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Investing in the Future

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By Buying Up Foreign Companies, Emerging Economies Show their Power

In the 16th century, Machiavelli was one of the few to have the foresight to see the importance of political change in terms of its potential to revitalize the economy. He called these agents of change the “new princes” and saw in them enemies of the established order, whether they were consciously trying to be or not.

Today’s new princes are the BRIC economies – Brazil, Russia, India, China – gradually establishing themselves as economic heavyweights with major political ambitions threatening the economic weight of the European Union and the United States. And yet, these two actors are still keeping the BRICs – along with all other emerging economies – at bay by limiting their influence on institutions such as the World Bank and the International Monetary Fund.

A key indicator for monitoring the development and international economic standing of a country are the flows of Foreign Direct Investment (FDI). The table below summarizes the situation of the four BRIC countries in 2005.

	FDI Inflows	FDI Outflows
<i>Brazil</i>	15,066	2,500
<i>Russia</i>	15,400	13,500
<i>India</i>	3,700	1,400
<i>China</i>	80,000	18,000

Figures expressed in millions of USD

In many cases, the outward flow has been carried out by government-owned natural resource companies often in pursuit of national policies rather than profits alone through the capture of distribution outlets. The creation of “national champions” that can become major global players and influence strategic decisions in developed countries are, increasingly, being considered by countries that do not want to stay at the edge of development.

Funds are in most cases widely available due to soaring reserves as a result of large positive trade balances between the BRIC and developed economies, in part due to the soaring prices of raw materials.

Foreign investments, which lead to an improvement in margins due to market domination through vertical integration, are often more profitable than national investments, which require diversification in areas where existing expertise may be irrelevant.

In other cases, investments have been made to acquire corporations possessing skills and technologies that are of value to the companies originating in the BRIC countries. As markets globalize and become increasingly complex, few companies have all the resources required for success. Cash-rich companies believe it is vital for their survival to acquire these resources as quickly as possible, and inevitably go through an acquisition process. When investments have been made by private corporations, the reduction of the political risk borne in their home country has been a motivating factor.

Funds used for foreign acquisitions originate from the profits of local corporations as well as from the ability of these companies to raise equity funding on foreign stock markets. In the present period of high liquidity, this is not a major achievement. Global central bank assets stand at \$ 5.8 trillion, more than three times what they were ten years ago, thanks mainly to the production of excess money.

Companies from developing economies are beginning to invest more broadly. It is estimated that the total amount of Russian investment abroad is around \$140 billion, although most of it is exported illegally and domiciled in shell companies that are totally opaque. While some Russian private investors view investments abroad as a hedge against possible government moves that would, through more or less legal procedures, seize their domestic assets, industrial corporations, whether state-owned or not, have a different view of the potential such investments offer.

Acquiring assets in their own industries allows them to extend control of their sector and attempting a global consolidation of assets, while integrating downstream allows them to have access to added value rather than being a supplier of untreated raw materials. In certain industries, it is easier to acquire a foreign company than to waste time building capacity.

The Russian oil industry, in particular, is in need of technological know-how and acquisitions in this area should be forthcoming. Russian steel and metal companies are also venturing abroad. Evraz, in particular, has acquired U.S. downstream transformers such as Oregon Steel Mills as well as plants in the Czech Republic and Italy. Norilsk Nickel has also made U.S. acquisitions and has become a shareholder in companies as far apart as Australia and Finland.

The Chinese Central Bank holds \$ 1.3 trillion in reserves and Chinese firms have invested \$60 billion abroad. The country's financial power has allowed it to purchase a large number of firms abroad (including, according to a report, part of all the publicly listed companies in Australia and Taiwan) and to manipulate financial markets.

Chinese firms, in particular oil companies, are securing upstream sources, as lack of access to resources is expected to be the strongest resistance to the country's continued economic growth. While investments in sources of raw materials represent 50 percent of China's foreign investments, other industries are investing as well, particularly in telecommunications, IT and leisure electronics.

The preferred destination of Chinese capital remains Asia – Hong Kong in particular – followed by Latin America and Africa. In Africa and Latin America, China is investing primarily in infrastructure, which leads simultaneously to closer political ties. Thus, China, which is an important foreign investor in Sudan, has prevented the United Nations from imposing a solution to the Darfur crisis.

In early July 2007, China announced the creation of a \$1 billion fund to assist Chinese corporations to trade with and invest in Africa. The fund could be expanded to reach \$5 billion. China also recently established a sovereign fund, China Investment Co, capitalized to the tune of \$206 billion, which has been frightening developed countries with rumors of its possible targets, which include Wal-Mart. Chinese authorities are trying to be reassuring, stating that investments will mostly be made in foreign portfolio managers rather than used for hostile takeovers.

China does not hesitate to deal with countries that the United States considers to be “rogue states” and, in fact, embargoes declared by the United States favor China by limiting competition.

In dealing with these countries, however, China is taking the risk that if present governments are overthrown, previous arrangements may be declared null and void.

For its part, India now has foreign reserves of \$200 billion, and the rupee has appreciated against the U. S. dollar. Indian corporations that have carried out industrial investments abroad have taken advantage of proximity with their main market as well as weak currencies in certain countries.

Most of India’s global economic movement has been in the steel industry. Mittal Corporation, although not really India-based, bought Arcelor thus becoming the world’s largest steel producer and is now diversifying into energy, in particular in Central Asia. Tata Steel purchased British-Dutch steel producer Corus, providing it with an entry into the European market; and Hindalco purchased Novelis, a manufacturer of rolled aluminum sheets used in the production of beverage cans.

In Brazil, by contrast, most of the activity has been in the mining sector, with CVRD – Companhia Vale do Rio Doce – buying first INCO of Canada, for which it paid \$16.7 billion, followed by the purchase of Australian coal producer AMCI for slightly over \$600 million. These acquisitions have boosted the rank of CVRD into second place in the global mining industry.

Not all countries welcome investments from corporations from the BRICs. Part of the resistance is due to protectionism driven by public opinion that is, in turn, influenced by the effects of globalization on lower-paid workers.

While nationalism is one element driving this defensive attitude, there is also the perception that the conditions that allowed these corporations to be successful in their own countries – cronyism, protection of market share through monopolies or oligopolies - neither exist, nor are desirable, in developed economies. Reactions against potential BRIC investors can be quite strong, particularly if the target is a company or industry perceived as vital to the interests of the country.

The most negative reaction to Chinese investment has been in the United States, where the bid of the CNOOC (Chinese National Overseas Oil Company) for Unocal was blocked by the U.S. political establishment, even though Unocal’s production is predominantly outside U.S. borders

Russia’s president, Vladimir Putin, has repeatedly stated that a parallel must be drawn between the ease with which Russian investments are welcomed and the openness of Russia to foreign investors. This has echoed the words of Chancellor Merkel who took exactly the same view on Russian investments in the EU.

The EADS case is a case study in the matter. Russia’s Vneshtorgbank acquired 5 percent of European aeronautics group EADS, only to be told that it is not welcome as a decision-making shareholder. Such restrictions were not put in place by Russia when EADS acquired 10 percent of the Russian plane manufacturer Irkut. As a consequence, the Russian bank has announced its intent to sell its shares in EADS.

The EU has stated its intention of blocking investments by non-EU member countries in the energy sector, and particularly in the area of energy transmission which, under present regulations, would be unbundled from energy production.

While details of the implementation have not yet been worked out, the main barriers would apply to countries that do not allow reciprocal investments in their own energy transport infrastructure, such as Russia or Saudi Arabia.

Probably the biggest difficulty corporations from the BRICs will encounter if they are allowed to invest in developed countries is the lack of global experience on the part of their management, which has rarely operated outside their own turf. The solution here consists in providing relevant training for these managers rather than hiring locals who would have problems adjusting to the culture of the corporation. It is important that executives of the foreign subsidiaries adapt the home culture to the needs of the country rather than attempt to introduce the totally new culture of the host country.

Another difficulty is the lack of understanding of local customer needs, and this barrier can be overcome by expanding first in countries that are culturally similar to domestic markets. Consumers in developing countries are generally price-sensitive. This, however, could be seen as a positive factor, since generally consumers everywhere are trading quality for price.

The high price of commodities, oil first among them, has generated substantial capital flows from developing countries to the coffers of emerging countries other than the BRIC. Traditionally, excess funds were invested in dollar-denominated government securities and precious metals. With the substantial drop in the value of the dollar and continuing uncertainty over the ability and willingness of the country to stop a further slide, several governments have set up sovereign-wealth funds that are now about to invest in stockpiling commodities and investing in foreign companies. Oil-producing countries have extremely large sovereign-wealth funds and will compete with the BRIC in the acquisition of foreign corporations with or without ulterior political motives.

Other sizable sovereign funds include the Abu Dhabi Investment Authority, Singapore's Government Investment Corporation and Temasek, the Saudi sovereign funds, Norway's Government Pension Fund and the Australian Government Future Fund.

It is difficult to say whether the BRIC economies are truly emerging as a major economic force with the introduction of a new industrial model, or, rather, mega corporations are being created, some of which happen to be from developing economies.

If the latter is the case, then we will see in the near future major rivalry among global groups for complete domination of the market in which they are active, whatever the origin of the capital or the nationality of the labor force might be. 

