A quantitative approach to guiding the promotional efforts of Investment Promotion Agencies (IPAs) in emerging markets

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Synopsis

Investment promotion agencies (IPAs) conduct a range of activities to improve FDI inflows. The choice between image building and investment generation activities depends on investors’ perceptions of the IPA’s location. This study employs an innovative quantitative finance approach that allows IPAs to speedily measure risk perceptions using real-time data. The paper focuses on determining whether the risk of nationalisation is a concern for large multinational companies in the natural resource sector. The results demonstrate that such companies are not concerned about nationalisation risk. The findings have implications for guiding the promotional efforts of IPAs, both in countries where nationalisation is a risk and in countries where changes in the political environment have reduced the risk of nationalisation.

Introduction and Background

IPAs across the world compete intensely to attract FDI through activities such as image building, investment generation, investor facilitation and servicing, and policy advocacy. However, at any particular time, promotional efforts tend to concentrate on image building or investment generation. Image building is generally conducted prior to investment generation; with the objective of building an image of a location as an attractive site for investment. Once an appropriate image is formed in the minds of prospective investors, IPAs tend to shift their efforts towards investment generation. Thus, the focus of promotional efforts depends on investors’ perceptions.

For IPAs in emerging markets, determining investors’ perceptions is a challenging task due to the presence of political risks. Moreover, a company’s susceptibility to political risks can change over time due to changes in FDI policies of host governments. This paper focuses on changes in nationalisation risk that arise due to the intensification of populism in a host country. A nationalistic ideology often underlies the populist fervour; therefore, host governments have an incentive to nationalise foreign investments to meet the demands of the populace. In May 2006, such populist sentiment led to the nationalisation of Bolivia’s oil and gas sector. This paper uses financial market data to measure investors’ perceptions around events that heightened the risk of nationalisation.
Issues and Questions Considered
IPAs endeavour to conduct the most appropriate and effective activities since they have limited budgets and resources. Targeting companies through investment generation is considered effective when prospective investors do not have negative perceptions of the IPA’s location. In this situation, company-focused sector targeting is much stronger in producing investment leads compared to image building activities such as PR campaigns. In contrast, image building is more appropriate when investors’ perceptions are worse than the reality in a country.

As image building and investment generation are effective in different circumstances, the key to IPA success involves getting the balance right between the two activities. Despite this, IPAs often persist with image building when there is no need to improve investors’ perceptions. Conversely, they often rush into investment generation without ensuring that prospective investors do not have negative perceptions of their location.

We consider this issue in the context of the risk of nationalisation for large multinational companies in the natural resource sector. Such companies are capable of successfully entering and conducting business in foreign markets. However, they are also susceptible to nationalisation risk since they have a greater capacity to exploit a host country; and are prone to attracting the attention of local authorities. This research aims to guide the promotional efforts of IPAs in targeting these companies.

Moreover, our methodology allows IPAs to base their promotional efforts on more up-to-date and relevant information. At present, investors’ perceptions are measured using qualitative methods; and IPAs are advised to refer to publicly available reports on their location and investment climate. Surveys of business conducted by political risk insurance providers are also used to measure perceptions of political risks. These methods only provide a measurement of risk perceptions at a point in time; thus, they become outdated with developments in the political environment. Furthermore, they are limited as to the information they provide about specific companies’ perceptions of risk. In contrast, we apply a quantitative finance technique that allows for the timely identification of changing risk perceptions. This approach also provides IPAs with a method to assess the risk perceptions of targeted companies.

Methodology
High-frequency data (HFD) for companies affected by nationalisation in Bolivia are used to accurately measure volatility changes around events that paved the way for nationalisation. In July 2004, a national referendum revealed that 92 percent of Bolivians were in favour of nationalising all of the country’s hydrocarbons. In May 2005, the Law of Hydrocarbons increased state control of the production of hydrocarbons, introduced a new 32 percent tax on oil and gas production, and required private companies to renegotiate contracts with the government. In December 2005, Evo Morales, a candidate who supported nationalisation, was elected as president. We calculate the daily realised volatility for both BG Group Plc. and BP Plc. using 5-min return intervals in the days surrounding each event.

Outcomes and Findings
The unique contribution of this paper involves the application of HFD to measure large multinational companies’ perceptions of the risk of nationalisation in the natural resource sector. Our results demonstrate that for each of the events that preceded the nationalisation of oil and gas resources in Bolivia, the market did not perceive nationalisation to be a concern for either BG Group Plc. or BP Plc.

The findings have implications for guiding promotional efforts in countries where there is a risk of nationalisation. In such countries, IPAs could attract FDI to the natural resource sector by focusing their activities on investment generation and targeting large multinational companies that do not have negative perceptions about nationalisation risk.

Our findings also have implications for guiding promotional efforts in countries where changes in the political environment have reduced the risk of nationalisation. In such countries, IPAs tend to focus on image building to inform investors of the improved environment for FDI. However, our results indicate that IPAs that intend to attract large multinational companies in the natural resource sector should not focus efforts towards image building. Such companies do not have negative perceptions about nationalisation risk; therefore, image building is unnecessary and wasteful of resources. Alternatively, IPAs should focus their efforts towards investment generation activities. While predominantly beneficial for IPAs, these activities would also benefit the companies that would immediately be made aware of investment opportunities in the IPA’s location.

The methodology used is generic and can be applied to any risk that hinders FDI. It can also be used by IPAs to assess targeted companies’ perceptions of risks. This would provide IPAs with a comparison measure of targeted companies and guide their promotional efforts in attracting the preferred investment.