations for the acquisition of major producer collapsed. Therefore, the company had to work with a leased plant belonging to a minor producer, which was gradually expanded. Expansion of production capacity in these two countries was done gradually, first by introducing old equipment from the Athens plant and later by purchasing some brand new machines. This occurred because Delphi was cautious of foreign investment business risk and was concerned about whether local demand would be sufficient to recoup the initial investment. On the contrary, in Yugoslavia the investment was about new machinery only, and was designed to have from the outset a higher level of production capacity. Market indicators in Yugoslavia were more optimistic and the company was more experienced, so feared less country risk despite the political problems observed there.

The first investment in Bulgaria acted as a driving force for investment projects to come, so the initial stimuli not only triggered the first FDI, but also set in motion a whole expansion strategy for the ice cream business abroad. This clearly shows the relevance of capital investments to Delphi's corporate strategy and suggests that the decision-making activity did not stand on its own, but took place in a certain context, influenced by previous strategic choices and following a pattern of previous actions. Delphi saw more business opportunities in the Balkans and felt more confident after the first FDI in Bulgaria. The members of staff working abroad were carriers of new ideas, who favoured further expansion in other markets, and their presence there offered to the

company greater knowledge and experience and facilitated future moves. This view depicts the adaptive mode of strategy (Mintzberg, 1978).

VIII. Conclusion

As already noted, the FDI decision process has similarities as well as differences with the domestic CI process that covers the vast majority of the studies in the area of capital investment decision-making. Practice from Delphi has revealed that the FDI decision process is more complex because several risk factors, unique to the process, should be considered. These are factors usually related to the foreign investment environment. Therefore the nature of the factors considered and of the decision process at large is more strategic, less analytical and less detailed/sophisticated. This fact determined the reliance mainly on market and strategic factors and less on financial criteria in making any investment decision. These findings on the characteristics of the FDI decision process support previous empirical works (Aharoni, 1996; Robbins & Stobaugh, 1973; Pike & Dobbins, 1981).

In Delphi's experience, the FDI diagnosis stage concerns mainly macro-elements in the analysis that have to do first with political risk and then with the country's overall demand for the product, as determined from the market size and the national income. Also, during diagnosis the company makes the first contacts with partners or agents from abroad. This phase of investigation and data collection is perhaps the most important stage of this decision process because this information is key to the decision. Information about the economic, political and market environment, as well as prospective partnerships, is important in order to examine whether a project fits the corporate strategy for expansion and how the issue of risk will be dealt with.

Most executives interviewed suggested that the role of past accounting data, economic forecasts and financial analysis in Delphi's FDI decision-making was of limited significance. At times, financial analyses were perceived as a barrier to investment abroad. Many of the criteria applied to Delphi's FDI decision-making could be characterised as more strategic rather than merely financial. Any decisions to invest abroad are taken at the early stages of the process where market information is received and strategic considerations are made. Fundamental information available at the screening stage determines materially whether an investment occurs or not. The company believes that indicators on the market and the country in general are critical to the FDI decision. Formal financial analysis, as expressed in the business plan, serves other purposes such as control, co-ordination of the project's implementation, and dissemination of the project's requirements to participants in the process. These findings from Delphi endorse previous empirical research (Aharoni, 1966; Wilson 1990; Wei & Christodoulou, 1997) on the role of financial information in FDI decision-making. Finally, information has also been used as a basis for negotiations between Delphi and its prospective partners, being a very important part of the process that shaped the project's implementation and determined the final outcome.

In Delphi, foreign expansion strategy evolved through decisions made during the FDI decision process, and the way in which each of these decisions was made and implemented came to affect how strategy was to be later reformed. A pattern of decisions made during the FDI decision process have formed the foreign expansion strategy, as past experience is used as input to future strategic planning. Other studies of FDI decision-making (Larimo, 1995; Wei & Christodoulou, 1997), though recognising past investment experience abroad as a positive factor for future projects, overlook the significance of continuity in foreign expansion strategy, instead treating each decision process as separate from the others.

From the experience gained during the first project in Bulgaria, Delphi formulated necessary conditions for investing abroad. Still the strategy of entry adapted for each country's situation and evolved in response to certain environmental incentives. Delphi's FDI strategy has been much less an intended plan, as may be understood from the discussion, and more the outcome of the organisation's experiences in the Balkans. Various decisions and preferences that emerged in the process came to affect materially any subsequent move. Such a continuous interchange between formulation and implementation characterises the adaptive mode of strategy, where past and current experiences inform a learning process for future strategic decision-making (Mintzberg, 1978). This learning process could be seen in the way that country risk was assessed and managed throughout the three consequent FDIs undertaken.

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