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Corso di Laurea Magistrale in
Amministrazione, Finanza & Controllo

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Subsidiary establishment in EMs

A unified framework for risk analysis

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Anno Accademico
2015/ 2016

Summary

ABSTRACT

Starting from the traditional capital budgeting models, the aim of this work is to analyze how MNCs incorporate (or should incorporate) the main risk factors affecting their decision to establish a subsidiary in an emerging country. The risks addressed (e.g. political, country-level, HR-related, tax-related, corporate governance-related, etc.) are both qualitative and quantitative, as well as exogenous and endogenous. After having been mapped, their impact on the overall risk position of the company will be evaluated and weighted considering both the effects on the MNC and on each other, ending up with a unified framework.

In order to prevent any "paralysis by analysis" as well as inconclusive outcomes, the study will develop through three different steps with a progressively higher degree of detail. The starting point is represented by the distinction between exogenous and endogenous risk factors, the former including the elements of the external environment that are likely to have a sizeable impact on the going-global company's risk position, the latter focusing on the firm-specific features expected to affect the viability and the outcome of the investment concerning the subsidiary establishment. The second stage involves the in-depth analysis of the main risk factors typologies and the way they are expected to affect the investment decisions of the MNC. Thirdly, these main risk factors will be further studied having special regards for various sub-types whereby they manifest in practice, deriving the likely consequences on the variables and parameters building the models applied for valuation purposes, ending up with a unified framework grounded on the connections between the risk sources.

The work is structured as follows: the Chapter 3 addresses the main topics regarding the entry strategies and paths that MNCs follow when they expand in foreign emerging markets; the array of risks factors (qualitative/quantitative and endogenous/exogenous) contingent to this kind of investment will be analyzed in Chapter 4 and 5; in Chapter 6, their impact on the overall risk position of the company will be evaluated and weighted considering both the effects on the MNC and on each other, ending up with a unified framework.

Fundamentally, the ultimate aim of the present work is not to provide an ultimate and ever-valid value for the discount rate to be applied (or for other variables constituting the valuation model), as it varies sensibly when different countries as well as different MNCs are considered, or when different levels, kinds and combinations of risks are evaluated. Conversely, the goal is to construct a tool and a framework to support the management in avoiding the pitfalls concealed in the valuation process when numerous (and often not straightforward) risk factors are considered, building a unified view.

1. INTRODUCTION

1.1 MNC expansion in emerging markets

Providing a broad definition, a multinational company (MNC) can be referred to as an enterprise that carries out its activities through the establishment of branches, divisions and subsidiaries in a given number of foreign countries. Given their huge population and increasing spending-power, emerging countries represent expansion opportunities for MNCs, providing a big market for goods and services targeting untapped needs. Moreover, for MNCs is far easier to address these markets with their offer due to the lower costs of production and distribution, allowing for relevant margins. One of the tools whereby a company develops its multinational basis is the foreign direct investment[1] in a target company (FDI). In this case, the investment can be carried out in different ways, for instance by setting up an associate firm or a subsidiary abroad, by the purchase of share of the foreign target, or again through a M&A or a joint venture. Another frequent form of FDI, although entailing different (and often more numerous) risks, is the so called green-field investment. In such an investment, the company establishes a new venture in a foreign country from the ground up without either acquiring a stake or investing in any way in an already existing local firm. The facts and reasons underpinning this international expansion are numerous, depending on the strategy devised by the company and the environment in which it competes.

Indeed, those drivers can be broadly divided in: (1) the opportunities present in a foreign country, (2) the factors related to the home-country institutional and business environment hindering the company to thrive within the national borders, and (3) the internal resources and competitive advantages that the company can leverage as well as the specific features of its own activities. It should be clear that those elements often act together underlying the decision of the firm to expand abroad, however some useful insights can be drawn from a separated brief analysis. Focusing on the characteristics of the company's activity, sometimes this kind of investments and strategies appears to be a compulsory way of operating in a specific business: it is the case for instance of the activities related to the extraction of raw materials, or those based on the transportations of either people or goods.

The reasons underlying FDI cannot be analyzed only as a set of proactive strategies, looking forward to the search for new income opportunities. It might also have a defensive ratio, to wit a reaction to the presence in the home-country of either new and aggressive competitors that are likely to shrink the company's market share, or the enactment of unfavorable legislation and tax-system by the ruling institutions or again the disadvantageous variation of the production input costs. Symmetrically, the presence in the host country of a more advantageous social, political, economic and financial context can drive the decision of the MNC to carry out the FDI. Those factors in the foreign environment enabling the company to settle a share of its activities abroad could be better infrastructures, an efficient legal framework, a slimmer red-tap, a fair tax system, the absence of corruption and nepotism, financial and tax incentives for investments.

Many enterprises view international expansion as a tool whereby pursuing greater production efficiency. Therefore, they are investing in countries where one or more of the factors of production, capital included, are more convenient with respect to the same or equivalent input in the national environment. Seeking this kind of enhancements, these firms are able to attain relevant economies of scale, scope or integration through expansion abroad. Taking the example of the expansion of the Japanese automobile industry in the North American market[2], FDIs can also be powerful drivers to satisfy properly the internal demand of a

[1] For further detail on the topic see also "*Foreign Direct Investment*" (Harrison G. Blaine, 2009)

[2] See Co (1997) on the Japanese FDI into the U.S. automobile industry

foreign country already target of the company's offer. Moreover, in some industries (like biotech or telecom), direct presence in a foreign market allows easier and more immediate access to strategic resources like technologies, knowledge and professional skills developed specifically in that country.
However, every company inclined to shift or expand in a foreign developing country must keep in mind that this type of operations represents a sizable source of risk beside of the aforementioned opportunities. The reason why these investments can have disastrous consequences, if not properly managed from the outset, is dual. First, a company developing a business established in more than one market is exposed to additional risks that would not otherwise be present if this activity was limited within the national borders. These additional risks stem from the drawbacks of globalization per se, a process embedding the company in a wider competitive network. New actors (customers, competitors, foreign governments and political systems, etc.) are therefore involved that are physically and culturally distant from the former, thereby multiplying the sources of risk, to which it is vulnerable.
Second, the launch of a business in a foreign country is subject to its specific political sources of risk[3], often totally different from those that would have otherwise affected the same activity whether it was carried out in the home-country. Moreover, unexpected variations in the exchange rate and in the differential between home-country and foreign inflation can have relevant consequences on the cash flows generated by the FDI negatively impacting on the competitive position of the MNC (or its subsidiary). The differences of the home-country tax system and that of the host country contribute to the additional complexities of capital budgeting for FDI[4] and can trigger fiscal arbitrage opportunities. At the same time, starting a new activity abroad can affect the value of other investments of the company, thus the valuation methods applied should accurately take into account the collateral side effects of the new FDI. The weight and the consequences of the aforementioned issues swell when an emerging market is taken into consideration instead of a developed one. The emerging countries' corporate and institutional environment is characterized by profitable opportunities, for example due to the low production costs and untapped customers' needs as well as the availability of specific tangible or intangible resources, but at the same time the cost of their instability is to be borne. Good uncertainty that underlies the opportunities characterizing these markets is related to an improvement of the economic activity, such as consumption, output, and investment, whereas bad uncertainty forecasts a decline in economic growth and depresses asset prices. This uncertainty, whether its outcome is positive or negative, stems from different sources of instability engendering a complex array of risks. For instance, the financial markets of these countries are less developed and sophisticated than those of advanced economies, leading to a lack of regulation and transparency as well as low liquidity. These burdens hamper the relationships between companies and investors and reduce the possibilities for companies to get their activity and projects financed (at a reasonable price). Many sources of instability are rooted deeply into the political system, that is often far from the democratic principles underpinning the developed economies. Indeed, cases of corruption, unfairness and power-abuses (often through military forces) in these governments lead to an economic and institutional environment that is unfavorable for companies to thrive. Political instability is likely to translate in poor infrastructures and low debt market access. Particularly, the legislation is subject to frequent manipulations and changes as well as characterized by inefficiencies, imbalances and gaps.
Furthermore, developing economies appear to have a high degree of volatility from a macroeconomic point of view, lowering the accuracy and reliability of predictions and estimations related to inflation or exchange rate fluctuations.

[3] See Henisz and Zelner (2010)
[4] See Pizzutilo (2014)

1.2 Subsidiary typologies

In order to gain useful insights as to how subsidiaries are embedded in the MNC network and how they take on a specific role in it, it is worthwhile to develop a framework to categorize the various kind of FDI on the basis of specific variables. It should be clear that the number of variables taken into consideration for classification purposes must be neither too few nor to many in order to avoid under-specification or over-specification problems. Fundamentally, the strategic choice that is up to every firm to undertake is influenced by the nature of markets it competes in (or wishes to compete in) and the capabilities it masters (or should master) to compete in these markets. Thus, the key challenge for the firm is to match its external and internal boundaries[5]. When a firm makes a choice about the type of capabilities it will develop and foster, it is expected to choose the appropriate market to deploy those capabilities. The strategic decision over markets and resources assumes a specific meaning in the context of the MNC. When a firm carries out its activity within a single domestic market this choice is limited to its industry or product market scope. However, as MNCs operate across national boundaries, external choices have both a product-market and a geographical-market implication. In this sense, product-scope, market scope and value-added scope have been widely used as "external" variables whereby defining subsidiary roles, integrating product-market and geographic-market boundaries of MNCs

Second, a firm must face the strategic decision concerning its internal boundaries, to wit the types of capabilities and resources needed to compete in the chosen market. A company develops a capability when it uses its resources to produce the relevant output, enabling it to position itself effectively within the competitive environment and, eventually, to win out. Again, this kind of choices has specific properties in the case of MNC with respect to domestically focused firms. This is because a relevant share of the MNC's resources and capabilities is often located and dispersed in its subsidiaries, which are likely to vary significantly in their attitude to either develop new capabilities or to deploy those developed elsewhere in the MNC network. Why is it important to develop a framework into which to categorize the various subsidiaries typologies? Of course it is not a process that has an end in itself, the focus is not on the knowledge of the array of alternatives but on the strategic as well as economic-financial consequences that this choice will turn out to have. Indeed, as explained above, the choice of the MNC to internationalize its activity in foreign emerging countries poses specific challenges in the form of additional sources of risk. However, the presence of certain specific kinds of risk and the intensity with which they manifest is likely to hinge on the roles and mandates that the subsidiary undertake within the strategic blueprint set by the parent company. Hence, the better way to define the risks the subsidiary establishment entails and their financial impact on the valuation is to understand the external and internal environment in which the subsidiary is set to operate, that ultimately depends on the role it takes on.

1.2.1 The findings of the previous literature

Before deepening in the discussion over the various subsidiary typologies, a reference to the previous literature has to be made to better understand how this framework has been developed and how it provides additional clarifications.

Until recently, empirical studies at the subsidiary level have always focused on the overall strategy, structure or systems of the multinational firm from the parent company perspective[6]. These approaches concentrate only indirectly on the subsidiary type as a consequence of these top-down strategies and as an

[5] See *"Organization: contemporary principles and practice"* (John Child, 2015)

[6] Stopford and Wells (1972), Johanson and Vahlne (1977)

evolution from a domestic to an international firm. Indeed, the starting point was the MNC's headquarter regarded as the fundamental driver of this process of expansion across national borders.
Since the 1980s, however, the focus on the parent has shifted to the subsidiary, prompting a growing interest in the national subsidiary as a unit of analysis, although only indirectly through the strategies and the organization of the MNC. The formulation of the overall international strategy was proved to have implications on the way MNC deploy its resources and activities and the both formal and informal levers devised to manage its network. This was expected to influence the types of subsidiaries in the various mandates and roles they were assigned, leading to the conception of various subsidiary categories as second-order effects. The development of specific subsidiary roles has also been associated to the process whereby the MNC gradually increases its commitment to international markets as well as the evolution of its international operations[7]. Following this perspective, overseas subsidiaries are initially established as export offices, which sometimes evolve into branch plants. Eventually they are demonstrated to take on wider responsibilities in the form of mandates to sell to neighboring, regional and, sometimes, global markets. The role of the subsidiary can be assumed first as an attempt to adapt the MNC's key technologies to local markets, and afterwards to be an "outpost" sending information to the parent about variations in local environment. However, whatsoever research perspective was to be chosen to analyze the role of the subsidiary and its evolution, the tendency has always been to develop conceptualizations of the subsidiary along two dimensions, ending up framing binomial matrixes based on:

- product and geographic scope;
- capabilities and strategic importance of the national environment;
- configuration and coordination;
- integration and responsiveness;
- knowledge inflows and outflows;
- autonomy and decision-making.

Source	Dimensions	Subsidiary type
White and Poynter (1984)	Geographic scope and product scope	Miniature Replica, Product Specialist, Strategic Independent
	Geographic scope and value added scope	Marketing Satellite, Miniature Replica, Rationalized Manufacturer, Strategic Independent
Bartlett and Ghoshal (1986)	Capabilities and strategic importance	Black Holes, Local Implementers, Contributors, Strategic Leaders
Jarillo and Martinez (1990)	Integration and responsiveness	Receptive, Autonomous, Active
Gupta and Govindarajan (1991)	Knowledge outflow and inflows	Local Innovator, Implementers, Global Innovator, Integrated Player
Taggart 1997	Autonomy and decision-making	Partner, Collaborator, Militant, Vassal
Taggart 1998	Integration and responsiveness	Autonomous, Receptive, Constrained, Quiescent
Randoy and Li 1998	Resource inflows and outflows	Resource User, Resource Independent, Resource Provider, Networker

Adapted from Enright and Subramanian (2007)

1.2.2 A Four-dimensional Classification

A classification based on two parameters, whichever couple is chosen, would result in a classification either too general or partial, being devoid of the variables with the proper scope to allow for a deeper

[7] See also Johansson and Vahlne (1977) on the "Uppsala Internationalization Model"

specification. To integrate the fragmented findings of the previous literature, recently it has been developed a framework grounded on a four dimensional approach[8] that focuses on capability creation, capability utilization, geographic scope and product scope. Before presenting briefly this framework, it is worth to emphasize again the relevance of a full understanding of the subsidiary typologies (and their propensity to be classified) as an introductory work prior to the analysis of the risk factors affecting their activity, environment and the valuation process to which they are subject.

Capability creation: the first dimension encompasses not only R&D activities but also strategy setting, and it is rooted in senior corporate management functions. Subsidiaries that can be labelled as "capability makers" are likely to be strategy makers as well as technology makers, providing inputs to other parts of the MNC network.

Capability utilization: the second dimension has to do with subsidiaries receiving substantial inflows of capabilities from the parent company or other parts of the MNC network, and presumably using them to implement the strategy set from the top or delivered by the subsidiary itself. A possible side-scenario is that in which the subsidiary demonstrating to be a source of capabilities is itself one of the ultimate users of these resources.

Product scope: the formal mandate assigned by the parent company to each subsidiary is structured along two dimensions, to wit the product scope and the geographical scope. As for the former, some subsidiaries may have responsibility for all of the firm's products (broad mandate) while others may take on a specialist role for a single product line or even a single product (narrow mandate). Clearly, the same statement holds for the provision of services and it is not limited to the manufacturing activity (for simplicity this dimension will be labelled only with reference to "product").

Geographic scope: the last dimension defines the geographical development and utilization of resources as well as the spatial scope of the product mandate. For instance, some subsidiaries might have product mandates that are local or regional, while other subsidiaries may develop capabilities for local, regional or global use or draw upon capabilities developed elsewhere in the MNC network.

The classification can be then built following different stages, increasing the specialization progressively with the addition of further details. The chart below sums up the first stage in which a principal and more general distinction is made along the first dichotomy of capability creation/utilization.

Capability creation \ Capability utilization	Low	High
Low	Observer	Implementer
High	Innovator	Leader

A subsidiary can be referred to as *leader* when its activity involves the development of significant capabilities by means of its R&D investments as well as managerial activities and at the same time are among the users of those capabilities in production, marketing and sales, and other functions.
Innovators are companies prone to capability generation without being significantly engaged in functions or activities that directly leverage these capabilities or others developed elsewhere into the local market.
Implementers are subsidiaries characterized by a low degree of capability creation, assigning a relatively negligible weight to R&D and management activities, but at the same time they are important users of capabilities generated in other parts of the MNC network.

[8] See Enright and Subramanian (2007)

A firm within the MNC can be considered an *observer* when its role is neither that of capability generator nor utilizer. The importance of this type of subsidiary is not straightforward being seemingly devoid of the attitude to bring value added to the MNC. In fact, the existence of representative offices, listening posts and other subsidiaries highlights the need for this category, even though these firms cannot be viewed as significant capability creators or users. In order to provide a meaning and visibility to the mandate a subsidiary is assigned by the parent company, the capability dimensions have to be connected and defined along the other two dimensions. Fundamentally, these are related to the features of "productive activities" that the subsidiary undertakes and the geographical scope over which they are carried out. Indeed, this connection must be consistent with the characteristics of the subsidiary and the strategic objectives that are to be attained: for example, a subsidiary characterized by global capabilities will be subject to sub-optimal allocation if it is not given a global market coverage. Thus in order to broaden the focus as well as reinforce the meaning and the legitimacy of the classification, the two dimensions related to the scope of the subsidiary need to be included in the analysis. Doing so, new features are attached to the aforementioned "leader", "innovator", "implementer" and "observer" labels, depending on the characteristics and the strategic choices made with respect to the production mandate and spatial mandate. As for the former, the final taxonomy will be the outcome of the addition of "generalist-specialist" to the four types resulting from the first stage. When the information about the geographical dimension is considered, the "global-regional-local" designations are assigned to the subsidiary.

1.2.3 Further implications of the four-dimensional approach

This framework could be expanded including insights about the governance, the degree of autonomy and the resource flow from and towards the subsidiary. Interestingly, these elements are already indirectly considered amid the four dimensions over which the classification is developed. For instance, when a subsidiary is assigned a global mandate, implicit assumptions are made about the kind of governance applied, that cannot entail low degrees of autonomy and decision-making power in order to ensure consistency and avoid imbalances and inefficiencies. Furthermore, the resource flow is significantly affected by the decision as to how the subsidiary position itself along the capability creation/usage dimensions.

The final choice made by the MNC regarding the roles of its subsidiary and the risks that this decision triggers heavily depends on contextual contingent factors, which emerge from the external (and often internal) environment where the MNC operates and dislocates its activities.

A key factor having a relevant role in determining the mandate of a subsidiary is the characteristics of the local environment in which it is located. These factors may relate to the national environment or focus on specific areas that are meaningful for that particular business. They can also have economic, political, legal and institutional features: resource endowments, legal, institutional and regulatory conditions, economic policies are likely to affect the nature and the behavior of the subsidiary, for example its ability to develop certain capabilities. Again, the opportunities offered by a large growing market are likely to lead the subsidiary operating in that country to take on a wide-scope mandate, from both the product and geographical point of view.

An important subsystem of the local environment that is worth special attention is the industrial environment and the elements constituting it. Notably some of these factors are the nature of customer demand, minimal or standardized service requirements, the characteristics of the distribution chain, the importance of technology and patents possession, and the weight of international competition. A factor that is recently impeding the expansion of MNC from developed countries into emerging economies is also the rise of the competition not only with companies whose home-country is developed as well, but also

with multinationals having their roots in these emerging countries (EMC)[9]. The increasing power and impact of EMCs stems from competitive advantage grounded on the direct experience they garner in the surrounding environment, enabling them to understand in a better and faster fashion another emerging market, often with flexible and less costly processes and organizational structures[10].
As for the internal factors affecting the subsidiary's role and nature, one of the most important is the set of structures and systems enabling the MNC to coordinate and manage the global network, since the organizational structure is complicated by international strategies and operations. Different subsidiary roles entail specific organizational arrangements, and given this substantial diversity, the MNC's structure is supposed to reflect this heterogeneity and complexity. Specific structural arrangements will be required to manage different levels of autonomy and delegation, different sizes of resource flows and, again, different geographical responsibilities and scopes. Another internal factor that, although it could seem straightforward, is worthwhile to be mentioned is the strategy setting activity either performed in the parent company or, rarely considered, in the subsidiary itself. When focusing on the strategy set forth by the headquarter, the consequences of the choice to centralize specific activities or to compete globally will be ultimately borne by the foreign subsidiaries as they are accountable for the local implementation of these strategic moves. Recently increasing attention has been given to the role of the subsidiary in setting its strategy or a part of it: credibility and accountability of local managers, relationships with key parent managers, and the entrepreneurial initiative at the subsidiary level can enable it to develop unique capabilities that add to the MNC's worldwide competitive advantage.

1.3 A theoretical perspective on the internationalization process

The expansion of their activity in foreign emerging countries represents an opportunity for MNCs to reach new customers as well as to seek access to knowledge and strategic assets in foreign markets. However, they also find themselves grappling with new challenges and barriers like different political and economic scenarios, new and global competitors, new laws and regulations, and market requirement.
The internationalization process undertaken by MNCs does not follow a predetermined pattern since it is influenced by the presence of external as well internal contingent factors, which may vary across the MNCs' international experiences. However, as stated before empirical findings in the literature have shown that this expansion strategy is often structured as a gradual and incremental commitment in the foreign country starting from an export office to a well-established branch. These findings point out furthermore to the tendency of conducting R&D activities abroad due to the presence of specific resources and cost advantages in loco.
Regardless of the specific theory or literature perspective adopted (which will be discussed briefly afterwards), it has indeed been demonstrated that MNCs are likely to follow a pattern of "gradual internationalization", since it eases the company's learning process that underlies the positive outcome of an internationalization strategy. The adoption of such a process helps the MNC cope with the geographical and cultural distance as well as the liability of foreignness, which have been found to be troublesome for firms operating in any foreign market. Furthermore, MNCs from developed countries are shown to have some specific advantages with respect to EMCs such as strong brands and important networks that are very crucial when a firm internationalizes its business. This is possible because MNCs can often rely on a longer experience of international strategies and investments.

[9] See Pillania (2009) on the rise of EMC
[10] See Amal, Awuah, Raboch and Anderson (2013)

In order to better understand the current empirical results regarding the internationalization strategies and patterns followed, some useful and interesting insights can be drawn from the findings of the previous literature and their integration.

As for the first of the theories presented, the key idea bolstering the eclectic (OLI) paradigm of international production[11] is that the level and structure of a company's foreign valuable activities will hinge on the following hypotheses:

- The presence and relevance of unique and sustainable ownership-specific (O) advantages possessed with respect to the global competitors;
- Locational advantages (L) and the role of governments influencing the decision to invest in a foreign country;
- The process of internalization (I) allowing the firm to gainfully exploit these firm-specific advantages;
- Given the configuration set by the previous three points, the firm's foreign activity and organizational strategy must be consistent with the long-term objectives of its stakeholders and institutions.

Instead, the insight underlying the Uppsala Internationalization Model (UIM)[12] is that the resource commitment in a foreign country is determined by the experiential knowledge and general learning gradually gathered about that market throughout the internationalization process. This process will indeed be carried out incrementally: the company will first arrange export relationships to pave the way for following investments and strategies, followed by the establishment of a specific representative office in the foreign market, the use of own sales subsidiary, and then eventually set up a manufacturing branch in the foreign market. The fulfillment of each steps is strongly influenced by the gradual development of experiential knowledge, which is the leitmotiv of this theory.

Both theories have been criticized for the shortcomings and short-sightedness of the assumptions considered as well as the scope of the outcomes. Particularly, in the OLI paradigm a strong emphasis is placed on the relative bargaining power of companies with respect to national governments, engendering a struggle influencing heavily the decision as to why and where to locate the FDI, though neglecting the relevant role of the market[13]. Another criticism is that the approach is meaningful as long it is concerned with manufacturing activities. Moreover, it has been shown that the lack of market knowledge is no longer a factor limiting the pace and pattern of firms' internationalization as it would have been in the past decades, weakening the basic assumptions of the Uppsala Internationalization Model.

In order to garner a more complete and meaningful view of the internationalization process, the main insights and hypotheses of the aforementioned theories are to be combined. In this sense, as anticipated before, a company's internationalization process will be influenced by the knowledge and experience gathered during the expansion path, which is expected to determine the pattern and the pace of the internationalization process. Yet it has been demonstrated that, due to the overall globalization of industries and markets, the lack of such a knowledge is no more a factor hampering the internationalization strategy. Indeed, this shortage can be compensated by the inclusion of the company in relationships networks based on the exchange of resources and/or information, easing the decision as to whether and where to place the subsidiary in the foreign emerging market, as well as the intensity of the commitment. This element, which can be actually deemed a location-related factor, highlights the need of integrating the framework with the interaction between ownership, location and internalization advantages, as stated in the OLI paradigm, but also including considerations from the behavioral approach. Doing so, parameters dealing with the exploitation of firm-specific assets taking advantage of the location, the government's role and the infrastructure will combine with a firm's market knowledge, which will reflect the extent to which it

[11] See Dunning (1979) on the Eclectic Theory of international production

[12] See Johansson and Vahlne (1977) on the Uppsala Internationalization Model

[13] See Wint and Williams (2002)

learns about the opportunities and threats in a specific country, affecting its decision to commit resources into it.

Fundamentally, the strategic choices regarding the internationalization path to be followed and the identification of the contingent factors determining it is likely to have strong implications as to which challenges, risk factors and barriers the MNC will grapple with as long as it will operate in that country, and the strategies deployed to cope with them. Furthermore, these risks will affect not only the entry decision, but their ongoing management will turn out to be crucial for the establishment and survival of the subsidiary in the foreign emerging economy.

2. VALUATION METHODS AND MODELS

2.1 The role of uncertainty

Psychologists and behavioral finance researchers have shown that companies and analysts are inclined to behave irrationally when faced with uncertainty. Some of the most dangerous reported reactions are:

- Paralysis. Companies might get stuck on a valuation issue on a particularly tough element to estimate and simply give up;
- Denial. It corresponds with the maintenance of the illusion to be able to estimate every variable with certainty relying on numerical models.
- Mental shortcuts. Companies are reported to resort to rules of thumb with no solid assumptions or tailored to get to the desired outcomes.

The best way to develop a solid response to uncertainty and deploy effectively the valuation models is to distinguish the various kind of uncertainty[14]. First, assuming that almost all the valuation inputs are the results of estimations, it could be possible that a given number of mistakes are rooted in these estimations and assumptions. Thus, collecting more information and processing them in a better way can improve the accuracy of the projections made, enhancing the value of the model applied. However, even though managers overcome this informational (or estimation) uncertainty, they would be faced with real economic uncertainty that cannot be tempered by the amount of data gathered. This economic uncertainty, notably in emerging countries, stems from the fact that markets and economies are unexpectedly and unpredictably subject to changes. Connected to the previous dichotomy, a further distinction can be made between micro and macro uncertainty. The former relates to the actions that an enterprise undertakes affecting only itself and a limited set of peer firms. This micro uncertainty, as the estimation one, can be curbed with a greater and higher-quality information collection. Instead, the latter refers to the macroeconomic volatility and the undiversifiable risk impacting more or less all the companies, regardless of the amount of information possessed. Moreover, uncertainty could be either discrete or continuous. A continuous source of uncertainty is embedded into the company's activity and inexorably influences the trends of its fundamentals (cash flows, discount and growth rates). An example could be the exposure to currency fluctuation of companies carrying out part of their activity abroad. Conversely, discrete risk is connected to unpredictable turmoil or relevant fluctuations of macroeconomic variables. This last typology is more likely to trigger the irrational behaviors explained above and there are no easy techniques able to incorporate them in valuation methods. Being aware of the behavioral and economic-financial pitfalls, in order to thrive in emerging markets MNCs are required to evaluate systematically the main sources of risks without limiting to those whose identification and measurement is straightforward. Furthermore, they should tweak and tailor the valuation models to incorporate all these risk factors in order to derive a value that can be effectively relied upon.

[14] See Damodaran (2013)

2.2 The valuation models

As a first remark, it is worth to acknowledge that in order to understand the effects of risks factors the paramount consequence to be analyzed is that on value itself and its components. In fact, the procedures applied are fundamentally just measurement tools connected to it[15]. Regardless of the entry mode chosen, a MNC willing to establish a subsidiary in an emerging foreign economy is not able to forecast the exact amount of future cash flows because they are unknown and therefore risky. This risk enters valuation both through the company's cost of capital, which is essentially the price to be borne as a consequence of this risk, and in the uncertainty surrounding both the amount and the timing of future cash flows. Although all the parameters included in the valuation models are worth special care in their forecast, probably the most crucial and tricky one is the cost of capital, given its complexity in estimation due to the high number of variables affecting it, whose identification is often not straightforward.
One of the differences between the discount rate to be chosen and the other parameters included in the valuation methods is ultimately the inclusion of investors' claim and concerns. The cost of capital is indeed the price charged by investors for bearing the risk that the company's future cash flows may differ from what they expected when they made the investment, hence they require a minimum threshold of return from the capital provided to the company. The risk mentioned in this introductory definition can be referred to as the non-diversifiable risk, that is the set of dangers that cannot be avoided resorting to alternative investment opportunities thus is not completely under the control of the company's management[16]. A crucial decision that must be critically evaluated is also that concerning which types of risk to hedge, related to the distinction made above between positive uncertainty and negative uncertainty[17] as well as the risk and volatility intrinsically connected to the activity in which shareholders invest their capital. Not only this kind of risk cannot be avoided in specific businesses, like in the case of commodity producers, for instance oil or gold extractors, yet it is expressly and gainfully sought by their investors. So while hedging may reduce the short-term cash flow volatility, it will have little effect on the company's valuation based on long-term cash flows.

2.2.1 DCF and FCFF valuation

Providing a basic definition, in the discounted cash flow valuation the value of either an asset or a company is estimated by discounting the future expected cash flows on that asset at a rate consistent with the riskiness of the investment, as it is perceived by both the company itself and the investors.
Initially keeping a broader view, as shown below in the most classical formulation, the value thereby measured is a function of the amount of cash flows generated, the timing and maturity of these cash flows, their expected growth and the related riskiness.

$$V = \sum_{t=1}^{n} \frac{Cash\ Flow_t}{(1+r)^t}$$

Then, the DCF model can follow two parallel paths leading to the same result: the first is to value just the equity stake in the business while the second is to focus on the value of the entire firm, including all the claimants without limiting only to shareholders[18]. The substantial difference between the two approaches lies in the nature of the cash flows taken into consideration and the specific hurdle rate applied to discount

[15] See "Valuation: measuring and managing the value of companies" (Tim Koller, Marc Goedhart, David Wessels, 2010)
[16] See Fama and French (2004) on the Capital Asset Pricing Model
[17] See Segal, Shaliastovich and Yaron (2014)
[18] See *"Applied Corporate Finance"* (Aswath Damodaran, 2014)

them. The former is computed by discounting expected cash flows to equity (the residual cash flows after all expenses, tax outlays, as well as principal and interest payments are met) at the cost of equity, whereas the latter consists in the application of the WACC to the residual cash flows after all the payments are met except those related to debt. For these reason the FCFF (free cash flow to firm) are also termed "unlevered cash flows". For the reasons of the present work only the second perspective, that is the one based on the estimation of the firm value starting from the FCFF, will be adopted in the discussion of the already mentioned risk factors and their impact on the MNC value and strategy. The reason is dual: on the one hand this method from the ease of use viewpoint is more straightforward as the cash flows considered are unaffected by changes in leverage, thus requiring less binding assumptions, and on the other hand because of the ease of use this approach has become the most widely used in practice.
One of the approaches that can be followed so as to estimate the cash flows to the firm, is to calculate the cash flows starting from the operating income (net of taxes), from which the outlays related to the reinvestment needs are subtracted, but without considering the debt repayments.

NOPAT (Net Operating Profit After Taxes)
- (Capital Expenditure – Depreciation)
- Δ non-cash Working Capital

= Free Cash Flow to the Firm

Another way of presenting the model anyhow yielding the same result is to consider the CAPEX and working capital variation as a percentage of the NOPAT, leading to a ratio that can be referred to as "reinvestment rate".

$$Reinvestment\ Rate = \frac{(CAPEX - depreciation + \Delta WC)}{EBIT\ (1 - t)}$$

Thus

$$FCFF = NOPAT(1 - Reinvestment\ Rate)$$

The next decision and estimation concerns the pattern of future cash flows and the related growth rate through time. Only for explanatory purposes, in this section a standardized and simplified trend will be presented in order to provide an initial understanding of the tool. In the following chapters related to the discussion and analysis of the risk factors and their consequences, one of the findings will concerns their impact on the dynamic of the cash flow growth and how the company's decisions as well as its environment are likely to affect and alter it.
The length of time according to which the valuation is carried out can be basically divided into two periods: first, a high growth period in which the company's resources are focused on expansion investments, followed by a stable growth period in which the company is assumed to grow at a sustainable constant pace forever, usually lower. In the high-growth period, the expected growth rate in operating income is obtained by multiplying the above presented reinvestment ratio to the rate of return that can be expected from these investments.

$$g_{EBIT} = Reinvestment\ Rate\ \times Return\ on\ Capital$$

where

$$Return\ on\ Capital = \frac{NOPAT}{(Book\ Value\ of\ Equity + Boof\ Value\ of\ Debt)}$$

The above formula for value computation presented above can be extended as follows:

$$V = \sum_{t=1}^{n} \frac{FCFF_t}{(1+r)^t} + \frac{FCFF_{n+1}}{r-g} \times (1+r)^{-n}$$

where the ratio $FCFF_{n+1}/r-g$ is called "terminal value".

Given the lack of economic-financial history of the newly established subsidiary, the better and sounder way for the MNC to estimate these figures is to either drawn from previous investment experiences with similar characteristics (e.g. branch opening in the same emerging country or other presenting similar features) or to look at the industry average for these values.
Another pillar that has to be estimated to set up the model is the cost of capital, whose value in this case can be assumed to be the WACC, that is a composite cost of financing encompassing the costs of both debt and equity weighted by their market value. It is worth to point out that the cost of debt to be considered is net of the tax rate, engendering the fiscal benefits connected to interests repayment widely known as "tax-shield".

$$WACC = \frac{D}{E+D} \times (r_e) + \frac{E}{E+D} \times (r_d^*)$$

where

$$r_d^* = r_d \times (1-t)$$

and

$$r_e = r_{risk\ free} + \beta \times (risk\ premium)$$

Once the cash flows are discounted back to the present, the value of non-operating assets as well as cash and marketable securities (although not frequent in the case of subsidiaries) have to be incorporated in the value of operating assets just obtained, in order to get at the real value of the firm. The last step to infer the value of equity is to subtract from the value of the firm the same amount of debt used to compute the cost of capital.

PV of FCFF during high-growth phase
+ PV of terminal value
+ Value of cash and marketable securities
+ Value of other non-operating assets
<u>= Value of the company</u>
- Debt (market value)
<u>= Value of equity</u>

Those showed in the figures above are complex and important variables that are very sensitive to the contingent risk factors that the firm is facing both internally and externally. Thus, as the subsidiary is established and thrives (assuming that it does so), they are expected to change according to the variation of

the risk position. These variations are likely to have a significant impact on the final value of the subsidiary as well as on the overall international strategy of the MNC, and as it will be explained in the following sections, they can be triggered by either the natural development of the firm (i.e. its life cycle) or by relevant extraordinary risk factors.
Before deepening the study of some of the alternative valuation models it is interesting to reflect on the reasoning underlying the overview about these methods, that is to identify the variables that are likely to be affected by the risks emerging due to the international expansion. For example, the tax rate and the risk connected to it will affect both the amount of FCFF and the cost of debt included in the WACC formula. Moreover, the risk connected to the foreign country institutional and political environment might have consequences on the cash flows as well as the value attributed to the beta. In this perspective, these parameters can be intended as the levers through which the risk factors present in the subsidiary's environment ultimately alter the overall final value; therefore, these factors will be analyzed closely tied to the corresponding effects on the valuation levers.

2.2.2 Scenario Valuation

One of the basic assumptions underlying the traditional application of the DCF model is the inclusion of all the risk factors (and their likely effects) into the discount rate instead of adjusting the amount or the timing of the cash flows. In fact, starting from a risk free and neutral condition, a premium is added according to the risk encountered, whose size is supposed to increase as the number and the weight of the risk factors rise. Despite all the benefits carried by this methods, it poses some problems as to its applicability, its interpretability and the validity of the decisions it triggers. These questions, notably the problems in actually measuring this premium, will be addressed later in the paragraph related to the cost of capital estimation.
An alternative method is grounded on the simulation of different alternatives in which the cash flows estimated are adjusted according to the likely effects of the occurrence of a specific event (i.e. a risk factor). A first basic scenario is devised on the assumption that no relevant changes will manifest in the external or internal environment (business-as-usual condition) affecting the cash flows. Afterwards a given number of downside scenarios is set up assuming that one or more risk factors materialize: for each the management shall forecast how the business-as-usual cash flows need to be modified and estimate the probability according to which these events might occur.
Following this approach, the emerging-market risk is taken into account in the lower expected value of future cash flows from weighting both scenarios by the assumed probabilities, without the need to estimate a risk premium. Assuming that the cost of capital should incorporate only the risks that are not diversifiable by the investor or the company, the original structure of the CAPM would leave investors in emerging market concerned about their exposure to other source of risk. For this reason, the scenario analysis provides a wider and more solid view of the risk position of the company willing to undertake a certain investment. Another relevant factor that is to be estimated is the recovery value that shareholders can expect to receive during crises, which in turn hinges on the characteristics of the particular business and the level of government intervention[19]. Hence this method allows companies to incorporate firm-specific variables and information instead of resorting only to bond spreads to estimate a risk premium.

[19] As explained in García-Sánchez, Preve, and Sarria-Allende (2010) "A company's recovery value can be modeled to reflect the views and assumptions of the analyst or user. For example, one analyst might project a certain reduction in operating cash flows for a given number of years. Another analyst, however, might assume the company would be sold in the crisis year for a given recovery value (stopping the cash flow projections at that specific time). In this case, the recovery rate could be assumed to be a fixed number, or a new random variable with an associated probability distribution (based on industry or sector data)".

From an operational perspective, when managers have to discuss critically emerging market risks and their effect on cash flows in scenarios, they gain more insights than they would get from the conception of a single risk mark-up. Indeed, easing communication and understanding, this approach enables managers to identify subtle implications and to intervene properly on the right and specific levers, mitigating the risks incurred. Moreover, managers as well as analysts are provided with better analytical tools for assessing the results of the valuation processes, including an estimated distribution of values that could be the basis for further decision-making and risk management.

In order to construct the scenarios and the cash-flows patterns, the most relevant macroeconomic variables to forecast are GDP growth, inflation rates, foreign-exchange rates, and interest rates. These items must be consistent with economic realities and should be included in the basic set of monetary assumptions underlying the valuation carried out by the MNC. Once the risk factors are identified[20], the next elements to be estimated are the likely impact of these risks on the business-as-usual cash flows and the probability to assign to each scenario. In this circumstance, it reveals useful for the company to have previous experience or knowledge of the specific market it is about to enter, so as to rely on better and more accurate estimations.

The quality of the results from this approach is very likely to hinge on the competences/capabilities and the experience of the management, since they are often required to draw on their personal judgment to assess the validity of certain assumptions. However, historical data on previous crises can give some indication of the frequency and severity of country risk and the time required for recovery. Moreover, recent research has shown that the future probability of emerging countries default can be inferred from the current government bond prices[21]. These findings provide managers with other sources whereby estimating the probability of downside scenarios.

2.2.3 Real Options Valuation

Although sound in many cases, the standard discounted cash flow (DCF) analysis sometimes is inadequate to handle high levels of volatility. Moreover, it fails to incorporate the value of choices management may have in the future depending either on changes in the external environment or on the strategy-setting competences of the management itself. An alternative model is represented by the real options valuation. It enables managers to overcome the shortcomings of DCF valuation conceiving the investment opportunity into the emerging market as a series of investment options[22]. Arguing that the subsidiary establishment process can be structured as a tree composed of different paths and alternatives, real option valuation adds flexibility to the investment appraisal with respect to DCF. Furthermore, this valuation process help managers justify the strategic reasons underpinning the launch of investment having negative NPV if considered alone.

As stated in the previous chapter, FDIs are characterized by continuous learning enabling the MNC to expand following the different internationalization steps. Therefore, companies are likely to make their initial investments in culturally similar countries, even if profit potential is lower. Having learnt from the first investments, companies increase their confidence and their commitment in progressively more culturally distant countries.

[20] It should be clear that the risk factors entering the valuation are those to which the MNC is not hedged (partially or fully).

[21] See for instance Duffie and Singleton (1999) on the term structure of defaultable bonds

[22] See Luehrman (1998)

By staging FDI investments in this way, companies effectively give themselves the option to re-evaluate the project economics at the end of each stage, and then revise their investments accordingly[23]. Clearly, the value of this learning should also be embedded into valuation. Technically, a company holds a real option when it has the right (not the obligation) to make a future decision on pre-determined terms. After having carried out the initial investment, the company could be in the position to exploit other opportunities that are to be assessed as the add value to the overall investment. For example, at a certain point in the future, the company may have the right to delay an investment, to make a further investment, or the right to disinvest. In this sense, the launch of an investment corresponds to the purchase of an option whose value can be estimated through binary models or the Black-Scholes formula[24]. The binary approach is flexible enough to incorporate expert predictions of future values, while Black Scholes relies on distributions from the normal probability curve.
For valuation purposes, the underpinning variables affected by the mentioned risk factors are the same regardless of the method applied. These are essentially those connected to the cash flow amount (and timing) and the rate to which they are discounted in order to infer the value of the investment. In the following paragraphs the main issues regarding their estimation will be presented, underlying the problems arising from investing in emerging markets prior to discussion of each risk factor.

2.3 How to forecast the model's fundamentals

The first decision that the MNC has to make regarding the financial forecast concerns the length of time on which the valuation will be carried out and the degree of detail. As introduced in the section relating to the DCF model, the cash flow trend can be modelled as a set of progressive stages characterized by different growth rate. According to this approach, the amount of cash flows and the rate to which they are discounted is expected to vary as the subsidiary evolves and is established in the host-country.
A general formulation for the analysis of new ventures assumes that the evaluation period is divided into three steps, namely high-growth period, transition period and stable growth period. Each time-length hinges heavily on firm-specific characteristics (previous experience, managerial competences, resource availability) as well as the environment in which the company operates. All the variables underpinning the valuation methods presented above are expected to change alongside the growth rate, reflecting different growth paths and stages starting from the very beginning and establishment to the maturity.
Recalling the FCFF analysis presented above, high growth companies and newly established subsidiaries will have relatively higher net capital expenditures and working capital needs. In other words, the reinvestment rate will generally be high in high growth and declines as the growth rate declines. Similarly, as these companies are characterized by a higher risk, they generally do not use much leverage to finance investment needs. However, as the growth tends to settle on a stable rate, the firm will be much more likely to rely on debt capital, leading to an increase in leverage. The move to an optimal debt level is really dependent on the corporate governance arrangement and the relative power of managers with respect to shareholders, as well as the ease of access to debt market. Due to the substantial amounts of working capital and capital expenditure, the cash flows could be negative even though earnings are positive in this initial stage, when reinvestment needs are high. As the company (in this case the subsidiary) enters a maturity phases, the cost of equity should be more consistent with the characteristics and needs related to that stage. Notably, the beta estimated should be closer to one in stable growth, namely a lower value due to the lower level of risk. Here a comparison with peer firms could reveal useful to determine the proper benchmarks. The dividend payout ratio, which is much lower (if not zero) for high growth firms, should

[23] See Naylor, Chen and Boardman (2015)
[24] See *"Options, Futures and Other Derivatives"* (John Hull, 2015)

increase as the growth rate take on a stable value. Moreover, the competitive driver characterizing a high-growth company is strictly related to its ability to provide an excess return with respect to the cost of capital. Conversely, in stable growth phases the return on equity should either be equal to its cost or to an industry average.
As changes in the subsidiary's market risk exposure affect its cost of equity over time, the same behavior should be expected for the cost of capital. The underlying reason is to be found in the variations of the default risk to which the company is subject. These variations mainly hinge on how much volatile the earnings will be and how the financial leverage is expected to be adjusted as the firm's size changes. Another variable that must be taken into consideration is the tax rate and its change over time, entailing relevant consequences in its capacity to provide an effective tax shield.
As a closing remark, it is worth to point out that there is no predetermined blue print that can be relied upon for building the assumptions and the estimations. The way the model and the estimation's assumption are structured heavily depends on the internal and the external environment in which the subsidiary is set to operate. For instance, higher managers' competences combined with previous experiences providing sound data are likely to increase the accuracy of the model as well as the confidence whereby the time-length is chosen. Oppositely, the presence of several country/political risk factors as well as the opaqueness of the financial market could undermine the validity of the assumptions and the conclusion thereby drawn.

2.3.1 Estimating Revenues and earnings

When a multinational company wants to set a subsidiary in an emerging market to organize and carry out the its activity in that specific country, its ability to generate revenues over time has to estimated. For this purpose, two approaches[25] can be adopted and deployed in combination. According to the top-down forecast approach, revenues are estimated[26] by analyzing the total market, determining market share, and thereby forecasting price; alternatively, the *bottom-up* approach relies on the utilization of the company's own customer-related estimations (existing and potential demand, turnover).
For companies in mature industries the application of a top-down approach is eased by the predictability of the long-term trends about aggregate market and consumer preferences. For this reason, emerging markets deserve special attention as the economic and institutional environment is less easy to forecast and the historical/current information is often too scarce to plot reliable trends. However, this complication can be usually overcome in various ways. On the one hand, the company could leverage its multinational experience in dealing with troublesome valuations in similar markets, and on the other hand it could exploit the advices and guidelines provided by professionals and local institution. As for the formers, researchers[27] have shown that analysts' forecasts are more precise in countries that are more prone to welcome foreign business and foreign direct investment. Nevertheless, emerging markets appear to hinder also valuations performed by professional analysts. In fact, their forecasts tend to be less accurate in countries with a high level of governmental intervention, a high level of corruption, and/or with a less competitive environment. Moreover, financial analysts' predictions are less flawed in an environment characterized by stable growth than in one experiencing a sharply accelerating or decelerating business cycle. Taking a more bottom-up approach, in the search for benchmark whereby estimate revenues the company could also analyze the peers' past and current choices about the marketing levers. Obviously, the bulk of the revenues estimation hinges on the short and long-term growth objectives that the parent company sets for the subsidiary.

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[25] See *"Valuation: measuring and managing the value of companies"* (Tim Koller, Marc Goedhart, David Wessels, 2010)
[26] This kind of study is often outsourced to professionals
[27] See Coën, Desfleurs and L'Her (2009)

Regardless of the method, it would be naïve to assume that revenues forecasts will be precise over time. The underlying reason is that corporate strategies are likely to change according to the variation in technologies, customer preferences and market trends. Therefore, the MNC must continuously test the validity of the hypotheses drawn and the consistency of the predictions with the industry and competitive environment. The confidence on the method applied and the decisions made can be bolstered through the development of multiple scenarios able to mitigate and cope with uncertainty.

2.3.2 Estimating Cost of Capital

In emerging markets, the cost of capital can be assumed as a global cost of capital adjusted for the local inflation rate as well as the capital structure. Although less precise in not-developed financial markets, the CAPM should be used to carry out these estimations. As markets become progressively more integrated, it will be a better indicator of equity returns. Moreover, in estimating the cost of capital for emerging markets, analysts and managers should keep in mind that it is very likely to change through time because of evolving inflation expectations, changes in a company's capital structure and cost of debt, or foreseeable reforms in the tax system. Following the CAPM approach, the following paragraphs will address the estimation of the components of the cost of capital (WACC) as introduced earlier in the section about the FCFF model.

2.3.2.1 The cost of equity

Risk-free rate

In emerging market, the estimation of the risk-free rate starting from the governments bonds is not as straightforward as for developed countries. This difference is underpinned by two reasons. First, government securities cannot be labelled as risk free because of the political and economic instability already presented in the introductory chapter. Indeed, the ratings on the bulk of this debt is often below investment grade. Second, the financial markets are not enough developed to enable analysts to find liquid and actively traded long term government bonds[28]. One of the viable alternatives proposed by practitioners[29] is to start with the risk-free rate associated to the long term US government bonds (or other developed countries). Afterwards, to compute the nominal risk-free rate in the emerging market currency the difference over time between US and local inflation must be added[30].

Beta

Beta is a measure of the correlation between a certain asset's or industry's and the returns of a broad market index. The CAPM model is able to derive a solid estimation of a company's cost of equity capital

[28] Moreover, the long term debt is often denominated in foreign currencies (U.S. dollar, Euro, Japanese Yen, etc.) thus discounting the nominal cash flows to these rates would result in flawed estimation.

[29] See *"Valuation: measuring and managing the value of companies"* (Tim Koller, Marc Goedhart, David Wessels, 2010)

[30] The inflation differential can be calculated from the spread between the yield of local currency government bonds and the dollar denominated ones (the maturity must be the same).

even though there are no publicly traded shares. A broad panel of similar listed firms (perhaps in the same industry) can provide a good proxy for the risk characterizing a private firm.
As already mentioned, emerging stock markets share a number of risk-related features: small size, low liquidity, greater concentration, high volatility, low transparency and regulation. Thus, it is harder to find a relevant sample of listed peer companies having similar features. Furthermore, some emerging markets do not have any company listed for certain industries, and therefore, no industry betas will be available at the domestic level. For instance, Brazil and Russia have no locally-quoted biotechnology companies[31]. A viable solution could be the reliance on betas of the same industries in similar emerging markets, assuming that they are available, reliable and representative. Otherwise, the estimation process could be articulated in different progressive steps. As a starting point, analysts should broadly identify the industry or sector index in the either the developing country or, if available, the region where the subsidiary will be active. After having estimated the asset betas[32] for companies in the United States and Europe, the next step is to examine whether there is any relevant markup over time with respect to those derived for the emerging market index for the same sector. Finally, this premium is to be added to the beta estimated for the sample of US and European peer companies.

Market risk premium

The market risk premium identifies the ability of stocks to outperform bonds over the long run having sizable consequences for corporate valuation[33]. To determine the equity risk premium of companies in emerging countries represents a major challenge for many reasons. First, the local stock financial markets are often not even efficient in the "weak form", so stock prices cannot be used to estimate neither the expected return nor the beta. Moreover, the reliability of risk-free rates is doubtful as in many emerging markets as central banks closely control and manipulate short-term yield thus they cannot be assumed as good indicators of inflation expectations. All these aspects are worsened by the general lack of past information, given the short histories of trading in emerging markets.
The estimation of the MRP is arguably one of the most debated issues in financial studies, and no single method has gained universal acceptance. Indeed, researchers and practitioners split between the following two approaches:

- measurements and extrapolations of historical returns[34] as a proxy for future risk premium, assuming that the risk aversion has not changed in the period considered;
- application of a forward-looking analysis to the current financial ratios (aggregate book-to-market ratio or dividend/price ratio[35]) to infer the projected market risk premium.

Again, the assumption is that the risk therein considered is only the one with a non-diversifiable nature, thus country specific risk factors should not be considered in the MRP estimation. Indeed, the MNC could decide to minimize its risk exposure by placing the subsidiary(s) in countries affected by less or different risk factors.
All emerging market are characterized by a higher level of risk if compared to developed economies, but these factors are likely to vary also across the set of developing countries. Hence, emerging markets-related risk factors can be assumed to have both a not diversifiable and a diversifiable component, and the valuation models applied by MNC shall incorporate them accordingly. The non-diversifiable risks, often market-related rather than country-related, will have an impact on the MRP used to compute the cost of equity. In contrast, the effect of diversifiable risks will be taken into account in the development of either a premium adjusting the final discount rate or a set of different scenarios. In the financial literature there has

[31] Pereiro (2010)
[32] In order to avoid distortions due to cyclicalities or sudden crises, the long term beats should be taken into consideration
[33] See Soenen and Johnson (2008)
[34] Adjusted arithmetic average of long-term government bonds yields
[35] See Goyal and Welch (2003)

been the attempt of devising an alternative formulation for CAPM, adjusting it for country and political risks. However, the practice of adding country risk to CAPM estimates would violate the ratio of the model, according to which discount rates should reflect only non-diversifiable risks[36].

2.3.2.2 The After-tax Cost of Debt

Given the almost total absence of liquid market for corporate bonds in emerging markets, MNC cannot rely on the availability market information to estimate the cost of debt.
However, the cost of debt in local currency can be derived from the sum of the risk-free rate and the systematic part of the credit spread[37], all adjusted for the inflation differential between local currency and dollars (or euros). Here the systematic part of the default risk can be assumed no to be higher than that of companies in international markets, thus the cost of debt must not include an additional country risk premium.
Moreover, the effective tax rate in emerging markets is inclusive of many elements, that are for instance investment tax credits, export tax credits, taxes, equity or dividend credits, and operating loss credits. However, some of these arrangements cannot be included in the WACC estimation as they do not provide a tax shield on interest expense. Therefore, these taxes or credits must be directly modeled into the cash flow projections.

2.3.2.2 WACC estimation

The cost of equity and the after-tax cost of debt computed according to the previous paragraphs have to be weighted for the planned capital structure of the subsidiary. It is worth to acknowledge that, in emerging market many companies are reported to have unusual capital structure compared to the other firms of the MNC network. As it will be explained later, these distortions are mainly due to the country risk and the likelihood of macroeconomic distress. However, another factor underlying these anomalies is the access to the local debt and equity market, often different and less developed than the home-country one. At this point, the company should forecast the capital structure trend keeping in mind that in the long run these irregularities are corrected, leading to leverage values more similar to those of peer companies. As for the ways to incorporate country risk in the valuation, if the "regular" DCF assessment is carried out instead of a scenario analysis a premium for this risk must be added to the WACC. Like for the MRP estimation, there is no agreed-upon approach to determine the country risk premium. However, one of the alternatives that could be applied is grounded again on the analysis of the long-term (e.g. 10 years) government bonds. According to this method, long-term country risk premium corresponds to the difference between a long-term U.S. government bond yield and a dollar-denominated local bond's yield having the same maturity. The result thereby obtained is a proxy for the country risk premium only if the FCFF trend is correlated to that of government bonds payments. A possible way to check the validity of the value estimated is to triangulate this result with those of the alternative valuation models available.

[36] See Abuaf (2015)
[37] Resulting from the rating differential between an A-rated developed-country corporate bond and another. The underlying assumption is that a certain rating differential entails the same cost of debt spread for emerging and developed countries.

2.4 Subsidiary coordination arrangements v. Valuation models accuracy

As a concluding remark of this chapter on the valuation methods, it is worth to present a parallel but interesting implication. Companies undertaking strategies of international expansion are often reported to incur substantial ''hidden costs'' when implementing these activities in a foreign country[38]. For example, local labor costs may suddenly rise beyond expectations or the relocation abroad of certain activity requires more resources than originally assumed. Firms sometimes fail to have a sufficiently wide and deep view of their investment, being unable to foresee the far consequences of the related decisions. There are many internal and external reasons leading MNCs to commit estimation mistakes, namely environmental complexity, regulation misunderstanding, and the interaction distance and intensity. However, to better understand the relevance of the (often underestimated) issue it is worth to focus on the consequences of these errors.

Indeed, the inability of the MNC parent company to properly estimate the cost emerging from the establishment of a subsidiary in a foreign emerging country is demonstrated to have a negative impact on the activities performed by the latter. The operations of the activity are expected to suffer from resource misallocation and managerial distraction as a consequence of flawed cost estimations.

However, specific mechanisms aimed at coordinating the foreign venture can influence and curb the negative impact on overall performance in important ways. Since cost estimation errors can be often intended as a local problem requiring a likewise local solution, coordination through modularity provides local subsidiaries with the autonomy to solve the problems caused by cost estimation errors internally and preventing contagious effect on other units. On the contrary, setting up a coordination arrangement based on ongoing and close interdependence would leave the foreign venture with less autonomy to win out the challenges caused by cost estimation errors. This therefore exacerbates the negative consequences on overall performance. These results point out that the decisions regarding the mechanisms enforced by the MNC to coordinate its network (and notably the newly established subsidiary) have implications on the amount of resources dedicated to increase the accuracy of the valuation methods employed. Indeed, the coordination through modularity could increase the appetite for estimation risk. In other words, the company must consider the role played by the coordination process chosen in the trade-off between the accuracy and the costs of the valuation model.

[38] See Larsen (2016)

3. ENTRY MODE STRATEGIES AND FDI TYPOLOGIES

3.1 Introduction

MNCs striving to reposition themselves in their markets or supply chain as a reaction to changes in the external and internal environment often need to acquire new and complementary resources. Amid the strategies through which the company can achieve these goals, the subsidiary establishment in a foreign country takes on a prominent role.
The establishment mode choice is fundamentally a long-term management decision, grounded on the kind of resources needed by the MNCs and the ways whereby it plans to seize them. If the company enters the foreign market as a Greenfield investor, it might seek and obtain specific resources such as real estate and labor setting up a subsidiary from the ground up. Conversely, as a partner in a joint venture it could access the resources of a local partner with the restrictions imposed by the agreement, sharing the control over the operations. Moreover, as an acquirer it would be able to attain an already existing set of resources, including inputs that are valuable and some resulting redundant. Yet in the case of a Brownfield investment, this set of redundant/valuable resources will undergo a process of complex restructuring, integration and, sometimes, disposal.

	Acquisitive	**Platform for growth**	**Organic**
Full Ownership	Full acquisition	Full Brownfield	Full Greenfield
Partial Ownership	Partial acquisition	Partial Brownfield	Joint Venture

As a first clarification, firm specific advantages cannot be regarded by themselves as an obvious guarantee for a strong economic performance of foreign subsidiaries. In fact, specific cultural, economic and political factors of the host environment act as entry barriers affecting the performance of the subsidiary once it is established. A first way for the MNC to address these obstacles successfully is to choose the appropriate entry mode consistently with the need of fitting its internal resources to the host country environment. Furthermore, the choice for the appropriate entry mode will have effects stretching far beyond present establishment and performance. Indeed, over time it will enable the subsidiary to better entrench and defend the new position gained. The decision to opt for one approach rather than another entails different implications as to the implementation costs to be borne as well as the post-entry economic performance. Moreover, the appropriateness of the entry mode chosen is expected to hinge on the strategy developed by the MNC as well as on the coordination structure adopted. For instance, researchers have shown that acquisitions carried out by Dutch MNCs outperform Greenfields at a low and intermediate level of affiliate integration, but at higher integration levels the results are opposite[39].

[39] See Slangen and Hennart (2008)

3.1.1 The implication of firm specific advantages on the entry mode choice

Given the presence of numerous risk factors in the host environment, the entry mode alternatives represent different ways to address and cope with them. Nevertheless, the company's internal environment must be consistent with the entry mode chosen. Notably it must be endowed with the proper resources to be able to deploy effectively a specific strategy and overcome the host country entry barriers[40]. Thus, the company shall adopt a double perspective when facing the decision as to whether perform a Greenfield FDI or a cross-border acquisition. MNCs are usually reported to consider the former option when their firm specific advantages are such to win out the transaction costs arising from the ground-up settlement of operation abroad. However, Greenfield ventures are negatively affected by the additional costs of the liability of foreignness combined with the liability of newness.

Unlike acquisitions, this kind of investment increases substantially the cost borne by the subsidiary for the adaptation to the local environment. Moreover, Greenfield investments imply the presence of more risk factors as the new projects start from the very beginning of the learning curve (liability of newness).

Conversely, the MNC could acquire an existing local firm that is already well established in the host market. The synergies thereby sought stem from the combination of the MNC core abilities with the subsidiary's resources and specific advantages. The new combined set of firm specific resources may then enable the subsidiary to better overcome the transaction costs barrier and to improve its position on the local market. In fact, brownfield acquisitions might quicken the reaction of the subsidiary to changing market conditions and to strategic moves of the competitors by strategically exploiting the resources of the existing firm.

On the contrary, when the entry strategy chosen is the Greenfield, the MNC is relying entirely on its own capabilities. Thus, the resilience of the subsidiary in the foreign emerging country is determined mostly by the parent company's competitive advantages. Undertaking this path, the parent company implicitly accepts to commit more time and resources for planning, establishment and market positioning.

As explained earlier in the introductory chapter of the present work, a new foreign venture is usually established through a progressive growth process starting from small outposts. Meanwhile foreign bidders focus on already existing local firms with growth potential but well established. Thus, the cross-border acquirers are better prepared to attract sufficient demand on the local market from early on, and to build on economies of scale. Greenfield investments might be able anyway to take premium prices if their products are protected by substantially competitive and firm specific factors. However, economic performance could be anyway undermined by the host market relatively small size and the presence of specific relevant costs for the creation of a new market. Taking the case of the Greek economy[41], subsidiaries established through cross-border acquisitions are reported to have larger market share, a bigger firm size, higher capital intensity of production, and more differentiated products.

Summarizing, the general superiority (reflected in the subsidiary competitive advantage) of cross-border acquisitions with respect to Greenfield FDI is underpinned by two factors. First, the exploitation of the strong and entrenched market position of the local firm. Second, the greater pool of dynamic firm specific advantages created consequently to the synergies sought via acquisition. However, the absence of a relevant company size (and bargaining power) or, conversely, the presence of sizable positive network effects and bonds with local institution could lead the company to opt for the Greenfield approach. Furthermore, Greenfield investment could reveal the best option when takeovers suffer the instability and imperfections characterizing emerging market. For instance, a company could face the opposition of the local institutions, or such an operation could appear too complex due to the not sophisticated regulatory framework and financial market.

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[40] See Georgopoulos and Preusse (2009) on the role of specific resources in the entry mode choices of MNCs entering the Greek market

[41] See Georgopoulos and Preusse (2009)

As a closing remark, it is worthwhile to point out that the decision-making process of the MNC's managers could be biased in several ways. In fact, it has been demonstrated that such companies sometimes rely on past decision when faced with the issue as to which entry mode (or ownership structure) opt for[42]. The existence of a preferred entry modes is stronger when these strategies can be easily reproduced. Moreover, researchers[43] have shown that the reliance on preferred strategies is mitigated by the differences in the institutional environment, preventing the MNC to devise one-size-fits-all solutions. However, experience and internationalization speed, reinforce the use of preferred entry modes.

3.2 Brownfield Acquisitions

As explained before, cross-border acquisitions allow the MNC to skip the first steps of the new venture establishment in a foreign market. These operations engender operating and financial synergies carrying relevant strategic implications, enabling firms to reshape their scope to boost growth.
Usually, these transactions and the following integration require significant organizational changes to be made in the target firm. In setting up the envisaged transaction, the cross-border acquisition may be followed by the redeployment or divestment of parts of the acquired operation, be they specific assets (real estate, HR) or whole business units. Such acquisitions characterized by extensive restructuring can be referred to as "Brownfield"[44]. An interesting case pointing out the restructuring process following the acquisition is the Pollena-Lechia (Poland) takeover by Beiersdorf (Germany) in 1997[45].

3.2.1 Valuation differences as drivers of cross-border acquisition

From a merely conceptual perspective, the reasons underpinning cross-border acquisitions are the same underlying domestic ones. However, they are affected by other factors that really depends on the transnational nature of the transaction and on the countries involved.
First, geographical as well as cultural distance is likely to increase the transaction costs related to the acquisition. In fact, mergers are more likely to occur between companies belonging to countries that already trade commonly with each other, as they are supposed to share a common cultural background. Governance-related drivers may explain cross-border acquisition as long as the new subsidiary can benefit from enhanced governance and control standards. Furthermore, the tax-system is expected to influence the investment decision since the acquirer is more likely to belong to a higher corporate taxes country with respect to the target. All these variables taken together are likely to be conceived either as barriers or drivers, depending on the specific context and the way they manifest.
Of particular interest are also differences in economic and financial valuation, whose underlying assumptions and factors are subject to fluctuations in exchange rate, imperfect integration of stock market

[42] See Benito et al. (2009)
[43] See Swoboda et al. (2014)
[44] See Meyer and Estrin (2001)
[45] As explained in Estrin and Meyer (2009) "(The) Polish ex-state owned company held the rights in Poland to the brand "Nivea", which was Beiersdor's primary brand worldwide. Yet, otherwise, Pollonia- Lechia held few resources of interest to the German firm. Beiersdorf failed to acquire the brand as such (nor did they succeed in their legal challenges to the Polish firms' claims). Hence, the only way to control the brand was to acquire the entire firm, and then to turn it upside down: The Beiersdorf management added a new, parallel organizational structure to market the Nivea brand along Western standards. The new departments for marketing, human resources and logistics recruited selected personnel from the old firm, but operated largely independent of the old structures. This set up allowed the restructuring to run smoothly."

and macroeconomic changes. Comparing changes in the exchange rate between the acquirer and target currencies before the acquisition, changes in the two countries' stock market valuations, as well as differences the two countries' market-to-book ratios, acquirers are reported to outperform targets by all measures[46]. Apart from the operating synergies that are sought by the MNC and the country-related issues, the presence of these elements contributes to explain the preference for a cross-border acquisition over a domestic one. An explanatory example is the currency fluctuation. If a company's currency appreciates for exogenous reasons, it could deem foreign target relatively inexpensive increasing the potentiality of an acquisition. At this point, other companies belonging to the inflated currency-country are likely to undertake the same behavior. Indeed, the financial literature has demonstrated that short-term fluctuations of the currencies of two countries increases the likelihood of an acquisition to be carried out by the company with the appreciating currency.

Moreover, the tendency of a company to merge with a foreign target is affected by the relative stock market performance. Again, the better performing firm is reported to take on the role of acquirer in the transaction, and the larger is the differential the greater is the likelihood for the acquisition to happen.

The double effect of exchange rate fluctuations and stock market performance points to a general tendency according to which higher valued firms acquire lower valued ones. This propensity is also explained by the wealth effect due to a lower cost of capital[47].

However, the effect of valuation differences on the likelihood of cross-border acquisitions ultimately depends on the permanent or temporary nature of the fluctuations[48]. If these differences are only temporary, the MNC's management has the chance to exploit profitably the inflated currency issuing their overvalued shares to purchase the asset of the target company. Instead, if the valuation differences are permanent, the attractiveness of the transaction would be supposed to be unaffected by the fundamentals' fluctuations. Nevertheless, there are cases in which permanent changes could make a potential target appealing for foreign bidders. For example, the profit of an exporter could increase after a permanent strengthening of its currency, making this company attractive for foreign acquirers. Alternatively, when a company's value increases with respect to the local peers, its cost of capital would be expected to lower under foreign control. This variation is likely to facilitate foreign MNCs' bids rather than those of domestic firms.

Anyway, it is worthwhile to point out that the solidity of the relationship between valuation differentials and cross-border acquisition substantially hinges on the information asymmetry intensity.

3.2.2 A RBV and IBV approach to Brownfield Investments

Which are the drivers in terms of institutions and potential acquisition targets leading MNCs to undertake a brownfield acquisition rather than alternative entry strategies? Which will be the consequences on the subsidiary's strategy in the wake of this kind of investment? This paragraph's aim is to provide an answer to these two basic questions, starting from two paramount theories in the field of economics, namely the resource based view (RBV) and the institutions based view (IBV). The principle underlying the RBV[49] is the conception of firm-specific resources as the ultimate driver for competitive advantage. When applied to FDI, it focuses on the resources exploitation and exploration throughout the investment and the subsidiary's life, shaping its growth path. MNCs entering foreign emerging market through cross-border acquisitions expect the subsidiary to thrive through the combination of the already owned resources with

[46] "The difference in firm-level stock returns in local currency is 10.38%, 19.34%, and 23.36% for the 12, 24, and 36 months prior to the acquisition, respectively. In addition, the average market-to-book ratio is higher for acquirers than for targets, mirroring prior findings for domestic mergers", Rhodes-Krompf and Viswanathan (2005). As reported in Erel, Liao and Weisbach (2012), these spreads are even higher when the acquirer and the target belong respectively to a developed and developing country

[47] See Froot and Stein (1991)

[48] See Erel, Liao and Weisbach (2012),

[49] See Wernerfelt (1984) for further details on the Resource Based View

those possessed by the target. Brownfield is a compelling entry mode where the target firm's size and value is far lower than that of the acquirer. Notably, the privatization process in many emerging economies led to a major underpricing of assets, which biased MNCs entry modes in favor of cross-border acquisition. In a more general sense, cross-border acquisitions will be attractive to multinational companies able to exploit highly specific complementary resources representing a sizable competitive advantage for local firms. The latter indeed are in the position to gain from connection to political elites or local institutions, as well as the specific knowledge of the industry. However, they are often devoid of managerial and technological competences or financial resources. Given the will of the MNC to seek resource-based synergies, the decision as to whether undertake a brownfield investment is mitigated by the specific characteristics of the institutional environment (IBV[50]). The importance of institutions is connected the extent and way they affect the costs of doing business in the foreign emerging country. Indeed, they have a role in defining transaction costs as well as agency costs, altering and shaping the corporate governance systems. Moreover, regulators could affect the subsidiary overhaul by enacting body of rules (regarding for instance labor and lay-off decisions) representing sever obstacles to the acquisition strategy[51]. These factors could drive the MNC to opt for alternative ways to enter a certain market. Developing countries are thus subject to extensive "institutional pitfalls" pushing the foreign investor to devise specific strategies to bypass or overcome the problems arising. However, the effect of the different institutional forces in play is not straightforward, and it is likely to have multifaceted impact on MNC decision-making process.
On the one hand, specific institutional obstacles can be overcome with the support of local partners, thus making brownfield acquisitions more advantageous. The support may result in an enhanced understanding as to how to deal with local bureaucracy concerning business regulations or in becoming more sensitive to critical aspects of local culture and tastes. On the other hand, other institutional obstacles may affect certain organizational overhauls, for example restrictive labor and tax regulation or corruption. These kind of hurdles are likely to turn brownfield investments less advantageous. Apart from downsides and upsides related to this entry mode, Brownfield acquisition represents a particularly high commitment given the investments and resources required at the outset as well as in the post-entry period. The willingness of the MNC to bear these costs can be explained adopting a RBV approach[52], therefore considering Brownfields as part of a firm's resources reconfiguration process. According with this view, one of the ways MNCs thrive is by redeploying resources not fully exploited in the current process. However, in order to maximize the utilization efficiency of these resources, companies may be required to either acquire complementary inputs or dispose of those available yet not valuable. In the context of an emerging country, the complementary resources may consist of key nodes of a distribution network, local brands, political connections and key staff, that can then be combined with the MNC's global resource and competences.
Thus, cross-border acquisitions may be conceived as not isolated and singular events but rather as elements of a broader strategy.

3.2.3 The role of the institutional context in determining the entry mode and the MNC investment policies

As anticipated earlies, emerging market represent a challenge for MNCs as the latter are faced with institutional obstacles hampering the therein established subsidiary to prosper. These institutional obstacles might be rooted in the public authority, as it is often imbued with red tape and corruption. Its role is evident also in its power to enact unfavorable regulation or tax-system, and in the inefficiencies characterizing the enactment process. The local financial market and the rules governing it represent a further hurdle. Access to debt or equity financing is troublesome due to the lack of transparency and clear rules, lowering the liquidity and reliability of these markets.

[50] See Peng et al. (2009) for further details on the Institutional Based View
[51] See Capron and Guillén (2009)
[52] See Penrose (1959), Tan and Mahoney (2007)

In a context where such institutional barriers are present, companies are likely to devise adaptive strategies and organizational structures to better cope with them. An example is the development of networks enabling firms to curb information asymmetries and the other transaction costs typical of emerging countries[53]. However, MNC are likely to lack the context-specific resources and competences to deal with the institutional obstacles. Thus, the adoption of cross-border acquisition as entry mode could be intended as a counter strategy to obtain the competences needed to survive in an unfavorable institutional environment. The MNC must be anyway aware of the need of integrating the local organizational with the global structure. This issue is due to the wide set of differences (cultural, governance-related, organizational) present between companies operating respectively in a developed and developing country. In such a context, the prospect to undertake radical changes and restructuring on the subsidiary arises in order to ease the integration process, further complicated by the institutional weaknesses.
These arguments suggest that brownfield acquisitions are more likely to be carried out when MNC are compelled to sidestep the institutional gaps, for instance those related to the strength of property rights[54].
The safeguard of property rights includes the absence of threat of expropriation, independence and incorruptibility of the public authority, and the ability of companies to enforce contracts. If problems were not expected to rise in the aforementioned issues, MNC would not need to undertake deep and costly overhaul. Moreover, recalling the transparency-related issues, companies are often lead and required to minimize potentially corrupt interfaces and unethical practices. When these behaviors are tolerated within the target firm, the MNC will face relevant challenges of organizational culture change to integrate and adapt internal activities. As stated before in displaying the IBV perspective, institutions play a relevant role in shaping the regulatory ground for post-acquisition processes and restructuring. Rigid bureaucracy as well as pressure from local powerful stakeholders may obstacle or delay the execution of investments and processes. They could also affect the relationship with suppliers, customers and the distribution chain.
Differences in organizational cultures are often associated with differences in the employment regulation, leading to cases of resistance against the MNC managerial practices and HR organization[55]. These constraints are exacerbated if local trade unions or employee representations are provided with strong bargaining power. This could undermine the implementation of the whole restructuring process whether it envisages a reduction of the workforce or wage cuts.
Anyway, institutions could affect positively the industrial environment. When this happens, MNCs should reconsider their assumptions as to whether the brownfield acquisition is the best choice. Take for example the case in which the institutional framework directly stimulates the establishment of new firms within the national borders. In such a context, MNCs are likely to opt for another entry strategy, namely the Greenfield FDI, the joint venture or the "regular" acquisition. The explanation can be found in the fewer integration costs arising from the combination with a young firm rather than an old one. In fact, the latter is expected to have accumulated substantial administrative heritage and organizational inertia[56].

3.2.4 The role of subsidiary's strategy in determining the entry mode and the MNC investment policies

The entry mode decision first and foremost hinges on the objectives that the MNC aims to attain with the new subsidiary. Therefore, the strategic role of the subsidiary within the network will affect the extent of restructuring and improvements that the parent company is willing to undertake.
Given the addition of the restructuring costs to those related to the acquisition, Brownfield acquisitions are undertaken only when the strategic advantages of the subsidiary exceed and justify the associated higher

[53] See Peng (2003), Danis et al. (2010)
[54] See Estrin and Meyer (2009)
[55] See Björkman et al. (2007)
[56] These issues are more frequent when the target belongs to a more restrictive regulatory regime, or even to a history of state-ownership and/or central planning as is common in transition economies.

costs. These strategic advantages and directions are defined through a specific combination of the aforementioned complementary resources. Fundamentally, they are on the one hand technologies and organizational arrangements rooted in the global organization, on the other hand distribution networks, local brands, and reputation with local institutions[57]. Furthermore, subsidiaries that are large relative to the size of the parent firm are also reported to be strategically more relevant. The reason is that a higher financial performance is thus expected, requiring a consistently greater degree of control and effort in the restructuring process. Their financial performance will make a greater contribution to the parent company.
Moreover, if the interface between the subsidiary and other parts of the MNC network is larger, a special care needs to be dedicated in carrying out the proper changes aimed at smoothing and ease this interface.
As for the geographical scope of the subsidiary, the MNC will be required to calibrate its commitment depending on whether the former is mainly aimed to serve the local market or to have a transnational breadth. In the first case, if a subsidiary is mostly designed to support the MNC in spreading its products in the local environment, it is reasonable to expect that the target already possesses the bulk of the capabilities needed. Therefore, the parent company will be required to carry out a less extensive overhaul of the current operations. The focus will be just on an enhancement of the competitiveness with respect to the local companies. However, when the goals of the subsidiary stretch beyond the emerging market national borders, the MNC will be compelled to perform a higher and more pervasive upgrade of the existing activities, reorganizing all the internal processes and reconfiguring the resources deployed. The higher effort is here also explained by the actual inclusion of the subsidiary in the global supply chain of the MNC, therefore specific qualitative and organizational standards shall be enforced.
Further insights can be drawn shifting the focus on the overall MNC network. Transnational companies thriving only on a geographical basis while being specialized on a single industry are more likely to rely on a uniform global business model. This strategy is often based on an organic growth rather than on the deep restructurings of the existing structures. Conversely, highly diversified conglomerates are supposed to have built their multinational basis through a series of acquisitions as well as the development of specific competences aimed to manage and integrate the new operations. Such a diversification is possible only under the Brownfield investments entailing profound overhaul of the target companies to allow for a coordinated network[58].

3.3 Greenfield FDI

As anticipated earlier, another way a MNC can set up a new venture in a foreign emerging market is the Greenfield FDI. According to this entry strategy, the company starts an activity (i.e. its subsidiary) in a foreign country from the ground up, with no resources, facilities or network already existing. Instead of obtaining the needed complementary resources directly acquiring an already established company, the MNC's affiliate must build new networks and develop new resources from scratch.
Indeed, the success of a subsidiary established following a Greenfield approach ultimately depends on the capability of its managers to build and foster a supportive local network so as to better interact and cope with the institutional environment.
This capability is deemed the cornerstone of such a strategy as the local industrial and institutional environment is likely to pose harder obstacles and complexities to the establishment of a new venture with respect to the development of a subsidiary through acquisition. These tougher challenges are the reasons why Greenfield FDI researchers often start from the institutional-related literature applying it to the local environment where the subsidiary is set to operate[59].

[57] See Cheng (2006)
[58] Estrin and Meyer (2009)
[59] See Drogendijk and Andersson (2013)

3.3.1 The Greenfield FDI environment and network

Despite of the overall shift towards a globalization of markets and trade, this development has not fully (if not at all) reached many emerging economies. Thus, MNCs expanding in these directions are expected to suffer even more from the already mentioned liability of foreignness, worsened further by the liability of newness. In order to overcome these liabilities, MNCs and their subsidiaries must learn how to operate in the specific market avoiding the harsher institutional pitfalls and voids. To do so, they must develop and foster a new network allowing them to thrive and gain legitimacy in the host environment.
These local relationships are expected to provide the resources that are not acquirable though a process of "learning by doing", namely raw materials, financial resources and influence[60].
The new networks in order to support effectively the development of the subsidiary should encompass both market and non-market actors. Widening the scope of the relationships, the new venture can rely on a broader set of resources and contributions to challenge the various environmental obstacles. Market actors are those affecting more directly the business operations and opportunities of the subsidiary, while the non-market actors are those defining guidelines and rules likely to influence the boundaries and scope of the subsidiary's operations. For example, the former category includes suppliers, distributors, customers and competitors. Conversely, the latter comprehends either governmental or non-governmental organizations (NGO), both local and international. In order to close the circle, public opinion influencers like the media should also be taken into account, given their capacity to undermine the fragile legitimacy of the newly established subsidiary.
However, dealing with powerful stakeholder not only provides additional and precious resources, but also at the same time puts the subsidiary under the pressure deriving from the interest and purposes of these actors. This is especially troublesome as these interests are, as often so, conflicting with each other representing trade-offs that the subsidiary must consider in choosing a strategic path. Indeed, actions undertaken by subsidiaries in order to increase their legitimacy and embeddedness in the local environment might in the meanwhile decrease their legitimacy and embeddedness within the MNC, and vice versa. For instance, the compliance with local practices and rules might contrast with the demands and instructions set forth by the parent company[61]. This could be the case of HR policies, as local regulation may require the subsidiary to adopt specific training and incentives schemes deviating from those demanded by the MNC headquarter. Alternatively, the subsidiary could be required to adapt its productions processes in order to fit the local technological conventions in a way that contrast with the MNC procedures. All these issues might impede and delay the flow of resources and knowledge within the MNC network.
The choice of the strategic direction from this perspective is often connected with the choice of which compromises and claims to accept and which to ignore, as well as the extent to which such commitments are undertaken. These decisions substantially depend on the ways the subsidiary prioritize the different stakeholders' claims. Accordingly, managers are likely to assign a more relevant role in the priority ladder to the actors providing resources to which the subsidiary has a critical dependence. This suggests that the more the new venture's survival relies on resources flowing from another organization, the more intense and committed the relationship with it should be. Moreover, the commitment should be greater if the relationship is particularly complex and demanding, when for example a multi-dependence is created and more actors are involved simultaneously. As the subsidiary is subject to the interplay between expectations and demands coming from the external local environment and the MNC[62], it has to decide carefully how to respond to such pressures and how to manage those relationships. Furthermore, while managing this interplay the subsidiary's management must not neglect the claims of the other relevant stakeholders in order to build a solid network.
Therefore, the following sections will address specifically the main actors involved in the Greenfield network.

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[60] See Hillman and Wan (2005)
[61] See Kostova and Roth (2002)
[62] See Andersson, Forsgren, and Holm (2007)

3.3.2 The role of the MNC Headquarter

The parent company is the actor mostly involved in the decision making process regarding the establishment of the subsidiary and the choice of the host market. As stated earlier, if the investment takes place as a Greenfield expansion, the parent company must commit its own resources, regardless of their financial or not financial nature. Consequently, the new venture is supposed to be highly dependent on the financial, technical and managerial support of the parent company, and the headquarter maintains a hands-on control over it. Indeed, it has been shown that subsidiaries are often granted a period (usually few years) in which they are not expected to neither break-even or to financially contribute more generally to the overall MNC[63]. The higher is the dependence to the parent company, the greater is the pressure faced to emulate the internal processes and comply with the MNC's standards and routines in order to increase its internal legitimacy. However, as the subsidiary thrives and develops in the local environment, this dependence is likely to phase out because of the increased control over its activity and the accumulation of resources and capabilities. Nevertheless, even if the relationship strength decreases over time, both the headquarter and the subsidiary must ensure that a minimum level of exchange exists. In fact, if the relationship loosens beyond a desirable threshold, the subsidiary far from the parent company's resources could face the risk of divestment. Recalling the jargon introduced in the first chapter, the subsidiary maintains its role of "implementer" of the head quarter's resources and capabilities (strategy, products, knowledge, technologies, and internal processes)[64]. As the subsidiary grows further, the relationship progressively becomes an interdependence since it creates specific and unique resources. Therefore, new roles within the MNC network are taken on ("Innovator" or Leader")[65]. In order to facilitate the increasing exchanges of resources it is important to reinforce back the relationship in this stage of subsidiary life cycle.

3.3.3 Other subsidiaries within the MNC network

The dependence relationship characterizing the Greenfield subsidiary in the early stage is built not only towards the parent company, but also with respect to the other subsidiaries ("sisters") within the MNC. This latter dependence hinges on the capabilities and resources that the subsidiaries have gathered dealing with similar problems and opportunities, though in different countries or institutional environments. Thus, the new venture can rely on the experience and learning process through which the existing subsidiaries have already gone. Moreover, at the outset the relationship is not very strong since it occurs only indirectly, through the decisions and actions of the head quarter. As the relationship with the parent company evolves when the subsidiary becomes more independent, a similar interdependence will be established with the sister subsidiaries. After the early stage, the new subsidiary is likely to have progressively established its "own" relations with the other units, relying on them for further development of resources and capabilities. Thus, as the subsidiary turns more mature, it will provide sister subsidiaries with internally fostered resources and competences.

3.3.4 Local market actors

After having briefly analyzed the relationships with internal MNC actors, it must be acknowledged that the resources to which the Greenfield subsidiary is dependent come for a great extent from the external

[63] See Drogendijk and Andersson (2013)
[64] See Phene and Almeida (2003)
[65] See Ambos and Schlegelmilch (2006)

environment. As anticipated earlier, the newly established subsidiary must build relationships with market actors like suppliers, customers and distributors acting as bridges towards the local market and institutions. Moreover, they must learn where to find information and how to exploit them effectively to prosper in the new business. The higher the quality of this learning and resource gathering process, the better will be the business opportunities present in the local market. This last statement underlies the importance of the establishment of a local business network enabling the company to obtain complementary resources and capabilities as well as support in dealing with local institutions[66]. The capability of the subsidiary to prosper in the host market is ultimately dependent on its ability to fit its resources with those provided by the local partners to cope with the challenges posed by the foreign market. The combinations of resources sourced from within the MNC with those locally provided, the subsidiary increases its capability to learn and generate unique resources and capabilities. Again, the relationships with local market actors will in turn change from one of dependency to one of interdependency, allowing the subsidiary to gain legitimacy and acceptance as well as grow further. The centrality of the development of local network for the subsidiary to prosper in the foreign country is supported by empirical findings: indeed, the lack of these relationships is likely to drive the Greenfield FDI out of the new market[67].

3.3.5 Governmental actors

The subsidiary, beyond internal and market-related actors, must also face non-market actors having a role in determining the social, political and legal framework in which the former is set to operate. The company must respond to the pressure and expectations of such actors as the lack of their support could seriously jeopardize its business in the host country. Complying with the requirement set forth by the local government is paramount in order to gain legitimacy. However, this behavior has consequences also on the subsidiary's performance and opportunities given the direct effect of regulation on the local business and competitive environment. Moreover, as for the aforementioned institutional obstacles, the relationship with local regulatory bodies might solve them facilitating the exchange (and lowering the cost) of information and the provision of various kinds of support. The relationships with these actors are first started by the negotiation activities performed by the MNC before the actual establishment of the Greenfield FDI. On this ground, the subsidiary has to develop its own ties with local regulatory bodies in order to better follow and adapt to the changes that may occur over time to rules and laws affecting its activity. One of the viable ways to gain acceptance is through hiring local employees with already strong connections with the most important institutions[68]. However, even though building solid relationships with institutions may appear specifically important in the early stage of the new venture, these connections take on an equally relevant role in the later stages of development. In fact, as the subsidiary grows in size, it will increasingly be affected by changes in the regulation, therefore needing an even stronger legitimacy in the political environment to curb these negative impacts[69]. The weight of strong relationships with local government officials is even greater in politically and economically unstable countries, like China or Eastern European markets. Furthermore, in these countries where the political authority on the market is large the strength of the relationship is more likely to be maintained at a higher level over time.

[66] See Phene and Almeida (2003)
[67] See Olivier (2001)
[68] See Kostova and Roth (2002)
[69] See Hillman and Wan (2005)

3.3.6 Non-governmental actors

Among the actors involved in the network built by the subsidiary there are groups that do not provide resources directly, but can anyway affect its legitimacy and the success of its activity. The likelihood of being affected by the influence of these non-governmental actors increases with the size of the subsidiary. Moreover, these relationships gain greater importance in the later stages of life-cycle rather than in the Greenfield start-up.
Both local and international public opinion activists are reported to have a large impact on the overall MNC decisions and strategies, since the reputational capital has been taking on increasingly importance in recent years. This trend underlies the need for the development of political strategies to address non-governmental actors. Indeed, in recent years MNCs and their subsidiaries have become more vulnerable to the critical judgment of public opinion and NGOs, especially when they operate in industries that are monitored carefully for their environmental and social consequences (like chemical industry, food and beverages, toys, textiles, and extraction of natural resources).

3.4 The Ownership Mode Strategy

MNCs must undertake two strategic and interlinked decisions when they want to establish a subsidiary in a foreign emerging country. The first one concerns the already discussed entry mode strategy, distinguishing essentially between cross-border acquisition and Greenfield investment. The second choice involves the ownership mode strategy. According to the strategy chosen the parent company determines the level of equity commitment, that can lead to either a wholly owned subsidiary or a joint venture with one (or more) local partner[70].
The two choices, although closely correlated and influencing each other, can be undertaken separately. Indeed, without considering the specific characteristics of the MNC and the environment, a subsidiary can be wholly or partially owned regardless of the entry mode chosen.
Deepening the analysis, a first fundamental ownership structure that can be adopted by a MNC entering a foreign market is represented by the joint venture (JV). The implementation and management of this typology is more complex than the wholly owned subsidiary (WOS), and it can be further divided into dyadic (DJV) and multi-partner (MJV). According to the former, the MNC undertakes a single relationship with a local partner, while the latter case involves two or more foreign or local partners[71].
The additional complexities arising from the establishment of a JV increase further when MJV are considered instead of DJV, and the explanation is dual. On the one hand, as the number of partners involved is higher, the possibility for them to engage in free-riding behaviors increases[72]. On the other hand, a higher number of relationship within the JV may lead to the creation of sub-partnerships and dysfunctional coalitions[73]. For these reasons, MJV are generally deemed more unstable as the parties are incline to bargain aggressively for each other's resources, seeking control over the whole operation.
As it will be further pointed out later, the presence of inefficiencies in the host market is likely to lead to the emergence of JV rather than WOS, since it provides more chances to cope efficiently with the higher transaction costs and uncertainty. Indeed, in such contexts the benefits of joining forces are expected to outperform the additional costs deriving from information gathering, operation monitoring and contracts enforcement. It is argued that the gains of JV are likely to be greater than those related to a WOS also because of the synergistic effects of integrating the MNC existing resources and capabilities with the local partner.

[70] See Slangen and Hennart (2007)
[71] See Beamish and Kachra (2004)
[72] See Gong et al. (2007)
[73] See Garcia-Canal et al. (2003)

There are alternative paths whereby the additional costs of a JV can be mitigated. For instance, specific arrangements driving the partners to adopt a longer-term view might reduce short-term opportunistic behaviors. When they are combined with incentives to share information between the parties, transactions costs and other asymmetries can be reduced. Nevertheless, the benefit of these arrangements are coupled with the risk of losing proprietary knowledge with respect to the partner.
The equity commitment involved in the establishment of DJVs implies that both the partners share profits and losses. This mutual influence position might help aligning the interests of the parties thus reducing the likelihood of opportunistic behaviors. However, matters differ in the case of MJVs. In fact, since the number of parties involved is greater, the costs devolved in monitoring and resources coordination are expected to increase. Moreover, if equity stakes are not equally distributed, additional transaction costs will emerge from the danger of opportunistic behaviors. The likelihood of the latter is closely connected with contract incompleteness, which in turns depends on the characteristics of the partnership as well as the cultural and physical distance.

3.4.1 The role of economic freedom distance

One of the factors influencing the entry mode choice and, notably, the ownership mode strategy is the economic freedom spread existing between the countries (and companies) involved in the transaction.
Economic freedom distance is the result of the differences in terms of the institutions governing financial and trade market, and it is one of the biggest sources of uncertainty for the MNC investing in a foreign country. This uncertainty is likely to entail additional costs for the management of the subsidiary given the MNC's lack of knowledge about the host country institutions[74].
The degree of economic freedom of a country has been proven to be connected to its economic development and, consequently, to the amount and typology of FDI inflows[75]. As defined by Gwartney, Lawson, Norton and Hall (2008), the main constituents of economic freedom are ''personal choice, voluntary exchange coordinated by markets, freedom to enter and compete in markets, and protection of persons and their property from aggression by others''. Therefore, differences with the level of economic freedom of the host country are likely to influence both the establishment and ownership mode strategies of the MNC.
For instance, it has been demonstrated that in emerging industries characterized by a predominance of intangible assets (e.g. brands, patents, competences) foreign MNC tend to opt for wholly owned subsidiaries rather than joint ventures[76]. This trend is explained by the higher complexity inherent in intellectual and intangible capital that require strategies able to deal with them consistently. In fact, joint ventures might be a tool whereby companies gain access to new markets, resources and capabilities with the support of a partner enabling them to cope with economic freedom distance[77]. However, the presence of either competing interests between the parties involved or differences in management style can make this arrangement hard to handle. Moreover, the additional complexities associated with market and business practices are likely to impede further the execution of such a strategy.
Thus, the institutional environment again takes on a relevant role in affecting the ownership mode decision. Recently it has been demonstrated that a more favorable external environment lead MNCs to commit more resources in that host country, and that the presence of governmental restrictions result in a higher propensity for joint ventures[78]. Therefore, the countries characterized by high economic freedom induce MNCs to commit more resources and prefer wholly-owned arrangements over joint ventures.

[74] See Dermibag et al. (2011)
[75] See Meyer, Estrin, Bhaumik, and Peng (2009)
[76] See Chang, Chung, and Moon (2013) on the examination of financial data from foreign subsidiaries in China between 1998 and 2006.
[77] See Beamish and Lupton (2009)
[78] See Deng (2003), Child and Tsai (2005)

Conversely, companies are reported to opt for joint ventures when investing in emerging markets, where the level of economic freedom is low because of ineffective government, high taxation, less reliable financial structure and barriers on the foreign firm's operations. In this case, the MNC would have the possibility to share with local partners the additional costs and risks, despite the persistence of the issues associated with joint ventures management. Moreover, this strategy could positively affect the subsidiary with a further development of networks with key local players[79].

3.4.2 The role of cultural distance

At a first glance, the connection between cultural distance and the ownership mode might appear ambiguous. On the one hand, companies might prefer arrangements allowing them to retain a closer control over operations in order to mitigate uncertainty. On the other hand, this unfamiliarity with the host environment could be the reason why the head quarter should opt for a JV. Despite of the persistence of few inconsistent results[80], the bulk of the literature about the topic is favorable towards the second statement[81]. Given the influence of the cultural distance on the MNC choice of a JV over a MNC, the transaction costs however are likely to increase with the number of partners involved. Notably, a wider partnership entails additional communication and coordination costs[82]. JVs composed by a higher number of partners (MJVs) are supposed to require a more pervasive amount of interaction which may vulnerable to the problems associated with cultural distance. Thus, because of the increased transaction costs, the appropriateness of forming MJVs is lower.

3.4.3 Industry and firm-specific variables affecting the ownership mode

3.4.3.1 R&D and advertisement activity intensity

In R&D intensive industries, formation of MJVs may lead to an increase in coordination efforts so the control of proprietary assets might then prove to be difficult. R&D intensive industries might involve operations characterized by a great deal of embedded tacit knowledge (design, technologies, competences) which could be troublesome in the specification of contractual terms, especially under JVs. Since in these contexts the potentials for opportunistic behaviors are higher, a closer and wider control mode will be adopted (WOS). These conclusions are even more radical if a MJV is considered, due to the additional transaction costs and free-riding behaviors[83]. The specific assets and resources exploited in advertisement activities are intangible and marketing-related, and their development often requires a cooperation with local partners. A DJV is preferable over MJV as the latter alternative could overly increase the complexity of the interface hampering the overall activity. Moreover, advertisement activities are deemed to reflect the power of intangible assets like brands, trademarks, company's reputation and marketing competences[84]. Thus, the control of these resources entails the same problems of R&D activities, leading the MNC to commit a higher equity stake and involve less partners.

[79] See Kobernyuk et al. (2014)
[80] See Shenkar et al. (2008), Wang and Schaan (2008)
[81] Li et al. (2001), Bstieler and Hemmert (2008)
[82] Garcia-Canal et al. 2003 and Kaufmann and O'Neil 2007
[83] See Oxley (1997) and Gong et al. (2007)
[84] See Chung and Beamish (2005)

3.4.3.2 FDI population density

The amount of foreign investment in a certain industry can be viewed as an indicator of the overall market competitiveness as well as its relevance. From this perspective, researchers have demonstrated that MNC are less incline to share control with local partner if the perceived sector importance is higher[85].
A higher concentration of FDI could also be linked with the availability of potentially supporting partners that could enable the company to obtain specific resources or, alternatively, to decrease the uncertainty level. Moreover, as argued by Miller and Eden (2006), areas more densely populated by FDI are less likely to engage in discriminative behaviors towards the new entrants. This latter point represents the so called "liability of foreignness"[86]. In countries where FDI are more dispersed and the liability of foreignness is heavier, MNCs are likely to seek the support of local partners through the establishment of JVs.

3.4.3.3 Subsidiary Size

If the ownership mode chosen is the JV, the MNC willing to increase the size of its affiliate must pay special attention to the role of partners in providing the resources require. These resources can be either financial or not, as the subsidiary is likely to need political support and distribution channels in addition to capital. The basic turning point for the MNC is the research for new partners committing the required resources to champion the affiliate's growth. The presence of a greater number of partner is also expected to mitigate the additional risks encountered when the subsidiary size increases.
Thus, the likelihood of choosing a JV rather than a WOS increase progressively with the size of the investment[87]. Furthermore, when the size rises further MJVs will be preferred to DJV.

3.4.3.4 Subsidiary Location

The choice for a specific country rather than another has several implications in terms of the resources or opportunities available and pitfalls to be avoided. Therefore, the number of partners forming a JV and the resources required are closely connected with the factors endowments. The quantity and quality of the resources endowment are expected to vary substantially whether the MNC's target for its subsidiary is an emerging country rather than a developed country. Indeed, a foreign investment can be in general considered less risky in the latter with respect to the former. Taking the example of China[88] and Turkey[89], the probability of establishing a WOS or a JV as entry modes is reported to be positively and strongly influenced by the choice regarding the location of operations. Here the economic development plays a relevant role in shaping the decision, as advanced regions have better infrastructure and wider market demand than less advanced regions. Therefore, the former is likely to require a lower number of partners in order to foster its operation and gain legitimacy, opting for a WOS or a DJV. Conversely, developing areas are usually characterized by a lack of adequate resources and so local networks are required to involve more partners.

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[85] See Contractor (1990)
[86] See Zaheer (1995)
[87] See Zhao at al. (2004)
[88] See Wei et al. (2005)
[89] See Deichmann at al. (2003)

3.4.4 Institutional environment and variables affecting the ownership mode

In the literature, the institutional features present in the host country environment have been widely divided into regulative, cognitive and normative[90]. The regulative aspect of the institutional environment relates mainly to the bodies of law ensuring the political stability and order in the country. Conversely, the cognitive facet refers to the set of cognitive and relational structures present in a certain society that are often difficult to grasp. Instead, the normative perspective concerns the domain of social and cultural values. The structure and strategy of the affiliate is affected by the country-specific institutional norms and environment. Notably, the first strategy whose implementation is fundamental for the subsidiary establishment is the adaptive one. According to this view, institutional theorists have identified three mechanisms whereby the new venture adapt to and gain legitimacy in the host environment[91].

Coercive adaptation (or isomorphism) occurs when a company is obliged to comply with specific norms or structures. Conversely, normative adaptation relates to the compliance with internal norms and procedure embedded in the MNC. Moreover, because of the uncertainty of the external environment the affiliate might deem safer to copy peers' behavior (mimetic adaptation). The institutional pressures and expectations related to these behaviors are likely to trigger specific response in terms of the ownership structure chosen. As emerging countries are characterized by a relatively non-transparent regulative and political environment, informal pressure from the leading institutions could result in severe obstacles for the foreign affiliate. For this reasons, the latter often join in collusion with local partners (MJV) to increase the lobbying power and to enhance the management of political risk. This is often the case oil, gas and mineral companies.

Above all, two main elements inherent to emerging economies have been reported to be particularly felt by foreign subsidiaries, namely political constraints and the presence of corruption. The relevance of these variables are widely supported by the existing literature and empirical research. In this sense, particularly interesting are the findings of Demirbag et al. (2010) about the Turkish industrial and institutional environment, whose effects on FDI flows are consistent with those presented in this chapter.

As it has been just introduced, JVs are the most effective arrangement whereby overcoming the political barriers, especially when governments put restrictions on inward FDIs or equity ownership. Thus, foreign investors often attempt to mitigate these risks seeking the support of local actors whose knowledge of the local institutions and markets is already established. Being embedded in a local partnership, the foreign affiliate has also the chance to solve the issues related to the liability of foreignness therefore gaining acceptance in the host environment. Indeed, such a situation is likely to lead the wider society to prevent unfavorable government's interventions like expropriation, that would turn out to be a politically costly move. The other institutional obstacle likely to affect the investment decision of the MNCs is the corruption perception about a country. The problem here lies in the uncertain ability of the foreign investor to enforce contracts whose validity is safeguarded by the ruling institutions. The deriving instability and asymmetry are expected to influence the managers' decisions as to undertake equity or non-equity based entry strategies[92]. In the former case, the choices as to whether implement a JV rather than establish a WOS ultimately depends on the potential benefits and costs related to the ownership sharing. Indeed, the higher is the corruption perception in the host country, the more uncertainty the decision maker will face. In this situation the more appropriate alternative in order to minimize the risks should be the JV. Opting for this strategy, the MNC is able to provide greater flexibility to the subsidiary while maximizing the trade-off between control and costs.

As a closing remark, it should be clear that the relevant issue is not the cost of corruption by itself. Rather, the problem faced by a foreign company investing in an emerging country[93] is the seeming "arbitrariness" with which the relevant decisions are taken at the top institutional levels. The ultimate consequences for the subsidiary is the lack of transparency of the regulatory bodies as well as the market, and the resulting

[90] See Scott (1995) and Meyer et al. (2009)
[91] See DiMaggio and Powell (1983)
[92] See Wietzel and Berns (2006)
[93] See Rodriguez et al. (2005)

uncertainty surrounding the decision-making process. MNC's attempts to seek the support of local partnerships are aimed to tackle and mitigate these constraints.

3.5 The spillover and "gateway" effects of FDI

The aim of this final paragraph of the chapter about entry strategies is to convey another relevant factor, although subtler, influencing the FDI location choice. In the previous sections it has been argued that both economic and cultural elements are reported to affect the MNC's decision concerning both the entry mode and the ownership structure of the foreign affiliate. Implicitly, arguments about economic, cultural and geographical distance underpin also the location choice, explaining why and how a specific foreign country is more attractive given the purposes and the features of the subsidiary. However, drawing on their experience and ability to seize strategic opportunities, managers should broaden the scope of the decision-making process including less obvious implications. Indeed, alternative locations should not be regarded as distinct and isolated places. Consequently, the valuation of the attractiveness of a foreign environment should not limit to the economic and institutional forces acting within borders. Two relevant implications emerge from this argument. First, more or less geographically distant countries are likely to have an influence on the target host environment, and these influence can have different nature (economic, institutional, cultural, political, etc.). Second, these neighbor countries should be included in the investment's benefits assessment as the first foreign country entered might be regarded as the gateway for other markets. There might be cases in which the access to the second neighbor market would be complicated or even impossible without the prior establishment in the first host country. It should be pointed out that these implications not only hold when two or more different foreign countries are considered, but also when the size or the cultural-institutional features of a country entail marked differences within it. Thus, the spillover effect is a phenomenon that can manifest both across countries and within the national borders. As for the latter case, researchers have demonstrated the existence of significant spatial dependence between regions belonging to specific countries, like China and Russia[94]. The size and administrative arrangements of these countries lead to the creation of quasi-states within the national boundaries. Here the managerial implications are evident: the choice as to where placing the foreign affiliate does not limit to comparisons between country-level alternatives, but should focus also on the regional-level location within a specific host national environment.

If the FDI is driven by the search for new markets, then the nearby presence of urban concentrations of consumers will increase the attractiveness of a potential region or city, while more isolated cities will be less desirable. Here the development of the internal infrastructure and the consequent travel and transport-related costs take on a relevant role. Neighbor locations could also increase the availability of skilled labor, and provide easier access to specialized inputs and services, facilitating knowledge spillovers. Thus, the FDI attractiveness of a particular regional-level location hinges on the geographical, economic and administrative distance with alternative nearby locations[95]. While the first two factors have already been widely addressed within this work, the latter deserve further brief specifications. Administrative distance implies that there could be differences in the regulation in force at the regional or provincial level hindering or impeding the affiliate's activity. The bureaucratic burden is particularly present in the emerging countries and central-planned economies, where the government authority frequently interferes with the business environment imposing detrimental restrictions[96]. Therefore, locations with greater administrative autonomy from central government are expected to be more attractive to FDI than those subject to tight control. An indicator displaying the degree of administrative autonomy is the level of public expenditure at the local level: if this level is high, cities are able to retain bigger surpluses and can benefit from more

[94] See Coughlin and Segev (2000), Ledyaeva (2009)
[95] See Blanc-Brude et al. (2014)
[96] See Amiti and Javorcik (2008)

autonomy[97]. As stated at the outset of the paragraph, manager when engage in the valuation process must broaden the scope of the benefits deriving from investing in a foreign country. The inclusion of subtler and strategically positive considerations can reveal a more solid and complete valuation response. Notably, this is particularly true when establishing a new venture in a foreign country can be regarded as a gateway easing the access to other countries. Doing so, MNC's executives should structure the valuation method as a series of real options represented by the future investment opportunities made available by the first FDI. As explained in the previous chapter, the subsequent investment opportunities represent a series of call options whose value must be added to the NPV of the original investment. A foreign country can be meant as a stepping-stone entry for several reasons. Notably, a multi-stage expansion is often structured over (and facilitated by) the presence of macro-level agreements between countries aimed at fostering free trade as well as tearing down entry barriers. An example widely discussed in the literature is the one of NAFTA[98]. In the case of Mexico[99], trade liberalization policies enabled by NAFTA have increased the FDI inflows from North America and Canada[100]. Indeed, trade liberalization agreements are aimed at creating a favorable business environment for the first set-up of a MNC's affiliate. Afterwards, with the experience gained, the MNC can exploit opportunities for further expansion in countries that are geographically, economically and culturally close to the first. As pointed out by Serra (2004), NAFTA reduces entry risk in the Mexican market. Adopting it as a starting point, American and Canadian companies can then address and enter other parts of Latin America pursuing an enhanced production efficiency[101].

[97] See Blanc-Brude et al. (2014)

[98] See www.naftanow.org for further information on the "North American Free Trade Agreement"

[99] See the study carried out by Javalgi et al. (2010) about the NAFTA effects on Mexico, notably the conception of the latter as a gateway for the other Latin American countries

[100] As reported by Cavusgil, Knight, and Reisenberger (2008), it has risen from $4 billion in 1993 to nearly $20 billion by 2006

[101] See Garcia (2009)

4. EXOGENOUS RISK FACTORS

As reported throughout the previous chapters, the establishment of a subsidiary in a foreign country is a particularly risky investment because of the level of uncertainty present and the high commitment of the parent company. Indeed, many elements and likely consequences must be taken into account, stretching beyond the mere financial facets and including considerations about reputation, politics, and both cultural and economic distance. Notably, regardless of the entry and ownership mode chosen, these factors deserve remarkable attention when the investment concerns an emerging country. In such a context, the risks already inherent also to developed market are exacerbated by the presence of new and specific threats, rooted in either the external environment or the peculiar internal features of the investor.
The present chapter will deal with the former category, namely the exogenous risk factors. This category includes all the main aspects of the external environment (cultural, institutional, business, legal, etc.) that are expected to play a relevant role in the evaluation as to whether setting up a new venture in an emerging country.

As introduced in the first chapter, the risk factors here discussed are:

4.1) Country risks
4.2) Political risk
4.3) Labor market risk and host country unionization
4.4) Taxation risk

Specifically, each of the following paragraphs will be structured as follows:

1. General presentation of the existing literature over the risk factor addressed;
2. Discussion of the most recent empirical findings of the researches conducted about the topic;
3. Analysis and considerations as to which effects the risk factor is likely to have in the evaluation models and the related managerial implications.

In each paragraph, the strategies presented both in the literature overview and in the managerial implications are meant to provide a set of viable options through which prevent and mitigate the negative consequences on valuation fundamentals.

4.1 Country Risk

4.1.1 Literature and empirical findings review

Country risk can be broadly defined as the probability of a particular future event within a country that is expected to adversely affect the functioning of a given organization, regardless of the type of entity (business, government agency, non-governmental organization). It is the most generic conception of risk as it includes the various facets of the emerging countries' threats to foreign investment: cultural barriers, institutional gaps and obstacles, political instability, financial/business under-development. For this reason,

country risk is the first topic addressed in the discussion over exogenous risk factors, in order to introduce and clarify the topics presented afterwards. The features underlying country risk hinge on and are expected to vary according to the specific organizational context at stake.

Indeed, a certain element of external environment might be seen as a significant risk factor to one business while another could thrive thanks to it. For instance, the presence of diseases such as malaria is likely to undermine the functioning of many firms yet for pharmaceutical companies it represents a business opportunity. Moreover, logistics bottlenecks might hamper the activity of humanitarian NGO while being the target of logistics suppliers' improvement activities. This lack of specificity has posed many challenges for researchers' attempts to conceptualize and measure country risk, both broadly as well as focusing to specific organizational context. These efforts can be divided on the basis of the adoption of a qualitative or quantitative approach to analysis[102]. The former type of assessment generally addresses the overall complexity of the political, economic and social environment (often through statistics) without deepening in the specificity of the single contexts. Following this approach, researchers often lack a structured format as they rely heavily on the opinions and assumptions of analysts and experts. For instance, The Economist Intelligence Unit (EIU)[103], Stratfor[104], and Business Environment Risk Intelligence (BERI)[105] offer risk analyses that can included into this category. The World Economic Forum's Global Competitiveness Report (GCR)[106] is also encompassed, which is based on the experts' scoring across a wide array of variables.

On the other hand, quantitative measures are often aimed at ranking countries against specific variables. The services provided by the Political Risk Services (PRS)[107], Maplecroft[108], and Roubini Global Economics[109] are examples of this approach. Ranking can be carried out across all countries, grouping them into clusters (this is the case of "Emerging Markets"), or focusing on the specific-risk level. Furthermore, risk ratings can be performed with the support of hard data or, like in the qualitative approach, through qualitative experts' opinions. Quantitative risk assessment is usually based on econometric and statistical modeling techniques, such as regression analysis or principal component analysis. Notably, some researchers have focused their studies on the insurance markets to testify their validity as political violence risk indicators[110].

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[102] See Coccia (2007) and Nath (2008)

[103] The EIU (www.eiu.com) is a commercial service that provides extensive raw data, qualitative country and sector risk analysis and forecasts, and content tied to being part of the Economist magazine. The EIU also offers specialized indices, such as its "Democracy index" and "Where to be born index". Its risk briefing seeks to quantify the risks to business profitability and forecast the coming two years.

[104] See www.stratfor.com for further information

[105] See www.beri.com for further information on the Business Environment Risk Intelligence

[106] See www.weforum.org for further information on the World Economic Forum's Global Competitiveness Report

[107] PRS Group (www.prsgroup.com) offers qualitative and quantitative analysis through a monthly journal, the International Country Risk Guide (ICRG), and a Political Risk Service (PRS) System, both tied to quantitative forecasting. The goal of the ICRG is to provide an early country risk warning system for multinational firms, banks, and equity and currency traders over a 1–5 year time period. The goal of the PRS System is to provide objective risk forecasting in three investment areas: financial transfers (banking and lending), foreign direct investment (e.g., retail, manufacturing, mining), and exports to the host country markets. The PRS' System provides industry specific 18-month and 5-year forecasts.

[108]Maplecroft (www.maplecroft.com) is a commercial service that through its Global Risk Portfolio (GRP) constructs some 200 indices across a variety of country risk categories. The goal of the service's quantitative tools and qualitative analysis is to monitor and forecast country risks for multinational companies, financial institutions, governments, and NGOs.

[109]Roubini Global Economics (RGE) (www.roubini.com) is commercial service that provides qualitative and quantitative analysis of macro-country risks, as well as research, scenarios, and 10-year economic forecasts. Through RGE Country Insights, RGE provides the Social, Institutional, and Regulatory Risk Index (SIRR), a tool used to identify investment attractiveness and business opportunity.

[110] See Jensen & Young (2008)

In the recent years, because of the benefits of FDI inflows for an emerging country's economic environment[111], regulatory policies have been devised to create a more favorable context for global investors, especially in the service sector. For instance, banking licenses systems and insurance legislation have been improved in Bahrain and Turkey, while foreign property and land ownership have been extended in Oman's tourism industry. Corporate income taxes have been cut in Egypt, Turkey, Kuwait and Saudi Arabia. Notably, the latter since joining the WTO has undertaken a massive process of foreign ownership extension, taxation reduction and creation of free trade areas for foreign investors[112]. The Moroccan government in 1995 adopted an Investment Charter whose purpose is to promote foreign ownership in the manufacturing sector, remove restrictions on the repatriation of capital and dividends and protect foreign investors from the risks of nationalization and expropriation[113]. Despite the improvements implemented by several emerging countries, MNCs willing to expand in these markets are still faced with many barriers. Especially in the MENA region, which welcomes a low percentage of FDI with respect to other EM like Latin America[114], the political systems and cultural differences still hinder these nations from attracting FDI. As already explained in the previous chapters, these countries are characterized by rigid and centralized governments, overstaffed public sector and weak regulation[115].
The following sections will present the most relevant country-related issues and threats. First, the various dimensions of distance will be discussed together with the main problematics arising from them. The main findings and insights of the literature about the topic will be here explained in order to provide a general framework. Indeed, these dimensions will be deepened and integrated with the analysis of some of the main specific risks that the MNC is likely to face. After the literature overview, the last section will identify the major managerial implications and consequences on the valuation fundamentals.

4.1.1.1 Geographical, cultural and psychic distance

The studies focusing on how distance affects firms' international expansion have brought several insights as to the nature, typologies and consequences of these factors[116]. In the context of this work, distance will be analyzed along three dimensions, namely geographic, cultural, and psychic. These are in fact the distance conceptions most widely addressed in the literature on international business[117]. Moreover, other typologies such as institutional and economic distance have already been discussed in the previous chapter and will be further analyzed in other paragraphs of this chapter. As defined by Ojala (2015) "Geographic distance is the physical separation between one location and another, typically involving the space between the home of a firm and the foreign location in which it is selling, or exploring possible sales". Physical distance is likely to increase the time and resources needed for commercial transactions, thus making the foreign market less attractive. Conversely, low managerial costs, familiarity with the host environment and rapid information flow are reported to be the underlying reasons of mutual entry between geographically close countries.
The financial and strategic impact of physical distance has not been completely dampened by the recent development in ICTs and transportation infrastructures[118]. This is especially evident if emerging market are considered, whose embeddedness in the global commercial network is weaker. MNCs can be deemed

[111] Sixteen of the nineteen countries in the MENA regions gained markedly from the FDI inflows (UN, 2005).
[112] See Siddiqi (2007)
[113] See Bououiyour (2003)
[114] 8.3%, according to UN (2005)
[115] See Abed (2003)
[116] See Hakanson and Ambos (2010)
[117] See Ellis (2008); Ojala and Tyrvainen (2008) and Ragozzino (2009)
[118] See Gooris & Peeters, 2014

better equipped to cope with geographical distance than small firms, as the former can rely on an already established transnational network as well as the experience and knowledge gathered though the expansion processes. Nevertheless, this risk cannot be neglected even by large MNCs for at least two reasons. The first and perhaps most straightforward one, the affiliates network cannot reasonably be expected to cover uniformly every market and to be equal for every MNC. Thus, geographical distance will affect different MNCs in different extents. Second, the effects of physical distance are either mitigated or worsened by the interplay of the other two dimensions, namely cultural and psychic.

Throughout the literature, the terms "cultural distance" and "psychic distance" are often used interchangeably. Though closely related, a better interpretation is the one describing the former as a subset of the latter[119]. Scholars have regarded cultural distance generally as differences in values, communication styles and cultural stereotypes between groups of people. Apart from theoretical definitions, in practice it is not easy to identify and act upon the various set of cultural values and norms, and the reasons are multiple. It would be naïve and superficial for MNCs to associate one unique and uniform set of value to each country, since national cultures within national borders are not homogeneous[120]. For example, cultural values may vary between cosmopolitan cities and rural areas within a country or, like in the case of Italy and England, wide differences might exist between the north and the south of the same country. Moreover, it is often not possible to disentangle the components of cultural values and norms into independent variables to work on. Instead, companies should focus rather on the behaviors of people over time and their reaction to specific events, from the launch of a new product to a political scandal. Multinational enterprises are reasonably expected to lean on several advantages with respect to small companies in dealing with cultural distance. Indeed, the international experience and knowledge might enable them to be better prepared in coping with obstacles rooted in cultural norms and differences. Moreover, they can use their existing networks or financial resources to hire employees with relevant cultural knowledge. However, as emerging markets' business environments are often composed by many small and locally rooted enterprises, small foreign companies may have a subtle advantage in seizing the needs and characteristics of these firms. The reason is that generally smaller firm give a higher weight to the involvement of local communities and care for cultural values than transnational companies. Therefore, though belonging to different cultural and ideological frameworks, small firms are sometimes reported to integrate better than MNCs in foreign local environment especially if family-rooted, thus mitigating cultural distance.

Particularly interesting are the effect of cultural differences specifically on cross-border M&A, where people with often conflicting values are required to integrate and coordinate with each other. These effects must be taken into account within the discussion since this kind of transaction is the most widely adopted approach for the development of foreign subsidiaries. Another reason is the increasing importance and frequency of the phenomenon that according to Erel, Liao and Weisbach (2012) nearly doubled in the last decade, from 23% of total mergers in 1998 to 45% in 2007. Like physical distance, differences in cultural dimensions[121] are expected to hinder the success of a cross-border merger. Synergistic effects require post-merger coordination efforts between the employees of the companies involved. If employees do not have many cultural values in common, coordination efforts are likely to be curbed by mistrust, misunderstanding and goals misalignment. For instance, in Western countries is deemed more acceptable to question authority than in Asian culture. Conversely, the latter is more based on teamwork and informal meetings while the former is more oriented to individualism. The mismanagement of these differences could undermine the realization of the aforementioned synergies. However, Page (2007) argues that greater cultural difference might increase the likelihood of a successful merger if this diversity fosters innovations

[119] See Sousa & Lages, 2011

[120] See Avloniti and Filippaios (2014)

[121] According to Ahern, Daminelli and Fracassi (2015) the relevant cultural dimensions to be considered are: (1) trust v. distrust, (2) hierarchy v. egalitarism, and (3) individualism v. collectivism

and promotes new perspectives for problem solving. Moreover, cultural diversity could lead to a more flexible organization able to respond effectively to changes in the surrounding environment, providing a wider array of resources than can be built internally[122].

Slightly differently from cultural distance, psychic distance is related to the general perceptions of the actors involved towards a certain foreign market, its values and customs[123]. The existing literature on the topic describes psychic distance as a general construct including a set of different dimensions. According to Sousa and Lages (2011) and Freeman et al. (2012), these dimensions may be related to differences in geography, culture, language, politics, the level of education, the economic situation, the level of industrial development, and many others. The presence of these differences affects negatively information flows by decreasing mutual understanding and acceptance[124]. Being the result of many distance-related perspectives, psychic distance is often felt differently and asymmetrically by the actors involved. For example, the purchase department of an MNC located in the US is likely to have a better understanding of the behavior of a small business who sells only in India than the latter has about the American company. Therefore, the psychic distance from the American company to the Indian seller is shorter than the reverse distance.

Also in the case of psychic distance MNCs are in a more favorable position to curb the negative effects than a small local company is, mostly because of previous international experience and resource availability. This is even more evident taking into account the information and resource-related shortcomings of the latter, for example the lack of specific language skills. A number of studies have highlighted how managers of small and new ventures may be forced to use interpreters, recruit foreign employees, or find partners with relevant language knowledge[125].

Chinese Cultural Environment

The culture of a country may create risks that make it difficult for multinational companies to operate safely and effectively. In China there are seven major dialects and many sub-dialects. Mandarin, the predominant dialect, is spoken by over 70 percent of the population. The rest, concentrated in southwest and southeast China, speak one of six other major Chinese dialects. Non-Chinese languages spoken widely by ethnic minorities include Mongolian, Tibetan, Uyghur, other Turkic languages and Korean (U.S. Department of State). Even in Mandarin dominant areas some translation problems are still a concern. For intance, when Coca-Cola expanded into the Chinese market, its tradename was translated as “keken-kela” which means “it can bite and it is spicy”. Afterwards, Coca-Cola learned more about Chinese languages the name was translated to “kekou-kele” which means “delicious and joy.”

Western MNCs should follow local customs and avoid cultural taboos. For instance, Chinese people appreciate friendships with customers and frequently ask questions about family, hobbies or daily life. They are also likely to invite customers to restaurants to display their loyalty.

Adapted from Ethridge et al. (2011)

[122] See Carrillo and Gromb (2007)
[123] See Child et al. (2009)
[124] See Nebus and Chai (2014)
[125] See Ojala (2008)

4.1.1.2 Macroeconomic environment

A research conducted by Hisarciklilar, Kayam and Kayalica (2007) has demonstrated that GDP of host economies in MENA affects significantly the amount of FDI inflows in the country. Demirbag, Taloglu and Glaister (2008) found that market potential in Turkey, expressed by growth rate and market size, is positively correlated with FDI inflows in the domestic market. According to Bouoiyour (2003), market size has a positive impact on FDI in Morocco. Other findings from Tahir and Larimo (2004) confirm the same correlation also for other developing countries. As for the exchange rate volatility, the literature indicates that generally it is an impediment to FDI. For instance, Erdal and Tatoglu (2002) showed that exchange rate instability in Turkey hindered its chances to attract a higher amount of FDI. As stated in the previous chapters, MNCs belonging to countries with strong and overvalued currency are reported to invest more in countries whose currency is weaker and undervalued. This appreciation hampers export making it more expensive but increases the opportunities to achieve cost reductions and enhanced competitiveness by directly investing in those countries. Exchange rate fluctuations are expected to affect FDI essentially in two related ways. First, the appreciation of the home-country's currency with respect to the host country implies that, once implemented, the investment increase in value if denominated in the host country's currency[126]. Second, an appreciation decreases the relative cost of capital, providing the investor with more power through which committing more aggressively in foreign countries. However, the advantage persists as long as a relevant spread exists between the two countries. The instability of exchange rate in emerging countries has the effect on the one hand of decreasing the attractiveness of these economies as FDI targets, and on the other hand of threaten the post-entry success of the FDI already established. It must be pointed out that, differently from culture-related risks, the company has the availability of plenty of financial instruments whereby hedging against this risk. Therefore, even though the aforementioned considerations maintain their relevance in investment policies, post-entry exchange rate risk can be mitigated quite easily. Apart from the specific typologies of risk under the macroeconomic "umbrella", MNCs should structure the valuation models and processes taking into account the risk inherent to macroeconomic volatility itself. As it has been demonstrated by Bansal et al. (2014), an increase in volatility is associated with a rise in discount rates and a decline in future consumption. These effects will be deeply analyzed in section regarding the managerial implications.

4.1.1.3 Business and industrial environment

Since MNCs' affiliates are embedded in the host country institutions and networks, their legitimacy within them is likely to be influenced by the characteristics of the local clusters. As already argued several times in this work, legitimacy and recognition can enable foreign companies to gain support and cooperation in the host market, as well as the provision of relevant resources and knowledge. Folta, Cooper and Baik (2006) define local clusters as "groups of firms from the same or related industries located in close geographical proximity". As stated before, by reducing geographical distance companies can ease the access to suppliers, labor market and local knowledge. In order to properly assess the effect of cluster on the internationalization process, MNCs should differentiate between the several aspects of the former. For instance, different ownership structures within a cluster (connected with differences in norms and identities) are reported to affect the performance and legitimacy of the subsidiary. In the recent years, many emerging economies have undergone many political and institutional changes.

[126] See Dewenter (1995)

Notably, China has shifted from the domination of state-owned enterprises (SOEs) in the communist era to the development of Chinese private-owned enterprises (POEs), along with an openness to foreign-invested enterprises (FIEs). In a cluster of SOEs, as depicted by Knutsen, Rygh and Hveem (2011), governmental institutions set forth normative guidelines for local firms in order to enhance social welfare, while imposing regulatory barriers on outsiders. Conversely, a cluster of POEs is characterized by the development of free market mechanisms and the promotion of entrepreneurship[127]. It can be reasonably expected that foreign subsidiaries are more likely to obtain legitimacy and resources if established within a cluster of POEs. Moreover, Tan, Shao and Li (2013) found that subsidiaries placed within a cluster of FIEs from the same home country are abler to attain legitimacy and engage in collective network increasing their bargaining power with respect to local institutions. However, the marginal benefits of legitimacy may be dampened by intensified competition and groupthink in the latter stages of cluster formation. Thus, it can be argued that a foreign firm's presence within a cluster of FIEs from the same home country is likely to have an inverted U-shaped relationship with the firm's performance[128].

Another important country-specific element of the business environment affecting the valuation process is the business-related regulation. Notably, the bankruptcy code and the relationship between shareholders and debt holders should be under the valuation spotlight. MNCs should assess the opportunity for the shareholders to default strategically and how this practice is likely to affect the riskiness of the investment as well as the valuation fundamentals. In fact, when a firm is in financial distress, its shareholders and debt holders may benefit from a debt renegotiation to avoid an inefficient bankruptcy or liquidation. However, the possibility of a debt reduction through renegotiation might induce shareholders to default even if the firm is solvent. In the case in which the bankruptcy law of the target country favors a renegotiation, according to Favara, Schroth and Valta (2012) a higher shareholders' expected payoff in renegotiation increases the value of the put option to default and decreases the risk of equity.

4.1.1.4 Political instability, economic freedom and civil liberties

Literature and research findings strongly support the claim that political, financial and economic instability are severe obstacles to FDI inflow in emerging countries[129]. For example, Demirbag, Taloglu and Glaister (2008) and Chan and Gemayel (2004) found that investment entry mode is influenced by country risks such as political and economic instability, especially in Turkey and other MENA regions. Consequently, related studies conducted by Disdier & Mayer (2004) confirm that higher levels of political freedom and civil liberties in target countries may be beneficial for FDI development. Notably, Jensen (2003) indicates that democratic countries attract more FDI than their authoritarian and centralized counterparts. Nevertheless, the considerations about the benefits of democratic governments towards FDI inflows are controversial. In fact, as reported by Li and Resnick (2003), the former on the one hand are expected to promote FDI, e.g. protecting property rights and reducing transaction costs, but on the other hand they are likely to create barriers to foreign FDI when domestic producers are protected against foreign competition.

The rich literature of institutional determinants provides interesting analytical insights as to how economic freedom affects FDI in emerging countries. Taking FDI attractiveness as dependent variable, researchers have demonstrated the positive impact of economic freedom improvement measured as the extent of government intervention and property rights protection[130]. A study conducted by Javorcik and Spatareanu

[127] See Park, Li, and Tse (2006)

[128] See Liao (2015)

[129] See Globerman and Shapiro (2002)

[130] See Kapuria-Forman (2007) and Bengoa and Sanchez-Robles (2003) on institutional determinants of FDI inflow in respectively in MENA and Latin American countries

(2004) showed that a labor market characterized by low flexibility and development is associated with smaller FDI inflows in that country. A similar correlation was founded by Campos and Kinoshita (2003), according to whom developing countries with less efficient legal system attract less FDIs. Moreover, anticipating another topic that will be deeply discussed in the following sections, high taxes and complexities or uncertainties concerning tax regulation is reported to have a negative influence on FDI inflows[131]. Recalling an issue presented in the previous chapter, several studies on the issue argue that high levels of corruption has a critical role in the subsidiary management, however the direction of the correlation is under debate. On the one hand, Habib and Zurawick (2002) and Wei (2000) support the notion that that corruption in host countries represent an impediment to inward FDI. On the other hand, Okeahalam (2005) found that high levels of corruption do not hamper investments in emerging country. According to this idea, MNCs will continue to establish their affiliates in corrupt and poorly governed resource-rich countries but specific considerations will be made with respect to the valuation fundamentals. Indeed, investors are supposed to apply higher discount factors asking for higher levels of expected return, or to modify the likelihood of certain scenarios accordingly.

Current Account Deficit

In many emerging countries the volatility of oil prices has a significant effect on the current account. In the past decade, oil prices brought large surpluses on the current account as a percentage of GDP. However, the governments of oil-producing countries were obliged to intervene with strong fiscal adjustment when these surpluses phased out because of oil-price tumble. For this reason, emerging countries resorted to excessive external borrowing to finance their inefficient public investments. Strong imbalances in the current account are expected to aggravate especially political instability, discouraging foreign MNCs to invest in these countries. However, specific policies could be devised specifically to attract FDIs in order to finance the current account deficit. Therefore, the effect of current account deficit on the willingness of foreign companies to invest in emerging countries ultimately depends on the way these countries plan to tackle these imbalances. Political, institutional and regulation instability are likely to pose severe challenges to creation of such policies.

FDI in conflict zones

As the UN (2009) has pointed out, conflict and post-conflict countries are characterized by a large range of problems including corruption, lack of solid governance structures and protection of property rights. The literature focusing on FDI in conflict zones is extremely limited. In fact, the bulk of the existing studies focuses on the relationships between international business and institutions, but virtually all of it addresses the issue only with respect to corruption[132]. More recently, Branzei and Abdelnour (2010) examine the extreme cases of the impact from the threat of terrorism in developing countries. However, their research is based on household level information instead of firm level information, and the focus is on local enterprises instead of international businesses. As highlighted in the previous chapters, the IBV literature assumes that investments are hindered by weak institutions, especially if the targets are foreign markets. MNCs are deterred not only by corruption or low legal protection, but also by the unfamiliarity with the foreign institutional environment. The OLI paradigm presented earlier is based on the relevance of firm

[131] See Carstensen and Toubal (2004) and Edmiston, Mudd and Valev (2003)
[132] See Javorcik and Wei (2009)

specific assets and the ability of the firm to coordinate and exploit them in the foreign country. Therefore, a remarkable advantage in investing in conflict countries is the stockpile of experience gathered in dealing with weak institutions in the home-country. Conversely, firms from more stable economic and political environments are thus expected to shift their investments away from unstable ones. Similarly, Li and Vashchilko (2010) argue that companies belonging to a country with strong institutions are less likely to invest in a weaker one also because of the greater involvement of the government in the former and the weight of its approval/disapproval. Another interesting insight delivered by the literature on FDI in conflict countries is connected to the activity and business of the investor, as well as its reputation. In fact, as noted by Driffield et al. (2013), "the company's CSR image is potentially more important where external stakeholders are final consumers (i.e. the general public) than other businesses". For instance, firms operating in the extraction of minerals have generally been relatively prone to invest in trouble locations, driven by the presence of resources and leveraging their political clout. Moreover, the concept of CSR is an underlying pillar of the so called "stakeholder theory", according to which companies not only have an economic duty towards their shareholders but also have wider legal, moral, and social responsibilities. Thus, larger MNC can be expected to be better equipped to invest in conflict zones, as they rely on greater bargaining power with the domestic stakeholders. However, at the same time they are likely to suffer from adverse commentary and media pressure. In the literature the extent of CSR policies implemented by the firm are determined by the view the firm has of itself with respect to its ethical responsibilities, the pressure from stakeholders; and the assumptions about the expectations from the host country. Generally, companies less concerned of CSR issues and implications are reported to be more likely to invest in conflict regions.

Chinese Economic and Trade Environment

Extreme purchasing power disparity exists between the rich and the poor in China, and it essentially depends on current income, prices, savings, debt, and credit availability. Chinese government has often been unable in effectively and safely control prices, and the "control - subsidy" mechanism has often proved flawed.
Even though China has progressively open its economy to foreign investors, many barriers have yet to be dismantled such as import barriers, an opaque and inconsistent legal system, and restrictions on market.
The Minister of Commerce established the Catalogue for Goods Subject to Import Licensing. Three categories of products require import licenses: raw materials for chemical military weapons, toxicant or drugs, and ozone depleting materials. Products subject to import quotas also require import licenses, including some wool, grains, oilseeds, oilseed products, and cotton. Import licenses are usually difficult to obtain as the Chinese government must verify the eligibility of the trader.
China's service sector has been one of the most heavily regulated and protected parts of the national economy. The high capital requirements imposed and geographical distances might result in limiting market access.

Adapted from Ethridge et al. (2011)

4.1.2 Managerial implications and effects on valuation

Several considerations can be drawn as to how MNCs should incorporate country risk assessment into the valuation models and processes. Moreover, the effects of country risk assessment are likely to expand beyond the mere cash flow valuation. In fact, many strategic implications can be derived from the scanning of the host environment, regardless of the specific lens through which it is analyzed (legal, institutional,

industrial, economic, political, etc.). For instance, assuming that the investment result financially feasible and convenient, the MNCs will tailor the choice of the entry and ownership mode to the risks previously discussed. Specific agreement and relationships will be built rather than others, or subtler organizational changes will be carried out. However, before diving into the analysis of the managerial and valuation consequences, the first issue to be discussed is that concerning the measurement of country risk itself.

4.1.2.1 The measurement of distance

Recalling the definition provided earlier, geographic distance is the space separating the location of the parties involved in the transaction. Several indicators have been utilized in the literature as proxies of physical distance. For instance, the distance between capital cities, major cities, seaports, and the geographic centers of countries have been employed with success[133]. Moreover, the selection of the best-suited indicator for geographic distance will hinge on the unit of analysis (individual or firm) and the characteristics of the product or service. For example, seaports might provide the best measure when physical products are considered. Conversely, geographic centers of countries are more useful in the case of intangible products such as software because of the absence of a logistic structure.
As for cultural distance, researchers have provided several scales to enable managers to measure it. The most commonly used method is the one based on the cultural dimensions devised by Hofstede (1980, 2001) combined with the Kogut and Singh's (1988) composite index[134]. In contrast, other studies have applied Schwartz's (1999) framework together with Hofstede's dimensions and/or the GLOBE framework[135] to identify cultural differences. Overall, there are three aspects of cultural distance that MNCs must analyze in order to select the most suitable method: (1) the particular cultural question at stake, (2) the societal groups observed, and (3) the effect of time on the study. For example, Ojala (2015) observes that "when differences in power distance or time orientation between societies become salient, researchers should consider explanatory measures such as Hofstede's cultural dimensions". Moreover, if the activity of a single industry is under analysis, the cultural dimension to be studied is that referring to the specific industry, without broadening the focus on the entire population of the country. When studying and measuring cultural distance, managers must keep in mind that some industries are more "global" than others. For example, in the telecommunication industry there are worldwide standards preventing it to suffer from cultural differences on a large extent. Due to the greater complexity, the measurement of psychic distance is less straightforward. Again, there are three aspects that managers should consider when assessing psychic distance, namely the specific typologies, the effects of time and the context into which the psychic distance manifests. At the individual level, psychic distance is connected to the perceptions of individuals and their likelihood to influence either small groups or organizations. Focusing on this unit of analysis, qualitative methods are more appropriate, enabling the analyst to consider also the effects of time as well as the asymmetrical nature of psychic distance. Although this approach impedes the generalization of the findings, it facilitates the later application of and testing through quantitative methods. Conversely, when companies are more interested in the aggregate behavior of peers and competitors at a national level, the psychic distance stimuli scale by Dow and Karunaratna (2006) can be applied.

[133] See Brock et al. (2011), Hutzschenreuter et al. (2014), Ojala and Tyrvainen (2008)
[134] See Clark and Pugh (2001), Ellis (2007), Ojala and Tyrvainen (2007)
[135] See House et al. (1999)

4.1.2.2 A new managerial tool for the measurement of country risk

Because of its validity and the insights that can be drawn from its application, the measurement of country risk will be discussed through the presentation of the Robinson Country Risk Index. The tool, proposed by Brown et al. (2014), is based on four broad dimensions: Governance, Economics, Operations, and Society (GEOS). The ultimate purpose is to allow the user to run diagnostics on a country or a subset of it within a specified strategic vision or research need. As pointed out by Brown (2014) itself, this tool "puts a unique, dynamic, and integrated mix of functionalities in the hands of the user", fostering strategic thinking. The RCRI is complementary with many existing services and tools and its validity is maximized when used in conjunction with historical and statistical approaches. The RCRI is aimed at integrating the models proposed by the institutions mentioned earlier in the chapter leveraging their insights and overcoming their shortcomings. Political Risk Services' "International Country Risk Guide" is based on 22 variables divided into political, economic, and financial risk categories, with the 12 variables that make up the political risk category incorporating 15 additional variables or "sub-components". Maplecroft developed a broad spectrum of variables whereby devising 500 indicators tied to political, legal and regulatory, global, climate, human rights, legal and regulatory risks. Conversely, Roubini Global Economics' Social, Institutional, and Regulatory Risk Index ranks 174 countries according to four main "drivers" (social/ political, business environment/regulatory quality, property rights/corporate governance, and government effectiveness) structured upon 155 variables. The RCRI's four dimensions are analyzed across 70 sub-dimensions, 126 countries, and 8 years of data. In this framework, each country is ranked according to the overall level of risk measured against an extensive array of 273 time-series variables, on which the user can act and focus. Countries are clustered by region (Africa, East Asia, Europe, Former Soviet Union, Latin America, Middle East, North America, Oceania, and South Asia) as well as according to the perceived level of development (Advanced, Developed, Emerging, Frontier, and Least Developed). In order to determine the regions, the RCRI relies on standard classifications done by a variety of organizations, such as the World Bank. Instead, for identification of the development level services such as MCSI Barra and FTSE provide denominations and labels of advanced, developed, emerging, and frontier markets. If necessary, the tool can be customized according to users' risk profiles and strategic priorities. This customization can be implemented by adjusting weights, adding new data or subtracting unnecessary data.

Governance

The RCRI's Governance dimension is based on the World Bank's Worldwide Governance Indicators[136] because of the reliability of the results obtained acting on the six main governance variables identified therein: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regularity Quality, Rule of Law, and Control of Corruption. Since 1996, the WGI has used more than 30 data sources, including surveys of companies, households, public sector enterprises, NGOs, and commercial business information providers.

[136] See Kaufmann, Kraay and Mastruzzi (2010)

Economics

Overall, the Economics dimension includes 46 variables grounded on data gathered from many sources. In addition to the Peterson Institute, data is retrieved from the U.S. Central Intelligence Agency's World Factbook, the International Monetary Fund's World Economic Outlook, the World Trade Organization's World Trade Organization Statistics, the United Nations Conference on Trade and Development's World Investment Report, the World Bank's Joint External Debt Hub and International Trade Centre, and the World Economic Forum's Global Competitive-ness Report (GCR) and Enabling Trade Report (ETR).

Operations

The Operations dimension is composed by four main sub-dimensions, namely Business Transactions, Logistics, Operational Landscape, and Short Term Currency Fluctuation, overall containing 110 of the 273 RCRI variables. As defined by Brown (2014), "the RCRI Operations' dimension is broadly analogous to a state's circulatory system, or the framework of economic institutions and infrastructure an organization must engage to be successful in a country". The main information source here is the World Bank's "Doing Business"[137].

Society

The Society macro-dimension includes 109 variables, which are in turn divided into 6 main sub-dimensions: Health, Education, Demographic Dynamic, Gender Gap[138], Middle Class Propensity[139], and Environmental Sustainability[140]. The variables therein envisaged are based on data available from the CIA's World Factbook, United Nations Children's Fund's State of the World's Children, the World Bank's World Development Indicators, the United Nations Office on Drugs and Crime's World Drug Report, the World Economic Forum's GCR, the United Nations Education, Scientific, and Cultural Organization's Institute for Statistics, the United Nations AIDS Statistical Database, the Inter-Parliamentary Union's Report on Women in National Parliaments, the United Nations Development Project's Human Development Report, the International Labor Organization's Labor Statistics Database, and the World Health Organization's World Health Statistics.

[137] See www.doingbusiness.org for further information about the WB project
[138] See World Economic Forum's Global Gender Gap Report (GGR)
[139] See Ravallion (2009), Cavusgil and Kardes (2013)
[140] See Environmental Performance Index (EPI)

GOVERNANCE 25%	ECONOMICS 25%	OPERATIONS 25%	SOCIETY 25%
• Voice and accountability (16.67%) • Political stability and absence of violence/terrorism (16.67%) • Government Effectiveness (16.67%) • Regulatory Quality (16.67%) • Rule of Law (16.67%) • Control of Corruption (16.67%)	• Macroeconomic indicators (55%): GDP growth, GDP per capita, unemployment rate, inflation rate, public debt,budget balance, savings rate, etc. • Market access (42,5%): barriers to Trade, trade index, FDI flows, FDI stock. • Currency under/overvaluation (2.5%)	• Business transaction (40%): starting and closing a business, getting credit, paying taxes, enforcing contracts, etc. • Logistics (17.5%): shipping infrastructure, timeliness, tracking ability, customs, etc. • Operational landscape (40%): innovation and sophistication, infrastructure, tech readiness, business environment, market efficiency. • Short-term currency fluctuations (2.5%)	• Health (16.67%): major health indicators, diseases, substance abuse. • Education (16.67%): basic education indicators and primary education, higher education and training. • Demographic dynamic (16.67%): population, pop. over 65, birth/death rate, pop. growth, pop. density, urbanization. • Gender Gap (16.67%): spread female/male in education attainment, labor market participation, health and survival, political empowerment. • Middle class prosperity (16.67%): pop. below the poverty line, consumption, Gini. • Environmental sustainability (16.67%): environment and public health, ecosystem vitality

In order to clarify the insights and information that can be drawn from the model, the chart below shows the better performing countries as well as the five worse performing countries according to the 2012 RCRI ratings.

	OVERALL		GOVERNANCE		ECONOMICS		OPERATIONS		SOCIETY	
COUNTRY	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
Singapore	1	1000	17	890	1	1000	1	1000	26	701
Norway	2	994	8	973	6	795	8	830	1	1000
Switzerland	3	964	6	975	7	771	14	792	2	972
Sweden	4	953	4	992	14	723	7	836	4	937
Netherlands	5	920	7	975	15	720	10	815	8	878
Gambia	115	130	88	282	118	13	101	329	115	288
Mali	116	128	89	281	105	232	108	270	117	119
Zimbabwe	117	17	119	1	119	1	117	171	113	305
Mauritania	118	10	110	149	116	176	115	186	119	1
Chad	119	1	118	47	73	441	119	1	118	12

4.1.2.3 Effects on the valuation process

The first suggestion that should be made to MNCs willing to open new affiliates in foreign market is to first assess their internal environment. Even though this topic will be further addressed in the following chapter, this is a remark worthwhile to be pointed out from the outset. The impact of the various dimensions of distance cannot be properly evaluated prior to the screening of the internal values, structures and resource-endowments. A fair and solid decision over the appropriateness of an entry mode strategy cannot be made focusing only on the opportunities and threats of the host environment. Indeed, the decision maker within the MNC should have a clear understanding of the resources available (and needed), the abilities possessed and the relationships/networks already established. Moreover, in order to assess the effects of institutional and cultural distance, the home country values and norms must be evaluated, as the firm's internal environment often is a reflection of them. A certain strategy may be successful or a total failure depending on the size of the investor, its business, its endowments, the target country, etc. These initial remarks could seem straightforward but are often neglected and given less importance, time and efforts than they deserve.

The impact of country risk on the whole valuation process can be broadly divided into two streams. First, such assessment is likely to affect the strategy-setting activity of the MNC as to whether and where establish its subsidiaries. Country risk evaluation here takes on a relevant role in determining the attractiveness of a foreign country and, consequently, in devising the entry mode accordingly. Second, country risk is expected to be included in the variables building the valuation methods presented in the second chapter of this work. While the latter set implications mostly rely on economic-financial assumptions and adjustments, the former is composed by qualitative judgements and strategic choices, although grounded on and supported by quantitative data. However, the strategic considerations and financial valuations are to be carried out in parallel as they are closely intertwined and underpinning each other. The separation presented here is merely conceptual. As for the former category of implications and decisions, these essentially revolve around three points: (1) the country attractiveness assessment, (2) the entry strategy and (3) the ownership mode chosen. Both for large MNCs and small companies, substantial market size and/or growth are the clearest indicators of significant opportunities for foreign market entry[141]. However, the investment-attractiveness of a country ultimately depends not much on the risks and opportunities present in the latter, but rather on the abilities and extents to which the company can respond and adapt to the host environment. Therefore, considerations about external risks must be coupled with internal screening in order to verify the presence of viable matchings. For example, the lower is the size of the investor, the more it tends to focus on nearby markets to overcome the distance-related risks[142]. Bell et al. (2003) argue that knowledge-intensive firms tend to focus on leading markets, such as US and Japan. Moreover, these companies are affected by the institutional environment in ways that are not felt by firms operating in capital-intensive industries. In fact, it has been demonstrated that pharmaceutical and high-tech firms are likely to increase their performance by acquiring targets in weak property rights protection (PRP) host countries[143]. Furthermore, the profit-generating opportunities are found to depend on the characteristics of the acquirer and its ability of gaining value in various levels of PRP host countries. When acquirer size increases, it becomes less able to gain value through acquisitions in host countries with weak PRP. Yet when the acquirers' international acquisition experience increases, they are abler to gain value through acquisitions in host countries with weak PRP.

As the various typologies of distance can be meant as the general framework over which more specific risks consideration can be made, market attractiveness can be assessed along two dimensions, namely market size and market proximity.

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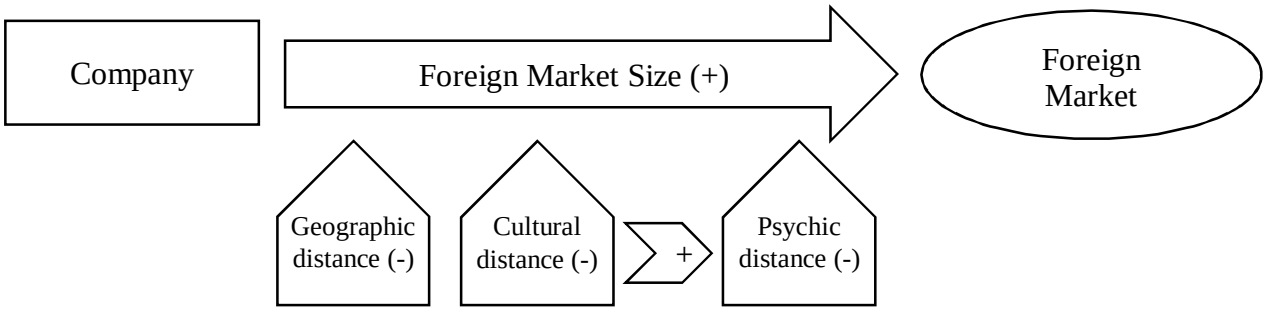
[141] See Bell et al. (2003), Ojala and Tyrvainen (2008)

[142] See Wright, Westhead and Ucbasaran (2007)

[143] See Zhu and Qian (2014)

Large Market Size	Small Market Size	
Attractive market	Less attractive market but easy to reach	**Nearby Market**
Less attractive market because difficult to reach	Unattractive market	**Distant Market**



The various distance dimensions have the effect of moderating the positive influence of market size on the attractiveness of a foreign market. These consequences are supported by the findings of Ellis (2008) and Malhotra et al. (2009). The former argues that in China psychic distance and cultural distance are expected to interact negatively with market size in determining the attractiveness of a foreign country. Even though large markets are per se more likely to attract FDI inflows, when the psychic distance is high, the potentials to attract foreign investments is reduced. Instead, Malhotra et al. (2009) focused on eighteen developing countries identified significant moderation effects between cultural and geographic distance, the size of the market (measured as country GDP), and the number of cross-border M&A. In addition to the curbing effect on the relationship between market attractiveness and its size, as shown in the figure above cultural distance has an important direct effect on psychic distance. The reason is that cultural value and norms influence what individuals and small groups believe, how they behave, how different they are from those in other cultures, and how they react to novelty (Hofstede, 2007).

The choice of the ownership mode essentially hinges on the spread between the resource endowment and those needed, the capabilities and internal structure of the MNC, and the network of relationship on which it can rely. In turn, the extent to which the foreign subsidiary will be able to undertake significant relationships and networking with the local companies is likely to depend on the cultural distance between them as well as the likelihood of the government to interfere. This could prevent the affiliate to gather the needed resources and knowledge as well as to gain legitimacy in the host market. Therefore, both the entry mode and the ownership structure need to be chosen and organized accordingly in order to sidestep these pitfalls. In this case a viable solution is opting for a wholly owned Greenfield investment. Furthermore, as shown earlier, in order to determine the effects of the industrial environment and the likelihood of gaining legitimacy within it, the structure of local clusters must be considered. The findings of Liao (2015) are particularly useful for this purpose. For example, the presence of a cluster of SOEs will have a negative impact on the performance of a foreign firm, while entering a cluster of POEs is likely to have positive effects. Placing the subsidiary in a cluster of FIEs leads to more controversial conclusion: the relationship here is U-shaped with the performance. In the valuation process the decision maker often gleans from the international experience gained through the years. It has indeed been further demonstrated by Liao (2015) that this experience represents a sizable information source having a positive impact on the subsidiary's performance. These effects are valid in the case in which the international experience was gained either in developed countries or emerging economies. Relevant implications can be found also in the relationship

between CSR, institutional weakness and ownership concentration[144]. Generally, concentrated ownership is a way to react and adapt to institutional weaknesses, notably the absence of specialized intermediaries in capital markets. By involving less stakeholders, these companies are less likely to suffer from careful and wide scrutiny and pressure, thus are more likely to undertake activities that might otherwise institutional obstructionism.

Shifting the focus on the effects on financial valuation, the ways through which country risk can be included in the models are multifarious. These implications depend also on the specific valuation model that is going to be applied for the establishment of the subsidiary in the foreign emerging country. Indeed, in the case in which the decision maker opts for the DCF model structured on scenarios development, country risk is expected to have a major impact on the probability attached to each scenario. The effects on cash flows are secondary and indirect. The reason is that country risk, being the most general conception, concerns the overall framework and host environment in which the foreign affiliate is set to operate. In order to have a deeper understanding on the consequences of a specific risk, e.g. taxation-related risk, the general environmental and institutional conditions first need to be defined. In this case, the specific taxation risk will have a direct impact on the amount and timing of cash flows as well as the discount rate. Afterwards, this specific risk is contextualized in the broader framework of the country risk, whose features and assumptions will determine a reasonable probability of occurrence. It would be inaccurate to point out that the former and the latter risk have separated effects of valuation, since the distinction is merely conceptual. In fact, taxation-related risk is a subset of country risk, therefore the latter has an effect on variables other than the probability, although just indirectly. Another example is the expropriation risk, which can be broadly included into the political risks. Given the effects of the potential manifestation of this risk on the amount of cash flow realized by the subsidiary in the period analyzed, the probability will be determined by the measures of institutional weakness and government intervention.

Similar considerations can be drawn for the aforementioned cultural, geographical and psychic distance. These dimensions of country risk are likely to have a joint effect on the cash flows and probabilities. The amount of the synergies that can be attained through a cross-border merger depends on the width of the cultural spread between the countries involved. However, elements of cultural distance as well as the other distance typologies (for example geographical proximity) will have a prominent role in determining the likelihood according to which these events are expected to manifest. While the development of valuation model based on scenario is relatively detached from consequences on the discount rate, the latter is likely to be the object of several adjustments if the "classical" DCF model is applied. In this case, elements of country risk will have a sizable impact also on the variables composing the CAPM and the WACC, reflecting the riskiness of the investment. Recalling the models presented in Chapter 2, the variables that are likely to be affected are the market risk premium and, even more prominently, the beta. There many examples through which these effected can be displayed. The previous paragraphs introduced the role of business-related regulation and bankruptcy code, pointing out the negative relationship between equity risk and shareholders' relative advantage in the renegotiation game. Here the main measure of equity risk is the company's market beta. When debt renegotiations are less likely, the value of the aforementioned put option of strategic default reduces and the equity value is more correlated with the firm's cash flow. Where debt renegotiations are not even feasible, equity risk becomes independent of shareholders' relative bargaining advantage. Favara, Schroth and Valta (2012) found that the average firm's equity beta and return volatility are lower in countries where the bankruptcy code favors a renegotiation of debt. Notably, these measures are expected to decrease if the shareholders' bargaining advantage rises with respect to debt holders in a renegotiation Moreover, beta appears less sensitive to shareholders' advantage in the case in which the bankruptcy code envisages more complex and articulated renegotiation processes. Therefore, in terms of cost of capital, these findings demonstrate that affiliates placed in countries with less debt renegotiation frictions pay, on average, between 23 and 30 basis points per month less. Other

[144] See Nazli and Ghazali (2007)

interesting implications are those related with the consequences of macroeconomic fluctuations. In order to examine this topic and the related effects Bansal et al. (2014) developed a dynamic asset pricing framework in which the discount factor and the risk premium are the outcome of three sources of risk: cash flow risk, discount rate risk, and volatility risk. Their empirical work yields substantially three findings that managers should bear in mind when structuring valuation models. Overall, an increase in volatility is associated with a rise in discount rates and a decline in future consumption, and this volatility risk plays a significant role in accounting for the joint dynamics of returns to human capital and equity. The reported positive relationship between macroeconomic volatility and discount rates results in a positive correlation between returns to human capital and financial wealth. Therefore, countries with high volatility risk are characterized by low economic growth and imply the addition of a sizeable positive risk premium. On average, volatility and discount rate risks account for about 35% of the overall risk premia in the cross section, and almost 50% of the total premium of the market portfolio. Ignoring volatility risk may result in large valuation biases and distortions in asset prices and misleading conclusions about the underlying sources of risk.

On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which country risk affects valuation fundamentals.

Risk Factor	**Effect on valuation fundamentals**
Socio-economic Distance	An increase of socio-economic distance is associated with a decline in FDI flow between a given pair of countries (correlation: -0.2).
Cultural-historical Distance	An increase in of cultural distance is associated with a decline in FDI flow between a given pair of countries (correlation: -0.15/-0.25).
	A change from the 25th to the 75th percentile is associated with a 28% reduction in gains from cross-border M&A. In an average sized MNC, this corresponds to a $50 million loss.
Physical Distance	An increase of physical distance is associated with a decline in FDI flow between a given pair of countries (correlation -0.27/-0.56).
Country Risk Premium	A 0.8% increase is correlated with a 0.4% increase in the banking borrowing-lending spread, with the overall effect of hampering access to financing
Macroeconomic Volatility	Higher macroeconomic volatility is associated with an increase in the cost of equity (correlation: 0.47).
	Higher macroeconomic volatility is associated with an increase in the level of optimal leverage (correlation: 0.014).
	Higher macroeconomic volatility is associated with shorter debt maturity (correlation: -0.011).
Creditor Rights Protection	Where these rights are not properly protected, it is observed a 0.23%-0.3% increase in the cost of capital
	Where these rights are not properly protected, it is observed a 0.08%-012% increase in the cost of equity
	Where these rights are not properly protected, it is observed a 0.29% increase in the cost of capital when there are high amounts of intangibles and insider ownership
Sovereign debt	An 11% increase (with respect to GDP) is correlated with a 9% higher spread on loans to companies. For a syndicated loan of $150 million (4 years maturity) such an increase would add roughly 1$ interests.
	In the case of weak creditor protection, the borrowing costs increase expressed by the aforementioned spread increase by 22%
Enforcement of property rights	Better property rights protection is associated with lower leverage (correlation: -0.09).

4.2 Political Risk

As seen several times across this work, MNCs expanding into emerging countries are faced with different and higher level of risk than those concerning economic activity in developed economies. In fact, these risks are the outcome of the weak regulatory frameworks and higher levels of state intervention characterizing the emerging countries' institutional environment. Howell and Chaddick (1994) correctly defined political risk as "the possibility that political decisions, events or conditions in a country will affect the business environment such that investors will lose money or will have a reduced profit margin". In order to thrive and prosper in these contexts, MNCs' affiliates must be able to effectively interact with the socio-political stakeholder and design relationships with non-market stakeholders as a means to reduce risk exposure. In the previous paragraph the focus was on the importance of network-building activities involving local enterprises able to fill the cultural and knowledge gaps between the home country and host country cultural environment. Conversely, in this section the focus shifts slightly towards the relationships with non-market actors shaping the institutional and regulatory environment of the emerging host country. As pointed out by Gao (2006), in these economies social conflicts arise more frequently and foreign firms can be confronted with discriminatory actions going beyond the cultural ground. Institutional barriers and political risks include expropriation and nationalization, war, civil disturbance, corruption, organized crime, discriminatory action and policies geared against foreign investors[145]. As it will be discussed throughout this section, these sources of risk are likely to harm subsidiary's performance and, consequently, to influence the MNC investment and financial policies in the host country. Investment choices and political strategies will deserve special attention due to their prominent role in determining the success of the affiliate and its legitimacy in the foreign environment. Before deepening into the examination of the political risk factors and the related consequences on valuation, a theoretical overview about the functioning of political system will be provided. Bearing in mind this theoretical framework in the following analyses will allow the reader to have a better and more detailed understanding of the phenomenon.

4.2.1 Literature and empirical findings review

4.2.1.1 The political system and the process of risk emergence

In the early literature[146], the concept of political system includes the set of political activities and processes of a society, and is not as legally and institutionally defined as the concepts of state and government. Generally, it has often been associated to and empowered with legitimate authority, coercion, rule-making, resource allocation and even punishment. However, at least in democratic frameworks, the government will rule with the consent of the ruled. According to those authors, political system can be analyzed in three different levels and functions. The first essentially relates to the conversion process transforming inputs into outputs. Inputs in turn can be divided into two classes, namely demands and supports. Demand-related inputs concern the provision goods and services (e.g., health care), regulation of corporate activity (e.g., product safety), symbolic commitments to values such as democracy or free-market. On the other hand, support inputs are needed to convert demand inputs into output, and include material support (e.g., tax payment), participation (e.g., political activism), and obedience to laws and regulations. From the MNC

[145] See Brouthers, Gao and McNicol (2008), Garvey and Gallagher (2012)

[146] Almond and Powell (1966), Easton (1965)

perspective, inputs might be generated either in the home or host country. Throughout the conversion process, different actors are in charge of and involved into the different steps as shown in the following chart.

Process phase	Actors involved
Articulation of interest/demands	NGOs and lobbies
Interests aggregation	Political Parties
Conversion of policy proposals into formal rules	Government rule-makers
Application of general rules to particular cases	Government's bureaucratic agencies
Adjudication of rules in individual cases	Judiciary authority

The second level of analysis concerns the interaction between the political system as a whole and its environment. The boundary between them is flexible and depends on political authority involvement and specific capabilities, namely distributive, symbolic and responsive. These capabilities are closely related to (and can be broadly meant as) the outputs of political system. The extractive capability refers the ability to obtain material and human resources from the domestic and international environment, for example through tax levies. The regulative capability is connected to the control over individual or organizational activities by means of specific bodies of rules. The distributive capability is related to the allocation of goods, services and benefits to individuals or groups within society. The symbolic capability indicates the ability to convey properly the values embedded in the society. The responsive capability is the extent to which the political system is able to convert legitimate demand into policies, laws and reforms.
The third complementary function is related to the maintenance and adaptation of the system itself. The figures in charge of the aforementioned roles must be recruited and trained properly. As stated by van Wyk (2010), in democratic environments "elections are the primary recruitment function to fill the important decision-making roles in the political system". Conversely, centralized and authoritarian systems, "more opaque recruitment methods are employed (e.g., appointment, cooptation, rigged elections)". The actors involved in the formal political system must then undergo a process of induction into the political culture of the society. Political culture is represented by the set of attitudes, economic ideologies, values and emotional feelings underlying the political system. In these frameworks, according to the different kinds of culture likely to manifest, individuals might exhibit different levels of political awareness, participation and involvement. In such a political system, the appearance of risk sources and their management can be broadly structured in a series of different steps as observed by Howell (2002). Nevertheless, this way of conceiving political risk definition and management should not be meant as a linear process. In fact, managers should combine quantitative information with experience and creativity to build different scenarios in which risks and opportunities are identified. Adopting this approach (connected to the "real options" seen previously), the decision-maker is able to explore possible and viable alternatives of political risk management. Thus, the process can be perceived as a flow starting from the conditions of risk emergence, and then identifying the politicized events engendering threats and risk. As it will be shown in the section addressing the managerial and valuation implications, this process is an opportunity for managers to develop viable and timely policy responses to the formation process before it eventually triggers a business risk. First, the search for the conditions underlying political risk should not limit to the host country institutional environment nor to the government authority and will. Indeed, internationalization of business activity and of domestic politics have brought into the dispute also NGO, IGO and activists groups/movement creating what McAdams (1998) refers to as a "multilevel game". The conflicting and competing political interests of these actors are likely to pose several risks to the MNC willing to establish its subsidiary in a foreign market. Taking the example of NGOs, according to Doh and Teegen (2003), they might be considered stake-givers or stake-takers. In the former case they support the affiliate by providing prestige and legitimacy with respect to human rights, business ethics and local values. Conversely, stake-takers NGOs have a prominent role in attacking, altering and distorting the relationship

between governments and businesses. These conditions are transformed into events when the aforementioned interests and issues are politicized by a certain group whose demands are brought on the political system.

The occurrence of a politicized event may be triggered by a boundary-crossing input or a "withinput" (van Wyk, 2010) inside the political system. In the former case, a certain interest group (e.g. labor union) puts forward a demand regarding a specific policy or a change of it (e.g. protectionist regulation to save job against strong competition from international companies). Demands in cross-border input might manifest through protest marches, legal actions and consumer boycotts. Conversely, "withinputs" demands originating within the political system are driven by institutional powerful groups in the bureaucracy or legislature that are involved in the formal agenda setting process. The company's risk exposure may be increased by the occurrence of politicized events such as changes in the political authority or regime. The investment of a foreign MNC could be deterred by the protectionist barriers set by a new government. Alternatively, it could be supported by a new government committed to trade liberalization. An interesting comparison is that between Italy and Venezuela in the late '90. Italy underwent eighteen changes of government between 1970 and 1995, but without sizable impact on business risk since the country's regime have not been changed significantly. In contrast, the Chavez government in Venezuela changed the regime by adopting a new constitution after its electoral victory in 1998. This change heightened political instability including labor strikes, public protests and an attempted coup[147]. MNCs should be routinely scanning the environment searching for early signals of the manifestation of such threats. Few examples of these indicators are threats of industrial action, public speeches by political elites, media reporting on the probability of harmful action and the introduction of regulation hampering business operations.

Analyzing the various facets of political risk against the functions identified above, van Wyk (2010) insightfully connected his study with the classification of strategic risk made by Simons (2000). First, operations risk is connected to the unexpected and unfavorable cost of production downtime. Second, asset impairment risk is represented by the likelihood of the company's resources to lose value (not only physical and financial assets, but also the piracy of intellectual property rights is included). Third, competitive risk stems from the changes in regulation shrinking the firm's competitive edge in the host market. Fourth, franchise risk and reputational risk are related respectively to legal liabilities and unfavorable stakeholders' opinion towards the company. The following chart provide a set of examples combining the two researchers' analyses and findings.

FUNCTIONS\RISK	Operations	Asset Impairment	Competitive	Reputational
Conversion process	Value creation processes (production, supply chain) hampered by civil conflicts and legitimacy crisis.	Physical damage to production facilities and extensive inventories theft.	Higher political instability leading to decline in consumer demand and access to suppliers.	Consumer boycotts due to MNCs' wrongdoings (dangerous products and sweatshops).
Regulative Capability	Labor market shortcomings and lack of facilitations.	Restrictions on cross-border transfers of profits, dividends and investments.	Constraints on foreign ownership and discrimination towards foreign MNCs.	Flawed implementation and enforcement of contracts and property rights.
Extractive Capability	Compliance to local regulation leading to lower productivity and efficiency.	Assets expropriation, discriminatory Taxation and corruption.	Discriminatory taxation.	Piracy and counterfeit of the MNCs' intangible assets (patents and brands).

[147] See Shifter (2006) and Whalen (2006)

Distributive Capability	Government policies aimed at isolate the MNC; Underdeveloped infrastructure.	Assets expropriation and confiscation	Higher cost for companies acting on the behalf of government for the provision of public goods such as education and health care.	Regulation imposing to foreign companies to share intangible assets and intellectual property with local enterprises.
Responsive Capability	Prominent role of protectionist groups such as NGOs and labor unions in the formal agenda setting for issues like wages, benefits and products' features.	Formal agenda setting dominated by political groups.	Prominent role of protectionist groups such as NGOs and labor unions in the formal agenda setting for issues like wages, benefits and products' features.	Courts Politicization aimed at undermining MNCs' interests.
Symbolic Capability	High political groups' rhetoric in favor of greater state intervention in MNCs' activities.	High political groups' rhetoric in favor of state ownership.	High political groups' rhetoric in favor of alternative ideologies against market capitalism and free market.	High political groups' negative rhetoric towards foreign firms and of intellectual property protection.

4.2.1.2 The trade-off between political benefits and control benefits

If a MNC implements a FDI in a given emerging country, it keeps the control over the subsidiary's operations. Conversely, with FPIs (Foreign Portfolio Investments) and JVs the foreign investor's ownership is limited to a more or less great share of the total. In the former case, the company benefits from both ownership and control of the affiliate's activities. However, when an ownership share is held by a domestic partner, the foreign MNC can obtain several advantages from the connections of the latter with political and institutional authorities. Therefore, by investing in foreign emerging country MNCs are faced with several trade-offs, among which there is the choice between political benefits and control benefits.
When a foreign investor decides to enter a foreign country through a WOS, the profit diversion by inside shareholders is reduced, minimizing agency costs. Nevertheless, it must seek alternative paths to gain access to tangible and intangible resources that are essential for operating in the host environment. Notably, the subsidiary will be supposed to build relationships with local firms and political authorities from the ground-up, potentially delaying the legitimacy attainment. Oppositely, if the MNC engages in FPIs or JVs, local shareholders have the power to lobby the government for preferential treatment such as tax cuts as well as for more favorable market regulation. Moreover, majority foreign-owned companies are often directly or indirectly disadvantaged by the tax-code and regulation in force in the host country. For instance, in Russia during the '90s tax-cuts were granted discretionally by politicians, favoring domestic firms. According to the regulation in force, companies owned by foreign investors with a share greater than 40% are prohibited from acquiring land with agricultural purposes or close to the country's borders. Additional examples are Cuba and Brunei Darussalam, that announced preferential tax treatment for projects funded by local investors for amounts not lower than specific thresholds. Moreover, domestic companies can often rely on easier access to government contracts and external financing[148]. For example, in Brazil, subcontracting from state enterprises is prohibited for companies without local ownership and control over operations. The choice of a majority-owned investment rather than a FPI/JV depends on the

[148] See Rajan and Zingales (2003)

valuation of the payoffs deriving from the considerations about the aforementioned trade-off. Considerations about another trade-off, namely that between the internationalization scope and political risk, will be drawn and discussed in the next section.

4.2.1.3 Political risk and internationalization scope

Political risk has been acknowledged to affect firm's decisions as to whether and where undertaking an international expansion strategy. Notably, apart from the choice of the specific target country, political risk has a role in determining the internationalization process and scope of the MNC. As it has been shown in the previous chapters, there are several frameworks through which analyzing the drivers of FDI in emerging countries and the modes chosen by MNCs to gain access to these markets. On the one hand, the ''eclectic paradigm'' or OLI model of Dunning (1981, 1988) suggests that the decision to engage in FDI is driven by three advantages, namely ownership, location and internalization advantages. However, this model has been criticized because it is unable to properly explain how FDI is actually carried out, although it provides useful insight as to which characteristics drive domestic firms to become multinational.
Interesting considerations have been drawn in the literature from the application of the Uppsala model (Johanson and Vahlne, 1977, 1990) in the analysis of the internationalization process. According to this perspective, companies' foreign expansion is divided in small and subsequent steps in which the required knowledge and experience are gradually acquired. This model, based on empirical observation of Swedish firms, identifies four stages in the internationalization process: no regular export activities, export through independent agents, creation of a foreign sales subsidiary and, eventually, foreign production facilities. Although exceptions to this behavior have been found (e.g. firms with experience in similar markets and "born-global" companies[149]), the Uppsala model entails a second assumption. According to the model, companies expand towards foreign countries starting from the closer ones. Notably, a firm will establish one or more subsidiaries abroad up to its tolerable risk frontier, expanding it only when enough resources, knowledge and experience have been gathered decreasing market uncertainty.
These insights are supported by the findings of Wan (2005) and Henisz and Zelner (2005), in which companies are documented to enter politically safer countries with lower bureaucratic costs due to liberalization policies. However, as reported by Jimenez et al. (2008), internationalizing firms might opt for riskier environments because of the opportunity to acquire more diverse and complementary resources as well as gaining competitive advantages through negotiations with host governments. Following the Uppsala model perspective, these firms will invest in politically risky countries only after having gathered enough knowledge and experience. Thus, only MNCs with a wide scope of internationalization can be expected to invest successfully in markets with high levels of political risk. This statement is demonstrated also by the research conducted by Jimenez et al. (2010) on 166 Spanish companies with FDIs in 119 countries. This research offers further interesting implications about the relationship between not only internationalization scope and political risk level, but also with the diversity of political system and risk. In fact, international diversification provides the MNC with the possibility to enhance core competencies and gain unique knowledge by gleaning into the emerging market environment and local networks[150]. Multinational companies are motivated to diversify internationally their activity in order to renew the set of skills and competencies as well as managerial talent. Therefore, environmental diversity is expected to drive companies to widen their scope of international expansion to exploit these benefits. Moreover, by investing in a greater number of (different) countries MNCs are able to react to competitive pressure as well as to hedge against local fluctuations in supply and demand. Assuming the logic of the portfolio

[149] See McDougall, Shane and Oviatt (1994)
[150] See Hitt et al. (2006)

theory[151], international companies widen their geographical scope when the targets of their FDIs are considered risky, thus diversifying risk and creating an efficient portfolio of countries. Generally, International diversification is expected to benefit MNC with the exploitation scale economies as well as more access to unique resources, knowledge and relationships[152]. The creation of economies of scale enables the company to spread more fixed costs on a wider market, and this is particularly important in R&D intensive industries. Access to unique resources and knowledge allows the company to structure more flexible and efficient internal operations and to improve its competitiveness with respect to both foreign and local firms. Transnational expansion is able to provide value to the MNC only when these benefits from diversification outweigh both the costs of running foreign operations and the risks the company must cope with in the host environment. As it will be further discussed in the following sections, the positive relationship between political risk and internationalization scope ultimately hinges on the development of political capabilities[153]. These specific skills allow international companies to effectively negotiate with host governments taking advantage of the high levels of political discretion and, often, corruption. Several researches, for instance that conducted by Wan (2005) on Latin America, have demonstrated that MNCs investing in emerging countries are more likely to develop "non-market" rather than "market" capabilities in order to prosper in these environments. In emerging countries, in fact, governments often centrally control and allocate resources and foreign investors attempt to access them by building close relationships with political authorities. Furthermore, Brouthers et al. (2008) interestingly reported that some companies might find advantageous to invest in highly corrupted countries, since this phenomenon may create resource-allocation efficiencies in systems with low economic and legal regulation. Efficiency here is ensured by the fact that only the individuals or groups really willing to commit in a certain project will be willing to pay. Nevertheless, managers should carefully assess the importance of corporate social responsibility in terms of corporate image as well as the compliance to ethical value without limiting the focus on short term competitive advantage. MNCs relying on corruption risk to jeopardize the legitimacy and influence gained through status strengthening in the host country. Moreover, considerations involving economic efficiency would be more than offset by the adverse effects in economic growth as well as income distribution and poverty.

4.2.1.4 Political Risk and Corporate Governance

It has generally been assumed that improvements in investor protection, corporate governance and relations with the institutions have positive effect on cross-border valuation. These results hold only when the variables are considered singularly. However, according to the "twin agency problems" identified by Stulz (2005), the moderating effect of government intervention must be taken into account, especially when it manifests as expropriation activities. Recent surveys of the Economies Intelligence Unit and the World Bank's Multilateral Investment Guarantee Agency (MIGA) revealed respectively that political risk is acquiring progressively greater importance in corporate agenda and that expropriation is the third most cited cause for companies that have scaled back, canceled, or delayed investments. Expropriation risks can take on several forms such as contract viability, overregulation and confiscatory taxation. These risks still rank as some of the highest concerns on corporate agendas as they consider investing in Latin America, Middle East and North Africa. In countries characterized by predatory governments, foreign investor will consume more private benefits because the financial resource they leave in the firm may be wholly or partially expropriated by the state. Moreover, while increased disclosure makes it more difficult for insiders

[151] See Markowitz (1959) and Tobin (1958)
[152] See Kyaw, Manley and Shetty (2011)
[153] See Holburn (2001), McWilliams, Fleet and Cory (2002) and Henisz (2003)

to appropriate from outside investors, on the other hand it eases state expropriation. Therefore, foreign MNCs find it costly to increase the quality of governance and disclosure since the benefits are not fully captured by the shareholders but are shared with the state. Thus, the value of cross-border transfer of better governance and more disclosure is under predation. In the case in which the twin agency theory verifies, the value gained through increased protection brought by the acquirer is mitigated by the target state expropriation risk. The moderating effect is demonstrated by the research conducted by Col and Errunza (2015), in which targets are reported to receive a significantly lower premium because of expropriation risk. Generally, the merger premium is higher in acquisitions where the acquirer's corporate governance practices are more developed than those of the target. This higher premium is the outcome of the likely improvement that are expected to be realized in the latter. In fact, researchers documented that "one standard deviation increase in the difference in shareholder protection results in 4.5% increase in the average premium". However, a one standard deviation increase in expropriation risk is reported to lower the cross-border acquisition premium by 4.57%. As will be insightfully discussed in the section about the managerial implications, this premium reduction is the outcome of variations in the predictions concerning the subsidiary's cash flows and profitability. These findings support the claim that the subsidiary is likely to miss the benefits from the improvement in corporate governance and disclosure as they suffer from the risk of appropriation by the host country political authority.

4.2.1.5 Political Risk, government elections and policy changes

The previous sections showed how politic systems and institutions in emerging countries are likely to affect the investment decision of the foreign company because of the instability characterizing them. Notably, the uncertainties surrounding the changes in government policies and leadership may have severe implications for political groups and companies, both local and international. In the literature it has been argued that this uncertainty is likely to affect especially the timing of the investment as well as the financial and human resource commitment of the foreign company. The elections involving the appointment of the national leader has frequently been used as the context in which studying political uncertainty. Elections outcomes are relevant for companies' policies and decisions as they are likely to shape industry regulation, trade and monetary policy, taxation and, as the previous paragraph highlighted, expropriation of private assets. This array of risks is heightened by the cyclicality of political terms and mandates. The notion that political instability is expected to deter FDI inflows is supported by empirical evidence. For instance, Barro (1991) and Alesina and Perotti (1996) reported that cross-country differences in investment rates are motivated by political instability and violence. Similar conclusions are those of Pindyck and Solimano (1993) and Mauro (1995), claiming that political risk (especially corruption) is negatively related to investment spending.
Phenomena such as political elections increase temporarily this uncertainty and instability, inducing both domestic and international companies to reduce their investment rates. This cyclicality of corporate investment around political elections is supported by Julio and Yook (2012). Their research, based on national elections in 48 countries between 1980 and 2005, found that in the period before the election investment expenditure declines on average by 4.8%, and investment cycles are larger when the political parties compete on the same level and number of votes. Moreover, they found that this temporary decline in investment rate is accentuated in countries with civil law heritage[154], fewer check and balances, less stable government and centralized control over public expenditure. Industries considered more sensitive to political outcomes and support are likely to reduce investment spending on a rate above the average. In

[154] Given that common law countries are generally characterized with stronger investor protections, it is reasonable to expect that these protections are likely to remain intact even after a transfer of political power, limiting the range of potential outcomes.

fact, some companies might be driven to modify their investment policy to help their political connection remain in the office after the election. This behavior is demonstrated by a research conducted by Bertrand et al. (2006) on the investment policies of politically connected CEOs in France. Companies are also reported to increase cash holdings by 4.3% of the average "cash to asset ratio" in the year before the election, suggesting that the funds that would have been used for investment are temporarily held as cash until the outcome of the election gest clearer. Evidence of the effects of political uncertainty related to election can be found also in the financial markets: as found by Bialkowski, Gottschalk, and Wisniewski (2008) and Boutchkova et al. (2011), stock market volatility is remarkably higher during election periods. Bernhard and Leblang (2006) specifically documented increases in exchange rates, bond yields and equity volatility around elections. Political elections represent a specific case in which several policy and regulatory changes are likely to occur with the rise to the power of a new leading party. However, uncertainty about government policy is inevitably inherent to the political system itself, regardless of whether polls are close or not. Changes in government policy are likely to be reflected in price reactions in financial markets, since they shape the companies' environment by levying taxes, providing subsidies or regulating competition. Pastor and Veronesi (2012) insightfully distinguished between two kinds of policy-related uncertainty, both affecting significantly stock prices. First, political uncertainty refers to the likelihood of the current government policy to change. Second, impact uncertainty is related to the impact that a new government policy will have on domestic and international companies. The effect of the announcement of a policy change on stock prices is dual. On the one hand, if the policy purposes are perceived advantageous, a change generally increase companies' future profitability pushing stock prices up. On the other hand, the adoption of a new policy is likely to change the "rules of the game" set forth by the previous policies, making the impact of the new policy on firms' profitability more uncertain. This uncertainty raises the discount rate pushing stock prices down. Pastor and Veronesi (2012) found that the latter effect is stronger than the former. The reason explaining the weakness of the future cash flows-effect is that the positive outcomes are more predictable through the information disseminated in the market, thus the policy changes are largely anticipated by investors. Moreover, in emerging market expected announcement returns are even more negative because of the higher amount of uncertainty about government policies. The political instability characterizing these countries enlarge the element of surprise of the policy change announcement.

4.2.1.6 Political risk and the importance of political strategies

At the outset of this paragraph about political risk, the importance of specific capabilities through which address and manage the relationships with non-market stakeholders has been pointed out. These capabilities refer essentially to the development of political strategies aimed at optimizing these relationships as well as prioritizing and meeting the interests of powerful stakeholders. Hillman and Hitt (1999) distinguish between three types of political strategies supporting MNCs reduce and curb the political risk in emerging countries. The first category is the financial incentive strategy, aiming at reducing the risk exposure using financial resources. Companies are able to support financially political and institutional bodies sponsoring speeches and events. Alternatively, MNCs could hire personnel with political experience and connections as advisors when implementing their investment choices. Financial incentives are deployed to align the interest of the policymakers with those of the MNC, allowing the latter to reduce their risk exposure in emerging economies. In absence of well-developed institutions and weak regulation, this strategy is important to create a more stable and supportive environment. Specifically, the enactment of detrimental laws could be avoided and the re-election of supportive government could be promoted.
The purpose of the information strategy is to address directly political authorities expressing preferences and opinions about policies and resource allocation. This strategy might drive actions such as lobbying,

providing survey results, reporting on research projects and supplying expertise in managing controversial issues. MNCs undertaking information strategy are able to reduce their risk exposure in several ways. The likelihood of beneficial regulation is increased as policymakers are more aware of the potential negative impacts of a regulation change on the company's business and the possible reactions of the latter. Moreover, political risk is also curbed by the provision of preferential access to information to political parties that are supportive towards the MNC's foreign operations. The third typology is the constituency-building strategy, and it is aimed at enhancing the public opinion and stakeholders' support towards the company. Adopting this strategy, MNCs may engage in activities related to public relation, public mobilization, display of political position and compliance to codes of conduct[155]. Not only political stakeholders are included, but also socially committed groups such as NGOs and trade unions are taken into account in the development of strategies aimed at building a credible, positive and sustainable corporate image. Once this image and reputation is strengthened, it would be hard for the government to enact regulation that may be harmful for companies close to and aligned with public opinion. Moreover, the likelihood of consumer boycotts is expected to decrease substantially. The effectiveness and the outcomes of political strategies heavily depend on the visibility of the MNC in the host environment. In the literature, the concept of "visibility" has often been associated to the investor recognition in the context of IPOs and international cross-listing. Focusing the study on MNCs, their visibility is connected to a broader level of "stakeholder recognition". In fact, as defined by Puck et al. (2013), a foreign MNC's visibility "relates to the degree to which stakeholders in a particular location, including consumer groups, unions, or the general public, are able to observe the particular firm's activities in the location". In the literature, authors like Hansen and Mitchell (2000) studied firms' visibility as the determinant of the political strategies carried out as well as the related activities such as lobbying. Claiming that visibility is the determinant and the source of political strategies, these authors assume that companies know more or less precisely which is their degree of visibility in the foreign country. However, other authors like Puck et al. (2013) suggest that elements such as the liability of foreignness and structural inertia may prevent foreign companies to assess correctly their level of visibility. Conversely, visibility should not be seen as the determinant of political strategies but rather as a moderating variable conditioning their effectiveness and their outcomes. Visibility affects the number and the kind of socio-political stakeholders as well as the pressure there are likely to exert on the company, thus MNCs must be able to devise strategies tailored to the needs and the pressures of these actors.

[155] See Capron and Chatain (2008), Taminiau and Wilts (2006)

Chinese Political and Institutional Environment

Political decisions and instability are two factors hindering western companies to operate efficiently in China. The Communist Party Committees strive to ensure that policies and guidance are followed, and non-party members are prohibited from creating autonomous organizations able to question them. Before operating in China, a foreign company is subject to close scrutiny and must obtain the approval of the central government. Especially for MNCs the regulation is particularly strict and complex. As for the political system, regulation formation and implementation rules are often complex and unclear, making it difficult for companies to comply with them. Policy-makers are distributed throughout the levels of government, therefore many inconsistencies and contradictions often emerge. Intellectual property protection in China is very weak compared to western countries. In order to comply with the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), Chinese policy-makers have reinforced the legal framework amending the Intellectual Property Regulation (IPR). Nevertheless, China is still a place where counterfeiting prospers, and the piracy rate remains one of the highest in the world causing severe financial and reputation losses to legitimate businesses. Thus, foreign companies have to undertake special measure to protect their intellectual property. Overall, companies in China must face fierce competition without the proper oversight, and often they are obliged to take drastic measures even at the expense of consumer safety and, consequently, reputation. Another critical point is the complicated relationship with China and other countries. For example, the decision by US to limit imports and exports to China in order to protect domestic economy disappointed many influential Chinese companies. Some of them even refused to trade with any American company, driving many of them out of Chinese market.

Adapted from Ethridge et al. (2011)

4.2.2 Managerial implications and effects on valuation

The impact of political risk on valuation criteria and methods as well as the related managerial implications are multifaceted. Again, on the one hand these considerations entail qualitative judgements and decisions within the strategy-setting activity. On the other hand, specific insights can be drawn as to how the fundamentals of the financial valuation methods are affected.

4.2.2.1 The political risk management policies

Policy\Sequence	Conditions	Politicized Events	Threats	Risk
Avoid	x	x	x	
Anticipate	x	x	x	
Share	x	x	x	x
Offset				x
Exit			x	x
Remedy			x	x

Along with the deployment of quantitative and financial tools, MNCs should develop appropriate policies in order to cope with political risk understanding the mechanisms of political system. The chart displayed above outlines some of the strategies that the company could undertake to react to the issues emerging in

the political risk formation process[156]. However, the successful implementation of proactive strategies heavily depends on the ability of the MNC to coordinate its international activity and to monitor the host environments in which its subsidiaries operate. The first and probably most prudent decision is that regarding the direct avoidance of a certain emerging markets because of adverse institutional conditions and politicized events making the country less attractive for FDI. This avoidance could also take the form of a delay, waiting for more favorable conditions. However, as it will be further discussed in the next chapter, this strategy could be the outcome of managers' characteristics such as inflexibility, conservativism and low risk appetite. MNCs have to be aware of these unmotivated deterrents as they could drive to the refusal of profitable investment opportunities. Anticipation is associated with the ability of the company to understand the aforementioned levels of the political system, especially the conversion process. In this sense, anticipation is related to the set of actions carried out to prevent the emergence of threats and risks leveraging the political capabilities discussed above. For instance, the company could offer incentives as well as financial and information support to influential stakeholders. Moreover, specific alliances can be created with local enterprises to improve the legitimacy in the host environment and political decision-makers can be induced to issue more favorable policies[157]. These alliances are the basis of another possible strategic option, entailing the sharing of risk between different partners. The agreements may be developed along the supply chain, including suppliers or distributive networks. Alternatively, contracts such as joint ventures could be devised with local businesses to compensate the lack of knowledge and relationships and at the same time mitigating the risk by committing a lower amount of resources in the venture. Risk can also be managed and shared through the trading of financial derivatives (forwards, futures and swaps) and the subscription of political risk insurances such as those provided by the Multilateral Investment Guarantee Agency (MIGA). However, it must be pointed out that these services cover a limited set of risks. Another possible solution is to offset the negative consequences stemming from a risk that have already manifested. This is the case in which the implementation of a diversification strategy in the host country is particularly beneficial. In fact, it allows the company to be flexible enough to absorb the additional costs emerging from a trickier operation with the profits earned by a safer one. A company might decide to divest and exit from a foreign emerging country if severely adverse events occur, like for example consumer boycotts, sanctions from the home country for the investment in a specific market or the expropriations carried out by the host government. For instance, these were some of the reasons driving Exxon Mobil and Halliburton respectively out of Venezuela and Iran. Despite all the efforts by the MNC, certain events affecting negatively the affiliate's profitability cannot be predicted and anticipated by appropriate countermeasures. Sometimes, the unethical behavior of the company itself can severely harm its reputation and image among the stakeholders. A glaring example is the recent scandal involving Volkswagen that created a software able to reduce the NOX emissions only when cars were under monitoring tests, cheating the market and the customers. Companies can implement a wide array of actions to tackle reputational risk. For example, after having assessed the damages, managers can improve the corporate communication and gear the disclosure towards the achievement of new values and expectations. Specific managerial figures may put in charge of the development of specific metrics against which evaluate and monitor the improvement, ensuring constant learning.

4.2.2.2 The effective development of political strategies

Given the mitigating effects of firms' visibility, the effectiveness of the aforementioned strategies will depend also on the target of the subsidiary's offer, namely whether the activity is B2B or B2C. Researchers

[156] See van Wyk (2010), Hilbert and Jones (2004) and Minor (2003)
[157] See Van Wyk, Dahmer and Custy (2004)

have demonstrated that information and financial incentive strategies are likely to have a sizable negative impact on risk exposure when the company is more visible to local firms and government. Thus, companies operating in B2B industries should reduce their political and institutional risk by addressing the actors whose activity is expected to heavily affect their operations, i.e. the government and policymakers. These kind of strategies are reported to be particularly useful when the targets of financial incentive and information can be clearly identified and the relationships are specific instead of diffused. In contrast to companies operating in B2B industries, foreign firms targeting directly the end consumers are more required to advertise and promote their product and their message in the host market. Thus, they are visible and exposed to a wider set of stakeholders. However, the broader visibility reduces the scrutiny and relative weight of the individual actor, so the financial incentive and information strategies might not be the right choice in this case. Instead, the strategies geared towards building a solid and positive reputation may improve the perception of a wider set of stakeholders, in line with the objectives of the company to provide products and services to the general public. Therefore, MNCs operating in B2C industries could reduce their risk exposure by devising strategies aimed at enhancing their legitimacy and image among a wider number of stakeholders[158].

There are other factors that MNCs should consider in developing political strategies, as visibility is not the only variable influencing their effectiveness. In fact, many stakeholders in host emerging countries perceive MNCs' foreign affiliate as a menace[159]. Notably, as documented by Kostova and Zaheer (1999), NGOs may be skeptical and diffident towards their goodwill and the reliability of the information disseminated. Therefore, much of the efforts of the MNCs and its subsidiary to gain legitimacy in the host environment are dampened by this sense of mistrust. The belief that these strategies are aimed only at reputation-building reinforce the stakeholders' opinion that these affiliate do not contribute positively to the local environment, especially if they reduce domestic products sales. Foreign investors should also pay attention to the contraindications of reputation building strategies. In fact, an intense commitment in such efforts put the company under the scrutiny and pressure of external stakeholder, progressively raising their expectations and the risk exposure. Visibility is also affected by the entry mode strategy. Indeed, it can be expected to be lower if the MNC sets up a WOS in the foreign country, while it is likely to increase whether a JV is established with local partners able to leverage political connections. Moreover, as reported by Durnev et al. (2015), the value of these political connections are more valuable if the formal and institutional environment is less likely to suffer from turmoil and frequent changes. Thus, the preference for a JV over WOS should be stronger if the political environment is more stable. Notably, higher political stability, associated for instance with the party of the executive, increases by almost 5% the chances that a multinational will engage in JV as opposed to WOS.

4.2.2.3 The effects on valuation fundamentals

Beside more qualitative and strategically relevant considerations, political risk is expected to enter valuation models in various ways. Indeed, several variables should be adjusted to account for the adverse consequences of political and institutional instability in the host environment. Generally, higher degrees of political risk are associated with greater uncertainty in the host environment about the future cash flows, increasing the both the cost of debt and equity. Given a certain amount of annual cash flows, these higher costs are expected to reduce the profitability of the foreign affiliate. Therefore, the company value, expressed as a function in which the projected future cash flows are discounted at higher rate, is likely to decline as political risk increases.

[158] See van Tulder and van der Zwart (2006)
[159] See Mattingly (2007)

Market Risk Premium

First, the effect of political risk combined with those related to the general country risk must be reflected in the CAPM, assigning a higher risk premium and a higher beta. The specific amounts that are to be added depend on the particular country that is considered, the time frame of analysis and the predicted impact on firm's operations. Moreover, if the valuation is executed through the development of multiple scenarios, risks emerging from the formal environment should be joint to those of the informal environment in order to determine the probability to be attached to each scenario. Throughout the literature there is no doubt over the notion that market risk premium is significantly higher in emerging countries than in developed economies, although the conditions explaining those differences are still under debate. Generally, it is assumed that in companies investing in emerging country have to compensate investors for the risk borne with higher returns. Illiquidity of financial markets, transaction costs and the risk of unfavorable policies are some of the reasons underpinning the request for higher premia. Additionally, these risk premia in emerging countries are less stable and predictable that those of developing countries because of the instability of the formal environment. For instance, empirical findings of Barro (2006) demonstrated the relationship between risk premia and institutional dangers deriving from adverse regulation, corruption and government incompetency. When these risks are more present in emerging economies, international investors are likely to ask for higher premia.
The following chart displays the average risk premia documented by Donadelli and Persha (2014) in the time frame between 2003 and 2012 in 18 emerging countries, highlighting the difference with that of the US market.

Country	**Avg Market Premium 2003-2012**
United States	8.70
China	23.51
India	23.94
Malaysia	17.56
Pakistan	12.35
Philippine	29.58
Sri Lanka	17.81
Thailand	24.19
Argentina	16.52
Brazil	29.39
Chile	20.44
Colombia	34.23
Mexico	21.32
Peru	29.06
Czech Rep.	20.53
Hungary	9.75
Poland	18.61
Russia	26.36
Turkey	29.79

Timing of the Investment

As anticipated in the previous section, sometimes the best option for the MNC is to put off its investment in the foreign emerging country. Therefore, another valuation fundamental that is likely to be affected by

political risk is the timing of both the investment and the related cash flows. This implication is particularly evident recalling the relationship between political elections and investment cycles. Specifically, if the output of an election could potentially be unfavorable for the foreign investor, the value of the option of waiting to invest increases and the firm may reasonably decide to put off its commitment in the host environment until political uncertainty phases out. As discussed above, negative changes in the regulatory regime may result in detrimental taxation and disadvantageous competition rules. The outcome of an election could also be deemed positive by foreign companies, for example when a corrupt and incompetent government is substituted. However, they still have the incentive to delay the investment since the upcoming election is likely to increase the expected returns of future investment. The option to wait increases also when the result of an election, although advantageous, change the priorities set by a company for the resource allocation between alternative investments.
As further specification, it can be argued that the option to wait is less valuable in common law countries where investors are better protected regardless of the political regime in force. Conversely, in more politically unstable systems investments are subject to wider cyclicality. Similarly, political uncertainty is also correlated to the adoption of a democratic/parliamentary system rather than an authoritarian/presidential. The latter are characterized by frequent checks and balances preventing regulation (and leading parties) to change easily and frequently. Conversely, in the former changes in control within government and legislative system occur more rapidly and with fewer constraints. Therefore, parliamentary systems are more likely to generate political instability, thus creating wider investment cycles as well as increasing the value of the option to wait.

Cash flows

As documented in the literature discussed above, political risk has a direct effect on the future expected cash flows generated by the foreign subsidiary. If a MNC projects to enter a foreign emerging country through a cross-border acquisition of a local company, the premium paid for the merger is significantly lower as political risk increases. This lower premium reflect the likelihood of future cash flows to be reduced because of political risk and government intervention. In fact, higher degrees of political instability and detrimental regulation might prevent the MNC from benefiting of the synergies stemming from the acquisition. The capability of the foreign affiliate to generate solid and stable cash flow can be dampened both by government policies aimed at harm foreign companies and by political/institutional uncertainty hampering also local companies to operate effectively. For instance, regulation stifling competition might hinder the efforts of foreign companies to gain legitimacy and market share, shrinking their revenues. Another frequent case is that of unfavorable taxation, especially towards foreign investors rather than local firms, that could severely hit the profits of the subsidiary. Other extreme examples are the risks of consumer boycotts and state expropriation, which could eventually drive the company out of the market terminating the cash flows. The risk to which future cash flows are subject can be reduced and shared through agreements and alliances with local companies (JVs) providing the foreign investor with political connections whereby influencing policy-makers. As reported above, these agreements allow the foreign company to be more flexible by committing less resources and, therefore, decrease the cash flow risk exposure. All these considerations can be generalized, including subsidiaries established through other forms of FDI such as Greenfield investments.
Overall, political instability is expected to affect both the timing and the amount of the cash flows, and these effects should be taken into account in the development of downside scenarios.

Capital structure

The previous sections showed that MNCs are expected to adapt their investment and financial policies to the characteristics of the local institutional environment that might give rise to different sources of risk. As it has been displayed, these risks include expropriation, discriminatory taxation, and unreliable contractual regulation. In the first scenario the company lose all its assets without been compensated by the political authority. The second threat is likely to affect directly the profitability of the subsidiary and is often associated with bribery. Conversely, the third risk is expected to hit the revenues of the affiliate by worsening market conditions. The company must bear in mind these threats when choosing the optimal financial strategy as it affects both debt-holders and equity-holders. This decision regarding leverage should maximize the trade-off between tax-shield advantage and bankruptcy risk, and it is closely connected with the ownership share that the MNC aims to control. It has been demonstrated that both the optimal debt level and the ownership share decrease if the political risk related to expropriation increases. In fact, regardless of the debt level, this risk decreases the likelihood of interest repayment as overall revenues are expected to be smaller. Moreover, this likelihood is further lowered by the higher interest rate required to compensate the additional risk. Because of this higher probability of default, the MNC should opt for a lower debt level.

Conversely, unfavorably higher taxation has a completely different effect on leverage optimization, as demonstrated also by Kesternich and Schnitzer (2010). This threat does not hinder the subsidiary to repay back its debt, instead it drives the company to increase its leverage to compensate the higher drains on profits, thereby exploiting the tax-shield. This strategy is even more advantageous if debt-holders do not feel menaced by this policy and maintain the same cost of debt. The overall effect on leverage depends on the specific political risk factor considered. If expropriation risk or adverse-taxation risk are analyzed, a positive correlation with leverage is expected. Conversely, if the risk is reflected in weak creditor protection, a negative correlation with leverage is expected. These effects on capital structure are expected to be incorporated in the WACC model. The expected lower debt level is likely to decrease the weight of the cost of debt in the overall formula, but at the same time the debt level could be pushed up to exploit the tax shield. The debt-holders could seek to protect themselves requiring a higher cost of debt as stated before, adding this effect on the adjusted leverage. Moreover, the cost of equity might be expected to rise because of the inclusion of a premium aimed at rewarding shareholders for the additional risk. The higher cost of equity combined with a higher weight of the latter with respect to debt will contribute in pushing the WACC. Because of the complexity and variety of effects, the decision-maker will be required to assess the single contribution of each specific factor included in the formula.

On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which country risk affects valuation fundamentals.

Risk Factor	Effect on valuation fundamentals
Regulation on shareholders protection	A regulation enhancement is associated with a 4.5% increase in the premium paid for the acquisition (cross-border acquisition or brownfield investment).
	Stronger shareholder rights lead to 23% decrease in leverage through lower equity costs and easier access to equity financing.
Regulation on bankruptcy and creditor protection	Weaker administration of the bankruptcy process leads to lower leverage (10%–31%).
	A regulation enhancement is associated with longer debt maturity (correlation: 0.095).
	Stronger creditor rights are associated with a 7% increase in leverage.
	Weaker regulation is associated with a 3% decrease in the firm's leverage adjustment speed.
	Stronger regulation is associated with a 1-6% increase in the firm's leverage adjustment speed.
Contract enforcement	Weak contract enforcement is associated with a 0.11% and 0.08% increase respectively in the cost of debt and equity.
	Strong contract enforcement is associated with a 15% decrease in leverage.
Expropriation Risk	Higher expropriation risk in the host country is associated with a 4.57% decrease in the premium paid for the acquisition (cross-border acquisition or brownfield investment).
	Higher expropriation risk in the host country is associated with a 2.3% increase in leverage.
Adverse-taxation risk	Higher adverse-taxation risk in the host country is associated with a 2.9% increase in leverage
Election-related uncertainty	Investments reduce by 4.8% and cash holdings increase by 4.3%. The value of the "option to wait" increases.
Political risk and flaws in the institutional environment	Higher risk premia (see chart above).
	More transparent institutional environment is associated with a 0.7%-0.9% decrease in the beta.
	Higher political stability is associated with a 5% increase in the likelihood of setting up a JV rather than a WOS.
	The occurrence of government crisis is associated with a 3.9% increase in the likelihood of setting up a WOS rather than a JV.
Corruption	A 1.74% increase is associated with a 4.3% increase in leverage and a 7.14% decrease in debt maturity.

4.2.2.4 Political Risk and Cultural Distance

Although conceptually separated, country risk and political risk are closely intertwined and the impact on the internationalization strategy should be evaluated jointly. In fact, the external uncertainty that foreign companies are faced with stems from both the elements formal and informal environment of the host

country[160] that are difficult to isolate. Throughout the literature risks related to the informal environment have been associated with cultural distance reflecting differences in values, norms and behaviors. As seen in the paragraph about country risk, these aspects increase the liability of foreignness and hamper the legitimacy of the subsidiary in the host environment. Conversely, the formal environment includes political, economic and social sources of risk related to the likelihood of changes in the government authority and in the policies issued. Additional insights as to which entry mode can be regarded as more appropriate can be drawn by combining the implications and risks emerging from the informal as well as formal environment.

Recalling the findings discussed previously, the MNC could prefer to invest in the foreign emerging country through a JV in order to gain the access to local resources, knowledge and relationships sharing the ownership of the venture with a local partner. The local partner, being more familiar with the country culture, allows the foreign investor to shrink the cultural gap existing between the nations involved. In order to cope with the challenges posed by political risk, establishing a JV the MNC can limit its resource commitment as well as share the risks with another partner. Moreover, differently from WOSs, the MNC can more easily divest from a JV if unfavorable changes occur in the institutional environment. Therefore, it could be argued that the best option is to establish a JV rather than a WOS when both informal and formal environments are perceived as risky by the foreign investor.

However, cooperating with one or more local partner when the external environment is highly uncertain is expected to raise transaction costs that could be avoided opting for a WOS. In fact, the more the host environment is culturally distant and politically unstable, the more problems the company is likely to grapple with in finding and negotiating with local partners. Volatility in the formal environment is likely to limit the ability of the company to tackle proactively all the threats and the subsequent enforceability of agreement is also hindered[161]. This array of complications counterbalances the positive effects coming from the cooperation with a local partner. Generally, in the literature there is no doubt about the effects of political risk if considered alone: the adverse consequences on entry mode and the preference for WOSs are supported by empirical findings. Conversely, the evidence about the way entry modes strategies are affected by cultural distance is more controversial, especially if combined with political risk. In fact, wider cultural gaps drive foreign investor to seek the support of local partners to gain access to knowledge and resource, but at the same time increase the transaction costs in dealing with them. Potential problems emerging both from negotiation and the dependence on institutional actors heighten political risk.

Lopez-Duarte and Vidal-Suarez (2010) identified a third variable able to support companies in solving this paradox, that is the language diversity between the parties involved in the partnership. The insights brought by the authors are grounded on a separated analysis of language distance from the broader concept of cultural distance. They argue that the role taken on by the local partner ultimately depends on the characteristics of the relationship with the foreign investor, that has been demonstrated to be language dependent. In fact, communication is paramount to establish an effective partnership because of its ability to build trust and foster collaboration between the actors involved in the JV. Therefore, language can be meant as the bridge between the cultural and political perspectives, being the key for successful negotiations and political strategies. Since, language diversity could turn into a real source of conflict between the parties, the MNC should select the functional language for the venture straight from the outset. This point reveals the political relevance of this third variable, as the design of the formal language to be used in carrying out the subsidiary's operations hinges on the bargaining power of the parties involved.

As pointed out by Luo and Shenkar (2006), language is one of the means whereby one partner can gain higher control over decision and information flows, strengthening its position. Language proficiency can give informal powers to specific groups within the JV, becoming able to influence the management process as well as alter the hierarchy structure. Therefore, the choice of the functional language must consider the

[160] See Slangen and van Tulder (2009)

[161] See Brouthers and Brouthers (2001)

likely introduction of dependency relationships that may not reflect the actual resource commitment and responsibilities held. Apart from strictly political considerations, language diversity can be expected to hamper information flows and knowledge transfer in the subsidiary's internal environment as well as with the external stakeholders. Messages and meanings could be easily distorted and altered through the communication channels, and partners misunderstanding could end up decreasing credibility and trust between them[162]. Furthermore, another language-related issue that MNCs should be aware of is that identified by Fredriksson et al. (2006), namely the creation of language-based clusters within the JV that might harm the efficient information and knowledge flows.
On the basis of the aforementioned considerations, it can be argued that the establishment of a JV is the better solution to cope with high levels of political risk and cultural distance if and only if the language barriers are low.

4.3 Labor market risks and host country unionization

The aim of this paragraph is to deal with and address the ways certain facets of political risk affect the availability and the management of a specific resource: labor.
Labor market in the host country from a political point of view is ultimately shaped by the regulation and policies set forth by the government as well as union activity. These relationships represent a great source of risk for the MNC in an emerging country since it suffers from the threat of unstable and unreliable regulation that could hamper and harm both its investment policies and its profitability. Moreover, the power and degree of local union penetration in the labor market (i.e. unionization) are likely to affect the flexibility and freedom through which foreign companies can manage the workforce. Therefore, bargaining power, legitimacy and negotiation are again the kernel for the risk management success.

4.3.1 Literature and empirical findings review

4.3.1.1 Labor regulation

MNCs willing to expand in emerging countries through the establishment of a foreign subsidiary should be properly equipped with the informational resources and skills to manage the relationships within the institutional environment. Each developing country has its own operational risks shaped by the political and socio-cultural structures in force, whose instability and weaknesses might hamper the success of the affiliate and its HR policies. Therefore, these companies should review their HR management agenda taking into consideration both the local and global company perspective in order to maximize the potential of emerging market employees. Recruitment and retention policies, learning and development practices, and reward strategies will need to adapt to the legal and institutional framework as well as its flaws.
As shown in the previous sections of this chapter, emerging markets regulation is often geared towards protecting domestic business and investors limiting the foreign companies' scope of actions. An example presented previously is the threshold imposed to foreign ownership in Russia or Brazil. These challenges are likely to pose severe pressure and constraints on the MNC's strategy setting, hence local laws and regulation should be included directly into preliminary planning and cost analysis. Although often not efficiently, emerging market governments have a primary role in defining the main employment issues (e.g.

[162]See Harzing and Feely (2008)

tax, social security, health care, retirement scheme and unemployment compensation) emerging in the case of individual dismissal or multiple terminations resulting from divestment or restructuring. For example, some countries might not allow to terminate employment contracts without providing substantial prior notice and incurring in government-mandated costs.
Brazilian law prohibits companies to employ foreign workers for more than one-third of the total workforce. This threshold, combined with strict visa requirements, can represent a hard constraint for companies wanting their managers to conduct the initial operations in the foreign country. Furthermore, thanks to the Labor Contract Law introduced in 2008, in China employees can easily file wrongful dismissal claims. Every termination must have a cause whose proof must be provided by the employer to justify the reason. Dealing and complying with local regulation in emerging countries is complicated by the rapid changes and amendments that hamper foreign companies to interpret their disclosure and legal duties. This complexity is further worsened in countries such as China where different layers of local and municipal laws must be considered according to the location of the subsidiary. For these reasons, MNCs might find difficult to gain enough legitimacy and acceptance in order to enter institutional and business networks. In fact, the consequences of breaching the regulation in force do not limit to the imposition of heavy sanctions and penalties. The company's brand and reputation could be damaged as well as its ability to undertake solid relationship with local authorities and businesses. These implications insightfully highlight again the importance of negotiation and relationship-building activities with local institutional as a means through which manage and curb political risk. Once build, the ties with local policy-makers provide the MNC with many advantages. On the one hand, the latter is able to understand the political system and preventing it from delivering unfavorable policies. On the other hand, it becomes easier for the foreign company to adapt to regulation flaws and volatility.

4.3.1.2 Host country unionization

In the literature, the notion that FDIs carried out by multinational companies have important implications on negotiation with local unions is widely accepted. Because of their international presence, MNCs can react to labor disputes by shifting the production of the same good in another country to prevent output flows to stop. For instance, in 2007 the Ford Motor Co. in Russia imported cars from another affiliate in Germany to offset the production losses due to a strike in the St. Petersburg Plant[163]. This flexibility in subsidiaries' management provides MNCs with an advantage in terms of bargaining power with respect to host countries unions, as they can threat to serve local market from foreign plants. In so doing, foreign companies are able to negotiate lower wages, and the extent of this wage discount is an important determinant of a MNC's decision to expand abroad through FDI.
Furthermore, these considerations are also affected by cross-border trade costs. In fact, given that wages are the outcome of unions' unilateral decision, lower trade costs make the host country more attractive as an export target rather than as FDI target. On the other hand, if wages are the outcome of negotiations between firms and unions, MNCs can benefit from a trade costs reduction by serving local markets with goods produced elsewhere in the subsidiaries network in the case of labor disputes. Therefore, a fall in trade costs increase the bargaining power of the MNC towards local unions[164]. The effects of host market unionization and union bargaining power has several effects on MNCs' strategies and policies. For instance, the literature analyzing how union activity affects company's operation found that labor unions influence corporate investment and financing decisions (Klasa, Maxwell, and Ortiz-Molina, 2009; Chen, Kacperczyk, and Ortiz-Molina, 2011), executive compensation (Gomez and Tzioumis, 2006), and financial reporting

[163] See Moscow Times (2007)
[164] See Eckel and Egger (2009)

outcomes (Mora and Sabater, 2008). Moreover, labor unions can influence firm's decision with the threat of withdrawing the provision of resources by means of work stoppages or strikes.
Because of their relevance and breadth, the present work will focus essentially on the consequences of union activity on the company's investment decisions and tax aggressiveness as well as on its operating leverage and flexibility.

Impact of union activity on the company's tax aggressiveness and investment policies

Adopting a narrow stance, corporate taxes are likely to reduce all the stakeholders' wealth because of the lower profitability of the firm, thus the best choice for the latter is to commit in extensive tax aggressiveness strategies. However, Slemrod (2004) and Scholes et al. (2005) highlighted the need for a broader agency view of the companies' strategies and decisions including the non-financial interests and risk exposure of different actors. Ignoring these non-financial agency costs could adversely affect firm value.
Indeed, the company should evaluate the risk preference of the different stakeholders without treating their interest towards specific strategies (e.g. tax aggressiveness) as homogeneous. For instance, researchers suggested that the political drivers and risk preference of labor unions make them more conservative with respect to the company's investment policy and strategies. Therefore, the riskiness of the investment carried out by the foreign company in the host environment are likely to decrease as the local labor unions' presence and influence increases.
Moreover, unions are likely to suffer more than other stakeholders from bad investment outcomes because the time horizon of their stake in the firm is longer. In fact, managers and shareholders have the possibility to either quit their mandate or withdraw their funds from the company turning quickly to other investment (or employment) opportunities. As pointed out by Faleye, Mehrotra and Morck (2006), the risk exposure of labor unions is more similar to bondholders rather than managers and stockholders. In fact, the claim of the former consists of a fixed stream of wages and benefits directed to both current and retired employees. Since these claims are not residual like those of shareholders, labor unions' interests are on the generation of enough cash flow to cover the aforementioned stream of benefits. Given the payoff function, unions are expected to be more averse to risk. The preference for less risky investments is documented by Chen, Kacperczyk and Ortiz-Molina (2011), showing that the amount of firms' risky policies and R&D investments is remarkably lower in more unionized countries. Following the Crocket and Slemrod (2005) model of optimal tax evasion, Chyz et al. (2013) showed that if the company undertakes tax aggressive strategies, unions' risk exposure and scrutiny increases with the overall effect of raising the marginal cost of such strategies. Managers can often rely on private information regarding both legal reductions in taxable income and illegal tax evasion. They prefer not to extend corporate disclosure to these details to keep taxing authorities from identify such behaviors and to minimize proprietary costs. The lack of transparency prevents unions to develop an accurate and sound assessment of the company's claims, so they could perceive a higher amount of tax aggressiveness and risky investment than that displayed by managers. Consequently, the transaction costs between firms and labor unions rise, increasing the marginal costs for the firm to engage in these strategies.
Other strands of literature[165] suggest that unions are characterized by rent-seeking behaviors that shape their risk tolerance and their bargains with companies. Since tax aggressiveness and risky investments are expected to increase after-tax cash flows, managers might be less willing to undertake those strategies as the additional cash flows are vulnerable to union capture. Thus, the return on such behaviors decreases pointing again to the negative relationship between gains from tax aggressiveness and unionization.

[165] See Klasa, Maxwell, and Ortiz-Molina (2009) and Matsa (2010)

Moreover, recalling the comparison with bondholders, if labor unions perceive that their risk exposure has increased due to the company's investment policy, they are likely to demand a higher cost for the resource they provide (i.e. labor)[166]. Therefore, rational managers should reduce tax aggressiveness consistently in order to avoid the need to compensate external stakeholders for the higher risk.
Desai and Dharmapala (2008) extended the agency view on the relationship between tax aggressiveness and union activity including considerations about firm's corporate governance. They insightfully found that tax aggressiveness is expected to have a positive (negative) impact in firm value in the presence of strong (weak) corporate governance arrangements. Since tax aggressiveness has been documented to decrease if host country unionization is higher, financial markets are likely to react negatively if a well-governed company operates in an industry where labor union's power and activity progressively intensifies. The reaction of analysts contributes to further lower the return on risky investments and financial strategies especially when the company exhibits strong governance.

Operating flexibility and operating leverage

Although in early literature labor capital is considered flexible and adaptable according to the firms' needs, more recent evidence documented that company's operations are actually and adversely affected by unionization. As showed above, unions are likely to put several constraints to the company's investment policy because of a lower appetite for risk. Nevertheless, there are other ways in which the impact of union (and unionization) on MNCs' activities manifests, reducing substantially the company's operating flexibility as well as increasing systematic risk.
For instance, unions exploit their bargaining power vis-à-vis the firm to raise the wage of unionized workers and increasing the costs of layoff. Notably, collective bargaining agreements lead to contracts that are expected to decrease wage flexibility, as adjustments are set out in advance or are modified only according to inflation[167]. On the other hand, labor unions often intervene in plant closure and labor relocation, adversely affecting the ability of the firm to adjust both its labor capital and physical capital. Moreover, as shown by Dowrisck and Spencer (1994), unions might hamper the adoption of new technologies whether these are likely to harm job security. These findings suggest that unionization increases the share of fixed costs on the total amount of labor costs, namely the MNC's operating leverage. Hence, investors should require higher returns because of these constraints and irreversibility, as predicted by Merz and Yashiv (2007) and Cooper (2006). In the literature, there are many references to the relationship between operating flexibility and the cost of equity faced by the company. Operating leverage is measured by Mandelker and Rhee (1984) as the elasticity of profits with respect to sales, finding a positive relationship between this indicator and market beta. More recently, Garcia-Feijoo and Jorgensen (2010) reported that operating leverage is positively associated with book-to-market ratio and stock market returns. Focusing specifically on labor market, Rosett (2001) considers a company's committed labor expenditure as a proxy for operating leverage. This figure appears to be positively connected with stock returns volatility and market beta. The reason why the cost of equity increases is the inability of the firm to adjust its operation during downturns, remaining with overloaded with unproductive labor or capital (i.e. committed expenditure).
While the aforementioned conclusions concern firm's inflexibility with respect to labor demand, Donangelo (2014) analyzes operating leverage from the point of view of labor supply, namely the risk exposure related to the human resource losses due to high labor mobility. This risk is connected to the idea that mobile workers take away some of the firm's productivity when they leave. For instance, Lustig et al. (2011)

[166] See the Chen, Chen, Cheng, and Shevlin (2010) framework
[167] See Wunnava and Okunade (1996)

examined the threat of highly skilled employees to carry away OC (organizational capital) when they leave the company.
The underlying notion to the model set up by Donangelo (2014) is that labor mobility can be intended as a labor-induced kind of operating leverage that increase company's inflexibility with respect to its resources and its exposure to systematic risk. This inflexibility is translated in the inability to adjust labor costs of mobile workers to offset the consequences of industry shocks. Employees with more general skills have more bargaining power as they might search for higher wages in other industries, therefore this rigidity might severely harm the MNC whether industry-specific shocks occur. Thus, systematic risk increases because of the higher weight of fixed costs with respect of the variable ones (i.e. operating leverage). He measured labor mobility as the distribution of workers in terms of both occupation and industry. As reported in his paper, "workers in occupations concentrated in a few industries are associated with industry specialists with low LM, while workers in occupations dispersed across the economy are associated with generalists with high mobility". Hence, a worker is associated with high mobility if its occupation is present in more than one industry, implying that occupation dispersion is deemed a proxy for the inverse of human resource specificity. Through this model, he found evidence in favor of the negative relationship between LM and elasticity of wages to industry-specific shocks. Similarly, when a company operates in a high mobility-industry, its cash flows are more sensitive to these shocks. Given that the MNC's investors can be compared with portfolio holders (assuming that each subsidiary is a set of equal stocks), they are expected to require higher returns for a portfolio hat is long in high-LM stocks and short in low-LM stocks.

Unionization in emerging countries

Recently, a not extensive yet quite valuable literature on unionization in emerging countries has emerged. These researches usually discuss labor movement or unionization processes in developing economies[168], or compare union activities between different countries[169]. As pointed out by Baiocchi (2005), unions in developing countries have taken on a prominent role in the shift towards democratization, civil society, and organized social movements. Similarly, Frenkel and Royal (1997) found that unionization in emerging economies might compensate the lacks and flaws of ineffective states. Through their bargaining power, they could challenge authoritarian regimes in order to improve working conditions and protecting domestic firms from foreign multinationals. Following Martin and Brady (2006), the forces affecting unionization in emerging countries can be broadly divided into three categories.

Institutions

Institutions are the outcome of historically rooted ways of organizing and regulate labor markets aimed at influencing the power of collective actors in the political arena. In emerging countries, unionization can be expected to be influenced by the belonging to ex-communist regimes, democracy, the influence of the International Monetary Fund (IMF) and the International Labor Organization (ILO).
As explained by Jones (1995), current unions in former communist countries are likely to be influenced by the legacy of unions active during the period of the Soviet Union. Thus, they are expected to attract far more participation and membership than other developing countries.

[168] See Cavalcanti (2002), Collins (2003), French (2003) and Tran (2005)
[169] See Seidman (1994) on the histories of labor movements and militancy in Brazil and South Africa

In the last decades, unions had an important role in the shift from certain authoritarian regimes towards democracy. Jose (2002) and Heller (1999) remark that formal democratic institutions provide lower-class workers with more freedom and space to mobilize in collective movements. Conversely, transitions towards authoritarian regimes are often associate with union repression and the abolishment of mobilization opportunities. These effects on unionization were particularly evident in the 1964 shift to military authoritarianism in Brazil and the apartheid state in South Africa (Seidman, 1994).
The agreements signed by many developing economies with the IMF forced the former to adopt and implement policies of free market and fiscal austerity. These agreements have severely hit the public sector and harm workers' position in general, leading to huge layoffs and unemployment as well as the rile of a large informal sector. For example, in some Latin American countries, workplaces became less stable and unionization declined (Roberts, 2002). Moreover, IMF agreements weaken the collective negotiating position of workers and encourage business resistance to labor.
Lastly, ILO conventions are formal agreements signed by governments in order to ensure the protection of workers' civil and human rights through the compliance with specific standards. Examples of these standards are those related to forced labor, child labor, gender discrimination and the workers' right to engage in associations and collective bargaining. However, in the literature there is still skepticism towards these treaties, as they cannot rely on formal enforcement and mandatory compliance.

Industrialization

Historically, industrialization took on a relevant role in the Western working class mobilization and collective interest organization. In the case of South Africa and Brazil, Seidman (1994) demonstrate that unions follow the same pattern of development in relation with the industrialization rate and process.
Notably, industrialization creates a skilled working class conscious of its collective potential in shaping the work conditions and labor protection. Therefore, industrialization is positively associated with unionization in emerging markets. Additionally, a research conducted by Silver (2003) reported that unionization could be generally expected to follow the industrial life-cycle. Therefore, a country just entered into the industrialization process is characterized by low competition as well as less focus on cost efficiencies, and unionization is likely to thrive.

Globalization

In the literature there are contrasting opinions as to whether globalization could foster or, conversely, undermine unionization. On the one hand, globalization enables developing countries to build relationship with democratic counterparties in which unionization is higher, facilitating the transnational diffusion. Globalization also increases the bargaining power of workers as they have the opportunity to easily find workplaces in which they are better off (Silver, 2003). Moreover, in countries characterized by high FDI inflows and trade openness workers have more class capacity to disrupt production and demand improved collective representation. On the other hand, globalization might increase the threat of agreements between political authorities and MNCs at the expense of domestic unions and organized labor. Moreover, MNCs often gain from globalization in the search for flexible, low-cost and organizationally weak workers (Frenkel and Royal, 1997; Cooke, 1997). Indeed, also companies can threat or decide to relocate production in other cheaper emerging countries, decreasing the negotiation power of unions (Silver, 2003).

Chinese labor market regulation and environment

The Chinese State and especially the Communist Party plays an important role in the regulation of labor market through "hard" norms and rules. However, the compliance to such legislation is hindered by the complicated implementation carried out in the various administrative layers, engendering inconsistencies between central, provincial and municipal authorities.
The development of the current labor regulation started in the wake of the post-1978 reform. By the mid-1990s, the socialist administrative regulation has been replaced by a new legal framework for wages and employees contractual rights. In fact, the Ministry of Labor and Social Security enacted the "Enterprise Minimum Wage Regulation" and the Labor Law aimed at shaping the workers' legal and contractual rights as well as a mechanism for handling labor disputes within the ACFTU (All China Federation of Trade Unions). However, this legislation addresses mainly individual rights while neglecting collective interests. Many individual rights are not actually enforced because of patron-client relationships between local government and companies. Therefore, labor dispute arbitration procedures have become the only legal means whereby solving diatribes between workers and employers, although often not effective. Bypassing both unions and law, work stoppages and protests have been organized despite the right to strike has been removed from the Constitutions in 1982. Because of their illegitimacy, these protests were scattered, unorganized and spontaneous.
After joining the WTO in 2001, China has undergone several economic and political changes. Notably, from 2004 specific policies have been issued towards the protection of rural workers' civil rights. The subsequent stream of reforms progressively encouraged workers to engage in progressively more organized strikes, especially in 2010 when two outbreaks of worker protest occurred: the first was the series of workers' suicides in Foxconn; and the second, the wave of strikes led by Honda workers. These disputes led the Guangdong provincial government to increase the minimum wage significantly.
From 2007 the Central Government enacted three new labor laws to ensure enhanced rights for workers. The Employment Promotion Law provided local authorities with guidelines on monitoring employment agencies and promoting vocational training. The Labor Dispute Mediation and Arbitration Law simplified the legal procedures for mediation and arbitration. The Labor Contract Law aimed at stabilizing and regulating employment relations by imposing the obligation for employers to stipulates written contracts specifying the conditions for legal termination. Moreover, in 2010, the Social Insurance Law was issued in order to provide basic social security for population.

Adapted from Chan and Nadvi (2014)

4.3.2 Managerial implications and effects on valuation

The discussion of the consequences of labor market risk on managerial and valuation practices will generally follow the considerations presented in the paragraph concerning political risk, as the former is a subset of the latter. However, more detailed insights and suggestions can be provided with respect to both qualitative implications and financial/quantitative models. First, specific behavioral and strategic guidelines will be provided in order to manage the various sources of labor marker risk in emerging countries, namely hard regulation, trade union and workforce recruitment. Secondly, the impact on the financial valuation methods and variables will be assessed, assigning special attention to the risk premium dynamics.

4.3.2.1 CSR-soft regulation

Beside the policies set forth by the host government to regulate local labor market, in recent times it has been documented the rise of private initiatives aimed at addressing labor-related issues emerging from globalization. Thus, company and industrial-specific codes of conduct have been drafted as a result of the higher engagement of private companies and civil society organizations in monitoring workforce management[170]. As pointed out by Thomsen and Pillay (2012), this tendency is connected to the growing importance of CSR intended as an effort by private firms to include environmental, social and labor concern in their value creation process, widening the scope of stakeholders involved. This set of soft rules and CSR practices are aimed at constraining managerial freedom when it is harmful for employees, especially when governmental policy-makers and institutional environment are not well developed. In the recent decades, emerging countries have been the target of outsourced production networks established by foreign companies mainly through FDI. As explained in the previous sections of this work, the purpose of these strategies is to address a new and wider customer base as well as exploiting specific cost advantages. The global value chain framework (GVC) by Gereffi et al. (2005) highlighted the formation of power imbalances between the parties involved in those structures, in which the "leader" firm (often from developed countries) holds the control of smaller foreign suppliers by means of informal and formal arrangements. This stronger position enables foreign investor to exploit local resource (e.g. labor) in the search for new ways to respond to global competitive pressure. Considering the Chinese example, local garment industries are the biggest exporters in the world and are reported to be substantially "buyer-driven" (Gereggi, 1999). Working conditions were characterized by low hourly pay, long and unstable shifts and harmful environmental impact in order to keep up with global competition requiring higher quality and higher amounts at a lower price[171].

Following the principles identified by the GVC, the Global Production Network (GPN)[172] framework has taken into account also the role of the State and the overall institutional environment. Thus, the decline in labor standards and protection are the result not only of the search for low-cost suppliers by MNCs but also of the weakness of political authorities in developing countries. Given the recent rise of stakeholder influence and engagement[173], in order to thrive in these environments foreign companies must counteract the institutional and regulatory gaps. Exploiting their financial and technical clout, MNCs must increase the governance of these issues by implementing company/industry-driven standards on working conditions and environmental impact. The definition of these soft rules entails the involvement of a broader set of social actors such as NGOs and trade unions whose pressure is likely to induce a wider participation in the so-called multi-stakeholders initiatives (Lund-Thomsen and Nadvi, 2010). This can be meant as another source of political risk revealing again the need for the MNC to take into serious consideration the importance of negotiation and the effects on corporate image[174]. However, soft regulation should not be intended as tool whereby substituting state-driven regulation, but rather as a complementary set of rules filling the gaps of the local institutional environment. Especially in the context of emerging markets, where both public and private sectors are not well developed, companies and political authorities should respectively compensate their weaknesses bolstering economic activity. For instance, Pires (2008) and Coslovsky (2014) showed how Brazilian public labor inspectorates have collaborated with private companies in the implementation of national labor laws can codes of conduct. Amengual (2010) documented the same behaviors in Dominican Republic. This is another fact underpinning the importance for the MNC's subsidiaries to gain legitimacy in

[170] See Blowfeld and Frynas (2005) and Nadvi (2008)
[171] See Chan and Siu (2010) and Butollo (2013)
[172] See Henderson et al. (2002) and Coe et al. (2008)
[173] See Freeman (1984)
[174] See Hale and Willis (2007)

the host country business and institutional environment in order to be included in these interplays aimed at shaping the regulatory framework.

4.3.2.2 Strategies to mitigate the effects of unionization

As seen before, host country unionization is likely to put several constraints to the investment and financial policies of the MNC and its foreign subsidiary. However, the company can rely on several policies in order to anticipate or mitigate the negative effects of unionization. A first set of policies are related to the HR and performance management systems. In the literature, these systems are often analyzed through the AMO (Ability, Motivation, Opportunity) framework that develops along three different dimensions of workforce management[175]. "Ability" is related to the improvement of employee knowledge, skills, and abilities by means of training and rigorous recruitment processes. "Motivation" refers to the increase of employees' motivation to engage in discretionary actions and decision potentially beneficial to the company. "Opportunity" concerns the workplace empowerment and employee involvement, which provides employees with the opportunity to engage in such discretionary actions. A widespread idea in the literature about this framework for performance management is the shift from a collective representation of employees, which fosters unionization, towards the individualization of the employment relationship. The relevance assigned to individual or group competition is based on values remarkably separated from those underpinning collective consciousness and mobilization. Thus, even if the adoption of this framework is primarily oriented towards performance improvement, many elements could help the company deal with unionization issues. Notably, strategies included into the "ability" and "motivation" dimensions have been demonstrated to be the most effective in substituting union activity. For example, the "contingent pay" factor proposed by Godard (2009) is one of the policies encompassed into the "motivation" dimension. He found that the adoption of such a method for performance management highlights the benefits of pursuing individual interests at the expense of organizational solidarity. Conversely, incentive systems based on fixed wages and seniority are likely to promote the perception of community of interest. Putting contingent pay systems at the center of corporate incentive strategy is more likely to attract employees that are more individual-oriented than collectivists, therefore potentially less prone to engage in unionization. Another policy related to workforce management is the use of flexible employment practices, like for example part-time and temporary contracts. Workers employed through flexible work arrangements might not deem union engagement valuable given their unstable relationship with the employer[176]. For this reason, also unions are discouraged from organizing efforts addressing these workers. On the other hand, there are other policies that the company could undertake in order to minimize the effects and avoid the presence of trade unions before the FDI implementation. For instance, Foulkes (1980) demonstrated how companies could avoid unionization through greenfield investment targeting countries with low levels of unionization instead of acquiring another company already established. Such greenfield facilities allow the company to start the foreign operations form the ground up, with completely new employees and employment systems. Conversely, brownfield sites often carry a legacy of employment practices and potentially an existing union. MNCs are reported to favor greenfield sites in foreign activities since this strategy provides the possibility to implement more individualist employment policies and a new organizational culture against the formation of collective mobilization[177].

[175] See Boselie, Dietz, and Boon (2005)
[176] See Booth and Francesconi (2003), Conley and Stewart (2008)
[177] See Baird and Leopold (2001)

4.3.2.3 Talent recruiting, retention and management in emerging markets

A deeper understanding of local institutions and employment legislation from the outset allows the MNC to determine also the quantity and quality of available talent. The review of the formal system should be coupled with the analysis of the broad demographic and educational environment. In fact, one of the main reasons for the shortfall of talents in developing countries is the inadequacy of the education and training system. Although the number of graduates has grown steadily (between 30% and 50%) in these markets over the past few years, it has been found that only a small fraction (10%-20%) of them are employable consistently with the requirement and standards of international companies. Another problem rooted in the demographic environment is the population (and labor market) segmentation between rural area and industrialized centers. This phenomenon is worsened by the strikingly higher population concentration in former, resulting in high disparity in terms of educational and occupational opportunities. Such regional disparities may even be statutory, like in China where rural/urban distinction, the "hukous" system, is envisaged by law. Under this system, migrant workers from rural areas have far less employment rights and less social protection than urban residents. Despite of the mobility costs outlined above, employees in emerging economies are often aware of this lack of talented workers. Therefore, they are able either to bargain for better working benefits and wages or to switch easily organization to pursue these objectives. This is another explanation for the operating inflexibility that foreign companies often bear in emerging countries. Thus, MNCs should rethink more creatively and proactively about long-term systems aimed at retaining the best employees. Through a deep analysis of the local culture and demographics, these companies should understand which elements are more valuable for workers from country to country. Even the simplest solutions could be the most effective, as demonstrated by the better retention rates resulting from improvements of food quality and work environment in some Chinese factories. The challenge for the foreign organization and especially for the HR function is to abandon the strategy of adapting domestic norms and practices to the host environment becoming acquainted with the relevant local cultural customs. Only catering to local employees' needs and preferences without one-size-fits-all assumptions the company will be able to retain the best human resources as well as develop the most effective engagement systems. These engagement strategies are strictly related to talent management practices to further develop and empower employees after the recruitment. Both hard and soft incentives could be devised by the company. Well-developed remuneration schemes rewarding employees according to the achievement of specific corporate goals can be a viable solution to motivate them, aligning their interest with those of the company. These incentives are then to be combined with transparent and flexible career opportunities, effective training programs and involvement in the decision-making process.
Also in the development of performance management systems the company has to be aware of local cultural values and customs. For example, Western companies often commend the top 5% high performers and identify poor performers stressing the separation between the two groups. However, in Asian countries, where people focus on strengths rather than weaknesses, direct and especially public criticism is not culturally acceptable. Therefore, the engagement techniques used to implement these practices should take into account the market and cultural sensitivities.

4.3.2.4 The impact on valuation fundamentals

The considerations and consequences of labor market risk can be included in the valuation methods in various ways. Notably, the two valuation fundamentals that are more likely to be affected are the subsidiary's profitability and the risk premium. It is worth to point out that managers should not make these adjustments after having taken into account the various facets of political risk, as labor market is a

subset of the latter. Thus, adding up again all these elements could lead to an information redundancy and double-count. Instead, the insights provided in this last section are useful to provide a more contextualized and detailed description of one of the more troublesome categories of political risk. Managers should use these information and implications to be more detailed and accurate in their assumptions and predictions.

Many valuation implications have been identified throughout this paragraph about labor marker risk, this final section will sum them up providing a unified and more detailed view. First, an increase in unionization is expected to decrease the subsidiary's profitability in at least three ways.

As reported above, unions affect the investment policies of the companies because of their higher risk aversion. These institutions have been compared with bondholders for the characteristics of their claims. Moreover, their commitment has a longer time horizon than managers and shareholder, that can switch easily their competences and funds in other companies. For these reasons, unionization often represents a constraint on managerial decision-making process, and the extent of the restrictions imposed depends on the relative bargaining power of the parties involved. Overall, it has been demonstrated that the riskiness of the investment implemented by companies operating in highly unionized industries is remarkably lower. On the one hand, this could benefit the company by imposing more scrutiny on its decision in order to limit the likelihood of negative outcomes. However, on the other hand, high unionization could lead the company to reject profitable investment opportunities characterized by high returns and a risk profile that normally would be bearable for the company. Therefore, underinvestment is one of the main ways in which host market unionization can adversely affect the foreign subsidiary's profitability. In the discussion about the overall investment policy of the company, the implementation of tax-aggressive strategies has also been analyzed in connection with unionization's effects. In this case, profitability is reduced in terms of lower opportunities to curb taxation rather than the rejection of profitable investments. Wider and deeper consideration about taxation risk will be presented in the following paragraph, nevertheless it is worth to point out here its connection with unionization risk. As explained above, unionization increases the weight of tax-aggressiveness costs on the return on these strategies in many ways. They could block the implementation of risky but profitable projects, higher transaction costs could be imposed together with the threat of disputes and work stoppages, and rent-seeking behaviors could harm the company's after tax cash flows. Chyz et al. (2013) found that a 14.3% and a 31.1% increase in unionization (measured as union membership) is associated with respectively a 2.04% reduction in tax aggressive strategies and a 1.57% increase in effective tax rates. The market-to-book ratio is lower for companies operating in highly unionized industries, stressing the fact that unionization is associated with a reduction in shareholders' wealth. Lower ratios in unionized industries could also be the result of industry-specific features, as unions are more active in manufacturing firms than in high-tech companies. Moreover, lower values have been reported for the ROA in unionized industries, consistent with the notion that unionization lowers profitability. According to Matsa (2010), management is likely to strategically respond to increased unionization by issuing more debt, therefore leverage is expected to be higher in unionized countries. The lower potentials for profitability and the increased riskiness due to unionization are reflected in higher premia demanded by investors. The so called "unionization premium" has been demonstrated to raise the cost of equity of about 1.23% for a 1-standard-deviation increase in the unionization rate.

The consequences of unionization on the cost of equity are stronger if unions' bargaining power is higher. This is often the case of countries with low labor regulation and/or with the predominance of democratic institutions in the political system. Unionization premium is higher when economic activity is low, measured as GDP growth, inflation rate and market returns. Moreover, as explained in the previous paragraphs, an increase in leverage could lead debt holders to increase the cost of the financial resources they lend. The effect of leverage is not included into the unionization premium, as demonstrated by Chyz at al. (2013). Their research documented that companies operating in more unionized industries face a higher unlevered cost of equity. Overall, as a combination of the aforementioned effects, the WACC is expected to rise as unionization coverage increases. In the previous section it has been discussed how labor mobility

affects the company's operating flexibility and leverage. The evidence suggests that investors require higher returns when the company invests in countries characterized by labor market with high mobility. Notably, a 1-standard-deviation increase in labor mobility is associated with an increase of about 2.5% in the expected return. Therefore, this effect has to be considered in addition to the unionization premium, although some elements of labor mobility are per se a consequence of higher unionization. However, in emerging countries labor mobility is more controversial despite the efforts of labor unions. As shown in the chart below developed by Artuc et al. (2015), the mobility costs faced by workers (measured as a multiple of average annual wage) in emerging countries is higher than in developed countries. On average, the mobility cost is 2.76 for developed countries and 3.71 for developing countries. Thus, risk exposure stemming from labor mobility is lower for MNCs placing their FDI in developing economies. Because of lower labor mobility, these companies have more bargaining power vis-à-vis local unions and gain more flexibility. However, it is not possible to determine which effect prevails on the overall risk position and cost of capital, thus it is up to the company to evaluate the single contributions and the individual forces.

Country	**Mobility Costs**	**Country**	**Mobility Costs**
Jordan	5.07	Iran	3.24
Philippines	5.06	Bolivia	3.2
Bangladesh	4.89	Hungary	3.16
Mauritania	4.79	Romania	3
Bulgaria	4.67	Sweden	3
Ukraine	4.62	Italy	2.95
Latvia	4.58	Syrian Arab Republic	2.94
Ethiopia	4.52	El Salvador	2.93
Azerbaijan	4.47	Czech Republic	2.92
Cameroon	4.2	Kazakhstan	2.88
Georgia	4.02	India	2.87
Lithuania	4	Mongolia	2.82
Colombia	3.96	Belgium	2.81
Costa Rica	3.83	Slovenia	2.76
Senegal	3.83	China	2.75
Korea	3.77	South Africa	2.68
United Kingdom	3.72	Poland	2.66
Malta	3.61	Singapore	2.57
Ecuador	3.59	United States	2.21
Spain	3.54	Argentina	2.13
Chile	3.47	Ireland	2.02
Indonesia	3.46	Austria	1.9
Egypt	3.4	Netherlands	1.82
Oman	3.29	Germany	1.7
Russia	3.28	Finland	1.43
Denmark	3.25	Estonia	1.29

On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which country risk affects valuation fundamentals.

Risk Factor	**Effect on valuation fundamentals**
Unionization	A 14% increase is associated with a 2.04% reduction in tax aggressive strategies.
	A 31.1% increase is associated with a 1.57% increase in the effective tax rate.
	Higher unionization is associated with lower the market-to-book ratio

	(correlation: -0.66).
	Higher unionization is associated with a 5.39% increase in leverage.
	Higher unionization is associated with a 1% decrease in ROA.
	A 12.2% increase at the macro level (industry) is associated with a 1.23% increase in the cost of equity (i.e. unionization premium).
	A 12.2% increase at the micro level (firm) is associated with a 1.13% increase in the cost of equity (i.e. unionization premium).
	An increase in labor mobility is associated in a 2.17%-2.97% increase in the cost of equity.

4.4 Taxation risk

It is a widely recognized notion that governments' fiscal policy has a prominent role in either facilitating or hampering business activity within national borders. On the one hand, subsidies or exemptions can be devised to support the development of specific companies and industries. On the other hand, the imposition of a broad and complex array of levies might represent a severe institutional burden for other firms. This complexity is even more accentuated when economic activity expands beyond national border.
As seen several times throughout this work, in the development of an international strategy MNCs should pay the proper attention to the various typologies of risks and hidden costs that could hinder the foreign subsidiary from thriving. In cross-border investments, taxation is likely to accentuate the institutional burdens and risks that the company would face domestically. Taxation risk does not limit to the fact that a potential host country is characterized by the imposition of a higher personal or corporate tax rate. Instead, taxation risk can be analyzed along different dimensions that are closely intertwined. First, it can be intended as the likelihood of a tax regime change that could adversely affect the MNC's foreign operations. In this case, the political and economic volatility of the host environment must be examined in order to determine the direct consequences on after-tax profitability. Second, the company risk exposure related to taxation is strictly connected to the ability of the former to insightfully identify and understand the subtle and indirect effects of the cross-border taxation schemes on its investment and financial policies. Third, another source of risk is embedded in the ability of the company to develop the appropriate response to these issues and the consequences of these strategies. A glaring example highlighting the importance and complexity of the aforementioned issues is the case of General Electric, whose tax department headcount amounts roughly to 1000 employees.

4.4.1 Literature and empirical findings review

In the literature, the claim that foreign-owned subsidiaries pay far less taxes than domestic affiliates has received many explanations. These findings mostly refer to special characteristics of foreign subsidiaries (e.g. accounting standards), preferential tax treatments (e.g. deductions and subsidies) or tax-planning strategies undertaken by the parent company. The latter strategies can be essentially divided into two streams, namely profit and debt shifting. MNCs engaging in profit shifting activities are able to exploit the differences between the tax rates of the home and host countries, determining the prices for internal resource transfers accordingly. Notably, these transfer prices will be devised in order to swell the profits for the counterpart placed in the country with the lower tax rate. Doing so, the MNC is able to minimize the tax

outlay distributing the taxable income strategically among the affiliates[178]. The same purpose underlies debt shifting strategies, although the mechanism is different. In order to exploit the benefits deriving from the tax-shield, the MNC will shift its liabilities to countries with higher tax rates. Through a higher deductibility of interests expenses the company can achieve substantial tax reductions[179]. The pursuit of these advantages explains the high cost savings achieved by foreign subsidiaries with respect to domestic "twins". As reported by Egger et al. (2010), the differentials range from 367 thousand euros to 1.3 million euro. Moreover, they found that firm-specific characteristics matter as well, since old and large foreign companies tend to engage in tax saving more likely and effectively than young and smaller ones.
Together with tax planning strategies, that will be further discussed in the following sections, the management and the extent of taxation risk hinges on the presence of international regulation and bilateral treaties aimed at shaping the tax regimes.

4.4.1.1 International taxation and avoidance strategies

In order to understand properly the current international taxation frameworks enforced when transnational businesses are analyzed, the three cornerstones developed in the '20s by the League of Nations need to be introduced. The economists were mainly concerned about the issue of double taxation, occurring when foreign profits are taxed both in the host country and when repatriated in the home country. The first pillar refers to the obligation to pay corporate taxes to the country considered the source of that profit. This principle is not troublesome if applied in a situation in which a company owns a subsidiary producing and selling its products in the same host country. However, the enforcement of this principle is complicated when, for example, the parent company imports and distributes in the home country the goods produced by the foreign subsidiary. Since the identification of the source of this profit is not straightforward, a second principle was defined. The second principle, namely the "arm's length pricing", postulates that the entities involved in the cross-border internal transaction must compute their profit (and set the transfer price) as they were separate companies bargaining according to market conditions. Furthermore, following the third principle, international taxation issues are to be addressed through bilateral treaties instead of global agreements. The reason can be found in the remarkable differences between the national tax regimes in force impeding the conception of a unified framework. As a result, the MNCs willing to expand their operations in a foreign host country have to plan their investment relying on bilateral treaties. The tax-planning strategies developed by multinational companies are geared towards seeking and taking advantage of loopholes in the aforementioned principles. Thriving on the inconsistencies deriving from the implementation of a high amount of bilateral agreements, MNCs are able to carefully choose the location that is more favorable according to the treaties in force. This phenomenon is known in the literature as "treaty shopping". A prominent example is the "double Irish Dutch sandwich" strategy undertaken by Google in the early years of the last decade[180]. In 2003, Google US transferred a set of intangible assets to Google Holdings, a subsidiary incorporated in Ireland but resident in Bermuda for Irish tax purposes. This subsidiary created another affiliate, Ireland Limited, and granted it the licenses to use Google's intangible assets and technologies. In turn, the Irish subsidiary licensed these assets to all the other EMEA affiliates, receiving the royalties for the use of these resources. In so doing, the income generated is taxable according to the Irish corporate tax rate which is 12.5%. Then, Google devised a mechanism to make these profits seem to have been occurred in Bermuda in order to benefit from a 0% tax rate without paying the withholding taxes in Ireland. To do so, Ireland Limited payed royalties to a shell

[178] See Bartelsman and Beetsma (2003), Mintz and Smart (2004)
[179] See Haufler and Runkel (2008)
[180] See Kleinbard (2011)

company based in the Netherlands (Google BV) without paying any tax as they both belong to EU. At the end of the process, the Dutch company paid back the whole amount to the Irish/Bermudian holding. This final transfer was tax-free as well because the Dutch authorities deemed the holding to be Irish, not Bermudian. In order to avoid US regulation on taxable royalties, Ireland Limited and Google BV were not treated as separate companies but as Google Holdings' Divisions. As reported by Zucman (2014), by exploiting inconsistencies between treaties "Google generated stateless income, nowhere taxed in the year it is generated". From the US point of view, Ireland Limited and Google BV do not exist and Google Holdings is Irish. From the European (perspective) the former two companies are real and the Google Holdings is Bermudian. Another strategy for tax avoidance (especially repatriation costs), yet more extreme, is the so called "tax inversion". In this case, the company taken over becomes the parent company and the bidder becomes the new subsidiary. As introduced above, according to recent streams of literature the most important method whereby MNCs exploit treaties loopholes is the manipulation of internal transfer prices. The opportunities pursued by these strategies derive from the limitations of the arm's length pricing. For instance, high complexity in the supply chains might prevent tax authorities from identifying wrongdoings. Alternatively, there could be severe difficulties in determining the market price at which transfers should be done. A more detailed analysis of the issues related to transfer prices and profit shifting will presented in the following sections.

4.4.1.2 Transfer prices manipulation and profit shifting

Taxes are documented to have substantially a double negative effect on corporate profits. The first and more direct way is the imposition of a tax rate on the company's EBT that reduces the after-tax earnings distributable to the shareholders. These implications will be addresses afterwards. Conversely, the purpose of this section is to describe the second and indirect effect. It is represented by the reaction of the company to the imposition of a tax rate that is higher than the one applied in another country. In this case, the firm shifts voluntary a share of the before-taxes profits to an affiliate located in a country characterized by a lower tax rate. It has indeed been demonstrated that a 1% increase in the corporate tax rate reduces a subsidiary's EBIT on average by 1%. The implementation of profit-shifting strategies is influenced by the aforementioned opportunity to easily relocate assets and manipulate transfer prices. As pointed out by Weichenrieder (2009), also the ownership structure is likely to have a sizeable effect these strategies and transfers. Moreover, the regulatory framework in the host country and the limitation of the Arm's Length Principle are likely to shape the aggressive pricing strategies of MNCs. As demonstrated by Beer and Loeprick (2015), the effectiveness of profit shifting activities depends on the ability and characteristics of the company allowing it to be less transparent with respect to regulatory scrutiny. The example of Google reported above highlights two endowments that are likely to lessen transparency: the possession of intangible assets whose market price and transfer cannot be easily determined, and the complexity of the subsidiaries network lowering the probability of wrongdoings to be identified. The presence of intangible resources and complex structures are expected to increase the elasticity of corporate profits to variations of the corporate tax rate[181]. In fact, subsidiaries with high intangible endowments are reported to decrease their profits by 1.2% when faced with a 1% increase in the tax rate. Conversely, the profit reduction of companies with below-the-mean intangible endowments is lower (0.76%) when the same increase in the tax rate occurs. As for MNC complexity, measured as the degree of vertical integration and internal transfers intensity, above the mean values are associated with a profit reduction of 1.92% when the tax rate increases by 1%. In contrast, companies with more linear and simpler structures are reported to decrease their profits by 0.56% when the tax rate increase by 1%.

[181] See Beer and Loeprick (2015)

These findings have sizeable impact on the processes and methods applied for valuation purposes. These implications will be discussed in the last sections of this paragraph. With respect to the consequences of intangible endowment and MNC structure complexity, the intervention of regulators and policy-makers is expected to have a mitigating effect. In the last two decades, government have dedicated much of their efforts in devising appropriate regulatory responses to the threat of transfer mispricing. Notably, specific provisions and policies have been issued in order to strengthen the Arm's Length Principle as well as imposing the obligation to provide a more detailed disclosure. For instance, the number of countries requiring an enhanced reporting of related party transactions has surged from 5 to more than 70. Overall, the mitigating effect of the introduction of mandatory disclosure requirements amounts on average to a 0.26% reduction in the aforementioned elasticities. Moreover, estimated profit shifting is lowered by 52 % 2 years after the introduction of mandatory documentation obligations, on average. Therefore, the obligation to provide information on internal transactions and to document transfer pricing policy details remarkably reduces profit shifting opportunities. The chart below displays an overview of the documentation requirements in order to provide emerging country-based insights as to whether profit shifting purposes can be achieved. MNCs establishing their subsidiaries in developing countries are abler to take advantage of tax loopholes stemming from political instability and regulation flaws[182]. In this special case, weaknesses of the institutional environment in emerging countries might represent a positive opportunity for the foreign company to engage in tax-planning strategies. However, as shown below, many countries are devolving many efforts in keeping up with developed country in the development of a stricter regulation. This is a specific and subtle source of risk to which MNCs should pay progressively more attention.

Country (year of introduction)	**Documentation**
Mexico (1997)	Article 76 of the Federal Fiscal Code: 50 % reduction in the if the taxpayer provides transfer pricing documentation
Poland (2001)	Broad requirement in Art. 9a of the Corporate Income Tax Law (CITL). Since 2007 also applied to PE profit allocation. 50 % penalty of income assessed for failure to submit the required documentations
Slovak Republic (2009)	Since 2009 all Slovak taxpayers have to report the value of intra-group transaction in CIT form and comply with the obligation of providing transfer price documentation.
Slovenia (2005)	Since 2006, also TP documentation for cross-border inter-company transactions must be prepared; domestic companies only upon request from the tax authorities in case of inspections
Turkey (2007)	Art 13 of the Corporate Income Tax Code, General Communique Series 1 requires annual transfer pricing report. Sanctions in case of failure to present the required documentation.
Israel (2006)	Israel Tax Ordinance Section 85A and Israel Tax Regulations.
Hungary (2010)	In 2009 a new decree on documentation requirements (in force from 2010)
Czech Republic (NO)	Reliance on OECD guidelines, but no specific documentation requirements.

[182] See also the UN "Practical manual on transfer pricing for developing countries" (2013)

4.4.1.3 The problem of double taxation

The home country institutional and regulatory environment is generally assumed to affect the tax regime to which the parent company and the other subsidiaries are subject. Some countries tax the worldwide income of domestic MNCs, while other countries exclude foreign subsidiaries' income from the domestic taxation. In the former case, the multinational company risks being subject to cross-border double taxation on the income generated by foreign subsidiaries. This is an issue often taken into consideration in transnational mergers and acquisition, such as the case of Daimler and Chrysler. The merger took place in 1998 and gave birth to a multinational company whose parent company (Daimler) is located in Germany. This choice was grounded on tax-related considerations, since in Germany foreign-generated income is exempted from domestic taxation in contrast with the US regulation[183]. Another strategic choice that the MNC could make is that between a foreign subsidiary and a foreign branch, since some home countries tax income generated abroad as dividends differently from business income generated by foreign branches. Because of purpose of this work, the former case will be the object of analysis. Income generated by the foreign subsidiary in a host country F is first taxed in that country at a rate t_f, and the remaining income $F*(1-t_f)$ is either reinvested or repatriated in the home country through dividends. At this point, the host country F could also apply a nonresident dividend withholding tax w_f to the share of income repatriated to the home country H. Therefore, the overall amount of taxes paid by the foreign subsidiary on dividends amounts to $t_f + (1-t_f)* w_f$. The after-tax dividend is further taxed in the home country if a regime of worldwide taxation is in force. This double tax rate hinges on two elements, namely whether the MNC can defer home country taxation until repatriation and the provision of double tax reliefs. If these are not granted, the double tax rate amounts to $t_h + (1-t_f)*w_f$ encompassing both the country H corporate income tax and the country F withholding tax.

Many countries are aware of the detrimental effects of double taxation on outward FDI, therefore an increasing number of bilateral treaties and tax reliefs have been designed. Some countries adopted a source-based tax system in order to exempt foreign income from domestic taxation, so the overall tax rate is $(1-t_f)*w_f$. Some kinds of relief have been devised also in the countries implementing worldwide taxation regime. In this instance, the home country provides foreign tax credits for taxes already paid in the host country. The foreign tax credit can be indirect if it is applied to both the dividend withholding tax and the corporate income tax. Otherwise, it is said to be direct when is applied only on the former. Some countries with worldwide taxation do not provide any credit facility but allow foreign taxes to be deducted from the MNC's domestic taxable income. The adoption of a specific relief scheme (exemption, credit, deduction) depends on the presence of bilateral agreements and tax treaties. The chart below displays the regimes adopted by a set of emerging countries in Eastern Europe (if treated as home countries) and the tax rates in force (if treated as host countries). In this special case, the establishment of a subsidiary in an emerging country can have a double implication. First, the choice of the best location should be made seeking to minimize host country taxation, regardless of the tax regime in force domestically. Second, given the detrimental effects of the worldwide taxation system, the MNC could exploit the host country tax advantages by implementing the so called inversion strategies (Huizinga and Voget, 2009). In this case, the two entities switch their role and the subsidiary becomes the new parent company.

[183] See Bogenschutz and Wright (2000)

Country	Corporate Tax rate	Inward dividend		Outward dividend	
		With treaty	Without Treaty	Double Tax Rate	Withholding Tax Rate
Bulgaria	19.5%	Credit	Credit	9.1 %	7.4 %
Croatia	20%	Exemption	Exemption	8.1 %	6.1 %
Czech Republic	28%	Credit	Deduction	5.6 %	5 %
Hungary	17.7%	Exemption	Exemption	9.1 %	6.8 %
Poland	19%	Credit	Credit	6.9 %	5.1 %
Romania	25%	Credit	Credit	6.9 %	6.7 %
Slovak Republic	19%	Exemption	Exemption	3.2 %	0 %

The implications of host country tax regime on divided do not limit to the extent to which after-tax foreign cash flows are reduced. In fact, the presence of a specific taxation system on dividends is expected to remarkably affect the MNC local investment and financial policy. These considerations will be addressed in the following sections.

4.4.1.3 How taxation risk affects the MNC investment policy

The taxation system in force in the foreign emerging country chosen as host location is expected to affect the MNC's decision making process in multiple ways. Notably, the consequences of these burdens are likely to hinder the company from implementing certain investments and/or hamper its access to financing. From a practical point of view, these two streams of implication are closely intertwined, but for conceptual and explanatory purposes they will be addressed in two separate sections.
There are several ways in which taxation can affect a company's investment policy. Some of them are more direct as taxes can be intended as a cost that the firm bears in the implementation on new investment, even more if these projects are developed on a transnational basis. For instance, the previous sections discussed the issues emerging from the multiple tax layers to which the MNC is likely to be subject. The lower the levies are in a foreign country, the easier and cheaper the investment is likely to be[184]. Moreover, there are other indirect ways in which MNCs' investments might be constrained. This section will address two topics that are interesting to analyze the effects of taxation from multiple perspectives. In fact, from the host country point of view, payout taxes are reported to have sizable effects on the allocation of investment by the MNC and on the choice between internal and external financing through equity. Second, from the home country point of view, a higher domestic taxation is documented to create negative externalities on the subsidiary's investment policies and capital expenditure. As seen previously, corporate payout[185] is subject to taxation in almost every country. According to Becker et al. (2013), levies are expected to create a wedge between the cost of external equity (i.e. share issuance) and internal equity (i.e. retained earnings). This wedge increases as payout taxes rise, making the reliance on external equity more expensive. Therefore, a negative association exists between the amount of internal resources and the sensitivity of capital expenditure to variations in the payout tax rate. In other words, the presence of higher payout taxes favor investment financed by retained earnings over equity issuances.
More specifically, it has been demonstrated that the difference in capital expenditure between companies relying on internal equity and those on external equity widens from 5.33% to 7.59% after a payout tax increase. Conversely, this gap shrinks from 7.27% to 5.54% when taxes are cut. Thus, investments flow from firms with limited access to internal equity to those with more internal equity. There are straightforward implications for financial policy as well, since equity issuances are expected to be reduced when corporate

[184] In this case, "cheaper" refers only to the taxation costs.
[185] Either dividends or share repurchases

payout taxes are high. This effect on leverage in accentuated by the fact that interests on debt are assumed to be exempted from taxation (i.e. tax shield). Also governance is expected to have a prominent role in this interplay between investment rate and payout taxes trends. If the decision makers have lower financial stakes in the firm, they are less affected by changes in the tax rate thus their behavior toward risks is not changed (on average).
The chart presented below displays the tax systems in force across 12 emerging countries.

Country	**Tax System**
Brazil	Classical Corporate Taxation
Hong Kong	Classical Corporate Taxation
Hungary	Shareholder Relief
India	Classical Corporate Taxation
Indonesia	Classical Corporate Taxation
Korea	Partial Imputation
Malaysia	Classical Corporate Taxation
Mexico	Full Imputation
Poland	Shareholder Relief
Singapore	Classical Corporate Taxation
Taiwan	Full Imputation
Thailand	Shareholder Relief

In classical corporate taxation systems corporate profits are subject to double taxation: at the corporate level before being distributed as dividends and at the individual shareholder level as dividend income. Conversely, when shareholder relief systems are adopted this burden is reduced. Common forms of shareholder relief are lower tax rates on the dividends received or the exclusion of a share of dividends from the taxable income. In the presence of an imputation system, taxes paid by a company are considered as paid on behalf of its shareholders. Thus, the latter are entitled to a credit (imputation credit) for the levies already paid at the corporate level. As a result, they are liable only for the difference between their marginal income tax and the imputation rate. The difference between a full and partial imputation system is on the characteristics of the imputation credit, that could be the full corporate tax or only a portion. In dividend tax exemption systems dividend is generally not taxed.
A second way in which the role of taxation can be analyzed is the identification of the externalities generated by the home-taxation scheme on the FDI carried out in a foreign country. As pointed out by Nielsen et al. (2010), MNCs are likely to rely on common inputs and assets (e.g. brands, patents, marketing investments) that increase the productivity throughout the subsidiaries network. The return on these investments are generated and spread across all the affiliates. Therefore, if these returns are reduced by taxes in one of the host countries, the real capital investment becomes lower in all the subsidiaries. Moreover, if a MNC is credit constrained and has to finance new investments with internal resources, an increase in the domestic tax rate may shrink the availability of funds to implement these investments. In fact, as it has been demonstrated by Becker and Riedel (2008), capital expenditure in foreign subsidiaries declines on average by a range between 0.76% and 0.84% if home country taxation rises by 1%. This effect is enlarged if the parent company owns intangible resources and if the MNC is relatively small thus more likely to be credit constrained.
This externality effect of domestic taxation is reported to curb the advantages sought by profit shifting activities. When the tax rate rises in the home country, empirical evidence showed that MNCs undertake specific strategies such as transfer prices manipulations in order to shift the profits towards a host country with lower tax rates. However, this higher profit abroad is mitigated by the lower capital expenditure due to the effects presented above. Becker and Riedel (2008) showed empirically that, between the two

implications, the profit shifting effect dominates although it is remarkably mitigated. Therefore, because of this compensation, the economy is brought close to an efficient solution.

4.4.1.4 How taxation risk affects the MNC financial policy

As seen in the previous section, the risks emerging from unfavorable changes in taxation regimes has relevant effects on the investments implemented by the MNC. However, the impact on capital expenditure is often the outcome of the interplay between taxation issues and the channels whereby these investments are financed. The inclusion of tax-related considerations in strategy setting and financial planning leads to several consequences on capital structure and optimal leverage. For instance, previously it has been pointed to the effects of payout taxes on the relative advantage of internal equity over external equity, the tax disadvantages of equity issuances and the positive effects of higher leverage due to the tax shield on interests. Not only the amount of debt appears to be heavily affected by the tax regime in force and its instability, but also the choice of the maturity of these liabilities depends on this variable. Faccio and Xu (2015) demonstrated empirically that both corporate and personal taxes affect remarkably capital structure choices. In fact, companies increase leverage after an increase in corporate taxes or personal taxes on dividends, while indebtedness is reduced after an increase in personal taxes on interest income. On a sample of 25 countries, including the eastern European emerging countries analyzed above, a one-standard-deviation increase in corporate taxes (6.35%) was found to drive a 2.52% increase in leverage.
The imposition of levies at the corporate level enables government to capture a relevant share of the cash flows produced by the subsidiary in their jurisdiction. However, it is assumed that many countries allow companies to deduct interest expenses from the taxable income, exploiting the tax shield and increasing the overall firm value. The benefits deriving from the tax shield are expected to increase with the amount of leverage up to the extent to which bankruptcy costs offset these benefits (Miller, 1977). Therefore, an inverse U-shaped association between corporate taxes and the company's leverage can be expected. On the other hand, investors receiving interest payments are taxed at the personal level, and this can offset the positive implications of the interest deductibility at the corporate level. Thus, the higher is the personal tax rate on interest income the lower is the optimal amount of leverage. Like interest payment, dividends are taxed at the personal level, but here a positive association between the tax rate and leverage is expected. As explained before, the higher is the tax rate on dividends the lower is the incentive for the firm to raise new equity capital. The findings of Faccio and Xu (2015) bring important insights as to the quantitative effects of the relationships presented above. Notably, a 1% increase in corporate tax rates and personal tax rate on dividends lead respectively to a 0.41% and 0.10% increase in leverage. Conversely, a 1% increase in personal tax rate on interest income is associated with a 0.17% decrease in leverage. Moreover, the extent of the effects of corporate tax rate on leverage is likely to depend relevantly on the company's profitability. Therefore, more profitable firms are expected to make greater adjustments on leverage after changes in the tax regimes than unprofitable firms.
Similarly, firms that pay more frequent and significant dividends are likely to be more affected by dividend tax reforms than other companies paying less or no dividends.

The effects of the Chinese taxation system on foreign companies' capital structure choices

National People's Congress of China drafted and passed the new Corporate Income Tax Law in March 2007. The law, which took effect from 2008, was issued to comply with the WTO "National Treatment" rules and represented the end of the dual corporate income tax regime. Specifically, it removed the fiscal benefits towards foreign MNCs subjecting them to the same treatment of the Chinese domestic companies. Under the previous regime, foreign companies could benefit from an effective corporate income tax rate of 15% in contrast with the 25% tax rate applied to local enterprises.
The introduction of a new tax regulation has essentially three consequences on foreign investors. First, they responded to the new law by shortening the maturity of their liabilities. Second, the effects were particularly strong in the Hong Kong-Macau-Taiwan (HMT) district. The reason can be found in the higher responsiveness of family-controlled foreign companies to the removal of preferential tax treatment. Given their ownership structure, these companies are more concentrated thus more sensitive to external negative changes. Third, the new law adversely affected he groups of POEs rather than SOE, as the latter are likely to receive more favorable treatment by the Chine policy-makers.
These findings, obtained through 362,200 observations, are consistent with the notion presented in this paragraph that higher tax rates are associated with greater leverage and shorter debt maturity.

Adapted from An (2014)

Beside the aforementioned considerations about the effects of taxation on capital structure choices, there are other ways in which the former affects the MNC's decisions as to whether and where undertake a FDI. In fact, tax factors influence the choice for the location in which debt capital is to be raised. Specifically, following the notions addressed previously, a company investing abroad is likely to issue debt where the foreign country's government provides greater tax advantages as defined by Miller (1977). To evaluate the net advantage of debt, both corporate and personal tax rate must be considered.
However, also the way in which the foreign tax regime treats dividend payments is likely to take on a prominent role in the decision as to where to locate debt. Recalling the dividends taxation regimes, in the classical tax systems companies are subject to double taxation of dividends and interests on debt are deducted from the taxable income. Conversely, if the tax regimes provide companies with some forms of relief, dividends are taxed at a lower rate at the personal level or not taxed at all at the corporate level. In dividend imputation tax systems, MNCs can deduct interests on debt at the corporate level while receiving a tax credit for the levies paid abroad.
For foreign subsidiaries placed in countries with dividend imputation or dividend relief tax systems the after-tax cost of debt is higher than the cost of issuing new equity. Therefore, the incentive to use debt capital is lower. The tax advantage of a foreign location is also affected by the domestic and foreign treatment of repatriated profits. In fact, although debt raised abroad might lower the taxable income of the foreign affiliate, any tax advantage accrued to the parent company could be lowered by the host-country withholding taxes[186]. As explained by Huizinga et al. (2008), withholding taxes are imposed by the foreign host country on outward dividends used as income cross-border transfers. Since withholding taxes can be assumed to be an additional tax on corporate income, MNCs are driven to issue debt in foreign countries where these taxes are higher. Moreover, since withholding taxes on interest payments can be assumed to be an additional tax on domestic personal income, investors might demand higher returns for the bonds

[186] See Newberry and Dhaliwal (2001), Graham (2003)

issued by the foreign subsidiary[187]. In this case, if withholding taxes on interest payments are higher, MNCs might be discouraged to issue debt in that foreign country. The institutional environment is another variable that should be taken into consideration. In fact, if the parent company is placed in a common law country it is less likely for the MNC to raise debt capital in a civil law country, and vice versa. Moreover, if the home country is characterized by good law enforcement and developed financial markets, there are incentives for the MNC to issue debt domestically, and vice versa.
As the section concerning the managerial and valuation implications will discuss, high economic volatility in a foreign country (e.g. exchange rate risk) is likely to drive the MNC to issue debt as an exchange rate risk hedging strategy. According to Bartram et al. (2010), multinational companies whose cash flows are mostly generated from foreign operations may hedge their exchange rate risks by issuing foreign currency debt through the subsidiary.

4.4.2 Managerial implications and effects on valuation

4.4.2.1 The impact on valuation fundamentals

The consequences of taxation risks on the foreign subsidiary's operations can be modelled into the valuation models in multiple ways. The impact of taxes on profitability and the overall firm's value does not limit to the direct burden imposed on the EBT. Instead, because of its complexity, the analysis of taxation can be assumed to be an optimization problem in which the effects are modelled as a function including all the variables affected, such as leverage, capital expenditure and leverage. This way of conceiving the management of taxation risk is particularly insightful especially given the aforementioned set of relationships often intertwined. Moreover, the relationships between the tax rate and other valuation variables are useful especially for the generation of multiple scenarios in which the whole final consequence on firm's value is examined according to the tax rate change projected. The set of adjustments that should be made to the valuation fundamentals can be analyzed substantially on two dimensions, namely the two strategies that the MNC could undertake in response to taxation issues (i.e. profit shifting and debt shifting).
At the beginning of this paragraph, it has been described how MNC pursue taxation advantages shifting profits from countries with high tax rates to countries with more favorable tax regimes. Widening the taxable income in the latter countries, MNCs are able to reduce the overall amount of taxes paid. Profits can be shifted from an affiliate to another also through the manipulation of the prices paid of internal transfers. This relationship has been quantified on average as a 100-bp reduction of EBIT every 100-bp increase in the tax rate. Moreover, this effect is amplified if the company owns a sizeable amount of intangible assets (120-bp) and if the MNC structure is large and complex (192-bp).
Therefore, the first valuation variable that is likely to be affected by the tax regime enforced is the amount of cash flows. As reported earlier, a direct and indirect effect can be identified. The latter corresponds to the profit-shifting behavior summed up above, while the former is represented by the erosion of the company's net result through higher tax rates. Overall, ceteris paribus, it is reasonable to expect that the higher is the tax rate in a foreign host country, the lower is the amount of cash flows generated. However, engaging in profit shifting activities is an advantageous strategy as long as the gap between the tax rate of the home and the host country is not the outcome of the rise of the former. In fact, for every percentage point-increase of the home country tax rate the capital expenditure in the foreign subsidiaries is expected to be reduced by 0.76%-0.84% on average. The lower investments implemented in the host countries is

[187] See Kim and Stulz (1992)

likely to curb the affiliate's profitability mitigating the positive effects of profit shifting. Furthermore, the presents of high amounts of intangible assets have again a relevant role they amplify the mitigating effect of home country taxation. Beside these considerations, the cash flows accruing to the parent company from the foreign subsidiary is likely to be reduced by the taxes levied at every stage, engendering disadvantages such as the double taxation problem addressed previously. This issue is accentuated in home countries adopting worldwide taxation systems. On the basis of the regimes in force in the home country and the set of potential host countries, the MNC could seek tax advantages also in the engagement in an "inversion" strategy. Undertaking this option, the foreign firm taken over becomes the new parent company exploiting the favorable tax system with respect to the income from foreign operations. Because of its complexity, this solution is not frequent among the overall set of M&A operations carried out in the world. However, the MNC should carefully evaluate this possibility comparing the tax systems enforced in the host countries analyzed as reported in the chart presented above. On the other hand, the MNC could pursue tax-related advantages undertaking debt shifting strategies. In this case, debt is shifted from countries characterized by low tax rate from location with higher tax rates in order to exploit more effectively the tax shield on interest expenses. In fact, a 6.35% increase in the foreign host country tax rate has been found to be associated with a 2.52% increase in the subsidiary's leverage.
Higher leverage entails higher interest outlays, thus decreasing the cash flows generated by the foreign subsidiary. The impact on the cost of capital is even more relevant. In fact, changes in leverage due to variations in the tax systems are reflected by the adjustments that are to be made in the WACC formula. In the case in which the cost of equity is higher than the cost of debt, the adjustments made to the weights attached to these costs lead to a lower overall cost of capital. Moreover, a higher tax rate mitigates the effect of the cost of debt in the WACC formula because of the tax shield. However, in order to have a more detailed understanding of the effects of taxes on leverage, the former has to be divided into the taxes levied on corporate income and personal income both from dividend and interests. While the effects of taxes on corporate income have already been included in the tax shield adjustments, the other two relationships deserve further explanations as to how they shape the level of optimal leverage. A 1% increase in the dividend tax rate has been reported to trigger a 0.10 increase in leverage for many reasons. Fundamentally, in the presence of higher taxes on dividends it becomes more convenient for the MNC and its subsidiary to finance itself through debt capital instead of issuing new shares. Anyway, if new equity capital is raised, shareholders are likely to require higher return on their investment because of the higher taxes they have to bear, resulting in higher cost of equity. Similar implications can be drawn regarding taxes personal taxes on interest payments, since bond-holders may raise the cost of debt requiring greater returns to be compensated for the higher taxes. However, if personal taxes on interest payments increase (+1%), the optimal level of leverage is likely to decrease (-0.17%). Therefore, these last considerations might represent a constraint on the advantages of debt shifting. In order to exploit the differences in the taxation treatment of debt and equity between the home and the host country, the MNC could undertake other policies likely to affect its capital structure. These implications will be addressed in the following section.

4.4.2.2 The issuance of hybrid financial instruments for tax avoidance purposes

The presence of cross-border differences in the tax systems might lead to the possibility that the same financial instrument is labelled as debt in a country and as equity in another country. For example, a perpetual loan is considered equity in some countries due to the fact the principal is never reimbursed. However, the tax system enforced in other countries may consider it as debt because of the absence of

voting rights and risk participation. These discrepancies represent a tax planning opportunity[188] for the MNC, whose payments made on certain financial instruments might be treated as tax-deductible interest expenses in the host country and tax favored dividends in the home country. By doing so, the company is able to achieve a double tax saving. Obviously, this opportunity is present only if the home country adopts a tax system in which companies benefit from tax reliefs on foreign dividends. However, some kind of relief such as tax credit are present also when a worldwide tax system is applied. Therefore, in order to assess the advantages of such a strategy, the company should examine the country-specific threshold beyond which a financial instrument is labelled as equity or debt. These thresholds are to be assessed against three variables and the relative weights assigned by the tax system in force. First, the maturity of the instrument is a usual parameter used for distinguishing equity instrument from debt, since the former has generally no maturity. Second, the instrument can be considered equity because of the inclusion of voting rights. Third, in contrast with interest on debt, the returns on investment in equity are represented by dividends whose amount is not fixed and distribution is not mandatory by law.

Johannesen (2014) provides an example that could be useful to understand the potentials of hybrid instruments for tax avoidance purposes. US regulation distinguishes debt and equity instrument for tax treatment on the basis of several features, while French regulation takes into account only the presence of voting rights. In order to benefit from a double tax saving, a MNC based in the US could issue in a French subsidiary an equity instrument that does not provide voting rights. Conversely, a French MNC could attain the same advantages by financing an investment in the US through the issuance of debt instruments that confers voting rights to the holder. The implementation of this strategy could include the participation of other subsidiaries located in third foreign countries (Johannesen, 2012) in order to minimize the impact of withholding taxes. In this system, funds are transferred in the form of equity from the parent company to the first intermediary affiliate located in a different country. Then the funds are passed to the second intermediary affiliate located in another country through a hybrid instrument that is transmitted to the target affiliate in the host country in the form of debt. If the hybrid instrument exchanged between the two intermediary entities is treated as equity in the first and debt in the second, and the cash flows of the three financial instruments match, there is no tax burden between the two intermediary countries.

On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which country risk affects valuation fundamentals.

Risk Factor	**Effect on valuation fundamentals**
Corporate Tax	A 1% increase is associated with a 1% decrease in EBIT due to lower profit shifting opportunities.
	The aforementioned EBIT decrease rises to 1.2% in the presence of high intangibles endowments and 1.92 if the MNC structure is complex.
	A 1% increase is associated with a 0.41% increase in leverage.
Personal Tax on dividend income	A 1% increase is associated with a 0.10% increase in leverage.
Personal Tax on interest income	A 1% increase is associated with a 0.17% decrease in leverage.
Withholding Taxes and Double Taxation	Higher withholding taxes (and double taxation) is associated with lower premium paid for the acquisition of the target company (correlation: -0.677).
Home Country Taxation	A 1% increase is associated with a 0.76%-0.84% decrease in subsidiary's CAPEX. The effects are heightened in the presence of high intangibles endowments and if the firm is credit constraint.
Introduction on Mandatory Disclosure	Decreases the profit shifting opportunities (lower by 52% in two years after introduction).

[188] See Krahmal (2005)

4.4.2.3 The impact of host country volatility and unionization on taxation risk

Ghinamo et al. (2010) assumed a country's economic volatility to be related to a set of economic indicators (GDP growth rate, real interest rate and exchange rate) and political volatility to be the outcome of property rights protection and political stability. Given these measures of volatility, a strong relationship was found between them, the growth of FDI and corporate taxation. Specifically, a 10% increase in volatility is associated with a 0.1% decrease in the corporate tax rate. The previous paragraphs discussed the ways in which economic and political volatility are detrimental for the establishment of a subsidiary in a foreign emerging country. Notably, MNCs investing in countries characterized by high degrees of uncertainty have to frequently adjust their capital structure and internal operations in response to the host environment.

According to Panteghini and Schjelderup (2006), higher volatility leads the host country government to decrease the tax rate on corporate profit. This reaction by the policy-makers is explained by the fact that volatility reduces the amount of FDI inflows, therefore they lower the tax rate to counteract the negative effect of volatility. As indicated by Panteghini (2009), if the risk of expropriation by the government increases the MNC protects their investment by shifting their income in more favorable countries. In order to restore its credibility and reliability as well as stimulate FDI inflows, they set a lower tax rate decreasing the level of uncertainty.

As for unionization, Haufler and Mittermaier (2011) found that governments of countries characterized by high union activity tend to offset the negative effects of the latter on inward FDI through fiscal policies. These measures can be implemented in the form of subsidies (often for 25% to 30% of the present value of the investment) or through tax reductions. Moreover, the highest subsidies are paid in the countries with weaker economic activity and high union intervention. By issuing these policies, the political authorities aim to attain a double purpose. First, foreign investors are compensated for the disadvantages presented in the previous paragraph with benefits exceeding the higher costs faced. On the other hand, since more FDIs are attracted, local unions are given an incentive to lower their wage demands and disputes in exchange for higher employment opportunities in the foreign multinational companies.

5. ENDOGENOUS RISK FACTORS

The previous chapter addressed the risk factors present in the host country environment that are likely to affect and shape the success of the MNC's foreign venture. These risk factors have been divided into two separated streams, namely the informal and formal environment, along which the risks of an emerging country have been analyzed. The former dealt with the elements constituting the different dimensions of distance, examining and demonstrating how cultural, geographical and economic-freedom distance can hamper or facilitating FDI in an emerging country. The latter focused on the institutional environment and the role of politically-empowered actors in defining and threatening the subsidiary's operations in an emerging country. Several managerial and valuation implications have been drawn in order to raise the ability of the decision maker to identify and proactively respond to these informal and formal threats.
However, additional insights and specifications need to be provided in order to have a full understanding of the risks factors affecting the successful establishment of a subsidiary in an emerging country. In fact, the extent to which the MNC is able to devise an appropriate response to the aforementioned threats ultimately depends on the company's internal environment. Decision makers' personal characteristics and biases may pose additional risks and in the form of agency costs and of behavioral distortions. Firm-specific resources and competences gathered in previous experiences might affect future investments' traits and success. Moreover, special attention should be provided to the home-country cultural elements embedded in the MNC's internal structure and environment.
As these threats are rooted inside the MNC's structure, resource endowments and cultural framework, they will be referred to as endogenous risk factors. In contrast with the exogenous risk factors addressed and analyzed previously, this chapter will focus on these internal variables.
Depending on their form and strength, they shape the eventual and ultimate way in which the exogenous risk factors affect the subsidiary's operations in the emerging country, either mitigating or heightening them.
As outlined in the introductory chapter, the risk factors here discussed are:

5.1) Agency costs and behavioral distortions
5.2) The role of home country cultural and institutional framework
5.3) The effect of financial flexibility in emerging countries
5.4) The relationship between international experience and cultural distance

Specifically, each of the following paragraphs will be structured as follows:

1. General presentation of the existing literature over the risk factor addressed;
2. Discussion of the most recent empirical findings of the researches conducted about the topic;
3. Analysis and considerations as to which effects the risk factor is likely to have in the evaluation models and the related managerial implications.

In each paragraph, the endogenous risk factors will be analyzed in close connection with the exogenous ones discussed previously, in order to highlight the effects of the former on the latter.

5.1 Agency costs and behavioral distortions

5.1.1 Literature and empirical findings review

International business scholars and researchers focus their analysis on the "objective" internationalization risks in the form of political, economic and institutional risks in order to link industry-related variables to internationalization outcomes. This has been the kernel of the previous chapter. On the other hand, the aim of international entrepreneurship scholars is to highlight the role of entrepreneur's perceptions and biases as "subjective" internationalization risks[189]. This focus on the entrepreneur can be extended to all the main decision makers (i.e. managers and CEO) involved in the investment process. According to Kiss et al. (2013), the spread between objective and subjective risk represents the decision maker's risk bias and motivation shaping the FDI aggressiveness and commitment. This motivation is the driver for the post-entry subsidiary's growth in terms of both the number of target countries (i.e. internationalization scope) and the amount of activities and resources devolved to the foreign affiliates (i.e. international intensity).
The analysis of exogenous risk factors stemming from the informal and formal host environment does not explain how managers actually perceive and react to these risks. This is the reason of the many inconsistencies observed in the literature between the risk factor and its final consequence on valuation and profitability. The aim of this chapter and this paragraph is to fill this gap and capture the ways in which managerial behavioral distortions and biases filter the effects of emerging country risks.
The perception of internationalization risk is influenced by the uncertainty tolerance level of the decision maker as well as the potential benefits of the investment net of these perceived risks. From the outset of the present work it has been stressed the fact that emerging countries are characterized by high degrees of uncertainty because of the institutional instability and flaws. Moreover, cultural and geographical distance represents a burden for an efficient information and knowledge flow between the countries involved.
This uncertainty and lack of information are likely to increase the internationalization risk perception, thereby affecting both the internationalization scope and intensity (Acedo and Florin, 2006).
Given this higher level of uncertainty and instability of the host environment, the decision maker can be driven by two opposite motivations in choosing the optimal policy. On the one hand, reactive motivations often influence the entrepreneur in the form of external stimuli that are likely to lead to a risk bias implying a higher threat perception than it actually is. This kind of motivation are often related to unexpected changes in local demand or customs as well as industry conditions that increase further the information and knowledge gap. Thus, these decision makers often have a passive approach with respect to the external environment. A higher uncertainty leads the decision maker to an over-estimation of the risks incurred. On the other hand, proactive motivations are intrinsic to the managers and are rooted in a higher confidence in the strategy undertaken and sense of control over the external variables. These managers are often perceived as opportunity seekers but, as the following sections will discuss, overconfident decision makers are likely to underestimate the impact and the likelihood of the surrounding risk factors. Proactive decision makers are willing to exploit the opportunities of new investments more aggressively and with the commitment of a higher amount of resources (Knight and Cavusgil, 2004). Therefore, proactive motivations are associated with greater internationalization scope/intensity and post-entry growth.
The latter statement highlights the mediating role of risk bias on the way the subsidiary is established and embedded in the host industry. In fact, since the kind internationalization motivation adopted is expected to define the extent of the cross-border commitment, a subsidiary is likely to thrive more effectively under a proactive approach because of greater resource and knowledge flows as well as more decision-making freedom. In turn, these more aggressive and bolder behaviors are the outcome of a lower risk perception.
The empirical evidence brought by Kiss et al. (2013) corroborate the impact of proactive motivations, that is positively correlated with international scope and intensity (respectively 0.22 and 0.04) and negatively correlated with risk perception (0.19). However, the notion that a proactive internationalization motivation

[189] See Acedo and Jones (2007)

is connected to higher growth opportunities does not imply that these goals will be always achieved. It would be too narrow and simplistic to state that the investment will be automatically successful given the adoption of such a behavior. In fact, the presence of a risk bias as a mediating variable in the decision making process increases remarkably the likelihood of underestimation and overestimation of the exogenous risk factors. In turn, a flawed perception of the host environment is likely to lead the company to miss the fit between the latter and its strategy.
Beyond internationalization motivations, there is a wide array of behavioral variables that are likely to affect the way the decision-making process is actually carried out. As the present paragraph will further discuss, these factors can be either rooted in managers' personal characteristics and background or provoked by agency tensions between the actors involved in the process.

5.1.1.1 Biased estimations and behavioral traits

As introduced earlier, decision makers might suffer from biases distorting the reliability of the strategies undertaken. More specifically, behavioral and judgmental biases widen the gap between the decisions made and the policies that can be referred to as optimal given the environmental features and constraints. For instance, these policies might concern the choice of the financing source, the target country and the resource allocation. According to Alti and Tetlock (2014) MNC's decision makers are not able to observe and accurately forecast the subsidiary's future productivity, therefore they must rely on two sources of information. If the FDI is carried out through a cross-border acquisition, future profitability can be estimated from the current profitability of the target company. On the other hand, the foreign bidder could adjust its estimations about future profitability on the basis of soft information that complements those provided about profits.
Assuming this dual source of information, decision makers might suffer from two biases in forecasting the subsidiary's productivity, namely overconfidence and overextrapolation. Overconfident managers believe that the information available and more accurate than it actually is. In pricing potential targets, overconfident decision makers assign too much importance to soft information signals instead of profit signals. Therefore, their bias lead to target underpricing and underinvestment. In contrast, overextrapolation refers to the confidence that trends are more identifiable than they actually are. Thus, overextrapolative managers believe that the target will keep on being profitable for a longer term, so they overprice these firms. The MNC's decision makers should pay appropriate attention in detecting such biases both in the estimation made by its analysts and the forecasts carried out by the target company about its future profitability. The endogenous risk lies especially in the former case, in which the MNC must anticipate and prevent these biases in the estimation process. Notably, the optimization problem that in the previous chapter was limited to variables reflecting external risks and uncertainty, now must include flaws inherent to the decision making process. The consequence of these estimation biases are distortions and anomalies in the investment policy of the MNC and in the confidence with which decision and assumptions are made. With respect to objective estimations carried out by rational managers, Alti and Tetlock (2014) found that the investment anomalies deriving from overconfidence and overextrapolation amount respectively to -2.35% and 0.45%. If both biases are present among decision makers, the investment anomaly is -6.99%. Moreover, the confidence with which investment decisions are made are expected to increase with the extent of the biases present, since managers believe they are more informed than they actually are. In fact, the perceived error, measured as standard deviation, in estimating future productivity for a rational decision maker is 0.302 while for a biased agent it amounts to 0.132. Beyond the direct effects of managerial biases on the investment policies of the MNC, the presence of such distortions leads to additional costs connected to the worse perception of managers' quality and credibility.
The reputation and quality of managers have several signaling implications for the company's investment and financial policy. Credible and reputable managers are able to convey the real value of their firm to the financial market, reducing information asymmetry towards outside investors. Lower information asymmetry might enable the company to issue equity more easily and cheaply as their shares are correctly

priced. Therefore, it can be reasonably expected that companies with high-quality management are characterized by lower levels of leverage. In their research, Chemmanur et al. (2009) found that companies with high-quality management have, on average, leverage ratios that are lower by 3.8% than those with lower-quality managers. The effect of a lower cost of equity capital on leverage must be analyzed in parallel with a similar effect on the cost of debt. In fact, the latter is expected to be reduced by high-quality managers because of lower bankruptcy probability and costs. Given the benefits deriving from the exploitation of the tax shield, lower costs of debt capital will raise the leverage equilibrium level. The management of the MNC will have to assess which cost will be lowered the most and which effect on leverage will prevail on the other.

As for the effects on the company's investment policy, better and more reputable managers are able to identify and select project opportunities with larger NPV. Assuming decreasing returns to scale, the NPV is will fall to 0 only if larger scales are reached, therefore higher equilibrium levels of investment can be expected. This in turn will lead to higher degrees of capital expenditures. The regressions carried out by Chemmamur et al. (2009) provided empirical evidence supporting these relationships. In fact, the presence of larger and higher-quality management teams leads respectively to an increase of 1.4% and 1.1%-1.8% in the investment level of the firms included in the sample. These considerations can be further explored and expanded analyzing specifically the impact of CEO's reputation on the investment policies carried out by the company. In the literature, there are contrasting evidence as to whether higher CEO's reputation is likely to provide more costs or benefits to the company as well as its financial and investment policies. Fundamentally, two different perspectives can be taken in order to evaluate the direction of these correlations, namely the efficient contracting hypothesis and the rent extraction hypothesis.

According to the efficient contracting hypothesis, CEO's reputation is expected to increase the wealth effects of the investments carried out by the MNC. In fact, more reputable CEOs have built their credibility and competences through deals and policies effectively implemented. Moreover, they have more to lose both in terms of future employability and credibility if they select negative-NPV investment opportunities.

On the other hand, under the rent extraction hypothesis, CEOs are likely to engage in extensive investment policies in order to improve their personal reputation regardless of the impact on shareholders' wealth. Because of career concerns, these managers are likely to be overly focused on short-term profitability and to manipulate the information about the investments' risk profile. Moreover, their biases in the decision-making process could lead to investment distortions such as overinvestments. They could undertake investment with shorter maturity in order to anticipate the arrival of positive news strengthening their reputation. On the other hand, they might engage in projects whose outcome will be resolved in the distant future to put off negative news that could undermine their reputation. According to Jian and Lee (2011), higher CEO's reputation is positively correlated with announcement returns, providing support for the first hypothesis. To quantify this relationship, they assumed CEO tenure, the business article counts and industry adjusted performance as proxies for CEO's reputation. All these proxies are positively correlated with announcement returns, that are demonstrated to increase respectively by 0.1207%, 0.0645% and 0.0262%. Moreover, according to the efficient contracting hypothesis, the company's operating performance is expected to increase after the announcement of a new investment such as the establishment of a foreign subsidiary. Consistently with this assumption, Jian and Lee (2011) documented that the post-investment operating performance increase for companies with reputable CEOs is 1.42% higher than companies with low CEO reputation. Other strands in the literature identified specific personal characteristics that are likely to affect and shape decision-making biases in the investment evaluation. For example, regardless of the effects of cultural backgrounds (these will be discussed in the following sections), it has been documented that managers' risk appetite and biases are influenced by their gender and age.

As for gender, Huang and Kisgen (2013) showed that male executives are characterized by the adoption of more overconfident approaches in the decisions concerning investment policies than female managers.

Claiming that male executives are overconfident with respect to female colleagues implies that the latter generally undertakes less investments. This is because overconfident managers overestimate the net

present value of the investment opportunities accepting also certain deals that eventually end up being value-destroying. Therefore, investment decisions made by female executives are likely to receive positive responses and reactions from the financial markets. From this point of view, the gender of the decision maker involved in the FDI addressing an emerging country is even more crucial. Because of the presence of additional risk factors, overconfident male executive might take hazardous and risky decisions while women executives might be risk averse to the extent to which they forgo profitable investment opportunities.

As it will be discussed more in the detail in the section regarding the managerial and valuation implications, women are demonstrated to invest in less risky assets and undertake less acquisitions than male executives. Moreover, the former are likely to raise less debt capital and decrease leverage (-2% after three years of male-female executive transition). However, although the investment rate and capital expenditure decrease (-2.5% after three years of male-female executive transition) under female managers, they are shown to maintain ROA to satisfactory levels while men undertake investments that end up destroying value. Furthermore, the value-destroying acquisitions carried out by men executives account on average for 50% of the total, while after the transition to a female executive this value falls to 30%. These are the reason why financial market deems investment carried out by female executives more value-increasing than those implemented by men, leading to higher announcement returns (2%). As for measures of estimation confidence, male executives are reported to provide 6.3% narrower forecast ranges than female. Therefore, there is empirical evidence supporting the notion that male managers are overconfident with respect to female decision makers. These additional specifications should be insightfully connected with the risk biases presented at the beginning of this section. On the other hand, as for the effects of age on the investment policies, it has been demonstrated that the decision maker's career horizon is positively associated with the amount of capital expenditures and acquisitions carried out. The notion connecting executive's age and the amount of acquisitions implemented is the so called "empire building bias". According to this theory, managers whose retribution is related to firm's size, for example through stock options[190], are incentivized to pursue a higher number of acquisitions even if sometimes they could be value-destroying. This behavior is accentuated in the presence of specific and permanent bonuses for every transaction carried out[191]. Since young managers potentially have longer career horizon in which they can benefit from these permanent rewards, they are more likely to have a lower risk perception and to engage in more transactions. Starting from these considerations, Yim (2013) found that for every acquisition made the CEO's compensation jumps on average by 12%. Because of the longer career horizon on which these higher benefits can be accumulated, a CEO that is 20 years older has 32% lower probability to carry out an acquisition. However, as the sections about corporate governance will discuss, the relationship between decision makers' age and their risk-taking behavior is mediated by the ownership stake in the company. In fact, higher stakes are able to align managers' interests to those of the shareholders decreasing the overconfidence of the former.

As a final remark, it is worth to point out that decision makers' risk perception is also influenced by firm-specific factors, such as leverage and bankruptcy probability. As indicated by Milidonis and Stathopoulos (2014), the decision maker's perception of the investment riskiness is the result of two counteracting effects. In fact, higher risk implies an increase in both the discount (risk-aversion effect) and the market (wealth effect) values. In the case of firms with higher leverage and bankruptcy probability the former effect is likely to dominate the wealth effect thus managers' become more risk averse. The managers' risk bias in this case stems from both reputational costs and employment risk, since managers of companies that file for bankruptcy are less attractive from the point of view of a future potential employer. A more direct risk concern compensation cuts for CEOs deciding to keep their position in companies that experienced bankruptcy. Eckbo and Thorburn (2003) showed that these CEOs suffer from compensation cuts of approximately 47%.

[190] See Haford and Li (2007)

[191] See Grinstein and Hribar (2004)

5.1.1.2 CEO's biases and relationships networks

I decided to dedicate a specific section to the risks biases characterizing the MNC's CEO since he/she is the ultimate decision-maker and the most influential manager within the company's structure. As this section will show, CEO's risk perception and biases are likely to be influenced by the set of relationships and networks built throughout his career and the previous investment experiences.

Managers accumulate personal and professional experiences as part of their cognitive and emotional features. These features are likely to influence and distort the risk perception related to a specific situation, filtering and transforming the information coming from the external environment. For instance, Custodio and Metzger (2013) found that industry-specific managerial skills accumulated throughout the professional career are likely to strongly affect future acquisitions and investments. Moreover, varied career experience allows managers to accumulate not only competences but also valuable social relationships. These connections might curb information asymmetry and improve the access to external financing reducing the dependence on internal resources (Engelberg et al., 2012). The lower cost of external financing enables the company to overcome investment limitations due to insufficient internal funds. Thus, investment policies devised by managers with more diverse career experience are less sensitive to internal cash flows variations and shortages. Hu and Liu (2015) identified a 2% increase in leverage for firms with more diversely experienced executives, witnessing the ability of the latter to obtain debt financing at a lower cost. According to the resource-based view introduced at the outset of the present work, social connections represents strategically relevant resources as they can lead to better and timely information flows. Exploiting their social relationships, diversely experienced CEOs are likely to broaden the pool of a firm's accessible resources. Notably, thanks to nurtured relationships with relevant stakeholders, the MNC might obtain and retain business relationships with suppliers, customers and capital providers benefiting from either direct or indirect financial support. For instance, these CEOs are more likely to improve the access also to informal forms of financing (e.g. trade credit) enabling the company to mitigate working capital shortages.

These advantages are particularly relevant for companies expanding towards and operating in emerging countries. Because of the already mentioned institutional and regulation weaknesses, MNCs are hampered in gathering market information, enforcing contracts, and organizing resources. Therefore, as the previous chapters have highlighted, the ability of the company to build networks with local actors is likely to help the former gaining legitimacy and acceptance in the host country. However, the presence of CEO's personal connection might imply a series of drawbacks and distortions. In fact, these social ties could undermine the effectiveness of valuation processes weakening independent and rational decision making (Fracassi and Tate, 2012). Other researchers showed that personal connections built outside the professional sphere increase the likelihood of fraud. Moreover, CEOs might use this network influence to obtain the board support even for investments that could be detrimental for shareholders (Bebchuk, Cremers and Peyer, 2011). This value destruction through negative-NPV projects is connected to the empire-building behavior outlined before. In fact, El-Khatib et al. (2015) found that, given an increase in network-centrality (from the 25th to the 75th percentile), the probability of receiving a greater compensation is higher for bidder CEOs (from 44% to 69%) than for non-bidder CEOs (from 50% to 54%). The value-destruction is especially evident if cross-border acquisitions are taken into consideration. In the presence of personal connections, these deals are more likely to occur, because of the CEO influence on the other decision makers and the improved information flow. Nevertheless, significant value losses are incurred both by the acquirer and the target as CEO's risk perception is biased by the presence of permanent bonuses and compensations received for the deal completion. Starting from the findings of previous researches, El-Khatib et al. (2015) analyzed the effects of CEO network centrality identifying four dimensions, namely closeness, degree, betweenness and eigenvector centrality. Closeness measures the distance between an actor and all the other individuals in his network. It is an indicator of the efficiency with which individuals exchange

information. Degree refers to the number of direct ties an individuals have within a network and it is positively correlated with his centrality. Betweenness indicates the frequency with which an individual acts as intermediary in the information exchange between other individuals. Thus, it is a measure of control over the information flow. Finally, eigenvector centrality is a measure of the actor's importance in the network in terms if the number of connections with other highly-connected actors.
Exploiting their network centrality, CEOs might entrench themselves reducing the effectiveness of board monitoring over their activities. In M&A transactions, personal ties decrease the ability of CEOs to perform critical analyses and high-quality due diligences at the expense of shareholders. Less rational judgements and biases due to personal connections prevent decision makers from divesting from unsuccessful transactions even in the presence of negative responses of the financial markets. Analyzing the effects of CEO network centrality along the four dimensions presented above, El-Khatib et al. (2015) found that higher network centrality (transition from the 25th to the 75th percentile) is associated on average with a 28% increase in acquisition frequency. Moreover, the same increase in CEO network centrality is shown to decrease acquirer's announcement returns by 3.42%. The losses borne by the acquirer could be offset by the gains accruing from synergies with the target. However, all the four measure of network centrality are demonstrated to adversely affect the returns of the combined entity. In fact, synergy gains reduce by 3.06% in the case of a transition from the 25th to the 75th percentile of CEO network centrality.
Corporate governance rules and practices are likely to have a role in either mitigating or heightening the decision maker's opportunistic behaviors. Notably, governance mechanisms such as intense board monitoring, CEO-chair separation and the appointment of older CEOs are demonstrated have a moderating role on the acquisition frequency. The latter finding is consistent with the aforementioned considerations about the effects of decision maker's age on his risk biases and investment policies.

5.1.1.3 Corporate Governance and managers' ownership

Because of the presence of behavioral biases likely to distort managers' decision making process, it would be naïve to claim that an internationalization strategy is only the outcome of rational valuations.
As pointed out several times in the literature, companies can be viewed as political coalitions in which actors co-operate and compete to pursue their personal objectives. These objectives could be either aligned with those of the company or not. Therefore, the internationalization strategy undertaken by a MNC expanding towards one or more foreign emerging countries can be analyzed adopting the principal-agent perspective. Accordingly, managers and owners are supposed to have more or less different drivers determining their preference as to the extent and the means whereby implement the internationalization process. On the one hand, managers are expected to be interested mainly in protecting and increasing both their current and future income. However, their drivers are not limited to economic benefits but also include prestige and reputation. In order to enhance their status, managers pursue growth opportunities through industrial and/or geographical diversification, within or beyond national borders. On the other hand, shareholders are able to find diversification opportunities in the capital market without undertaking "physical" diversification strategies in the company. According to the ownership structure of the company, these actors will leverage their bargaining power in order to attain their particular interests and objectives. The agency problems are triggered by managers who, in the maximization of their personal utility, over-diversify beyond the threshold set by shareholders' risk exposure. In this case, costs of co-ordination and control exceed the benefits deriving from internationalization. In order to align these conflicting interests, specific corporate governance practices and compensation structures (e.g. stock options) have been devised. However, there are several limitations in their usefulness as tools whereby limiting managers' opportunistic behaviors.

As explained in the previous chapters, the choice of the entry strategy in a foreign emerging country implies a double decision. First, the MNC has to opt between two equity-ownership alternatives, namely a shared-ownership (i.e. joint venture) and a wholly-owned subsidiary. Second, the foreign investor has to choose between acquiring an already existing company (i.e. cross-border acquisition or brownfield) and establishing a new venture from the ground up (i.e. greenfield). In the former involves the purchase of an already present set of resources, knowledge and relationship with the local institutions. Whereas, in the latter case these resources and networks have to be contracted and built from scratch[192].

Managerial equity ownership and compensation structures are expected to heavily affect the choice of the entry mode strategy. Equity ownership and contingent pay based compensation structures are likely to shape the managers' risk perception and aversion. Therefore, these risk distortions will lead to the preference for either a greenfield venture or a cross-border acquisition according to the final uncertainty and expected payoffs. The issue of the entry mode strategy has been addressed in the previous chapter in relation with the transaction cost economics (TCE). According to this view, the decision hinges on the use and availability of resources, knowledge ad relationships in foreign operations. For instance, limited international experience and availability of competences are likely to favor cross-border acquisitions over greenfield investments. On the other hand, high cultural distance might favor greenfield ventures as such distance is likely to impede the effective transfer of knowledge and managerial practices to the target company. According to McVea (2009), the establishment of new ventures in foreign emerging countries represents an entrepreneurial effort that is characterized by uncertainty and unpredictable outcomes.

Greenfield ventures are usually characterized by higher levels of outcome uncertainty because of the liability of foreignness and newness faced by the foreign MNC. Notably, the presence of a foreign company might trigger retaliatory actions by the local enterprises who see their profits endangered. A relevant amount of resources needs to be spent in order to gain the appropriate knowledge about local institutions and market actors (suppliers, customers and competitors). Greenfield ventures' outcome uncertainty is exacerbated if the investment is implemented in the form of a wholly-owned subsidiary.

Conversely, MNCs expanding in foreign markets through cross-border acquisitions are expected to benefit from the knowledge of pre-existing local players. Therefore, far less resources are likely to be needed for building networks with suppliers, customers and political authorities as the foreign investor can rely on those already established by the local company. The uncertainty profile of subsidiary established through cross-border acquisition is lower as the performance of the target company can be carefully evaluated and forecasted before the actual implementation (Georgopoulos and Preusse 2009).

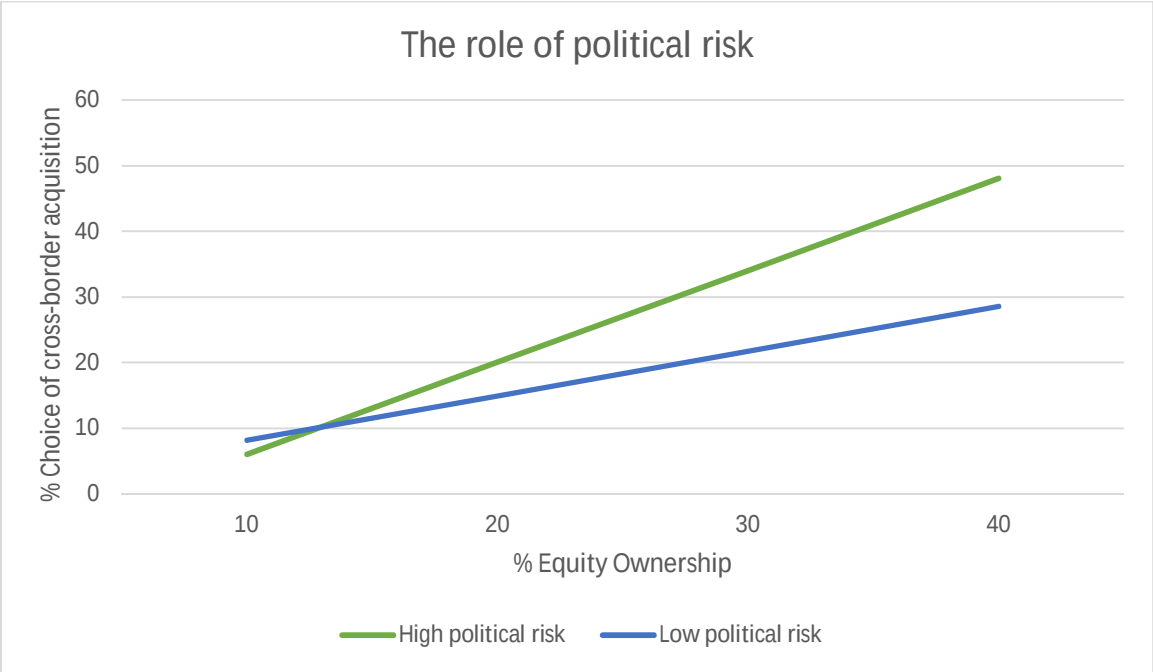
In addition to the uncertainty profile, insightful considerations can be drawn as to the differences in payoffs horizons. MNCs expanding internationally through greenfield investments are expected to engage in time and resource-consuming processes aimed at developing the appropriate knowledge and competences as well as building relationship networks to successfully operate in the foreign market. Payoff periods are likely to be longer for greenfield ventures because of the establishment costs and limited local demand for their products. The returns delay is accentuated by the presence of conformity costs incurred to curb the liability of foreignness and newness. Conversely, MNCs can get immediate access to relationships with local market actors and knowledge through cross-border acquisitions potentially shortening payoffs horizons.

These differences are reported to have an important role in shaping the relationship between managerial equity ownership, the consequent risk bias and the establishment strategy adopted. As seen previously, managers are likely to exhibit various biases whose extent is linked to the external uncertainty perceived. According to behavioral decision theory, managers evaluate potential losses compared to potential gains placing more weight on the former. The likelihood of potentially positive investment opportunities to be turned down is further increased if decision makers have more to lose. In fact, when their personal wealth is connected to company's and investment performance, decision makers are likely to reject projects whose final outcome is surrounded by higher uncertainty.

Therefore, managers with higher equity ownership are expected to select investments that are characterized by more certain returns accruing in a shorter time horizon. Decision makers involved in the

[192] See Slangen and Hennart (2008)

choice for the foreign entry mode are thus more likely to favor the acquisition of an already existing local company because of the less uncertain outcome. As seen previously, in this case the entrant firm is not faced with the challenges of gaining legitimacy, acquiring knowledge and building relationships from scratch. Cross-border bidders are also able to overcome the initial costs related the liability of foreignness and newness, shortening the time required for the achievement of the break-even amount of foreign sales.
Although successful subsidiaries in the form of greenfield ventures may provide the MNC with higher returns, these are more uncertain and unlikely to appear in the short term. Thus, this option is far less appealing for biased and risk averse managers willing to protect the value of their equity holdings in the company. Similarly, Finkelstein et al. (2009) found that compensation structures based on contingent pay systems (e.g. stock options) undertake a relevant role in influencing and distorting managers' decisions. Contingent pay systems are assumed to align the interests of managers with those of stockholders, leading the former to maximize investment value on a longer time horizon. Although these options are not exercised as long as the market price is lower than the exercise price, managers are concerned by the potential value of their option holdings. In fact, a study conducted by Larraza-Kintana et al. (2007) highlighted that option-holders decision makers are likely to reject potentially profitable investment opportunities if they imply high downside risks that could threaten the value of their options. In fact, they demonstrated that managers anticipate the value of the options' future exercise as a part of their personal current wealth. These are other reason bolstering the consideration that managers are expected to favor investment strategies which they believe will provide more certain returns. In addition, given the relatively short options' exercise periods, managers are likely to prefer investment opportunities with shorter payoffs periods that are more likely to raise the share price sooner. Therefore, managers biased by their option holdings are likely to prefer cross-border acquisition as an entry mode strategy over greenfield investments. The latter might have higher upside potentials but at the same time they carry higher downside potentials as well, and managers are demonstrated to weight more the latter aspect.
Connecting these behavioral distortions with the issues addressed in the previous chapter, several considerations can be made as to the effect of political risk on the effects of managers' equity ownership on their risk bias. It has been shown earlier in this work that political risk represents the likelihood for the company to be adversely affected by local policy actors' decisions. These decisions might involve disadvantageous changes in taxation policies of regulations that could favor local enterprises. Generally, political risk is associated with higher transaction costs, lower ability to enforce contracts and greater frictions in gathering the information needed to compete in these countries. Therefore, political risk can be viewed as a dimension of external uncertainty.
Given the aforementioned considerations, managers with higher equity stakes are expected to be particularly worried about the value of their stock options when their company invests in countries with high political risk. Being loss averse, options-holder managers are likely to favor cross-border acquisitions over greenfield ventures as the latter might be more heavily affected by political risk. The same conclusions can be drawn for the effects of contingent pay systems. Since managers treat equity-linked options as part of their current personal wealth, they are likely to favor safer investment. As the presence of political risk is associated with higher uncertainty, risk-averse decision makers are expected to prefer cross-border acquisitions to greenfield investments. The preference for this entry strategy is accentuated if the payoff horizon is considered. Given that higher uncertainty associated with political risk is likely to further delay the investment returns, managers are more reluctant to engage in greenfield investments. They are expected to opt for cross-border acquisitions in order to preserve their company-related wealth given the higher likelihood of subsidiary's profits to be jeopardized by host country political risk.
A research conducted by Datta et al. (2015) strongly support these relationships between managers' equity ownership and entry mode strategy. Notably, the graph presented below summarizes their findings about the role of political risk.



In the same direction, Panousi and Papanikolaou (2013) found that the level of insider ownership has a relevant mediating role between uncertainty trend (expressed as idiosyncratic risk) and the subsequent change in capital expenditure. In fact, a 49% increase in idiosyncratic volatility is associated with a 1.5%-2% cut in the investment-capital ratio in companies whose managers own relevant stakes. Conversely, in correspondence of the same volatility variation, companies with lower insider ownerships cut their investment-capital ratio by only 0.05%-0.4%.
Moreover, they indicated that companies with higher insider ownership are more likely to incur greater costs of external financing and, consequently, to have lower levels of leverage. The effect of large equity stakes owned by decision makers appears to be mitigated by the presence of high level of institutional ownership. In fact, institutional investors are likely to implement corporate governance practices and monitoring activities more effectively. This is particularly evident given the impossibility of small investors to effectively scrutiny managerial activity also due to free-riding problems. Consistently, Panousi and Papanikolaou (2013) reported that the difference in capital expenditure between companies with respectively high and low levels of insider ownership is particularly wide (4%-6.2%) in the presence of low institutional ownership. This difference is almost not existent in the case of large institutional ownership.

5.1.1.3 The impact of board connections

The previous section addressed the ways in which managers are likely to affect the MNCs investment decisions both on an individual and collective basis. Adopting a broader perspective, this last section will deal with the effects of extra-company relationships involving the acquirer and the target company sharing a number of common managers. This discussion is particularly useful given the importance that cross-border acquisition has had as a subsidiary-establishment mode throughout the present work.
Cai and Sevilir (2011) identified two typologies of board connections. The “first-degree connection” is that existing between two companies sharing a common director before the merger announcement. In the case of a “second-degree connection” two executives separately belonging to the entities involved in the transaction work together in a third board before the merger announcement.
Exploiting these board connections, the two companies are able to improve the communication flow enhancing the knowledge and understanding of each culture and operations. Easier and better information

flow represents a remarkably relevant advantage when the subsidiary is established in an emerging country. In fact, these advantages can be viewed by the acquirer as a bridge whereby filling the gaps of cultural and geographical distance. In the meanwhile, these connections might facilitate the foreign company in gaining legitimacy with the institutional investors as well as information about the local market. The connected acquirer might also benefit from higher bargaining power vis-à-vis other bidders, thus a lower premium is needed for the deal completion. Although both degrees of connections lead to higher announcement returns, they might differ in the corporate governance issues they trigger and the value created by through the acquisition. The director constituting a "first-degree connection" represents the interests of both the company simultaneously. In contrast, in a "second-degree connection" each executive represents the interests of his/her own company, therefore higher combined returns can be expected for the merger of the two companies. In fact, these executives have access to the private information of their respective companies thus they might have higher combined ability to carry out profitable transactions.

Moreover, the two typologies of connections are likely to imply different incentive-related consequences. In first-degree connections, if the director is also an executive in the acquirer company with access to its private information, he could have incentives to carry out the acquisition at price more favorable for the acquirer. Therefore, the deal is implemented in order to maximize the acquirer shareholders' wealth regardless of the overall value created and the target shareholders. Nevertheless, the target company might not have the bargaining power to limit this behavior also because of the ability of the acquirer to deter the competition with outside bidders exploiting private information. Consistently, takeover premia in deals with first-degree connections are 14.4% lower than the premium of non-connected transaction.

Cai and Sevilir (2011) found that target companies involved in first-degree connections are characterized by lower ROA and operating cash flow, suggesting that these companies underperform their industry peers. Therefore, because of the weak financial and operational influence, their ability to negotiate better deal conditions might be limited. Moreover, deals with first-order connection exhibit a lower amount of bidders, consistent with the notion that connected acquire exploit private information to rule out the competition. On the other hand, the deals completed by firms tied by a second-degree connection are more likely to be diversifying acquisitions. The abnormal return for non-connected deals in their sample is -2.33%, consistently with earlier findings that acquisitions usually are value destroyer for the acquirer when the target company is publicly traded. However, the negative returns are not significantly far from zero when the companies involved in the deals are connected (both first-degree and second-degree) therefore far less value is destroyed. In fact, the difference between abnormal returns between non connected companies and first-degree connected is 2.45% and 1.67% in the case of second-degree connections.

On the other hand, target companies are demonstrated to benefit from positive announcement returns in the case of both first-degree and second-degree connected deals. Notably, these returns amount to 18.72% in first-degree connections, 22.82% in second-degree connections and 21.24% in non-connected deals.

Overall, second-degree transactions are characterized by the greater combined returns (1.84% higher than non-connected transactions). Examining the role of first and second-degree connection in shaping the combined entity's future performance, it has been shown that the ΔROA following deals with second-degree connection (3%) is higher than first-degree connected (1.5%) and non-connected deals (0.4%). This evidence strongly supports the claim that second-degree connected deals are associated with higher combined value creation. Because of the communication improvements, higher information flows and deeper knowledge, connected deals are expected to incur less transaction costs. The likely reasons are several. On the one hand, the need for a third party's deal assessment might be lower since connected managers are able to exploit inside information. On the other hand, connected deals may be perceived more profitable by investment companies which could require lower fees (as percentage) on the deal completion. Consistently, it has been shown that acquirers pay on average an investment banking percentage fee of 0.55% in first-degree connected deals, 0.40% in second-degree connected deals and 0.62% in non-connected deals. From the target company point of view, a similar pattern can be identified.

In fact, in first-degree connected transactions it pays 0.77% banking fees, 0.64% in second-degree connected transactions and 0.84% for non-connected transactions.
The lower transaction costs and knowledge gap between the parties may facilitate the establishment of a subsidiary in an emerging country especially in the case of a joint venture or in a cross-border acquisition.

5.1.1.4 A further dimension of distance: corporate governance distance

The previous chapters already addressed the notion that the tendency of MNCs from developed country to invest in emerging countries can be rooted in corporate governance issues. Notably, given the higher likelihood of having better corporate governance practices and rules, these companies seek profitable investment opportunities in countries where corporate governance standards are lower. By doing so, they might gain sizeable returns and create additional shareholder value from the improvement of the target internal governance. However, corporate governance reforms both in the home and host country are likely to modify the width of the corporate governance spread, changing the profitability potential. Therefore, the likelihood and the effects of these policy changes are another source of risk affecting the foreign investor.
For the purposes of this section, the corporate governance reforms are defined as the deliberate intervention of a government, security and exchange commission or stock exchange through the issuance of corporate governance norms and guidelines. Substantially, these rules are aimed at regulating the following aspects:

- the role and composition of the board of directors;
- the appointment and conduct of external auditors;
- the distribution of rights and powers between management and shareholders;
- the protection of whistle blowers and penalties against corporate fraud.

This section will deal with the association between profit potential and home-host country corporate governance spread. It could be reasonable to argue that foreign bidders are expected to select better performing companies in order to face less mismanagement and gain from more synergies. These companies might be appealing targets also because of the higher amount of information available and obtainable about them. However, these arguments ignore one of the ultimate reasons underpinning the will of MNC to expand towards foreign emerging countries, namely cost savings. In fact, better performing local companies are more expensive to acquire because of their higher value in the market. Dycka and Zingales (2004) offered an explanation for the relationship between control premium and IP (investor protection) strength. They argued that the premium paid for the control in a target company is priced at the value of private benefits exploited by controlling shareholders. If the home-country offers stronger IP rules and puts more constraints on private benefits diversion, the acquirer will attribute a lower value to this premium. Therefore, the extent of corporate governance (CG) reforms in the countries involved in the deal is expected to carry remarkable effects on IP strength and, consequently, on the transaction potentials. For instance, if these reforms improve IP in emerging countries, they are likely to deter FDI inflows from developed economies because of the narrower CG gap. On the other hand, if these reforms are carried out in the acquirer's country, they are likely to bolster and encourage FDI flows towards emerging countries as the CG is enlarged. A study conducted by Kim and Lu (2013) highlighted the positive (negative) relationship between corporate governance reforms implemented in the acquirer (target) country and the amount of FDI[193].

[193] In their research, Kim and Lu (2013) took ACGR (acquirer corporate governance reforms) and TCGR (target country corporate governance reform) as independent variables. As dependent variable, they took the cumulative density function (CDF) of the growth rate of asset utilization rate of the target firm and CDF of target firm's EBITDA margin.

The first chart below outlines the corporate governance reforms implemented by 26 countries and the related level of enforcement. In order to be considered as a CG reform, the level of enforcement for the majority of new rules must be legal rules or comply-or-explain regulations, not purely voluntary. The second chart provides a more detailed description of the reforms' content in the emerging countries included in this sample.

Country	Year	Enforcement
Argentina	2001	Legal rule
Australia	2004	Comply-or-explain/Legal rule
Austria	2004	Comply-or-explain
Belgium	2005	Comply-or-explain/Legal rule
Brazil	2002	Legal rule (weak)
Canada	2004	Legal rule
Chile	2001	Legal rule
China	2001	Legal rule
Finland	2004	Comply-or-explain
France	2003	Legal rule
Germany	2002	Comply-or-explain
Hong Kong	2005	Comply-or-explain
India	2002	Legal rule
Italy	2006	Legal rule
Malaysia	2001	Comply-or-explain
Mexico	2001	Legal rule
Netherlands	2004	Comply-or-explain
Norway	2005	Comply-or-explain
Poland	2002	Comply-or-explain
Singapore	2003	Comply-or-explain
South Korea	1999	Legal rule
Spain	2006	Comply-or-explain
Sweden	2006	Comply-or-explain
Switzerland	2002	Comply-or-explain
United Kingdom	1998	Comply-or-explain
United States	2003	Legal rule

Country	CG reform
Argentina	The 2001 reform introduced by the government incorporated the Corporate Governance Principles from the OECD. The Decree 677/01 ("Capital Markets Transparency and Best Practices") was also issued, which became effective on June 1, 2001.
Brazil	The new Corporation Law (10.303/2001) was promulgated on October 31, 2001 with the aim of strengthening minority shareholders' rights and improving disclosure standards. The reform is limited in scope and is considered almost ineffective.
Chile	Listed companies in Chile are regulated by the Securities Market Law (SML) and the Corporation Law (CL). These laws were updated at the end of 2000 by Law No. 19,705, namely the "Tender Offers and Corporate Governance Law aimed at to improving fairness and transparency in the Chilean financial market.
China	In January 2001, the Chinese Securities Regulatory Commission and the State Economic and Trade Commission issued a new "Code of Corporate Governance for listed Companies". The Code essentially follows the OECD Principles of Corporate Governance.
India	Clause 49, which took effect in phases from 2000 to 2003, includes requirements and recommendations on the minimum number of independent directors, board meetings, codes of conduct and restrictions on simultaneous directorships. Companies breaching these requirements

The dependent variable is characterized by negative values in the case of TCGR while positive values in the case of ACGR.

	can be de-listed and imposed monetary sanctions. The original Clause 49 took effect on March 31, 2001 and the compliance requirements were extended to March 31, 2002.
Malaysia	The Malaysian Code on Corporate Governance (Code) was enacted in March 2000 and it took effect on January 22, 2001. The Code includes guidelines and best practices that companies may use to adopt an optimal governance framework. It focuses on four areas: board of directors, director's Remuneration, shareholders and accountability and audit.
Mexico	The new version of 1975 Securities Market Law (LMV), amended in 2001, encompassed several measures. Most notably, it granted the National Banking and Securities Commission the power to regulate tender offers to protect minority shareholders. Moreover, it restricted the issuance of non-common shares. It also set forth requirements for independent members on boards of directors, appointment of board members by minority shareholders, and the establishment of audit committees.
Poland	The Warsaw Code has been devised jointly by the Polish Securities and Exchange Commission, the WSE, and the Polish Confederation of Private Employers. The WSE provided Best Practices in Public Companies (Code) in 2002, requiring listed companies to disclose compliance with the Code on a comply-or-explain basis.

In a related study, Alba, Park and Wang (2009) analyzed the role that corporate governance reforms had on the Japanese FDI in the US in the 1990s. Although this contribution does not involve emerging countries, it is valuable for the present work since it sheds light on the role of such reforms on FDI in general without being case-specific. Therefore, the same considerations can be transferred to the FDI between a developed and an emerging country. During the last decades of the previous century, Japanese FDI flow into the US increased remarkably when US dollar depreciated and plunged when the dollar appreciated. This trend is consistent with the theoretical assumptions of the previous literature about the relationship between FDI flows and exchange rates movements. However, from 1991 Japanese FDI flow fell despite the dollar depreciation. One explanation is the decline in the credit access for Japanese firms due to the 1990s Japanese banking crisis.

Alba et al. (2009) provided a different but complementary explanation, namely that two corporate governance reforms in the US played a relevant role in the decline of Japanese FDI. Specifically, these governance improvements reduced the advantages related to FDI through cross-border acquisitions

Stroger corporate governance and investor protection in the target company reduces the opportunities to enhance performance and create additional shareholder value. If there are less under-performing companies because of a CG reform, there are less appealing cross-border acquisition targets. In 1992, the US Securities and Exchange Commission issued two policies aimed at improving corporate governance practices and rules. First, it reduced the costs incurred by shareholders in challenging under-performing management boards. Second, it set forth the requirement for public companies to increase the disclosure concerning the top executive compensation and its connections to company's performance.

Explicitly, these improvements led the rate of FDI form a firm willing to undertake an expansion strategy to decrease by 48.73%, given that all other factors are constant.

5.1.2 Managerial implications and effects on valuation

As introduced above, endogenous risk factors are rooted in the way corporate governance and managers' perceptions filter the exogenous risk factors present in the host environment.

Decision makers' behavioral biases might stem from either personal characteristics, such as age and gender, or firm-specific practices like ownership and compensation structures. These elements are expected to mitigate or amplify the risks related to cultural and geographic distance as well as to institutional imperfections. For instance, managers' reputation and board connection may enable the firm to overcome such distance-related issues through improvement in the information flows. Moreover, it is interesting to point out how FDI flow is hampered not only by institutional weaknesses. In fact, FDI carried

out by well-governed MNCs are deterred also by regulation improvements in the target emerging country if these involve the enhancement of corporate governance. Therefore, the considerations drawn in this paragraph and the whole chapter are to be intended as complementary to the consequences of the exogenous menaces identified before. The final impact of the latter risk factors heavily depends on the way the company evaluates and internalizes them. In this sense, it could be naïve to assume that managers are rational decision makers.

In parallel with the exogenous ones, endogenous risk factors are expected to shape and distort the subsidiary establishment in at least three different steps:

- The decision as to whether establish a subsidiary in an emerging country or not (expressed as the FDI probability);
- The entry mode strategy both in terms of greenfield/cross-border acquisition and JV/WOS;
- The future profitability and success of the foreign affiliate.

First, it has been demonstrated how CEO network centrality increases the likelihood of a FDI to be actually carried out. As reported in the previous chapter, cultural and geographical distance together with host environment's institutional flaws are likely to deter FDI hampering and efficient and effective information flow and preventing the foreign company to gather information about the local markets and customs. Moreover, the lack of local ties is one of the major impediment to the initial success of the foreign subsidiary. Well reputable executives endowed with numerous external relationships are able to counteract the detrimental effects of the distance dimensions between home and host country. Notably, these relationships (also in the form of board connections) act as a bridge between the countries involved in the FDI, shrinking the information asymmetry and the knowledge gap. Consistently, higher CEO centrality is correlated with a 28% increase in the acquisition probability. Executive's gender and age play a subtle role too. In fact, male executives are generally associated with overconfident attitudes leading them to implement more acquisitions than female managers, although more likely to be value-destroying. Moreover, younger decision makers are 30% more likely to carry out acquisitions than older executives for at least two reasons. On the one hand, younger managers are generally assumed to be overconfident compared to older executives. On the other hand, they can benefit from the permanent compensation increases associated with acquisitions for a longer time. Shifting the focus on the entry strategies that the MNC could undertake in the foreign country, the decision to opt for a greenfield or a cross-border acquisition carries different implications. It is not the purpose of this section to deepen the characteristics and external risks related to these alternatives since they have already been widely addressed in the previous chapters. In order to provide a more comprehensive understanding of the phenomenon, this paragraph deals with the behavioral and governance drivers that determine the preference for an entry mode or another.

In the first paragraph of this chapter, both greenfield investments and cross-border acquisitions have been analyzed along two dimensions, namely the uncertainty profile and the payoff horizon, and their behavioral consequences. According to the amount of their ownership stakes in the company, managers are reported to exhibit different risk perceptions and aversions with respect to these two strategies. Greenfield investments are characterized by higher uncertainty because of the lack of information about the local environment and relationships with both institution and market actors. Since more resources (in terms of time, money, and people) have to be deployed to build the new venture and it relationship network from scratch, the returns are likely to mature later than in cross-border acquisitions. In fact, opting for the latter the MNC can rely on the target company's pre-existing resources and relationships, therefore reducing outcome uncertainty and shortening the time needed for the pay-off accrual. Overall, the investment policies of managers owning large equity stakes in their company are likely to be more conservative and more sensitive to changes in external uncertainty. In the case of FDI, empirical findings demonstrate their preference for cross-border acquisitions over greenfield investments. This preference is accentuated in the presence of high political risk associate with greater external uncertainty.

Specific corporate governance measures can be adopted to mitigate the managers' investment sensitivity to external uncertainty due to the ownership of equity stakes. For instance, the presence of extensive institutional ownership is reported to cancel the effects of insider ownership on the investment policy because of closer and more intense monitoring. The acquirer's and combined announcement returns are insightful measures to assess the effects of behavioral and governance considerations on the subsidiary's future operating performance. Notably, announcement returns can be analyzed to evaluate the value-destruction consequences of the acquisitions implemented by biased and overconfident decision makers. In fact, behavioral distortions associated with gender is reported to have sizeable effects on the probability of value-destroying acquisitions, that is 40.89% and 20.28% in the case of male and female executives. Moreover, CEOs characterized by higher centrality in the information flow and decision making process are demonstrated to exploit these advantages for opportunistic behaviors (i.e. entrenchment). Because of empire-building purposes and overconfident attitudes, companies managed by these CEOs are characterized by overinvestments and acquisitions aimed at increasing CEO's private benefits even at the expense of shareholders. Increased CEO's centrality is associated with higher losses and lower announcement returns both for the acquirer and the combined entity. These negative effects on performance are mitigated by the CEO's reputation and quality. Better reputation is associated with higher post-deal announcement returns as the opportunistic behaviors are not likely to prevail on value-increasing investments. Notably, announcement returns are demonstrated to be higher for more reputable CEOs for all the four measures considered above (tenure, outsider, business-articles quotes and industry-adjusted performance). Also post-deals operating performance in terms of net-income and EBITDA-based measures is expected to increase with the CEO's reputation and quality.

Social and professional connections are not always associated with negative consequences on deal's and subsidiary's profitability. The previous sections discussed the effects of first-degree and second-degree connections on announcement returns and operating performance. The presence of a shared executive or close connections between executives is likely to provide the acquirer company with informational advantages about the local environment that particularly valuable in the case of emerging and culturally-distant countries. Moreover, the availability of inside information allows the acquirer to implement the acquisition offering a lower premium with respect to outsider bidders. This advantage is reflected by a higher announcement return especially for first-degree connections. However, first-degree connections increase the likelihood of opportunistic behaviors by the shared executive who could pursue the interests of the acquirer company without focusing on the combined post-deal profitability. Conversely, the managers involved in second-degree connections aim to maximize the wealth of their companies and, consequently, of the combined entity. In fact, deals with second-degree connections exhibit higher combined returns and higher post-deals ΔROA. Overall, connected deals exhibit higher operating performance than non-connected acquisitions and are able to benefit also from lower transaction costs because of the improved communication and information flows. Substantially, all the aforementioned considerations about endogenous risk factors are likely to shape the decision making process affecting remarkably the valuation fundamentals. On the one hand, these factors are expected to mitigate of accentuate the effect of exogenous risk factors. These relationships will be deeply analyzed and discussed in the conclusive chapter of this work. On the other hand, endogenous risk factors carry relevant valuation implication on their own. First, as shown above, behavioral distortions and governance practices have sizeable effects on profitability and operating performance, both from the acquirer's and target/subsidiary's perspective. These consequences can be measured in terms of announcement returns, post-acquisition ROA and profitability indicators (EBITDA and net income). Moreover, managers' behavioral biases and risk aversion are also reflected in their perception of the optimal leverage level. For instance, more reputable CEOs and higher CEO's centrality are associated with lower levels of leverage. The same trend has been identified for female executives, that are less likely than male managers to issue debt and maintain high levels of leverage. Overall, leverage is expected to increase with the level of overconfidence

exhibited by the decision maker. Another empirically supported reason explaining the lower level of leverage is the increased ability to access financing from the equity market for managers characterized by managers whose credibility, reputation and quality result in lower cost of equity capital. Moreover, reduced overconfidence is associated with lower upward biases in the market risk premium estimation. Given a constant cost of debt, the overall consequence of these considerations on the cost of capital depends on which effect prevails. In fact, since the cost of equity is usually higher than the cost of debt, lower leverage is expected to increase the WACC because of the higher weight attached to the cost of equity. However, if the cost of equity in turn is likely to be lower as well, it would lead to a reduction of the WACC. The MNC' decision makers, given their higher awareness of behavioral biases thanks to this work, have thus to evaluate the amount of the single contributions on the overall cost of capital. As a final remark, it is worthwhile to outline the potential measures that can be adopted to mitigate the presence and the effects of behavioral biases. In fact, beside the negative effects that certain corporate governance practices might have on the managers' behavioral response, there are several positive governance solutions that can be adopted. Since the impact of managers' biases is related to the power and decision-making freedom that these managers have, the company could enforce a closer and systematic monitoring over the decision making process. Specifically, executive's behavioral distortions can be prevented by the appointment of outsider managers, by the CEO-chair separation and the empowerment of older (and female) managers. Moreover, as discussed previously, large institutional ownership is likely to deter managers' risk and investment biases due to insider ownership through tougher scrutiny. On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which behavioral biases and corporate governance affect valuation fundamentals.

Risk factor	**Effect on valuation fundamentals**							
Overextrapolation	The presence of this behavioral bias is associated with a 0.45% investment anomaly (overinvestment).							
	If considered jointly with overconfidence, the market risk premium results overestimated by 0.5%.							
Overconfidence	The presence of this behavioral bias is associated with a -2.35% investment anomaly (underinvestment).							
Internationalization motivation	Proactive internationalization motivations are associated with lower risk perception (correlation: -0.19).							
	Proactive internationalization motivations are associated with wider internationalization scope and higher intensity (correlations: 0.22 and 0.04).							
First-degree board connections	Positive announcement returns (0.12%). 2.45% higher than returns of non-connected deals.							
	Lower takeover premium (55.8%) than non-connected deals (63.3%).							
	Higher operating performance (ΔROA: 1.5%) than non-connected transactions (0.4%).							
	Lower transaction costs for the acquirer company (investment banks' fees: 0.55%) than non-connected transactions (0.62%).							
Second-degree board connections	Negative announcement returns (-0.66%) but 1.67% higher than returns of non-connected deals.							
	Lower takeover premium (61.5%) than non-connected deals (63.3%).							
	Higher operating performance (ΔROA: 3%) than non-connected transactions (0.4%).							
	Lower transaction costs for the acquirer company (investment banks' fees: 0.40%) than non-connected transactions (0.62%).							
CEO network centrality (below/above the median)	Higher centrality is associated with preference for lower leverage.							
	Closeness		Degree		Betweennnes		Eigenvector	
	Below	Above	Below	Above	Below	Above	Below	Above
	0.233	0.189	0.234	0.191	0.221	0.192	0.243	0.184
	Higher centrality (shift from the 25th to the 75th percentile) is associated with higher acquisition likelihood (+28%).							
	Higher centrality leads to value-destroying acquisitions (acquirer's return: -1.5%). A shift from the 25th to the 75th percentile is associated with higher acquirer's losses (-3.42%).							
	Higher centrality leads to value-destroying acquisitions (combined return: -2.3%). A shift							

	from the 25th to the 75th percentile) is associated with higher combined losses (-3.05%).							
CEO's reputation and quality (low/high)	Higher CEO's reputation is associated with higher post-deal announcement returns.							
	Tenure		Outsider		Business-articles		Performance	
	Low	High	Low	High	Low	High	Low	High
	0.20%	0.873%	0.627%	1.092%	0.325%	0.516%	0.471%	0.632%
	Higher CEO's reputation is associated with higher post-deal operating performance.							
	EBITDA/sales		EBITDA/assets		Net income/sales		Net income/assets	
	Low	High	Low	High	Low	High	Low	High
	1.98	3.39	1.61	3.03	1.62	2.74	2.05	3.45
	Higher managers' quality and reputation is associated with lower leverage.							
	Low				High			
	0.228				0.198			
	Higher managers' quality and reputation is associated with higher investment (expressed as CAPEX/assets).							
	Low				High			
	0.221				0.234			
Gender	Male executives are usually associated with overconfident behaviors and value-destroying acquisitions.							
	Female executives are associated with 2% lower leverage and lower likelihood of debt issue.							
	Female executives are associated with -2.5% asset growth (more conservative than males) and fewer acquisitions. However, their investments are more value-increasing (2% higher returns).							
	The probability of value-destroying acquisition is lower under female executives (20.28%) than under male executives (40.89%).							
	EPS forecasts carried out by female managers are 6.3% wider than those carried out by male managers.							
Age	On average, female executives are usually younger.							
	Managers 20-years older are 30% less likely to undertake acquisitions.							
Managers' equity ownership	Higher managers' equity stakes are associated with the preference for cross-border acquisitions over greenfield investments (correlation: 0.14). The correlation is stronger in the case of high political risk.							
	A 49% increase in external uncertainty is associated with a 1.5%-2% decrease in investment in the case of higher insider ownership. The same increase in external uncertainty is associated with a 0.05%-0.4% cut in investment in the case of lower insider ownership.							
	Investments carried out by managers with higher equity stakes in the company are more sensitive to external volatility (CAPEX decrease: from -4% to -6.2%). This difference is no longer present in the presence of high institutional ownership (associate with better corporate governance and monitoring).							
Contingent pay systems	The presence of more extensive contingent pay systems is associated with the preference for cross-border acquisitions over greenfield investments (correlation: 0.12).							

5.2 The role of home-country' cultural and institutional framework

5.2.1 Literature and empirical findings review

5.2.1.1 The effect of culture on managers' risk perception

Home-country cultural context is likely to affect managers' risk perception even in a transnational company. Culture is expected to have a substantial role in shaping the decision making process acting on

multi-level variables: country-level (i.e.) formal institutions, firm-level (compensation and ownership structure), and individual level (managers' risk perception).

A country' institutional environment is composed by different features that might increase or reduce risk-taking attitudes. The previous chapters focused on the effects of formal/informal environment of the foreign country in which the subsidiary is established. Conversely, this section sheds some light on the home country-specific variables that are expected to affect the investment policy of the parent company which in turn reflects on the foreign subsidiaries. Following the psychological theories of cultural differences, Kwok and Tadesse (2006) and Li et al. (2013) argued that a country's institutional environment is influenced by specific cultural values, such as individualism, uncertainty avoidance and harmony.

National institutions are required to issue policies and rules aimed at protecting the rights of the contracting and competing parties especially in individualistic societies (Licht et al., 2005). Specific measures have to be adopted to protect the interests of investors and the other capital providers. In fact, individualist values are associated with the emphasis on individual freedom, self-interested competition and autonomy. On the other hand, collectivist societies promote the formation of informal ties and networks in order to protect the parties involved from opportunist behaviors (Li and Zahra, 2012). Institutions and cultures based on uncertainty avoidance stress the importance of social conformity and rule compliance. In these context, market-based financial systems are deemed less reliable because of their unpredictability and ambiguity. Germany is an example of how an economy based on uncertainty avoidance is heavily dominated by its banking system, in contrast with the importance of equity-financial market in the US. Member of harmonious societies are less comfortable with conflict and exploitation of other individuals' rights. Therefore, they tend to rely less on market-based financial systems as based on harsh competition and self-interests. For instance, Italy is considered a country with a high degree of harmony, in contrast with Israel. Consistently with the aforementioned considerations, individualism (uncertainty avoidance and harmony) is positively (negatively) associated with institutions' development. In turn, well-developed institutions such as financial markets are expected to promote higher manager's and corporate risk taking. Another aspect that is likely to influence risk-taking both at the individual and company-level is the level of shareholders' and creditors' protection (Djankov et al., 2008). In the context of a limited liability company, the former benefit from the upside potential and for this reason are expected to be less risk-averse. On the other hand, the latter are characterized by fixed claims on company's cash flows and are expected to be more risk averse. Expanding the implications drawn above, societies based on uncertainty avoidance are less likely to provide higher protection to shareholders as they are less comfortable with market-based financial systems. Similarly, harmonious societies discourage open and direct conflict thus are likely to offer less shareholder protection, that in turn lowers risk-taking attitudes.

It has been shown previously that managers are likely to be more risk averse than shareholders as they cannot diversify their investment and have higher career concerns. Therefore, many equity-based managerial compensations have been devised to align the interests of executives and shareholders avoiding resource-consuming agency conflicts. Moreover, these practices have been demonstrated to promote managers' risk taking attitude. Given their focus on self-interest, national cultures based on individualism are consistent with the practice of contingent pay systems (Bryan et al., 2012). In contrast with societies characterized by conflict avoidance and harmony, individualistic cultures are expected to raise the managers' and company risk-taking attitude. Complementary to these indirect effects on managers' risk taking through the institutional and corporate filters, the three cultural values discussed in this section are likely to directly affect managers' decision making. As pointed put by, Kreiser et al. (2010), individualistic managers are free to rely on their personal judgement to make risky decisions and are incentivized to stand out from the other executives. Moreover, individualistic managers often believe that they are more competent and performing than other managers, and they feel a higher control over investment outcomes. Thus, these executives are often associated with overconfident behaviors that lead them to underestimate investments' riskiness and uncertainty. This overconfidence is associated to the

choice for a discount rate that is lower than that actually reflecting the investment's risk profile. Overall, individualistic managers are expected to display more accentuated risk-attitude than others. Uncertainty avoidant decision makers are uncomfortable with the unpredictability and ambiguity characterizing risky projects such as the establishment of a foreign venture in an emerging country. Therefore, they are likely to impose a higher discount rate on these investments because of their higher risk aversion. Similarly, managers adopting harmony-related values tend to avoid the conflicts and the tough bargaining inherent to the expansion to foreign emerging countries. Thus, they are expected to require a higher discount rate for these investments because of their lower risk-taking attitude.

Overall, in institutional contexts in which managers are given more discretion (e.g. earnings discretion), cultural values are likely to affect more heavily their risk attitude in the valuation process. Conversely, if their scope of action is more rule-constrained, the effects of cultural values are limited. Moreover, a reduced effect of cultural values is expected also in the presence of better corporate governance practices.

The chart below displays the weight of the aforementioned cultural values in 35 countries, as a result of a survey conducted by Li et al. (2013).

Country	Individualism	Uncertainty Avoidance	Harmony
Argentina	0.46	0.86	4.27
Australia	0.9	0.51	4.13
Austria	0.55	0.7	0.62
Belgium	0.75	0.94	4.15
Brazil	0.38	0.76	4.04
Canada	0.8	0.48	4.20
Chile	0.23	0.864	4.49
Denmark	0.74	0.23	4.32
Finland	0.63	0.59	4.59
France	0.71	0.86	4.50
Germany	0.67	0.65	4.70
Greece	0.35	1.12	4.69
Hong Kong	0.25	0.29	3.61
Israel	0.54	0.81	3.35
Italy	0.76	0.75	4.90
Japan	0.56	0.92	4.30
Malaysia	0.26	0.36	3.68
Mexico	0.3	0.82	4.57
Netherlands	0.8	0.53	4.19
New Zealand	0.79	0.49	4.19
Norway	0.69	0.5	4.63
Peru	0.16	0.87	3.91
Philippines	0.32	0.44	4.08
Portugal	0.27	1.04	4.56
Singapore	0.2	0.08	3.99
South Africa	0.65	0.49	4.15
South Korea	0.18	0.85	3.56
Spain	0.51	0.86	4.65
Sweden	0.71	0.29	4.54
Switzerland	0.68	0.58	4.55
Taiwan	0.17	0.69	4.22
Thailand	0.2	0.64	3.67
Turkey	0.37	0.85	4.31
UK	0.89	0.35	3.82
US	0.91	0.46	3.69

The economic consequences of cultural values on managers' and corporate risk taking will be quantified and presented in the section about the valuation implications.

5.2.1.2 How managers' overconfidence is socially influenced by peer executives

The social and cultural environment in which an individual lives and operates is expected to influence his/her thoughts and behaviors. Notably, executive overconfidence is partly rooted in the social stimuli received in the organization that influence the collective sense-making of decision makers. Recalling the themes addressed in the previous section, these social stimuli are particularly powerful in social contexts based on collectivism (e.g. China) rather than individualism (e.g. US).
Li and Tang (2013) focused on the concept of executive hubris defined as "a managerial bias that causes one's own judgment to deviate from objective standard". Overconfidence, optimism and narcissism are three behavioral biases typically associated with the concept of executive hubris. These factors are commonly connected by the overly positive assessment that managers make of themselves. Hiller and Hambrick (2005) grouped all these three dimensions in a single concept known as "executive core-self evaluation (CSE)". Executive hubris can be referred to as a hyper level of executive CSE.

Main literature findings about the effect of executive hubris/overconfidence on cross-border acquisitions	
Author	**Finding**
Malmendier and Tate (2008)	Value destroying M&A
Hayward and Hambrick (1997)	Greater acquisition premium
Hayward et al. (2006)	Higher likelihood of venture failure
Lowe and Ziedonis (2006)	Poor post-deal performance
Li and Tang (2010)	Excessive risk taking

It has been demonstrated that an individual's behavior tends to converge and conform to the mental characteristics of the other individual in the same context. Notably, these executives are affected by the same set of context-specific social information that shape their attitudes and perceptions. This notion is related to the concept set forth by the social information processing (SIP) theory[194], according to which "individuals, as adaptive organisms, adapt attitudes, behavior, and beliefs to their social context and to the reality of their own past and present behavior and situation". As discussed in the previous section, managers' overconfidence and hubris are psychological biases rooted in both the personal characteristics of the individual (e.g. age, gender, role, etc.). Additionally, there are social stimuli received from peer executives and external actors (e.g. media) that are likely to shape managers' risk perception and attitude. Social information influences the way individuals formulate their needs, values and perceptions according to their interaction with other individuals in the same context. If the organizational culture and structure are such that foster the emergence of overconfident attitudes, managers exposed to the same social information are likely to exhibit the same level of hubris.
Peer managers are defined as a social group including executives operating in the same task environment of the individual taken into consideration. The boundaries of this social groups can be defined either geographically or from and industrial perspective. Organization structures and cultures promoting collectivism push these executives to exchange and interpret social information/stimuli on a collective basis, building a shared understanding. Through this process, an individual's psychological biases are more likely to emerge and be influenced by peer executives. This social process is likely to vary according to the cultural values characterizing the social context in which the executives are embedded. Recalling the previous chapter, a given society could adopt collectivistic or individualistic values according to its

[194] See Salancik and Pfeffer (1978)

preference for interdependency or decision-making autonomy. In relation to the cultural values adopted by the society, the individual will assign a different value to the social information received from the environment. In a context based on collectivism, the social information coming from peer executives' activities is expected to be given more attention and importance by the individual. In fact, collectivist organizations and societies require individuals to gather and consult between each other before taking a decision. Therefore, executives belonging to this kind of corporate cultures are likely to shape their beliefs and perceptions according to the social consensus (Crossland and Hambrick, 2007). Conversely, executives operating in individualist cultural contexts put less weight to the behaviors and actions of peer managers as there are deemed less relevant for their individual decision-making. Consistently, these executives tend to form their beliefs and attitude unilaterally relying only on their personal judgment. Therefore, it can be anticipated that the social influence of executive hubris will be much stronger in a collectivistic culture than in an individualistic one. Li and Tang (2013) insightfully examined two countries, namely China and USA, that differ substantially as to the cultural norms adopted. In fact, China is based on collectivist culture while US is generally associated with an individualistic environment. A prominent factor characterizing Chinese culture and its collectivism is the importance of social categorization. Given the higher extent to which Chinese society tends to divide individuals into social categories, both formally and informally, managers are likely to be more exposed and sensitive to social information. Therefore, overconfidence and hubris is expected to be strengthened. Social categories might be created in the basis of individual-level, company-level or contextual variables. For example, a manager operating in a better performing company is likely to identify more with other executives running similarly performing firms. This identification occurs also between managers running companies whose size is similar.

Social categorization in China can be analyzed along two dimensions: companies' government ownership (SOEs) and CEO political appointment. As stated by Li and Zhang (2007), Chinese SOEs are reported to "have legitimacy and receive support or protection from the government agencies that have founded them". Executives of companies having the same type of ownership are more likely to consider each other peers and in-group members. Given China's label of emerging country, this ownership difference might have relevant implications as to the opportunity of the company to access critical resources and relationships. The preferential treatment enjoyed by Chinese SOEs extends to the financial markets and banking system, since these companies might gain access to easier financing due to political privileges rather than economic considerations (Wang et al., 2008). An example of hubristic attitudes due to social categorization is the Chinese property price bubble. As most of the Chinese banks are state-owned, their managers are likely to identify with each other also through the channel of the Communist Party. This identification facilitated the formation of a common overconfidence towards the real estate market. On the other hand, executives' political connections provide them with preferential resource allocation beneficial to company's performance. For the same logic as before, these managers are expected to identify more with executives that are similarly appointed. The study carried out by Li and Tang (2013) provides empirical evidence in support of the aforementioned considerations. Analyzing the data about US executives, they found that hubris levels of peer executives are not significantly related to the hubris of the individual manager. Conversely, Chinese executives' overconfidence is reported to be heavily influenced by peers' hubris from both a geographical and industrial perspective. Moreover, the influence of peers' behavioral distortions is even more relevant between SOE and non-SOE as well as between politically appointed and non-political appointed managers.

5.2.1.4 How home-country cultural norms affects transnational disputes

The notion that high degrees of distance (cultural, geographical, economic, etc.) between the countries involved in the subsidiary establishment is a sizeable risk driver has been widely addressed in this work. However, one of the most important consequences and implications of distance has not been discussed yet. In fact, MNCs expanding extensively towards emerging countries are faced with high levels of

uncertainty that increase the complexity of the operation carried out throughout their network. Greater complexity in turn increases the likelihood of contractual disputes and lawsuits with local companies.
Therefore, the MNC must devise a conflict strategy able to minimize the monetary payouts associated with the litigation while at the same time leading to favorable outcomes. Home-country cultural values and norms are expected to affect and shape these strategies as well as their implementation in the host country. According to Roth and Kostova (2003), companies are characterized by a difficult-to-change set of cultural values and behaviors developed in their home-country and adopted in foreign operations, leading to potential misfits. Notably, this cultural/organizational imprinting leads to the formation of habits and routines that are deployed in the host country. For instance, Holburn and Zelner (2010) showed that the ways in which MNCs respond to host-country political risks is affected by the home-country political environment.
As suggested by White III et al. (2013), MNCs are likely to face transnational contract disputes adopting a conflict strategy tailored and aligned to the home-country cultural norms rather than rational economic considerations. However, when companies expand internationally towards foreign countries they are required to be sensitive and adaptive to the host environment (Shenkar, Luo and Yeheskel, 2008). By being bounded by their national/cultural imprinting, MNCs risks to make irrational and suboptimal choices. Therefore, although the conflict strategy might fit the domestic cultural values, this imprinting may adversely affect the dynamics of transnational contractual disputes creating economically significant losses. The effects of the fit/misfit between domestic cultural norms and the conflict strategy chosen are moderated by the cultural distance existing between the countries involved. In the literature, cultural distance is generally associated with greater complexity and costs related to the knowledge and resource acquisition. Consequently, higher adjustment difficulties are likely to accentuate formal transnational disputes. For instance, Vaaland et al. (2004) documented that higher cultural distance increases both the level of conflict and dissolution of contractual relationships.
Overall, MNCs failing to adapt their organizational structure and conflict strategy to the host country environment will be further negatively affected by the growth of cultural adjustment costs. As indicated by Lin and Miller (2003), these effects are indirect consequences of cultural distance as it does not directly determine the conflict strategy but its outcome. In essence, greater monetary payouts are expected to emerge whether the MNC is bounded by the conflict strategy fit in the presence of higher cultural distance.

5.2.1.4 The role of the liability of foreignness as an endogenous risk factor

The aim of this section is to provide additional information to the themes discussed in the country risks presented earlier in this work, specifically about cultural distance. The risks described in the previous chapter have been examined quite extensively from the host country perspective, pointing to the threats stemming from its cultural norms and the differences with the MNC. In this section, this theme will be discussed from the point of view of the MNC and the country-of-origin effects on internationalization.
The previous chapters have highlighted the effects of the economic and cultural distance existing between the home and host country. This gap is even wider if the MNC belongs to a developed country and is willing to establish a foreign subsidiary in an emerging country. Despite the risks, emerging countries are considered an appealing target for FDI because of the business opportunities they offer, as suggested by a study conducted by IBM (2008). In fact, this study indicates that by 2050 seven-eighths of the world's population will inhabit developing countries such as Russia, China, Mexico, Brazil and India.
However, the expansion towards these markets is imbued by a high degree of uncertainty, given the lack of knowledge and understanding of the local values and norms that prevent foreign MNCs to anticipate those risks. In the literature, these cultural gaps are referred to as the liability of foreignness (LOF) (Moeller and Harvey, 2011; Yildiz and Fey, 2011). The liability of foreignness lead to the emergence of additional costs for

the MNC substantially due to the unfamiliarity and lack of legitimacy in the host environment. The foreign company could suffer from severe restrictions imposed by local institutions and market actors.
Overall, the country-of-origin effects relates to the way host country individuals perceive the vale/utility of products/brands/organizations coming from a specific foreign country (Balabanis and Diamantopoulos, 2011). These assessments have been reported to have a prominent role in defining the foreign company's reputation. For these reasons, MNCs attracted by the market opportunities and lower business costs characterizing emerging countries should be aware of the possibility of not be welcomed by the local actors. In order to do so, the company must evaluate the impact of its country-of-origins features on its acceptance by host country supplier, customers and institutions. Notably, the MNC has to investigate the predisposition of local market constituents towards entering into contracts with it. The importance of relationship-networks as a means whereby overcoming the liability of foreignness is particularly evident considering the principles advanced by the Stakeholder Theory (Freeman, 1984) and the related following improvements. According to these notions, the decisions made by a company should be aligned with the interests of its stakeholders, including suppliers, customers and employees as well as government and other third agencies. Moreover, the outcomes pursued should be both tangible (e.g. profit, market growth, investment returns) and intangible (e.g. environment sustainability, improvement and inclusion of the local community). The assessment carried out by the host country is based on the expectations of all the local actors whose operations and activities are likely to be affected by the entrance of the foreign company. Furthermore, these expectations might be filtered and shaped by the previous experiences with foreign companies coming from the same home country, constituting tangible and intangible sources of LOF. Zaheer and Mosakowski (1997) indicated that the liability of foreignness is a kind of public stigmatization dependent on the socio-cultural barriers faced by the foreign subsidiary in the host environment. Public stigmatization manifests in various forms of exclusion preventing the foreign venture from integrating. Liability of foreignness is also related to the formation of negative stereotypes that could undermine company's performance. The impact of negative stereotypes is amplified if political groups or powerful individuals strengthen them with adverse propaganda. In this case, country risk and political risk are closely intertwined in creating and spreading the effects of a MNC's liability of foreignness.
It is imperative for the MNC to devise specific strategies in order to counteract the liability of foreignness. Notably, as argued by Majocchi and Zucchella (2003), these additional costs should be incorporated at the outset of any internationalization strategy to determine the risks of operating in foreign country that consider the firm/management as outsiders to the environment.
The assessment of the liability of foreignness-related risks are increasingly important if the MNC expands its international scope, and it should be carried out with respect to internal/external as well as tangible/intangible sources.

- **Internal/tangible.** The inclusion of a different number of home-country or local executives is expected to heavily influence the likelihood of the MNC's affiliate to gain legitimacy in the host environment (Riddle and Brinkerhoff, 2011). The predominant presence of home-country managers might lower the possibility of contracting with local distributors, losing access and knowledge about the host market. Also, the number of local employees hired could make a difference, building a corporate reputation based on ethnic diversity and local community inclusion. This aspect is likely to increase the chances of contracting efficiently with local suppliers.
- **External/tangible.** As argued by Yildiz and Fey (2011), the level of visibility and integration in the host community could facilitate the acceptance by the local actors and institutions. Moreover, the role of the policy-makers in moderating this legitimacy must be taken into account.
- **Internal/intangible.** The struggle of adapting to local norms and customs while maintaining consistency with the parent company organizational practices is a risk inherent to transnational companies in culturally different environments. Therefore, the subsidiary is required to satisfy the expectations coming both from inside and outside the organization.
- **External/intangible.** Local institutional actors have a prominent role in either facilitating or hampering the transactions in which the subsidiary engages as well as its operations. In other words, non-market actors shape the political risk profile of a given foreign country, that is expected

to be relatively concerning in an emerging country. Cultural differences engendering the liability of foreignness are also reflected in formal governance practices and regulation that might remarkably affect the MNC's reputation-building in the host environment.

Tangible sources	Intangible sources	
Headcount in home country facilities compared with host country;	Morale of host/home country employees;	**Internal**
Workforce size/composition;	Home/host country employees' career opportunities;	
Composition of top/middle management;		
Visa/immigration requirements;	Company's reputation in the home/host country;	**External**
Corporate visibility in the host country;	Relationships with the government;	
Governance regulation;	Local employees' willingness to work for the foreign MNC;	

5.2.2 Managerial implications and effects on valuation

The purpose of this paragraph was to provide additional insights as to how non-financial variables are expected to heavily affect the financial and strategic outcomes of the subsidiary establishment in the foreign market. Under the umbrella of non-financial factors, special attention has been given to three complementary aspects concerning cultural norms: home country cultural values, host country cultural values and the difference (distance) between the two. In the last chapter, culture-related country risks have been examined focusing on the latter aspect adopting the point of view of the host country. Given the higher cultural distance characterizing emerging markets, cultural values imbued in the informal environment of these host country have been analyzed together with their impact on the foreign affiliate. It has been shown that this impact is economically relevant entering valuation process in multifarious ways: modifying optimal leverage, adding a risk premium, moderating the cost of financing and the subsidiary's profitability. In contrast, the paragraph included in this chapter addressed the cultural issue adopting a different but complementary perspective highlighting additional and subtler effects. Notably, the factor under investigation as endogenous factor is the impact of the home-country cultural values in shaping decision-makers' mindsets and behavioral biases. As seen in the previous paragraph, decisional distortions are likely to affect the valuation process and outcome often leading to suboptimal investment and strategic choice. The analysis of the home-country's cultural values is likely to shed additional light on one of sources of behavioral biases as well as provide complementary information to the country/cultural risks discussed in the previous chapter. In this section, the cultural values taken in consideration are the degree of individualism, uncertainty avoidance and harmony. The identification of the impact of these cultural values on valuation fundamentals is not straightforward, as these effects are only indirect. The direct effects of cultural norms and imprinting is especially on decision makers' risk perception, that in turn leads to adjustment in investment as well as financing policy.

In order to evaluate the relationship between cultural norms and managers' risk-taking attitude, the 35 countries included in the chart plotted above will be taken into considerations. Two different proxies for managers' risk perception will be taken, namely Std(ROA) and R&D expenditure. As pointed out by John et al. (2008) and Zhang (2009), Std(ROA) represent the level of risk-taking expressed by the volatility of

corporate earnings. In fact, riskier investment policies and operations entail more earnings volatility. On the other hand, the ratio of R&D expenditures over total asset is a good proxy for long-term corporate risk taking as these investments are usually riskier given their low likelihood of success and high uncertainty (Coles et al., 2006; Bargeron et al., 2010).

Country	Std(ROA)	R&D
Argentina	5.29	0.03
Australia	10.81	3.33
Austria	3.63	0.38
Belgium	5.23	1.74
Brazil	5.64	0.05
Canada	9.1	7.07
Chile	3.58	0.01
Denmark	6.16	3.02
Finland	5.82	2.86
France	5.54	1.11
Germany	6.76	1.66
Greece	3.71	0.2
Hong Kong	7.46	0.11
Israel	5.67	3.62
Italy	3.91	0.26
Japan	2.67	1.96
Malaysia	6.5	0.04
Mexico	4.18	0
Netherlands	6.27	1.78
New Zealand	6.39	0.31
Norway	7.61	1.28
Peru	5.16	0
Philippines	9.18	0.67
Portugal	305	0
Singapore	6.48	0.27
South Africa	6.17	0.36
South Korea	5.78	1.58
Spain	4.14	0.07
Sweden	9.46	4.7
Switzerland	4.83	2.54
Taiwan	4.42	2.22
Thailand	6.64	0.02
Turkey	7.66	0.53
UK	8.06	3.01
US	9.87	6.83

Interesting insights can be drawn by combining the country-specific information[195] about managers' risk taking with the country-specific weights attributed to each cultural values. Specifically, individualistic cultures are positively associated with managers' risk taking in terms of both Std(ROA) and R&D expenditures. In contrast, cultures promoting uncertainty avoidant behaviors and harmonious attitudes are negatively associated with decision maker' risk-taking according to both the proxies considered.
As indicated by Li et al. (2013), these relationships are economically significant. In the sample examined, a one-standard-deviation increase in individualism leads to a 22% increase of Std(ROA) with respect to its

[195] Adapted from Li et al. (2013)

mean. Conversely, a one-standard-deviation increase in uncertainty avoidance and harmony is associated respectively with a 13% and 8% decrease of Std(ROA) with respect to its mean. The effects on R&D expenditures are characterized by the same signs and are even deeper. A one-standard-deviation increase in individualism leads to a 23.5% increase of the R&D ratio with respect to its mean. In contrast, a one-standard-deviation increase in uncertainty avoidance and harmony is associated respectively with a 21.8% and 25.9% decrease of the R&D ratio with respect to its mean.

Therefore, cultural norms and values based on individualism are likely to foster and heighten formation of overconfident behaviors and upward risk-biases, strengthening the consequences presented in the chart at the end of the previous section. Notably, company's leverage is negatively and significantly correlated to manager's risk taking. This aspect suggests that managers belonging to uncertainty avoidant and harmonious cultures are expected to be downward risk biased thus preferring low levels of leverage.

As discussed previously, home country cultural values have a prominent role in shaping the way MNCs manage their foreign affiliate's operations. For instance, it has been shown that the choice of the conflict strategy adopted in transnational contractual disputes is likely to be affected by domestic cultural values. Adopting a conflict strategy consistent with the home-country cultural values but conflicting with the foreign one is expected to increase the monetary payout associated with these disputes. Interesting managerial and valuation implications can be derived by combining the findings of Li et al. (2013) with those of White III et al. (2013). According to the latter, a MNC whose home country is characterized by high individualism is more likely to choose a conflict strategy based on litigation. Conversely, cultures associated with collectivisms tend to adopt more collaborative and cooperative approaches. MNCs based in developed countries and characterized by common law-based institutions are reported to adopt individualistic values rather than collectivistic. Therefore, when expanding abroad and faced with disputes in foreign countries, they are likely to undertake conflict strategies based on court litigation. However, these MNCs establish their subsidiaries especially in emerging countries characterized by cultural values based on collectivism (e.g. Latin America, South and Confucian Asia). Therefore, the achievement of conflict strategy fit will lead to inconsistencies with the host environment culture increasing the monetary payouts related to the contractual disputes. In fact, consistent with this view, White III et al. (2013) found that conflict strategy fit is strongly and positively correlated with contractual disputes' monetary payouts. Taking the case of MNCs based in Germany and Nordic Europe, they are reported to rely on private negotiation and cooperation when dealing with transnational contractual disputes although their culture is based on individualism. This conflict strategy misfit is aimed at adapting and aligning with the host countries' cultural framework. Therefore, the costs related to contractual litigation are significantly lower.

Germany and Nord Europe	**Number of firms**	**% using negotiation**	**Correlations**		
			Individualism	**Conflict Strategy Fit**	**Monetary Payout**
Germany	24	63%	0.25	-0.01	-0.06
Switzerland	7	43%			
Netherrlands	3	100%			
Denmark	2	100%			
Sweden	2	0%			
Total	38	61%			

Taking another opposite but consistent example concerning an emerging country, also MNCs based in South Asia are reported to rely on private negotiation and cooperation. However, this choice corresponds to a conflict strategy fit with their cultural values based on collectivism. When dealing with disputes involving partners in culturally distant emerging countries, they are likely to incur additional costs due to cultural mis-alignment.

South – Southeast Asia	Number of firms	% using negotiation	Correlations		
			Individualism	Conflict Strategy Fit	Monetary Payout
India	12	83%	-0.25	0.08	
Singapore	6	60%			
Philippines	5	67%			
Malaysia	4	100%			
Thailand	4	100%			
Pakistan	1	100%			
Total	32	81%			0.15

Thus, given the cultural framework of their home country, MNCs must be aware of the risks connected to the cultural imprinting that could potentially prevent them from adapting to the host-environment. Failing to do so in the context of contractual disputes might lead to lower profitability because of higher (transaction) costs. On the basis of the literature and evidence analyzed, the chart presented below summarizes the opinion and point of view I developed on the main ways in which home-country's cultural values affect valuation fundamentals. These considerations should not be analyzed on their own but as complementary to the chart displayed at the end of the previous section. As stated earlier, the effects on valuation and performance discussed in this section are indirect, since it addresses the cultural determinants of managers' risk biases and perceptions. The managers' risk taking attitude is strongly associated with risk bias and overconfidence. Conversely, the causal relationships identified in the previous section involve the direct effects of behavioral biases on valuation and subsidiary's performance.

Risk factor	Effect on valuation fundamentals
Individualism	A one-standard-deviation increase is associated with higher managers' risk-taking in terms of Std(ROA) (22%).
	A one-standard-deviation increase is associated with higher managers' risk-taking in terms of R&D ratio (23.5%).
Uncertainty Avoidance	A one-standard-deviation increase is associated with lower managers' risk-taking in terms of Std(ROA) (12.8%).
	A one-standard-deviation increase is associated with lower managers' risk-taking in terms of R&D ratio (21.8%).
Harmony	A one-standard-deviation increase is associated with lower managers' risk-taking in terms of Std(ROA) (13%).
	A one-standard-deviation increase is associated with lower managers' risk-taking in terms of R&D ratio (25.9%).
Managers' hubris/overconfidence	In cultures based on collectivism, individual managers' overconfidence is reported to be strongly and positively affected and determined by peer executives. Considering industry and location-based proximity, the correlation between individual executive's hubris and peers' hubris is respectively 0.13 and 0.12.
	In cultures based on individualism, individual managers' overconfidence is reported to be weakly and positively affected and determined by peer executives. Considering industry and location-based proximity, the correlation between individual executive's hubris and peers' hubris is respectively 0.04 and 0.03.
Managers' risk taking	As completion of the relationships outlined above, it has been documented that firm's leverage is negatively associated with managers' risk taking.
Conflict strategy fit	Higher conflict strategy fit is associated with greater monetary payout (correlation: 0.32). Therefore, misalignment with host country cultural values is likely to reduce future profitability in the prospect of contractual litigations.
	These monetary payouts associated with contractual disputes increase with the cultural distance between the countries involved (correlation: 0.11).

The last paragraphs of this chapter are aimed to shed additional light on two firm-specific factors already (although indirectly) discussed throughout this work, namely the role of MNC's financial flexibility and its international experience. The former represents a "hard" and quantitative endogenous factor that complements the overview about the "soft" and intangible endogenous factors such as behavioral biases. The latter will provide more detailed insight as to the role and effects of previous international experience on the subsidiary's performance as well as the mediating role of cultural distance.

5.3 The effects of financial flexibility in emerging countries

Underdeveloped financial markets in emerging countries are likely to pose several changes to the foreign affiliate's external financing decisions. One of the reasons identified by the literature is the high volatility of capital flows in these countries that restrain the supply of funds (Guo and Stepanyan, 2011). Therefore, it is likely that financial flexibility[196] is even more important in corporate financing decisions of foreign companies as a means whereby counteract the effects of emerging markets' volatility. As argued by financial economists, financially flexible firms are abler to overcome the negative effects of exogenous shocks. For this reason, the present section will discuss the role of subsidiary's financial flexibility in mitigating or heightening the effects of exogenous risk factors in emerging countries. Exogenous shocks are demonstrated to adversely affect the profitability and cash flows of companies operating in emerging countries. However, financially flexible subsidiaries are able to engage in more investment opportunities and invest more consistently when such downturns occur. Moreover, financially flexible companies are less reliant on internal funds as their untapped debt capacity facilitates external fund raising for the investment policies. Subsidiary's financial flexibility is expected also to affect its dividend policy. These implications should be insightfully connected with the effect of cross-border corporate payout taxation and the issue of double taxation. As indicated by Blau and Fuller (2008), companies with low leverage are likely to have low dividend-payout. Moreover, throughout the corporate finance literature it is widely accepted the notion that companies are more reluctant to cut dividends. Instead, they usually prefer share repurchase as a more flexible form of payout that can be more easily adjusted according to the company's needs and objectives. Therefore, in order to achieve financial flexibility both dividends and share repurchases are likely to be reduced. Another relevant impact of financial flexibility is that on the subsidiary's cash holdings. These resources allow the foreign affiliate to finance value-increasing investment opportunities without raising external funds or cutting dividends. Moreover, cash hoards represent an "insurance" protecting company's operations from shock to earnings or economic downturns. Arslan-Ayaydin et al. (2014) identified that companies can achieve financial flexibility both adopting a more conservative debt policy and increasing cash holdings. The value of financial flexibility through cash reserves is even higher in emerging countries given their volatility and unpredictability. Overall, given the aforementioned effects, financial flexibility is expected to increase firm's value in emerging markets because of the higher ability of funding new investment opportunities and avoid financial distress when facing external shocks. Arslan-Ayaydin et al. (2014) documented that financially flexible companies were abler to undertake investment opportunities during the Asian financial crisis of 1997–1998. In fact, financial flexibility positively affects the subsidiary's value more significantly during turmoil and financial crisis. Financially flexible companies facing external negative shocks are associated with smaller cutbacks in investment expenditures and equity payouts. Moreover, these firms also suffered smaller declines in profitability and sales growth. Similarly, there is empirical evidence supporting the negative effect of financial flexibility on the cost of capital,

[196] Following prior studies, a firm is financially flexible "if it has at least three consecutive years of unused debt capacity" (Yung et al., 2015).

another factor increasing the firm's value. Although financially flexible firms have lower leverage than not flexible peers, that amount is demonstrated to be still relatively high (Yung et al., 2015). This finding suggests that the financially flexible firms are facilitated to access capital markets. Additionally, as demonstrated by de Jong et al. (2012), financial flexibility is likely to mitigate and reduce the negative effects of managers' behavioral biases. The consequences on valuation and future performance are relevant and manifest essentially in two intertwined ways. First, financially flexible companies and subsidiaries are characterized by investment and financial policies that lead to remarkable differences in valuation fundamentals. On the one hand, these companies are associated with lower investment distortions and risk mis-perceptions. Therefore, the negative consequences of behavioral biases presented in the previous paragraphs are mitigated. On the other hand, financially flexible companies are demonstrated to have lower level of leverage, both directly and indirectly (through lower equity payout). Assuming that the cost of equity is generally higher than the cost of debt, lower levels of leverage increase the WACC. However, the effect of a higher discount rate is compensated by higher growth rates and higher profitability through a stronger and more efficient investment policy. Moreover, lower leverage is likely to push down the costs that debt-holders generally require to be compensated for greater risk exposure, hence increasing profitability. The first two charts displayed above summarize these effects on valuation. Second, the achievement of financial flexibility affects the way DCF valuation is carried out when based on scenarios. As it has been discussed, financially flexible companies are able to endure to external shocks better than non-financially flexible companies. Therefore, when the decision makers construct downside scenarios for valuation purposes, they should consider that financially flexible firms' profitability and investment level do not shrink as much as for other firms. The third chart at the end of the paragraph presents a comparison between the financial and investment policies between a financially and a non-financially flexible company during a crisis[197]. Given the insights provided by this comparison, the decision maker should adjust the valuation fundamentals of downside scenarios accordingly.

Variable	**Low financial flexibility**	**High financial flexibility**
CAPEX/total assets	5.73%	6.04%
Cash/total assets	8.22%	15.20%
Dividend payout ratio	3.16%	2.95%
Earnings/sales	5.93%	6.89%
Leverage	51.06%	42.91%
Sales growth	6.36%	7.78%
Decision-making distortions	High	Low

Higher Financial flexibility	12.30%-13.61% increase in CAPEX/TA
	19.48%-23.85% decrease in dividend payout ratio, consequently more equity
	22.32%-26.07% increase in cash holdings

% change before-during the crisis		
Variable	**Financially flexible subsidiary**	**Non-financially flexible subsidiary**
CAPEX/total assets	-1.2%	-9.4%
Dividend payout ratio	-8.6%	-21.7%
Earnings/sales	-3.5%	15%
Leverage	-4.7%	-12.3%
Sales growth	-7.5%	-15.5%

[197] The data are taken and adapted from Yung et al. (2015). The study focus on 33 emerging countries during the 2007-2009 financial crisis)

5.4 The relationship between international experience and cultural distance

As already discussed in the previous chapters, a company able to drawn from previous international experience is more likely to carry out subsequent FDIs progressively more efficiently. This effect is due to the presence of a learning curve that represents the beneficial effects of experience, and can be assumed to be true as a general principle. The widely accepted positive association between experience and future performance is grounded on two premises. First, that companies will draw precise inferences and gain valuable understanding and knowledge from previous experience. Second, that companies will be able to identify the principles underlying this knowledge and to apply them properly to the subsequent host environments. However, depending on the specific case under examination, this assumption might be overly simplistic and suffer from generalization. In fact, it has been recently debated in the literature that experience is not always associated with better performance as numerous other variables affect this relationship. As Levinthal and March (1993) and Huber (1991) pointed out, companies might draw erroneous inferences and misapply experience to context that are similar only on the surface.

Particularly relevant if emerging countries are considered, Zollo (2009) indicated that outcome uncertainty increases the likelihood of drawing incorrect inferences from the host environment. Moreover, recalling the topics discussed in the previous paragraphs of this chapter, effective learning is hampered also by individual-level distortions. In fact, the analysis of information and interpretation of experience is filtered by individual cognitive and behavioral constraints. Even though managers are able to drawn correct inferences, these are valuable for subsequent investments only if there is similarity between the two host countries. In fact, companies tend to misapply previous experience to dissimilar host countries resulting in investment inefficiencies and inconsistencies as well as lack of legitimacy in the host environment. Moreover, by accumulating international experience managers are reported to become progressively overconfident with respect to their ability to discern the country-specific features of the host environment. Therefore, overconfident managers tend to generalize previous experiences applying them to contexts that are apparently similar. At the company-level, the information and experience processing suffers from distortions rooted in the cultural, historical and political framework inherent to the firm. Notably, cultural distance plays a relevant role in shaping the usefulness of previous international experience. As seen in the previous chapters, cultural differences between the home and host country are likely to prevent the MNC to process and interpret properly the information gathered in the foreign country. Specifically, these gaps unable the company to identify the causalities involved in the FDI. Therefore, previous experience might produce useless and incorrect knowledge that could mislead the company in carrying out future FDIs in different countries. For example, Uhlenbruck (2004) showed that MNCs' ability to learn from their experiences in Central and Eastern Europe decreases as the cultural distance between the home and host country increases. The considerations previously drawn about cultural distance can be insightfully expanded through two notions. First, the effects of cultural distance between the home and the host country are not limited to the subsidiary's profitability and success but extend to the future FDIs in different countries through the learning effect. Great cultural differences hamper the current subsidiary to thrive and the MNC to gather correct insights and experience for future investments. Second, in order to properly understand the effect of cultural distance on experience and FDI, the differences between the previous host countries and the subsequent host countries must be included.

Although a share of the knowledge acquired through FDI can be generalized, often the peculiarities and uniqueness of the host environment make some of the experience accumulated location-bounded and applicable only to equal or similar contexts. Therefore, experience is expected to be advantageous only if managers are able to identify the differences and similarities between the precedent and the following FDIs, generalizing or discriminating the principles discerned. However, managers often take the applicability of previous experiences for granted because of surface similarities (similar customers and needs) that hide

deep differences (human resource regulation, tax distortions, institutional barriers to FDI inflows). The likelihood of experience misapplication increases with managers' overconfidence rooted in the progressive acquisition of international experience. Barkema (2006) found that Dutch retailers applied the experience accumulated in US-based operations to activities in Latin America and Asia, leading to disappointing results. Especially in the context of FDI towards emerging countries, learning from the foreign host environment and apply the experience therein accumulated is inherently troublesome because of the already and widely addressed cultural distance[198]. On the one hand, the cultural gap between home and host country might compromise the MNC's ability to draw appropriate inferences from previous foreign investments (Barkema and Drogendijk, 2007). On the other hand, cultural differences between previous host countries and future targets for FDIs is expected to further hinder the ability of the MNC to apply correctly the lesson learned in the previous FDI experiences (Nadolska and Barkema, 2007). This latter facet of internationalization experience is often neglected by decision makers as it is subtler than the cultural distance involving directly the MNC and the FDI host country. By combining the findings of the previous literature on FDI experience and the study conducted by Zeng et al. (2013), the following scenarios can be designed.

Double-proximate experience	The previous FDI host countries, the MNC and the subsequent FDI host country are culturally similar with each other. For example: a MNC based in Germany expanding to France after having established a subsidiary in Switzerland.
Home-proximate experience	The previous FDI host countries are culturally similar to home country but different from subsequent FDI host countries. For example: a MNC based in Germany expanding to France after having established a subsidiary in China.
Host-proximate experience	The previous FDI host countries are culturally different to home country but similar to subsequent FDI host countries. For example: a MNC based in Germany expanding to China after having established a subsidiary in Vietnam.
Double-distant experience	The previous FDI host countries, the MNC and the subsequent FDI host country are culturally different from each other. For example: a MNC based in Germany expanding to Vietnam after having established a subsidiary in Brazil.

Double-proximate experience refers to the situation in which no relevant cultural barriers exist between the home country and the previous host country as well as the previous host country and the subsequent host country. The MNC should be able to learn and draw correct inferences from the previous FDI because of the low cultural distance between the countries involved. Moreover, the similarities between the previous and following host countries might enable the company to transfer the knowledge gathered in the past FDI. In this scenario, previous experience is likely to generate valuable knowledge for future FDIs in different countries providing benefit for both the subsidiaries involved. Notably, this experiential knowledge is beneficial as it reduces outcome uncertainties and increases the ability of the MNC to scan the host environment for profitable investment and business opportunities.
Home-proximate experience refers to the knowledge that a MNC gathers from previous FDIs carried out in culturally similar countries that are different from the subsequent host countries. The ways in which MNCs can benefit from investing in culturally similar countries have been already addressed in the previous

[198] See Bjorkman et al. (2007)

chapters. Low cultural barriers allow the company to learn and accumulate valuable knowledge without drawing erroneous inferences from the host country. However, high cultural distance between the previous and subsequent host countries increases the likelihood of the MNC to misapply the information and knowledge accumulated in the previous FDIs. These gaps could be either evident (national cultural framework) or subtle (similar products and technologies), resulting in mis-perceptions between what is different and what is actually similar. Moreover, the MNC might have a strong tendency to generalize the knowledge acquired in the previous host countries that further strengthen the cultural imprinting provided by domestic culture. The accumulation of home-proximate experience might increase managers' overconfidence, resulting in the application of knowledge ad principles that are inconsistent with the subsequent host country's cultural framework. Interestingly, as suggested by Petersen et al. (2008) through the accumulation of home-country experience the MNC becomes progressively more expert in international operations, increasing its ability to identify country-specific differences and peculiarities. At the same time, a high degree of home-proximate experience enables the company to increase its knowledge stockpile and the amount of principles and behaviors that can be generalized also towards culturally different countries. Following these opposite effects, Zeng et al. (2013) suggested that the level of home-proximate experience and affiliate's mortality likelihood are connected by an inverse U-shaped relationship. Host-proximate experience refers to the knowledge acquired by the MNC in FDIs carried out in countries culturally similar to each other but different from the home country. This kind of experience provide the MNC with knowledge and process that are easily transferrable and replicable from the previous host country to the following one because of reduced cultural barriers. However, the differences between the home country and the previous host country is likely to hinder the MNC from correctly interpreting the information gathered in the host environment to infer useful insights. Overall, the effects of host-proximate experience are the same of the cultural distance discussed in the previous chapters with the addition of insights about the relationship between the two (or more) host countries. In fact, in order to gain legitimacy in the culturally different host country, the MNC must understand the business practices and local customs while partially abandoning the domestic ones. As seen earlier, this process is likely to be costly in terms of both time and financial resources as domestic cultural framework has a long-lasting imprinting on the MNC. Like home-proximate experience, the progressive accumulation of host-proximate experience enables the company to improve its ability of understanding and learning the local norms and customs. Thus, the likelihood of erroneous inferences decreases. As pointed out by Arregle et al. (2009), the MNC might develop new interpretation and adapting processes progressively embedded in the internal structure as a result of accumulated host-proximate experience. Therefore, an inversed U-shaped relationship is documented between host-proximate experience and the affiliate's mortality likelihood (Zeng et al., 2013). Double-distant experience represents the opposite of the first scenario, that is a situation in which relevant cultural barriers are present between the MNC, the previous host country and the subsequent host country. As the MNC ability to exploit home-country specific skills and knowledge is reduced, managers are less likely to become overconfident and to generalize previous experience. Generally, the literature suggests that by accumulating this kind of experience the MNC is likely to invest more efficiently and effectively in foreign countries due to higher learning abilities in foreign cultures. In fact, the MNC can rely on a heterogeneous stockpile of experience and knowledge allowing it to easily understand and adapt to local systems (Barkema and Drogendijk 2007). Thus, double-distance experience is likely to be negatively associated with foreign affiliate's mortality likelihood. The managerial and valuation implications of cultural distance have already been discussed previously in the paragraph dedicated. Nevertheless, some interesting additional insights can be provided as to the effects of a broader conception of cultural distance. As for the valuation process itself, managers must carefully assess the reliability and accuracy of the conclusions drawn on the basis of the information gathered in the host country. Therefore, a learning-orientation should become embedded in the organizational culture. Even though learning from FDI carried out in countries culturally closer to the home country is easier, decision makers could suffer

from misapplication of the knowledge accumulated. One way to mitigate this risk is to improve corporate governance practices aimed at curbing managers' overconfidence. A second way is represented by a conscious effort by the decision makers to reduce their dependence on domestically-rooted mindsets and processes. Furthermore, managers may develop processes such as formal internal auditing processes in order to assess the applicability of prior experience and reduce the likelihood of experience misapplication.
On the basis of the literature and evidence analyzed, the charts presented below summarizes the opinion and point of view I developed on the main ways in which a broader conception of cultural distance affects valuation fundamentals. The suggestions and relationships outlined below are to be connected with the findings presented in the paragraph about cultural distance in order to get two important insights. First, international investments' risk profile is not affected only by the cultural distance exiting between the home and host country but also by the distance between previous host countries and the current target. In fact, high cultural distance is not always detrimental for the subsidiary's profitability as it could be mitigated by the experience of previous FDIs carried out in countries culturally similar to the current target. Similarly, low cultural distance is not always beneficial for the subsidiary's profitability as it could be negatively affected by the experience of previous FDIs carried out in countries culturally different to the current target. Second, international experience is not always associated with higher subsidiary's future profitability. In fact, this experience could be either beneficial or detrimental depending on the cultural distance existent between the MNC, the previous host countries and the current target. Notably, international experience could undermine subsidiary's profitability if cultural distance hinders the decision makers from correctly inferring information and knowledge from previous FDIs as well as applying it to the new host environment. Interestingly, the association between subsidiary's profitability and double-distant experience is stronger when high cultural distance is present between the MNC's home country and the new host country. The reason is that the more different is the host country is from the home country cultural framework, the stronger is the learning effect of the FDI. Conversely, the association between subsidiary's profitability and host-proximate experience is stronger when the cultural distance between the MNC and the new host country is lower. Given that in this case previous FDI targets are culturally similar to the new host country, if the latter is less distant from the MNC's home country the same can be assumed for the previous FDI target. The overall cultural distance in the network reduces the riskiness of the investment and is expected to increase profitability.

	Relationship with subsidiary's mortality
Double-proximate experience	Negative
Double-distant experience	Inversed U-shaped
Home-proximate experience	Inversed U-shaped
Host-proximate experience	Negative

HIGH HOME vs SUBSEQUENT HOST COUNTRY CULTURAL DISTANCE	**Subsidiary profitability**
Double-distant experience	Positive association with profitability (correlation: 0.23, slightly stronger than the other cases).
Home-proximate experience	Positive association with profitability (correlation: 0.21)
Host-proximate experience	Positive association with profitability (correlation: 0.14, slightly weaker than the other cases)
LOW HOME vs SUBSEQUENT HOST COUNTRY CULTURAL DISTANCE	**Subsidiary profitability**
Double-distant experience	Positive association with profitability (correlation: 0.17, slightly weaker than the other cases).
Home-proximate experience	Positive association with profitability (correlation: 0.21)
Host-proximate experience	Positive association with profitability (correlation: 0.23, slightly stronger than the other cases)

6. THE JOINT IMPACT OF EXOGENOUS AND ENDOGENOUS VARIABLES ON VALUATION

The purpose of the last chapter of this work is to combine the findings and considerations drawn in the previous chapters providing additional insights about endogenous variables. Notably, the joint effects of risk factors emerging from the external and internal environment on the subsidiary establishment in an emerging country will be investigated. As seen earlier, these risk factors are likely to affect the valuation process in various ways, either adjusting the fundamentals or shaping the probability attached to the scenario analyzed. Also, the presence of institutional/cultural barriers in the host country together with firm-specific factors are expected to affect the decision as to whether implement a cross-border acquisition or a greenfield investment. Specifically, each financial valuation variable will be examined along with the ways they are affected and adjusted in the presence of specific risk factors. Moreover, a broader perspective on the effects on company value and the cost of capital will be taken.

On the one hand, the first part of this chapter will focus on the casual relationships connecting risk factors and the main valuation fundamentals, namely capital structure, profitability, growth rate and cost of capital (in terms of WACC). Specifically, this section can be viewed as the statistic framework on which linear and static relationships are identified. On the other hand, the second section of this last chapter adopts a more dynamic perspective built on the insights and principles outlined in the first part. Starting from the static perspective based on linear relationships, additional complexity is provided into the framework including subtler and dynamic variables. Notably, the purpose is to highlight the relevance of the strategic choices and directions undertaken by the MNC's managers as endogenous drivers of a specific investors' response in terms of cost of capital and, consequently, company value. In other words, given the same relationships between environmental risks and valuation variables and given the same level of these variables (e.g. growth rate) and assets, two companies might be valued differently by the market. The difference is made by specific endogenous elements, namely the strategic choices and paths that managers undertake to attain these growth rates, profitability level and leverage. Depending on how capital providers value these actions and how their risk exposure is affected by them, a different cost of capital is expected.

The chapter concludes with final remarks summarizing the main considerations, insights and objectives of this work.

6.1 Capital structure

$$\sum_{1=1}^{n} \frac{Cash\ Flows_n}{\left\{1 + \left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right]\right\}^n} + \frac{Terminal\ Value_{n+1}}{\left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right] - g}$$

The decision concerning the capital structure of the foreign subsidiary hinges on many factors belonging to either the external and internal environment. Notably, the amount of optimal leverage is shaped by the risks present in the foreign host country as well as by the decision makers' cognitive and behavioral biases. For instance, macroeconomic volatility has been reported to act both on the amount and the maturity of

the subsidiary's liabilities. In fact, empirical evidence indicated that leverage is positively associated with macroeconomic volatility while a negative correlation exists between debt maturity and volatility. Moreover, the MNC is expected to adjust the capital structure of the foreign affiliate in order to respond to threats emerging from the institutional environment. Institutions' under-development and political instability in emerging countries increase the likelihood of expropriations, discriminatory taxation and unreliable contract regulation.

In the first case the company loses all its assets without been compensated by the political authority. The second threat is likely to affect directly the profitability of the subsidiary and is often associated with bribery. Conversely, the third risk is expected to hit indirectly the revenues of the affiliate by worsening market conditions. The MNC must bear in mind these threats when choosing the optimal financial strategy of the subsidiary as it affects both debt-holders and equity-holders. As reported in the earlier financial literature, this decision concerning leverage should maximize the trade-off between tax-shield advantage and bankruptcy risk. It has been demonstrated that the optimal debt level reduces if the political risk related to lower contract enforcement increases. In fact, regardless of the debt level, this risk decreases the likelihood of interest repayment as overall revenues are expected to be smaller. Moreover, this likelihood is further lowered by the higher interest rate required to compensate the additional risk. Because of this higher probability of default, the foreign subsidiary should opt for a lower debt level. Conversely, unfavorably higher taxation does not prevent the subsidiary from repaying back its debt. Instead, this risk leads the company to increase its leverage to compensate the higher drains on profits by exploiting the tax-shield. As discussed in the dedicated chapter, the exploitation of the tax shield through the liabilities shift towards high-taxation countries can be referred to as "debt shifting strategy". Specifically, a 6.35% increase in the foreign host country tax rate has been found to be associated with a 2.52% increase in the subsidiary's leverage. In order to have a more detailed understanding of the effects of subsidiary-related taxation on leverage, the former has to be divided into the those levied on corporate income and on personal income both from dividend and interests. The effects of corporate income taxation have already been discussed in relation to the tax shield exploitation adjustments. In contrast, the way in which the other two forms of taxation affect the subsidiary's capital structure deserves further explanations. A 1% increase in the dividend tax rate has been reported to increase leverage by 0.10%. Substantially, it becomes more convenient for the MNC and its subsidiary to finance itself through debt capital instead of issuing new shares if dividend taxation increases. If new equity capital is raised, shareholders are expected to require a higher return on their investment because of the higher taxes they have to bear, increasing the cost of equity. Similarly, in the presence of high personal taxation on interest payments bond-holders may raise the cost of debt in order to be compensated. In fact, if personal taxes on interest payments increase (+1%), the optimal level of leverage is expected to decrease (-0.17%). Higher leverage entails higher interest outlays, thus decreasing the cash flows generated by the foreign subsidiary. The impact on the cost of capital is even more relevant. In fact, changes in leverage due to variations in the tax systems are reflected by the adjustments that are to be made in the WACC formula. The overall effect on leverage depends on the specific risk factor considered. If expropriation risk or adverse-taxation risk are analyzed, a positive correlation with leverage is expected. Conversely, if the risk is reflected in weak contract enforcement, a negative correlation with leverage is expected. These considerations must be joined with the trend and level of the forms of taxation presented above. The effects on capital structure are expected to be incorporated in the WACC model. A higher leverage chosen to exploit the tax shield is likely to increase the weight of the cost of debt in the overall formula. Assuming that the cost of equity is higher than the cost of debt, higher leverage is likely to decrease the overall cost of capital. However, depending on the specific kind of taxation, higher leverage might increase either the cost of equity or the cost of debt thus increasing the WACC. Because of the complexity and variety of effects, the decision-maker will be required to assess the single contribution of each specific factor included in the formula.

Nevertheless, the final impact of exogenous risk factors on capital structure is expected to be affected by endogenous and firm-specific risk factors. Specifically, political and country risk are likely to be either mitigated or heightened by the quality and personal characteristics of the MNC's decision makers. For instance, managers' reputation and credibility have several signaling implications for the company's investment and financial policy. Reputable managers are able to reduce information asymmetry towards outside investors, enabling the company to issue equity more easily and cheaply since their shares are fairly priced. Therefore, since the cost of equity is reduced, the companies with high-quality management teams are characterized by lower levels of leverage. Similarly, also the cost of debt could be reduced as the presence of credible and reputable managers is expected to minimize the likelihood of bankruptcy. Given the benefits deriving from the exploitation of the tax shield, lower costs of debt capital will raise the leverage equilibrium level. The management of the MNC will have to assess which cost will be lowered the most and which effect on leverage will prevail on the other.

Another measure of managerial quality is the achievement of financial flexibility, that enables the company to maintain higher levels of investment and profitability even during crises. Consistently with the consequences of managers' quality, financially flexible companies are demonstrated to have lower levels of leverage, both directly and indirectly (through lower equity payout). However, almost every manager exhibits a given degree of behavioral bias with respect to his/her risk perception. These distortions are more evident in low-quality decision makers that are often overconfident and irrational in the investment and financing decisions. Interestingly, female managers are demonstrated to be far less overconfident than their male peers, preferring lower levels of debt issue and leverage. Managers' risk-taking in the financing decisions are affect not only by personal characteristics but also by the cultural imprinting provided by the domestic country. As seen previously, cultural norms based on individualism are likely to foster the formation of overconfident behaviors and upward risk-biases. Therefore, these managers are likely to prefer higher levels of leverage. The contrary is expected in the case of cultures based on uncertainty avoidance and harmony.

Risk Factor	**Positive effect on capital structure**
Macroeconomic Volatility	Higher macroeconomic volatility is associated with an increase in the level of optimal leverage (correlation: 0.014).
Regulation on bankruptcy and creditor protection	A regulation enhancement is associated with longer debt maturity (correlation: 0.095).
	Stronger creditor rights are associated with a 7% increase in leverage.
Expropriation Risk	Higher expropriation risk in the host country is associated with a 2.3% increase in leverage.
Adverse-taxation risk	Higher adverse-taxation risk in the host country is associated with a 2.9% increase in leverage
Corruption	A 1.74% increase is associated with a 4.3% increase in leverage and a 7.14% decrease in debt maturity.
Unionization	Higher unionization is associated with a 5.39% increase in leverage.
Corporate Tax	A 1% increase is associated with a 0.41% increase in leverage.
Personal Tax on dividend income	A 1% increase is associated with a 0.10% increase in leverage.

Risk Factor	**Negative effect on capital structure**
Macroeconomic Volatility	Higher macroeconomic volatility is associated with shorter debt maturity (correlation: -0.011).
Enforcement of property rights	Better property rights protection is associated with lower leverage (correlation: -0.09).

Regulation on bankruptcy and creditor protection	Weaker administration of the bankruptcy process leads to lower leverage (10%–31%).
Contract enforcement	Strong contract enforcement is associated with a 15% decrease in leverage.
Personal Tax on interest income	A 1% increase is associated with a 0.17% decrease in leverage.
CEO network centrality	Higher centrality is associated with preference for lower leverage (Δ -4%).
CEO's reputation and quality (low/high)	Higher managers' quality and reputation is associated with lower leverage (Δ -3%).
Gender	Female executives are associated with 2% lower leverage and lower likelihood of debt issue.
Managers' risk taking	It has been documented that firm's leverage is negatively associated with managers' risk taking.
Financial flexibility	Higher financial flexibility is associated with a 0.21% lower payout ratio.
	Higher financial flexibility is associated with a 8.15% lower leverage.

6.2 Investment rate and growth

$$\sum_{1=1}^{n} \frac{Cash\ Flows_n}{\left\{1 + \left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right]\right\}^n} + \frac{Terminal\ Value_{n+1}}{\left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right] - g}$$

The subsidiary's investment rate affects valuation in two main ways. First, as the next section will discuss more in the detail, higher investment rate is generally associated with higher profitability as long as the return on the investment is higher than the cost. Moreover, profitability is positively affected by the investment rate also if the decision makers' behavioral biases and personal characteristics do not distort the subsidiary's investment policy. On the other hand, the capital expenditure enters directly into the valuation formula through the growth rate. Recalling the models introduced in the second chapter, the latter is represented by the product of the reinvestment rate and the return on invested capital. Since the subsidiary's investment and financing policies are closely connected, some of the considerations outlined in the previous section affect also the capital expenditure and the investment choices. Therefore, also the other effects on valuation should be joint in order to have a broader and deeper understanding of the overall consequences. Specifically, lower cost of capital (either equity or debt) allows the company to pursue more investment opportunities and to increase its market share in the foreign country. The analysis of all the factors both external and internal to the firm that enable it to reduce the cost of capital (e.g. leverage, managers' quality, macroeconomic and institutional variables) should be indirectly reconnected with the effect on the investment policy.

As shown several times throughout this work, emerging markets are characterized by high levels of political instability and institutional underdevelopment. This instability is often reflected by frequent changes of the government authority, more or less legitimated by democratic processes. Political volatility increases the likelihood of unfavorable policies to be issued (e.g. adverse taxation or regulation aimed at preventing foreign companies to operate locally), therefore the value of option to delay the investment increases. The more frequently the institutional environment is subject to upheavals and the deeper are the potential changes, the more pronounced the investment cycle will be. Expanding the insights drawn above as to the effects of taxation on the financing policy, interesting considerations can be made with respect to domestic taxation.

Substantially, higher home-country taxation is expected to create negative externalities on the subsidiary's investment policies and capital expenditure. MNC networks often rely on shared inputs and assets (e.g. brands, patents, marketing investments) that increase the productivity and the return of the investments implemented therein. If these returns are reduced by higher taxation in one of the host countries, the overall capital investment becomes lower in all the subsidiaries. Moreover, if a MNC is credit constrained and has to finance new investments with internal resources, an increase in the domestic tax rate may shrink the availability of funds to implement these investments. More specifically, capital expenditure in foreign subsidiaries declines on average by a range between 0.76% and 0.84% if home country taxation rises by 1%. This effect is enlarged if the parent company owns intangible resources and if the MNC is relatively small thus more likely to be credit constrained.

The way in which the risks emerging from the external host environment affect the subsidiary's and MNC's investment policy ultimately depends on the decision maker's behavioral traits. Notably, his/her overconfidence, relationship networks and gender are expected to shape the risk perception and the quality of the judgement. In the previous chapter, overconfidence and overextrapolation have been defined as the two main behavioral biases suffered by managers in the decision making process. Overconfident managers assign too much weight to intangible and soft forms of information instead of profit signals, often resulting in underinvestment. Conversely, overextrapolation refers to the confidence that trends are more identifiable than they actually are. Therefore, overextrapolative managers' policies are often characterized by overinvestment. Compared to objective estimations carried out by rational managers, investment anomalies deriving from overconfidence and overextrapolation amount respectively to -2.35% and 0.45%. If both biases are present among decision makers, the investment anomaly is -6.99%. Given the remarkably high detrimental effect of the instability and volatility characterizing emerging countries on the investment carried out therein, the consequences of managers' behavioral distortions deserve special attention. Moreover, managers' risk perception is also affected by the equity stakes through which they are rewarded. In fact, one of the downside effects of contingent pay systems (e.g. stock options) is to make managers more conservative in their investment decision. This behavior is accentuated in an environments characterized by high uncertainty and volatility like emerging countries.

In contrast, high-quality and reputable managers are associated with greater investments. These decision makers are able to select project and investment opportunities with larger NPV. Assuming decreasing returns to scale, the NPV is will fall to 0 only if larger scales are reached, therefore higher equilibrium levels of investment can be expected. This in turn will lead to higher degrees of capital expenditures (from 1.1% to 1.8%). Furthermore, well governed subsidiaries are able to be more financially flexible and to maintain higher (and more efficient) investment levels also during periods of crisis.

Risk Factor	Positive effect on investment rate
Overextrapolation	The presence of this behavioral bias is associated with a 0.45% investment anomaly (overinvestment).
CEO's reputation and quality (low/high)	Higher managers' quality and reputation is associated with higher investment (expressed as CAPEX/assets, Δ 2.3%).
Financial Flexibility	Higher financial flexibility is associated with higher investment (expressed as CAPEX/assets, Δ 0.31%). Non financially flexible firms are reported to cut investments by -9.%4 during crisis, while financially flexible companies cut them only by -1.2%.

Risk Factor	Negative effect on investment rate
Home Country Taxation	A 1% increase is associated with a 0.76%-0.84% decrease in subsidiary's CAPEX. The effects are heightened in the presence of high intangibles endowments and if the firm is credit constraint.
Political uncertainty	Investments reduce by 4.8% and cash holdings increase by 4.3%.
Overconfidence	The presence of this behavioral bias is associated with a -2.35% investment anomaly (underinvestment).
Gender	Female executives are associated with -2.5% asset growth (more conservative than males) and fewer acquisitions. However, their investments are more value-increasing (2% higher returns).
Managers' equity ownership	A 49% increase in external uncertainty is associated with a 1.5%-2% decrease in investment in the case of higher insider ownership. The same increase in external uncertainty is associated with a 0.05%-0.4% cut in investment in the case of lower insider ownership.
	Investments carried out by managers with higher equity stakes in the company are more sensitive to external volatility (CAPEX decrease: from -4% to -6.2%). This difference is no longer present in the presence of high institutional ownership (associate with better corporate governance and monitoring).

6.3 Profitability and investment's value creation

$$\sum_{1=1}^{n} \frac{Cash\ Flows_n}{\left\{1 + \left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right]\right\}^n} + \frac{Terminal\ Value_{n+1}}{\left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right] - g}$$

The previous paragraph analyzed the joint effects of exogenous and endogenous risk factors on the investment rate. Conversely, as part of the effects shaping future profitability, this section is aimed at deepen the insights as to whether these investments actually bring value to the subsidiary. In fact, the investment rate can be viewed as a positive component of the subsidiary's growth rate as long as these decisions do not waste resources or destroy value. In the first part of the fourth chapter the main dimensions of distance have been discussed. Specifically, it has been shown and demonstrated how cultural, geographical and economic distance are likely to affect cross-border investments. Especially cultural distance plays a prominent role in curbing the investment feasibility hampering the information and knowledge flow as well as the legitimacy in the host environment. For instance, higher cultural distance between the countries involved in a cross-border acquisition entails a reduction in gains from the deal by up to 28%, that corresponds to a $million losses for an average sized MNC. Also political risk has a direct effect on the future expected cash flows generated by the foreign subsidiary. If a MNC decides to commit to a foreign venture through a cross-border acquisition of a local already established company, the premium paid for the deal is remarkably lower as political risk increases. The reason is the reduced expectations regarding future profitability and performance, that is likely to suffer from adverse government intervention and regulation underdevelopment. In fact, higher degrees of political instability and detrimental regulation might prevent the MNC from benefiting of the synergies stemming from the acquisition. Moreover, regulation aimed at limiting competition might hinder the efforts of foreign companies to gain legitimacy and market share, shrinking their revenues. Another frequent case is that of unfavorable taxation, especially towards foreign investors rather than local firms, that could severely hit the profits of the subsidiary. Another risk factor and institutional force that the foreign subsidiary is likely to face is the host country's unionization. The presence of powerful unions limits the freedom of the company to set its investment and financial policy by imposing more scrutiny. Therefore, less resources are likely to

be wasted and this might be beneficial to the foreign subsidiary. Nevertheless, higher unionization could lead the company to reject profitable investment opportunities characterized by high returns and a risk profile that would normally be bearable for the company. Therefore, underinvestment is one of the main ways in which host market unionization can adversely affect the foreign subsidiary's profitability. Overall, higher unionization is associated to lower ROAs. Moreover, powerful unions are likely to limit the commitment of the company to tax-aggressive strategy, increasing the actual tax rate. There are many other ways in which the tax regime in force in the host country is expected to affect the amount of cash flows generated by the foreign affiliate. The erosion of the subsidiary's net results through higher tax rates represents a direct effect. On the other hand, an indirect effect of higher taxation is the so called "profit shifting" strategy, according to which the taxable income is reduced by shifting profits and revenues in countries with lower tax rates. However, engaging in profit shifting activities is an advantageous strategy as long as the gap between the tax rate of the home and the host country is not the outcome of the rise of the former. In fact, for every percentage point-increase of the home country tax rate the capital expenditure in the foreign subsidiaries is expected to be reduced by 0.76%-0.84% on average. The lower investments implemented in the host countries is likely to curb the affiliate's profitability mitigating the positive effects of profit shifting. Beside these considerations, the cash flows accruing to the parent company from the foreign subsidiary is likely to be reduced by all the taxes levied at every stage, engendering disadvantages such as the double taxation problem addressed in the previous chapters. This issue is accentuated in home countries adopting worldwide taxation systems. As stated at the beginning of this paragraph, higher investment rates result in higher profitability only if the former is not destroying value. Given the environmental risks present in the host country, the decision maker often relies on his/her personal judgment in deciding whether or not implementing the investment. Therefore, managers' behavioral traits and personal characteristics are expected to heavily affect the quality and accuracy of the investment decisions undertaken according to their risk perception. For example, gender is reported to have sizeable effects on the probability of value-destroying acquisitions, that is respectively 40.89% and 20.28% in the case of male and female executives. Moreover, CEOs having a central role in the information flow and decision making process often exploit these advantages for opportunistic behaviors. Because of empire-building purposes and overconfident attitudes, these risk biases often result in overinvestment through acquisitions aimed at increasing CEO's private benefits even at the expense of shareholders. However, these negative effects on performance are reduced by the CEO's reputation and quality. Assuming announcement returns for cross-border subsidiary acquisition to reflect future profitability, higher reputation is associated with higher post-deal announcement returns. Because of the lower likelihood of opportunistic behaviors, also post-deals operating performance in terms of net-income and EBITDA-based measures is expected to increase with the CEO's reputation and quality. Social and professional ties are not always associated with negative consequences on the subsidiary's profitability. In fact, the presence of a shared executive or close connections between managers is likely to provide the acquirer company with informational advantages about the local environment that is particularly valuable in the case of emerging and culturally-distant countries. Moreover, the acquirer is able to pay a lower premium for the acquisition through the exploitation of inside information. However, subsidiaries with first-degree connections still suffer from opportunistic behaviors by the shared executive who could pursue the interests of the acquirer company without focusing on the combined post-deal profitability. Conversely, the managers involved in second-degree connections is expected to maximize the wealth of their respective companies and, consequently, of the combined entity. In fact, deals with second-degree connections are characterized by higher combined returns and higher post-deals ΔROA. Overall, connected deals exhibit higher operating performance than non-connected acquisitions and are able to benefit also from lower transaction costs because of the improved communication and information flows.

Furthermore, the foreign subsidiary's profitability is likely to be affected by two other firm-specific factors, namely its financial flexibility and the kind of international experience previously gathered. Foreign subsidiaries able to achieve financial flexibility in the host country are likely to exhibit higher profitability both in terms of earnings and sales growth. Moreover, the profitability and performance of financially flexible companies is less sensitive to the external instability and crisis characterizing emerging countries. As for previous international experience, its positive impact on the foreign venture should not be taken for

granted. In fact, not only the cultural distance between the MNC and the new subsidiary must be considered, but also the distance between the previous host countries and the new target.
Often, the peculiarities and uniqueness of the host environment make some of the experience accumulated location-bounded and applicable only to equal or similar contexts. Thus, experience is expected to be advantageous only if the decision makers are able to understand the differences between the previous and the following FDI targets. Only then the best practices learned can be generalized or discriminated. However, managers often do not assess properly the applicability of previous experiences because of surface similarities that partially hide profound differences (human resource regulation, tax distortions, institutional barriers to FDI inflows). The likelihood of experience misapplication increases with the cultural distance existing between the previous FDI targets and the subsequent host countries. On the other hand, higher cultural dissimilarities between the MNC and previous host countries might compromise the ability of the former to drawn correct inferences from the latter. These differences between the home and host country are likely to prevent the MNC to process and interpret properly the information gathered in the foreign country. Specifically, these gaps unable the company to identify the causalities involved in the FDI, resulting in corrupted and misleading insights. Double-proximate experience, namely low cultural distance between the MNC and the previous/following host countries, is expected to be beneficial for the newly established subsidiary. However, this is not always the case for other patterns of international experience. When the previous host countries are culturally similar with the MNC but different from the new target, the investment valuation might suffer from mis-application of previous lessons. Surface similarities between the host countries might induce managers to apply the same behaviors and solutions to issues that are actually location-specific. These distortions lead the new subsidiary to have lower profitability and legitimacy in the host environment, unless a higher amount of experience has been gathered such that managers are enough competent to identify the underlying differences. Similarly, experience gathered in host countries that are culturally distant from the MNC increase the likelihood of the latter to accumulate incorrect and biased knowledge about the host environment. The reliance on previously drawn flawed inferences decreases the future subsidiary's profitability potentials. Again, if the MNC's managers are sufficiently experienced through numerous previous FDIs, profitability might increase even given the high cultural distance.

Risk Factor	**Positive effect on profitability and investment value**			
Host country regulation and institutional environment	A regulation enhancement is associated with a 4.5% increase in the premium paid for the acquisition (cross-border acquisition or brownfield investment).			
First-degree connections	Lower takeover premium (55.8%) than non-connected deals (63.3%).			
	Higher operating performance (ΔROA: 1.5%) than non-connected transactions (0.4%).			
	Lower transaction costs for the acquirer company (investment banks' fees: 0.55%) than non-connected transactions (0.62%).			
Second-degree connections	Lower takeover premium (61.5%) than non-connected deals (63.3%).			
	Higher operating performance (ΔROA: 3%) than non-connected transactions (0.4%).			
	Lower transaction costs for the acquirer company (investment banks' fees: 0.40%) than non-connected transactions (0.62%).			
CEO reputation (low/high)	Higher CEO's reputation is associated with higher post-deal operating performance with respect to deals involving less reputable managers.			
	Δ EBITDA/sales	Δ EBITDA/assets	Δ Net income/sales	Δ Net income/assets

	1.41%	1.42%	1.12%	1.40%
Gender	The probability of value-destroying acquisition is lower under female executives (20.28%) than under male executives (40.89%).			
Financial flexibility	Higher financial flexibility is associated with higher profitability (expressed as Earnings/Sales, Δ 0.96%). Non financially flexible firms are reported to reduce profitability by -15% during crisis, while financially flexible companies reduce it only by -3.5%.			
	Higher financial flexibility is associated with higher sales growth (Δ 1.42%). Non financially flexible firms are reported to reduce sales growth by -15.5% during crisis, while financially flexible companies reduce it only by -7.5%.			
Double-distant experience	Positive association with profitability and inversed U-shaped relationship with subsidiary mortality.			
Home-proximate experience	Positive association with profitability and inversed U-shaped relationship with subsidiary mortality.			
Host-proximate experience	Positive association with profitability and negative relationship with subsidiary mortality.			

Risk Factor	**Negative effect on profitability and investment value**
Cultural distance	A change from the 25th to the 75th percentile is associated with a 28% reduction in gains from cross-border M&A. In an average sized MNC, this corresponds to a $50 million loss.
Host country regulation and institutional environment	Higher expropriation risk in the host country is associated with a 4.57% decrease in the premium paid for the acquisition (cross-border acquisition or brownfield investment).
Unionization	A 31.1% increase is associated with a 1.57% increase in the effective tax rate.
	Higher unionization is associated with a 1% decrease in ROA.
Corporate tax	A 1% increase is associated with a 1% decrease in EBIT due to lower profit shifting opportunities.
	The aforementioned EBIT decrease rises to 1.2% in the presence of high intangibles endowments and 1.92 if the MNC structure is complex.
	Higher withholding taxes (and double taxation) is associated with lower premium paid for the acquisition of the target company (correlation: -0.677).
CEO network centrality	Higher centrality leads to value-destroying acquisitions (combined return: -2.3%). A shift from the 25th to the 75th percentile) is associated with higher combined losses (-3.05%).
Gender	Male executive are usually associated with overconfident behaviors and value-destroying acquisitions.
Conflict strategy fit	Higher conflict strategy fit is associated with greater monetary payout (correlation: 0.32). Misalignment with host country cultural values is likely to reduce future profitability in the prospect of contractual litigations.
	These monetary payouts associated with contractual disputes increase with the cultural distance between the countries involved (correlation: 0.11).

6.4 Cost of capital

$$\sum_{1=1}^{n} \frac{Cash\ Flows_n}{\left\{1 + \left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right]\right\}^n} + \frac{Terminal\ Value_{n+1}}{\left[\frac{E}{D+E} \times r_e + \frac{D}{D+E} \times r_d \times (1-t)\right] - g}$$

The last valuation fundamental analyzed is the discount rate, as the cost of capital is expected to capture many direct and indirect effects stemming from the other variables discussed. For instance, the leverage level is directly included in the WACC formula, thus a variation in the capital structure lead to an adjustment of the overall cost of capital, ceteris paribus. Moreover, changes in the level of leverage is likely to trigger capital providers' reactions since their risk exposure increases/reduces. Accordingly, equity holders and/or equity holders will require a higher/lower risk premium in order to be compensated for the risk borne. These indirect effects mediated by other valuation fundamentals have been presented in the previous paragraphs.

Since the risk factors likely to affect the cost of capital are numerous and the intensity with which they manifest can vary according to the external/internal environment, it would be pointless to look for a one-size-fits-all solution to the problem. This struggle would be even more tough given the complexity and instability inherent to emerging countries. The purpose of this paragraph (and of this work) is to shed light on the causal relationships connecting risk factors and valuation fundamental, trying to identify a likely range within which the latter is expected to change at the occurrence of the former. The impact of country and political risk on the variables composing the CAPM and the WACC is likely to manifest through adjustments to the market risk premium and the beta. In the related chapter, business-related regulation and bankruptcy code have been demonstrated to be negatively associated with equity risk, expressed as the market beta. When debt renegotiations are less likely, the value of the put option of strategic default is lower and the equity value is more tied to firm's cash flows. Consequently, subsidiaries placed in countries with less debt renegotiation frictions pay, on average, between 23 and 30 basis points per month less. Other relevant implications are those connected with the consequences of macroeconomic fluctuations. An increase in volatility is associated with a rise in discount rates and a decline in future consumption, lower returns to human capital and less financial wealth. Therefore, countries with high volatility risk are characterized by lower economic growth and imply the addition of a sizeable positive risk premium. On average, volatility and discount rate risks account for about 35% of the overall risk premium. Neglecting volatility risk in the decision making process may result in large valuation biases and distortions in asset prices and misleading conclusions about the underlying risk factors. Establishing a subsidiary in an emerging country is an investment implying the presence of a higher risk premium. Illiquidity of financial markets, transaction costs and the risk of unfavorable policies are some of the reasons leading to the imposition of higher costs in terms of higher premia. Additionally, these risk premia in emerging countries are less stable and predictable that those of developing countries because of the instability of the formal environment. As reported in the previous chapters, host country unionization represents an institutional force likely to heavy affect valuation process and fundamentals. The channels through which this influence manifests are restrictions in the investment and financial policy as well as higher labor-related costs that increase the operational flexibility. The market-to-book ratio is lower for companies operating in highly unionized industries and countries, highlighting that unionization is associated with a reduction in shareholders' wealth. Moreover, these companies exhibit lower ROA, consistent with the notion that unionization lowers profitability. Managers are likely to strategically respond to increased unionization through higher debt issuance, therefore leverage is expected to raise in unionized countries. The lower potentials for profitability and the increased riskiness due to unionization are reflected in higher premia demanded by investors. The so called "unionization premium" has been demonstrated to manifest through a 1.23%

increase in the cost of equity, on average. The consequences of unionization on the cost of equity are stronger if unions' bargaining power is higher. This is often the case of emerging countries with low labor regulation and/or with the predominance of democratic institutions in the political system. Unionization premium is higher when economic activity is low, measured as GDP growth, inflation rate and market returns. The effects of taxation on the cost of capital are mediated by the adjustment implemented on the capital structure. For instance, higher corporate tax rate reduces the impact of the cost of debt in the WACC formula (i.e. tax shield effect), reducing the overall cost of capital. However, this outcome is likely to manifest only if the "ceteris paribus" condition holds, namely if the subsidiary does not change its capital structure. In fact, higher taxation at the corporate level increases the optimal leverage level, and the company is likely to issue more debt to exploit the tax shield-related benefits. However, higher levels of leverage might induce debt capital providers to require a higher compensation as their risk exposure increases with that of the company. Moreover, bond holders and shareholders are expected to raise the cost of financing also in the presence of higher tax rate on personal income and dividend income, respectively. Again, managers' quality is reported to filter and mitigate the negative effects of emerging market-related exogenous risk factor on the cost of capital. As reported in the paragraph about capital structure, competent and reputable managers are able to fill the informational gap between the company and the capital providers in the financial markets. Information asymmetry is one of the main burdens generated by cultural distance that prevents the subsidiary from efficiently operating in the host emerging market as well as gaining legitimacy within it. Therefore, managers' quality is a paramount resource curbing exogenous risk factors as it is expected to reduce the cost of capital, especially the cost of equity. Similarly, financially flexible firms are characterized by higher market-to-book value witnessing their ability to create value for shareholders, a factor likely to reduce the cost of capital.

Risk Factor	**Positive effect on the cost of capital**
Country Risk Premium	A 0.8% increase is correlated with a 0.4% increase in the banking borrowing-lending spread, with the overall effect of hampering access to financing.
Sovereign debt	An 11% increase (with respect to GDP) is correlated with a 9% higher spread on loans to companies. For a syndicated loan of $150 million (4 years maturity) such an increase would add roughly 1$ interests.
Contract enforcement	Weak contract enforcement is associated with a 0.11% and 0.08% increase respectively in the cost of debt and equity.
Macroeconomic Volatility	Higher macroeconomic volatility is associated with an increase in the cost of equity (correlation: 0.47).
Political risk and flaws in the institutional environment	More transparent institutional environment is associated with a 0.7%-0.9% decrease in the beta
Creditor Rights Protection	Where these rights are not properly protected, it is observed a 0.08%-012% increase in the cost of equity
	Where these rights are not properly protected, it is observed a 0.23%-0.3% increase in the cost of capital.
Unionization	A 12.2% increase at the macro level (industry) is associated with a 1.23% increase in the cost of equity (i.e. unionization premium).
	A 12.2% increase at the micro level (firm) is associated with a 1.13% increase in the cost of equity (i.e. unionization premium).
	An increase in labor mobility is associated in a 2.17%-2.97% increase in the cost of equity.

Risk Factor	Negative effect on the cost of capital
Managers' quality and reputation	Higher managers' quality and reputation are associated with lower cost of equity because of their ability to reduce information asymmetry with capital providers.
Financial flexibility	Financially flexible companies are reported to have higher market-to-book ratio as they able to create more value for shareholders. Therefore, shareholders are likely to require lower cost of equity.

6.5 The mediating effects of endogenous factors on the cost of capital

The purpose of the previous paragraphs of this chapter was to show and describe how the main valuation fundamentals are affected by the risks emerging both from the external and internal environment. As stated above, assuming that each factor acts in an isolated fashion would be a too narrow and simplistic way to conceive these relationships. For instance, many firm-specific risks and peculiarities moderate and filter the impact of exogenous risk factors on the subsidiary's leverage, future profitability and investment rate. However, additional insights can be drawn as to the way the aforementioned risk factors affect valuation by taking a step forward in the discussion of these casual relationships. Notably, taking the latter as given, the following sections will explore how specific endogenous factors are likely to shape these relationships. These factors are essentially related to special endowments and internal processes that add complexity to the relationships under analysis moving from a linear and static system to a dynamic and multi-variable one. Shifting the focus on the dynamic side of the system means to analyze the effects of the decision making process itself and the strategic decisions on the risk perception of capital providers given the ways the decision making process is in turn affected by the external and internal threats. Specifically, the aim of this paragraph is to explore how managers' choices and strategies influence the cost of the capital provided by outside investors within the framework of the risks presented previously. The next sections will describe how different strategic paths and actions are likely to trigger different risk compensations in the presence of the same growth rate or capital structure. For instance, the shareholders of two different companies with a 4% growth rate are likely to require different compensations if different standards of voluntary disclosure or CSR are enforced. Similarly, the assets composing the balance sheets of two companies undertaking different ERM activities or entry strategies are likely to be discounted at different rate even though the same amount of cash flows is projected. Furthermore, beside the role of managers' strategic directions and actions in ultimately shaping the cost of capital, the examination of two special endogenous issues will complement the discussion. On the one hand, it will be shown how ICTs moderates the capital providers' requirements by providing specific competitive advantages. On the other hand, peculiar corporate governance issues such as family ownership will be analyzed as they are drivers that often shape many MNCs' strategies in relevant ways. The contribution of the previous paragraphs in combinations to the present one is to provide the reader with an understanding that is not limited to passive and causal relationships. Instead, this final chapter is aimed at building a broader view of the issue examined extending the discussion to a proactive perspective. That is, moving from a simplistic and linear point of view to a more complex and dynamic one.

6.5.1 The role of ICT investment strategies

As shown several times throughout this work, the MNCs' economic and financial performance through foreign expansion has been subject to intense debate. In the existing literature, there are controversial and inconclusive findings as to whether and how multinationality brings additional value to the company and its capital providers. On the one hand, many authors suggested that foreign expansion has positive performance effects. One of the reasons underpinning this stance is the availability of a higher amount of business opportunities than those of purely domestic firms. These opportunities are generated by the diversity both in terms of operating countries and inputs gathered therein. Other contributions aimed at highlighting the positive relationships between economic performance and multinationality focused on the expansion of geographic advantages (Rugman, 1981), the wider access to financial markets (Govingarajan and Gupta, 2001), the achievement of operational flexibility (Kogut and Kulatilaka, 1994) as well as the exploitation of firm-specific assets and scale economies (Porter, 1985).
Additionally, one of the major advantage presented previously is the opportunity "to tap into local knowledge reservoirs, absorb it and transfer it among MNC units" (Andersen and Foss, 2005). Through the proper combination of these inputs the company can accumulate valuable experiential knowledge and foster innovative thinking throughout the network. As stated by Kogut and Zander (1993), the accumulation of intangible resources in terms of both new knowledge and organizational learning might be facilitated by the presence of specific communication channels. Nevertheless, other authors focused on the downsides of foreign expansion claiming that its costs might outweigh its benefits. In fact, by expanding the geographical scope a MNC increases the level of internal complexity and uncertainty because of the activities carried out in different host environments. Moreover, the aforementioned cultural and institutional distance hamper the company from acquiring and processing information correctly and generate agency problems between the entities of the MNC network. Other arguments proving the disadvantages of multinationality are the already discussed liability of foreignness, managers' empire building behaviors and higher coordination costs. Overall, international expansion is reported to provide strategic investment opportunities inaccessible by domestic firms. These opportunities can be conceived as positive NPV projects and product/process innovations that potentially create additional economic value for the company. The ability of the MNC to identify and respond to local business opportunities is related to the subsidiaries' autonomous decisional power within a decentralized structure. On the other hand, the effective implementation relies on operational integration and coordination executed in a central planning process. Information and communication technologies represent a valuable tool enabling the company to carry out these dual objectives of identifying and responding to the business opportunities on a local basis and integrating them through a central process. As suggested by Galbraith (1994), local opportunities might become global through the application of ICTs able to functionally and geographically coordinate the organizational activities. By means of these channels, the flow of both tacit and explicit local knowledge in the MNC's external and internal environment is facilitated. These improvements are expected to bring additional value by overcoming many threats that are inherent to the implementation of foreign operations in emerging markets. For instance, the company increases its ability to gather and process local information correctly, to efficiently allocate resource to the different affiliates and to coordinate them in an effective and faster way. Moreover, Andersen and Segars (2001) pointed to the role of ICT in fostering innovation and superior performance through the decentralization of the decision making process and the consequent higher subsidiary's operational discretion. In fact, the implementation of ICTs aimed at enhancing internal communication is likely to support the learning process hence improving the ability to respond proactively to the unstable host environment. The uncertainty inherent to foreign emerging markets is generally associated with a higher amount of information that managers have to process centrally and locally in order to scan the host environment and coordinate the tasks between the subsidiaries. The investments directed at increasing and enhancing the information and communication technologies available to the

MNC are expected to improve both central planning and local autonomy. These factors are proven to be instrumental and complementary in order to achieve superior performance through foreign expansion.
Beside the improvements in terms of both coordination and collaboration within the MNC network, information and communication technologies have created a global business environment characterized by a higher competition level. Moreover, ICT play a relevant role in firm innovation as innovative capabilities are strongly connected and shaped by information technologies. For instance, the development of the Internet and of Enterprise Resource Planning software (ERP) had a strong influence on innovation since these technologies support and improve the resource allocation and processes coordination that derive from innovative strategies. The reliance on these technologies is particularly important for multinational companies that aim at integrating all the network affiliates in a unified and coordinated system.
The relevance of information technologies is not limited to the development of innovation, but also "as a means to improve production, marketing and distribution" (Allred and Swan, 2005). Furthermore, the adoption and development of information and communication technologies have resulted in the emergence of different business models and the overhaul of the mature ones. The research conducted by Andersen and Foss (2005) provides empirical evidence to the strategic and economic relevance of ICT. In fact, both higher investments in information and communication technologies and the operational autonomy allowed by the latter are strongly and positively associated with the MNC economic performance. Therefore, the shareholders of a MNC whose managers' actions and strategies are accompanied by strong ICT investments are likely to require a lower remuneration with respect to a company less reliant on such technologies even though the valuation fundamentals (e.g. growth rate) are the same. The lower cost of equity is driven by the capability of the MNC with high ICT investment to reduce external uncertainty and improving the efficiency of the coordination process. The capital providers' risk perception is also reduced by the ability of the company to respond and adapt proactively to the unstable economic and institutional environment of emerging countries.
However, in order to fully capitalize the benefits of ICT investments, it is imperative for the MNC to expand corporate governance rules to encompass and outline a IT governance framework looking for synergies between the two. The deep understanding the different roles and features of the ICT in force within the MNC and its network "can assist in regards to regulatory compliance, cost containment, and creating long term value" (Estrada, 2010). In fact, the MNC's board should be aware that ICT-related decisions and purposes must be aligned with the organization's objectives. As suggested by Jordan and Musson (2004), decisions and strategies involving ICT should therefore be designed with a broader and integrative focus instead of being isolated. Firms with an integrated ICT structure are reported to have higher economic performance (up to 20% in terms of profits) than companies with similar business strategies but without an integrated IT structure.

6.5.2 The effects of family ownership

The previous paragraphs dealt with some of the main corporate governance issues affecting the valuation fundamentals. Notably, the focus was on the behavioral biases characterizing the decision makers and on the resulting investment distortions. Instead, the aim of the present section is to analyze the capital providers' perception of a specific governance and ownership structure, namely the family-ran MNC. This topic is particularly insightful given that several of the largest MNCs in the modern economy are ran by families up to the 6th generation (see below).

Company	Generation	Mother country	Countries
Michelin	6th	France	More than 150
Hermès	6th	France	From 25 to 49
Levi Strauss & Co.	6th	U.S.A.	From 100 to 140
L'Oréal	5th	France	From 100 to 150
Exor	4th	Italy	More than 150
Ford Motor	4th	U.S.A.	From 100 to 150
Heineken	4th	Netherlands	From 100 to 150
Toyota Motor Company	3rd	Japan	More than 150
Prada Group	3rd	Italy	From 50 to 99
Hyunday Motor	2nd	South Korea	More than 150
Ikea	2nd	Sweden	From 25 to 49
Luxottica	1st	Italy	From 100 to 150

As seen previously, one of the governance issue affecting most severely especially large companies is the agency problems arising from the conflicts of interest between the stakeholders involved. The extent of the agency problems depends from the particular ownership structure of the company. For instance, in the case of diffused ownership or powerful institutional shareholders, detrimental conflicts of interest between managers and owners are likely to emerge (Type I agency problems)[199]. According to this type of agency problem, managers attempt to extract private benefits at the expense of shareholders. Conversely, the Type II agency problems refer to the conflicts arising between the controlling and minority shareholders.

The aforementioned literature has widely supported the notion that internationalization creates higher uncertainty and complexity of tasks. The increase in information asymmetry and conflicts of interest between managers and owners is likely to result in greater agency costs and to reduce the economic performance of the company. Despite of these burdens, governance mechanisms of family-ran MNCs have been demonstrated to reduce Type I agency problems. In fact, as the founding family is often the major shareholder, its members have strong incentives to collect information and oversee managers reducing managerial discretionary behavior associated with internationalization. These families are also likely to have access to greater knowledge and information of their companies' activity since they are personally and fully involved in it. Moreover, family-owners are reported to assume a longer time horizon in the strategy setting than other managers and shareholders since they project to pass the company on their heirs. Similarly, their longer investment horizon allows them to acquire the skills and abilities necessary to cope with increasingly complex issues such as internationalization in emerging countries. Overall, family-ran MNCs are more likely to maximize the benefits of international expansions while minimizing the related costs. For this reasons, as empirically demonstrated by Tsao and Lien (2013), internationalization is expected to have a stronger and positive impact of firm performance in the case of family companies rather than for non-family companies. Following this stance, the growth rate being equal, it can be reasonably expected that capital providers' risk-perception is lower when investing in family-ran MNC, that could benefit from a reduction in the cost of capital. In fact, the overall risk profile of the company decreases through both governance improvements (e.g. longer investment horizon and higher involvement) and lower agency costs that eventually result in higher ROA (Tsao and Lien, 2013). The positive effects of the governance improvement entailed by family-ownership are demonstrated also by Trevino and Alvarado-Rodriguez (2011). Specifically, they found that South American family companies generate higher annual ROE than non-family companies and for this reason are considered less risky by shareholders. These higher returns are motivated by the capability of family members to better monitor the managers reducing their opportunistic tendencies as well as by the longer time horizon adopted in the strategy setting process.

Nevertheless, there are certain governance issues that might be worsened by the presence of a family as the major owner of the company. In the case of Type II agency problems, entrenched families might act in order to expropriate minority shareholders in the pursuit of private benefits. Moreover, when these firms

[199] See Tsao and Lien (2013)

have access to relevant amounts of free cash flows, the family members might finance value-destroying investments rather than distributing the latter to the investors (Jensen, 1986). Additionally, they could eliminate the benefits of international expansion by over-diversifying the company globally. However, it has been empirically demonstrated by Tsao and Liao (2013) that the improvement carried out by family ownership in terms of Type I agency problems outweighs the downsides of Type II agency problems, thus reducing the investors' risk exposure. Still, regardless of these governance enhancements, investors might be concerned about one of the downsides of family ownership that leads to Type II agency problems, that is the lack of transparency. In fact, family firms are often characterized by concentrated ownership. In these context, family members are able to pursue selfish interests through the exploiting private information (Gilson and Gordon, 2003). As suggested by Cheung, Stouraitis and Tan (2011), these opportunistic behaviors and opaqueness are likely to push capital providers to require a higher compensation for the risk borne, thus reducing the overall company value. Starting from this evidence, the purpose of the next section is to shed light on how the company can implement additional governance improvements by increasing disclosure. Notably, given the enhancements that family ownership is expected to lead in terms of Type I agency problems, better disclosure is likely to mitigate also Type II agency problems. These implications are particularly relevant as they highlight the potential of managers' policies and decisions in reducing investors' risk perception and the cost of capital given the company's internal structure.

6.5.3 The role of voluntary disclosure and transparency

As stated before, managers' decisions and strategies are the forces shaping how the internal and external environment affects firms' value. Notably, by including the presence and role of managerial policies, the causal relationships between the risk factors and company's performance and risk profile become less linear and straightforward. Since a FDI towards an emerging country involve the presence of higher uncertainty and environmental instability, capital providers are likely to require a greater rate of return on their investment to be compensated for the risk borne. External uncertainty might also be accompanied by opaqueness in the internal environment if specific governance structures and arrangements are in force (e.g. family-ran companies). Therefore, one of the policies that managers can implement in order to mitigate the cost of capital emerging from information asymmetry is to increase disclosure.

Voluntary disclosure provides the market with valuable insight into the MNC's internal structure and policies. The channel whereby voluntary disclosure can be provided as several, including releases of earnings forecast as well as investor and analyst meetings. Transparency is one of the most important elements affecting the company attractiveness from the investors' viewpoint. It depends on the capability and willingness of managers to correct any information discrepancies with respect to the potential and existing investors. In the long run, companies with low transparency and disclosure standards might face an erosion of investors' confidence that in turn can jeopardize credit rating, market liquidity and capitalization. The reason why managers provide the market with additional information about the company's performance and governance structure is to shape the investors' risk perception given the characteristics of the external environment. Even in the presence of higher complexity and uncertainty, increased transparency is aimed at reassuring the capital providers about the fairness and solidity of the strategies undertaken in order to gain their financial support. Overall, investors are enabled to perform an accurate judgement about the value of the company and its capability to generate future cash flows. According to the existing literature, the governance improvements carried out in terms of higher disclosure reduce the "information premium" composing the cost of capital required by the investors.

Among the benefits of voluntary disclosure, higher management credibility is arguably the most relevant one in the context of an investment environment characterized by uncertainty and instability. When investors are confident about the decision makers running the company they invest in, the cost of capital is expected to reduce in many ways. For instance, lower information asymmetry improves the liquidity of the

company's shares, making them more attractive to institutional investors. In turn, greater institutional ownership and analyst following are likely to further decrease the information and financing frictions, thus pushing down the cost of capital for these firms.

In the context of the institutional instability inherent to many emerging countries, sound disclosure practices are likely to mitigate and reduce the effects of political risks on the cost of capital and, consequently, on firm value. Interestingly, Lambert et al. (2007) analyze the ways in which higher disclosure and transparency are reflected in the cost of capital distinguishing between direct and indirect effects. However, it is worthwhile to point out that the distinction between the direct and indirect perspective is merely conceptual. In fact, these effects are not separated but can be intended as the two sides of the same coin, acting together in shaping the cost of capital. In the first case, higher quality disclosure of accounting information does not affect directly the MNC's profitability but shapes the assessment performed by capital providers as to the capability of the company to generate future earnings. In fact, more accurate accounting information increases the ability of investors to perform a fair and accurate judgement about the firms' economic performance and riskiness. Less uncertainty in firm valuation leads to lower assessed variance of the free cash flows generated by the MNC and its subsidiaries. In turn, reduced assessed variance increases the stock price and decreases the expected return, reflecting a lower level of cost of capital and a lower discount rate to be applied to these cash flows. On the other hand, the "indirect effects" refer to the ways the quality of disclosure affect the cost of capital through its effects on managers' decisions. Many authors and researchers have demonstrated that better financial reporting and voluntary disclosure reduces governance and agency problems. In fact, the amount of cash flows that managers can appropriate decreases with the quality of the information provided to the market. Notably, better accounting information help the shareholders to enforce stricter governance systems and monitoring on managers' decision making processes, reducing the scope for discretionary and opportunistic behaviors. As suggested by Lambert et al. (2007), lower managers' misappropriation through higher-quality disclosure is expected "to move the firm's cost of capital toward the risk-free rate". Moreover, the relevance of higher disclosure manifest through not only the perception of future cash flows by the investors community, but also through actual future cash flows. In fact, better information quality improves the coordination between the demand and supply sides of capital in the financial markets. By optimizing the allocation of funds to the investment opportunities offered by the firm and increasing the investment equilibrium level, voluntary disclosure is expected to increase its future growth and profitability. Anticipating this effect, investors require a lower cost of capital since the risk from misalignment and misallocation of capital decreases. The negative relationship between the extent of voluntary disclosure and the post-disclosure cost of capital mediated by the company's cash flows is supported also by Cheynel (2013). Starting from the assumption that total amount of systematic risk is the same for disclosing and non-disclosing companies, she demonstrated that the market beta of the former is lower than that of the latter. This effect is due to the aforementioned higher cash flow-generating capability of disclosing companies. In fact, higher future cash flows "can dilute some of the sensitivity to the systematic shock, offsetting the systematic risk" (Cheynel, 2013). Overall, this lower sensitivity to systematic risk decreases the costs of capital and, consequently, increases the value of the company. In contrast, nondisclosure is associated with lower future cash flows and hence more systematic risk per unit of cash flow and a higher beta. The next section will examine a set of firm's policies that are closely related to the disclosure issue, namely the company's corporate social responsibility. In fact, the resolution of information asymmetry is one of the channels through which CSR affects the cost of equity capital. Specifically, the issues and policies encompassed under the CSR umbrella will be analyzed in terms of their impact on the cost of capital. Additionally, it will be shown how CSR strategies can be meant as a valuable tool whereby the MNC can create economic value for shareholders as well as all the stakeholders involved. Given the external and internal risks, the company can pursue CSR objective to shape and curb the cost of capital in many ways. However, there are also

remarkable risks that might emerge whether the company fell short of CSR standards or operate in certain industries.

6.5.4 The effect of CSR policies and strategies

In the recent years, corporate social responsibility has become a major issue in companies' strategy setting given the role of institutions and market actors in encouraging them to adopt business models aimed at creating shared value. This concept of shared value entails a broader set of purposes not limited to the achievement of financial goals but also including the care towards social and environmental causes. For this reason, corporate social responsibility issues have widened the set of metrics against which capital providers evaluate companies. For instance, as indicated by Guernster et al. (2010), large institutional investors such as CalPERS are recently focusing their investments on companies that commit to specific socially responsible activities. Therefore, managers should carefully analyze the relationship between CSR policies and its cost of equity including the former directly in the strategic planning agenda.
Social and environmental issues are particularly relevant in emerging markets, since MNCs might be induces to exploit the low social and environmental standards of those countries. Despite apparently economically efficient, these behaviors increase the risk for the company to lose the investors that are close to social and environmental issues as well as the risk of litigation especially with NGOs and public authorities. As reported in the previous chapters, the support of institutions in emerging markets and a solid reputation are prominent factors enabling the company to gain legitimacy in the foreign environment.
An example is the case of Nestle, that was forced by Greenpeace to stop using Indonesian palm oil for the production of its goods. The media impact of this litigation has been detrimental for Nestle as Greenpeace publicly denounced it for destroying the Indonesian forest in order to save production costs (The Economist, 2010). In the literature, it has been demonstrated that the value of the company and the cost of capital respectively increase and decrease with the width of the investors and analysts base. Moreover, as suggested by Heinkel et al. (2001), a smaller investor base is associated with a higher cost of capital because of the lower opportunity for risk diversification. As indicated at the outset of this section, green socially conscious investors prefer not to include the shares of low CSR companies in their portfolios. Therefore, polluting or workforce-exploiting companies are often compelled to pay higher cost for the capital they are provided as a compensation for the lower risk sharing. This tendency holds also for norm-constrained and institutional investors, that usually avoid purchasing shares of companies operating in specific industries such as gaming, military weapons and alcohol (Hong and Kacperczyk, 2009). Moreover, the cost of capital deriving from information asymmetry is expected to be higher for low CSR companies. First, high CSR firms are likely to increase voluntary disclosure as it can positively affect their image vis-à-vis the investors and all the relevant stakeholders. Second, companies operating in "socially and environmentally dangerous" industries are demonstrated to receive less analysts' coverage, resulting in higher information and transaction costs. Many authors, such as Robinson et al. (2008) and Starks (2009), have claimed that low CSR companies are perceived as riskier by the investors. Notably, if a company do not invest in product and working condition safety it is more likely to incur sever costs in the future both in terms of litigations and reputation losses.
Among the main CSR issues, El Ghoul et al. (2011) indicated that employee relationships, environmental impact and product safety are most likely to affect the equity premium required by the investors. Moreover, proactive behaviors with respect to environmental issues are often rewarded by the investors with lower cost of capital. These risks are even more remarked in the aforementioned "dangerous" industries. Especially the involvement in tobacco and nuclear power business sector it has been demonstrated to be perceived as riskier by the investors. Consistently with the relationships and notions supported in this work, El Ghoul et al. (2011) found that the equity premium of high CSR companies is 0.66% lower than that of low CSR companies, on average. Similar insights can be drawn following the distinction made by Fauziah et al. (2016) between the CSR in terms of environmental, community,

marketplace and workplace activities and their relationship with financial performance[200]. Assuming that higher financial performance leads to a lower risk perception by the investors whose capital is less endangered, these CSR dimensions are associated with a lower risk premium.
Interestingly, the commitment to marketplace activities increases the financial performance of the company through the enhancement of brand loyalty, perceived quality and brand image. The latter element can be intended as the customer-oriented value component of CSR. However, companies and decision makers must be aware of the fact that the CSR practices should be implemented according to the external and especially internal environment. In other words, there is no CSR activity whose success can be taken for granted like a one-size-fits-all solution. There are four dimensions that are to be taken into consideration as they shape the positive impact of CSR impact (Husted and Allen, 2009).
The first dimension is "centrality", namely the extent of the fit between a certain CSR activity and the company's mission. According to this view, the firm should tailor CSR programs not only aiming at meeting the interests of stakeholders, but also aligning them to the its core values and activities. Companies launching CSR programs that are highly central with respect to their business activity are more likely to create additional value for shareholders also because of the development of resources and capabilities that can be applied in both the CSR and current operations. Moreover, the company running CSR projects within its business domain can leverage its own expertise as well as enforce better monitoring and oversight on the operations. "Visibility" is the second factor affecting the success of the CSR activities implemented by the MNC. It refers to the extent to which the CSR initiatives are visible by the relevant stakeholders thereby enhancing the company's reputation and image. Thus, visible companies are able to both extract a higher amount of value both for the community and the shareholders through the expansion of the market share and the obtainment of a premium price from consumers. The third dimension is "proactivity", that is the ability of the company to anticipate social and environmental issues. Socially proactive companies are reported to gain the support of stakeholders in a more efficient and solid way and are associated with a higher value creation (Sharma and Vredenburg, 1998). Lastly, "specificity" refers to the capability of the MNC to connect the optimization of financial performance to the achievement of social or environmental goals. An empirically supported example is product differentiation through CSR (McWilliams and Siegel, 2001). The socially responsible element might be contained either in the products features or in the production process itself. In both cases, the company is able to develop a new market for its product and/or to obtain a premium price for its consumers. For instance, cause-related marketing and "fair trade" programs connect CSR attributes to products. Overall, companies engaging in CSR activities are associated with the achievement of a solid and more sustainable growth both from the social and financial point of view. All the considerations presented in this section highlight the negative relationship between CSR programs and investors' risk perception and, consequently, the cost of capital.

6.5.5 The implementation of ERM systems

As seen several times across this work, a MNC expanding in foreign countries faces additional risks that would not be otherwise present in the domestic market. The risks are even more worrisome in an emerging country both in terms of their number and gravity. Therefore, in order to thrive despite the cultural differences and institutional flaws, it is paramount for the MNC managers to adopt a proactive behavior with respect to the risks identified in the previous chapters.
In fact, the ultimate effect of the risk factors emerging from the external and internal environment on the investors' risk perception hinges on the ability of the management to implement effective strategies aimed at anticipating and tackling these threats. Specifically, ERM represent a tool whereby reduce the likelihood of downside risks to manifest and reducing external uncertainty. Furthermore, the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 2004) indicated that an effective implementation of ERM systems will support the company in the achievement of its goals creating long

[200] The metrics for financial performance adopted in the research are EPS and ROE.

term value for shareholders (Hoyt and Liebenberg, 2011). In fact, according to COSOERM (2004), ERM can be referred to as "a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity and manage risk to be within its risk appetite to provide reasonable assurance regarding the achievement of entity objectives"[201].

One of the most famous ERM systems is the COSO Enterprise Risk Management Framework, that is aimed at achieving the company's goals divided in the following four categories:

- Strategic-high level objectives aligned and consistent the company's mission;
- Operations, that is the efficient and effective utilization of resources;
- Reliability of reporting;
- Compliance with the laws and regulation in force.

These four objectives are likely to carry additional implications if an emerging country is considered as the environment in which the company operates.

First, and efficient and effective foreign expansion must be carried out with a clear and solid strategy set in advance in order to maintain the control over the different phases. However, these objectives should be high-level and not too much strict to allow the company to revise its strategic decision and to better adapt to the unstable emerging country environment. However, the adaptation sought to gain legitimacy in the foreign environment must be achieved without losing consistency with the company's mission. The alignment with its mission is relevant for the MNC to maintain the support of the relevant stakeholders (both in the home and host country) and to effectively convey its value proposition to the customers.

Second, the success of the subsidiary in the foreign host environment heavily depends on the availability of specific soft resources. Specifically, these resources are represented by the knowledge about the local customs and regulation and the relationships with the foreign institutions, companies and communities. The attainment and efficient exploitation of these resources are likely to depend on other core internal resources, namely a flexible organizational structure and the appropriate managerial talent.

Third, the relevance of reporting disclosure in terms of risk reduction has already been addressed in the previous sections. Overall, by reducing informational risk and asymmetries, it is expected to reduce the cost of capital because of the lower investors' risk perception. This improvement is particularly important in an emerging country where the business and institutional environment is characterized by higher uncertainty and instability.

Fourth, the knowledge and compliance with the regulation in force is paramount for the foreign affiliate to gain legitimacy and build solid and supportive relationships with the institutional environment.

Thus, these four objective are associated to the different risks emerging through the internationalization steps and from the foreign operations. Moreover, there is close relationship between the entity's objectives and the eight ERM framework components, that are the levers through which they can be achieved.

- Internal environment. How risk is viewed and conceived by the people throughout the organizational structure, their risk appetite and risk management philosophy.
- Objective setting. In order to identify potentially harmful events, the company's management needs to structure a process whereby setting the main objectives that the company aims to achieve consistently with its mission.
- Event identification. Identification of external and internal events that might affect the company's strategy and operations. These events need to be further distinguished between risks and opportunities.

[201] A deeper discussion of the components of the COSO framework and ERM systems goes beyond the aim of this work. Instead, the focus here is on the effects of these strategies on the company's value, the investors' risk perception and the cost of capital. For wider details on the building blocks of the COSO framework and ERM systems, see COSO (2004).

- Risk assessment. Analysis of the relevant risks and their impact on the organization.
- Risk response. Development of a set of actions (avoiding, accepting, reducing, sharing) consistent with the company's risk tolerance and mission.
- Control activities. Implementation of processes aimed at ensuring that the risk responses are effectively executed.
- Information and communication. Efficient information flow throughout the organizational structure to enable people to perform their tasks according to their responsibility.
- Monitoring. Monitoring of the entire ERM process (ongoing basis through managerial activities or separate evaluation) and modifications carried out if necessary.

In the context of ERM implementation, the decisional and strategy setting ability of the company's managers are particularly important as the actual implementation of these systems must be accompanied and aligned with the appropriate organization culture. Notably, value creation for shareholders (and consequently the reduction of the risk exposure) is created only if a dynamic learning-based culture is fostered. Particularly in a developing country, this kind of culture enables the company to reduce uncertainty and to anticipate risks by continuously adapting to the unstable environment, increasing the speed of reaction. The cornerstones of a learning organizational culture are the accomplishment of the company's goals through the share of ideas, decentralization of the decision-making process and the spread of accountability throughout the organizational structure. The connection with ERM systems implementation is evident, since the principle of a broader involvement of actors is included in the definition presented above. In fact, everyone in the organization is responsible for the effective implementation of the ERM system, from the board of directors to the front-line managers. Moreover, also external actors such as customers, vendors, auditors, regulators, and financial analysts often provide useful information for the effective ERM implementation.

The relevance of the implementation of ERM systems as a measure against which evaluate a company's riskiness (that is, its ability to manage risks) is demonstrated by the utilization by rating agencies. For instance, since 2007 Standard and Poor's (S&P) has included a risk management rating as a component of the overall rating of insurance companies. This sophisticated rating aims at assessing the risk management culture, practices and processes adopted by the firm. Especially in an emerging country where the risks are often closely related between each other, the MNC must shift from a traditional silo-based approach towards risk management to an integrated model. In fact, political or culture-related risks are not expected to be function-specific instead to affect the MNC and its subsidiaries as a whole. Furthermore, the traditional tools used by MNCs to face and reduce risks (hedging and insuring) have often revealed themselves to be insufficient in tackling the economic and institutional complexity of emerging countries. Therefore, while individual risk management activities are likely to curb earnings volatility stemming from a specific source (e.g. interest rate risk), an ERM system is able to mitigate volatility by preventing aggregation of risk across different sources. Also, the implementation of ERM systems carry remarkable implications as to the company's risk profile and long term performance (Meulbrowk (2002). In turn, the combination of these two improvement is likely to reduce the capital providers' risk perception and, consequently, the cost of capital. For instance, many authors such as Beasley et al. (2008) and Meulbroek (2002) demonstrated that companies are characterized by lower earnings and stock price volatility after the ERM implementation. A positive reaction of investors in terms of a lower cost of capital can be reasonably expected from lower cash flow instability and volatility. Moreover, the adoption of ERM systems has been reported to increase risk awareness both in the decision making process and the operations execution, reducing the company's risk profile.

The positive relationship between ERM adoption and company value is also supported by a study conducted by Bertinetti, Cavezzali and Gardenal (2013). Overall, the result of their research show that the adoption of ERM systems increases the company value. Importantly, these results hold regardless of the

specific industry examined. Hence, the capital market perceives the involvement of the company in ERM activities as a good signal for lower riskiness. A lower equity premium is therefore expected.

6.5.6 The entry and ownership mode

The focus of the third chapter of this work was the entry strategy undertaken by the MNC in the host environment given the presence of institutional and cultural barriers. Analyzing the role of managers' choices from the viewpoint of this paragraph, it can be argued that the entry strategy is an endogenous variable affecting the investors' risk perception and, consequently, the cost of capital. In other words, two different MNCs might have the same valuation fundamentals (e.g. growth rate) but their assets are discounted at a different rate because of the choices and strategies undertaken to achieve these valuation fundamentals. Among these choices, that concerning the foreign entry mode is expected to play a prominent role.

Two sets of choices were under investigation in the third chapter. First, the decision as to whether engage in a foreign expansion through the establishment of a greenfield venture, a cross-border acquisition or a brownfield investment. On the other hand, the second set of choices refer to the decision as to whether commit in the foreign venture through a joint venture (JV) or a wholly-owned subsidiary (WOS). Before further examining these two sets of choices, it is worthwhile to point out that there is not an ever-optimal solution or decision. If this was the case, every MNC would engage in the same entry strategy. Instead, the effectiveness of a specific entry strategy must be assessed given the external (market and institutional) and internal (resources and skills) environment in which the company operates.

Moreover, this discussion is based on a "ceteris paribus" assumption, namely the absence of peculiar internal or external elements that might strongly and decisively favor one entry strategy over the others. For instance, even if a greenfield venture is in general a riskier investment than a cross-border acquisition because of the lack of pre-existing skills, facilities and institutional relationships, there could be a case in which the availability of specific knowledge and experience or business connections reduces the riskiness of the venture. In my opinion, this lack of specificity does not prevent the analysis to provide interesting insights about the role of entry strategies in affecting the cost of capital. On the one hand, it would be an endless and overly complex effort to include every firm-specific variable or endowment in the model. On the other hand, its purpose is not to provide ever-lasting and linear rules to which the company has to stick. Instead, it is aimed at inducing the MNC's managers to further investigate their internal and external environment given the high-level causal relationship between a given strategy and its impact on the risk profile. As described earlier, a greenfield venture involves the establishment of a subsidiary from the ground up, without previous activities performed locally by the company. For this reason, these ventures need to develop a new network of relationships in order to thrive and gain legitimacy in the host environment. These new relationships are relevant as they provide the foreign affiliate with resources that are not obtainable by a "learning by doing" process. The network should involve both market (e.g. suppliers, customers, distributors) and non-market actors (e.g. governmental and non-governmental institutions). However, the extent to which the newly established subsidiary develops relationships with powerful actors and institutions increases the risks related to the dependence to them. Notably, the relationship-building extra effort performed by greenfield ventures put them under the pressure of these actors according to their interests and purposes. This disadvantage is particularly hard to eliminate especially if it is rooted in the early stages of the venture's development. Overall, for the considerations outlined above and discussed in the third chapter of this work, greenfield ventures are characterized by higher uncertainty about the external host environment and its future success. Especially in the early stages, the development of such ventures is particularly demanding in terms of financial resources and

skills. However, this greater effort is often not compensated by a reliable prediction of future performance, because of the uncertainty and instability of the business and institutional environment and because of the lack of past performance against which forecast future trends. Thus, investors are expected to perceive this entry as the riskier one and, consequently, to require a higher compensation for the financial resources provided.

The alternative to the establishment of a greenfield venture is represented by the cross-border acquisition of an already existing local company. This entry mode is expected to overcome the drawbacks of greenfield investments by the exploitation of a set of resources and relationships that have been previously built. In this sense, the MNC is able to save time, capital and skills that would have spent in the case of a venture established from the ground up. In fact, it has been demonstrated that subsidiaries formed through cross-border acquisitions have higher productivity and market share in the host environment. Moreover, beside the relationships and knowledge already present in the target company, the MNC is able to benefit from additional advantages through the synergies between its competences/resources and those of the latter. The advantages could be in the form of costs savings through production efficiencies or the combination of greater financial resources with promising R&D activities. Therefore, investors are likely to perceive this entry mode less risky than a greenfield venture, thus requiring a lower equity premium. However, if the cross-border acquisition is followed by deep restructuring in the target's operations and internal structure (i.e. brownfield acquisition) the outcome in terms of investors' risk perception is likely to be different. Notably, brownfield acquisitions are characterized by redeployment divestments of specific operations, assets and business units of the acquired company, leading to profound organizational changes. If the MNC opts for this entry strategy, most of the advantages of cross-border acquisitions with respect to greenfield ventures are likely to fade. In fact, the savings achieved exploiting the already existing relationships, skills and resources of the acquired company are offset by the additional transaction costs associated with the restructuring. Especially in emerging countries, the implementation of deep overhauls might be hampered by institutional flaws and obstacles for example in the labor or tax regulation. Moreover, profound organizational changes might heighten the hostility of local communities and companies (e.g. liability of foreignness), preventing the MNC from gaining legitimacy in the host environment.

Overall, investors are likely to perceive brownfield acquisitions as an unattractive entry mode because of the higher risks and costs of post-acquisition restructuring. Hence, they are unlikely to be the preferred option when conventional acquisitions or greenfield projects are feasible and enable attainment of the strategic objectives. Thus, higher cost of capital is expected compared to greenfield ventures and "simple" cross-border acquisitions. On the other hand, the second set of entry strategy choice involves the decision as to whether engage in a foreign investment through a partnership with local companies (i.e. joint venture) or the establishment of a wholly owned subsidiary. In the first case, a further distinction can be made between a multi-partner joint venture (MJV) and a dyadic joint venture (DJV). As seen in the previous chapters, the former involves a single relationship with a local partner while the latter refers to a partnership between more than two companies. The complexities stemming from the establishment of a JV are expected to increase if MJVs are considered as the preferred ownership structure instead of DJVs. Since the number of parties involved is greater, the costs devolved in process monitoring and resources coordination are expected to increase. Moreover, if equity stakes are not equally distributed, additional transaction costs will emerge from the danger of opportunistic behaviors. The likelihood of the latter is closely connected with contract incompleteness, which in turns depends on the characteristics of the partnership as well as the regulation development. Furthermore, a higher number of relationship within the JV may lead to the creation of sub-partnerships and dysfunctional coalitions. In fact, MJV are generally deemed more unstable as the parties are incline to bargain aggressively for each other's resources, seeking control over the whole operation. Therefore, capital providers are likely to require a higher cost of capital in order to be compensated for the higher risk borne in the case of the establishment of a MJV instead of a JV.

The main hurdles and inefficiencies emerging from the establishment of a WOS are similar to those identified earlier affecting greenfield ventures. Notably, this ownership structure might hinder the company from gaining the necessary knowledge, relationships and resources in order to operate and compete successfully in the host market. As seen previously, cross-border acquisitions enable the foreign firm to exploit the resources already existing in the target company. However, a cross-border acquisition requires a

high financial and organization commitment that is likely to increase the risk profile of the foreign investment. A more flexible solution is represented by the JV, in which the partners share profits and losses as well as risks and opportunities. The risk exposure is further reduced by the fact that such arrangements provide more chances to cope efficiently with the higher transaction costs and uncertainty. In fact, a foreign company engaging in a JV with local partners benefits from the availability of their experience, relationships and resources (skills and distribution channels) without acquiring them.
In this context, the benefits of joining forces are expected to outperform the additional costs deriving from information gathering, operation monitoring and contracts enforcement. Therefore, regardless of the company's future profitability or of the growth rate at which it is expected to gain market share in the host country, investors are likely to require a lower cost of capital in the case of a JV compared to a WOS.
As a concluding remark, another endogenous variable affecting the appropriateness of a JV rather than a WOS is the subsidiary's size. In fact, in order to thrive in the foreign emerging country, the affiliate is expected to need a relevant amount of financial, relational and knowledge-based resources. The need and the importance of this resources increases with the size of the subsidiary. Therefore, the presence of a greater number of partner is expected to mitigate the additional risks encountered when the subsidiary size increases. Thus, also when the size of the investment increases, the company's risk profile is lower when the subsidiary is created through a joint venture rather than a wholly owned venture.

6.5.7 The effects of financial flexibility

At the end of the last chapter it has been discussed how a firms' financial flexibility is expected to affect its main valuation fundamentals such as profitability, leverage and growth rate. As seen previously, financial flexibility refers to the ability of the company to access financing and modify its capital structure at a low cost. Specifically, following Yung et al. (2015), financial flexibility has been defined as the condition of a company with at least three years of unused debt capacity. A firm's financial flexibility hinges on external financing costs that might be associated with firm-specific characteristics such as its size. However, it is also the outcome of strategic decisions made by the company's managers related to the investment and financial policy. Eventually, these strategic decisions aimed at achieving financial flexibility is likely to affect company value both through adjustment to the investment rate (and profitability) and the cost of capital. The previous sections addressed the first set of adjustments, while the focus of this section is to come full circle by showing the evidences on the cost of capital. Financial flexibility in developing economies improves the investment ability of the company. At the same time, it reduces the sensitivity of the investment rate to the availability of internal funds as well as external shocks. Moreover, financial flexibility is associated with low levels of leverage reflected also by the lower equity payout and higher cash holdings. Overall, these implications regarding the financial and investment policy of financially flexible firms are likely to reduce the investors' risk exposure.
The effect on the risk profile is even more valuable in emerging countries where MNCs are plagued by a high cash flow volatility and institutional instability. In these contexts, negative external shocks might adversely affect the company's capital expenditure and future profitability. As demonstrated by Yung et al. (2015), the positive effect of financial flexibility on the value of the company is more pronounced during crisis and where the external environment is highly uncertain. In fact, exploiting lower financing costs and high cash reserves, financially flexible companies are able to endure and respond better to negative shocks as well as reduce investment distortions. In fact, the companies are able to seize more investment opportunities than non-financially flexible companies both during and outside periods of crises.
This ability is particularly valuable for the company's shareholders as the risk exposure of their investment is lower even though the activities are carried out in a highly unstable and volatile environment. Following this evidence, it's my opinion that financial flexibility enables the company to reduce its cost of capital consequently increasing its value. The idea that financial flexibility reduces the risk borne by shareholders is

also supported by the study conducted by Gamba and Triantis (2008). They indicated that companies with a high degree of financial flexibility are valued at a premium relative to less flexible peers. Moreover, this premium is expected to increase with the future growth expectations. In fact, companies at the maturity life-cycle stage or operating in mature industries with a mature business model are characterized by a lower flexibility-premium. According to this stance, MNCs expanding to foreign (emerging) countries might benefit from higher flexibility-premiums if the growth expectations are solid.

Similarly, Livdan et al. (2009) demonstrated that financially constrained firms are riskier and are characterized by higher expected returns to compensate the investors for the higher risk borne. Specifically, financial constraints hinder the company from financing all the desired investment opportunities, thereby reducing their flexibility in exploiting the investment policy to endure external shocks. Similar and complementary insights can be drawn by combining notions of behavioral theories with the role of financial resources, structure and flexibility. According to the former, the performance and risk profile of the company is moderated by its slack resources. Essentially, organizational slack represents the difference between the overall resources available and the minimum required to pursue a given strategic path. Its role is to provide a cushion of actual and potential resources that the MNC can exploit to counter the risks and uncertainty presents in the host emerging country. Interestingly, Sharfman et al. (1988) suggested that the effect of organizational slack can be analyzed by dividing it between high-discretion and low discretion slack. The former refers to specific resources such as cash holdings that can be exploited in a high number of contexts, while the latter category includes resources such as debt ad fixed assets that can be used only in certain contexts. High-discretion slack reflects the extent and speed at which the company has readily available resources to meet immediate and/or immediate needs.

Following the notions supported earlier, this set of resources enhances the firm's flexibility to adapt to the unstable and dynamic external environment of the host emerging country. Notably, MNCs with high degrees of high-discretion slack can exploit these excess resources to hedge against environmental fluctuations and unpredictable contingencies absorbing these shocks. At the same time, the flexibility accumulated through excess resources increase the ability of the firm to launch new activities to and pursue a higher amount of potentially profitable business opportunities. Therefore, as indicated by Lin et al. (2011), high-discretion slack increase the likelihood of bolder and more effective internationalization strategies. On the other hand, low-discretion slack is represented by the already mentioned unused borrowing capacity. Higher degrees of low-discretion slack have been reported to positively moderate the relationship between a firm's internationalization and its performance. Specifically, these resources enable managers to broaden the scope of potential strategic paths as they are not constrained by heavy debt and interest expenses. Put differently, a MNC with more low-discretion slack is expected to perform better (and to have a lower risk profile) than a peer with lower resource slack in the presence of the same internationalization strategy. The underlying reason is the higher ability of the former to adapt its operations to the external environment "experimenting" different alternatives.

6.6 Conclusion

As stated at the outset of this work, a multinational company developing a business in more than one market is exposed to additional risks that would not otherwise be present if this activity was confined within the national borders. The additional actors (e.g. foreign customers, competitors, institutions, etc.) involved are often physically and culturally distant from the MNC, hence multiplying the sources of risks to which it is vulnerable.

The establishment of a subsidiary in an emerging country is subject to its specific sources of risk, often totally different from those present in the home-country. These risks are rooted in the differences existing between the home and target country as well as in the economic and political instability inherent to emerging countries. For instance, unpredictable variations in the exchange rate and in the differential between home-country and foreign inflation can have relevant consequences on the cash flows generated by the FDI negatively impacting on the competitive position of the MNC (or its subsidiary). Moreover, differences between the home and host country tax system contribute to the additional complexities of capital budgeting for FDI and can trigger fiscal arbitrage opportunities. A subsidiary in an emerging country might represent a value-increasing business opportunity as the MNC can access to untapped customers' needs in places where production costs (e.g. labor) are low. However, these higher potentials should be evaluated in combination with the higher and numerous risk factors that the MNC (and its subsidiary) is faced with. For instance, the financial markets of these countries are less developed and sophisticated than those of advanced economies, leading to a lack of regulation and transparency as well as low liquidity. These burdens hamper the relationships between companies and investors and reduce the possibilities for companies to get their activity and projects financed (at a reasonable price).

Many sources of instability are rooted deeply into the political system, that is often far from the democratic principles underpinning the developed economies. In fact, cases of corruption, unfairness and power-abuses (often through military forces) in these governments lead to an economic and institutional environment that is unfavorable for companies to thrive. Political instability is likely to translate in poor infrastructures and low debt market access. Particularly, the legislation is subject to frequent manipulations and changes as well as characterized by inefficiencies, imbalances and gaps. Furthermore, developing economies appear to have a high degree of volatility from a macroeconomic point of view, lowering the accuracy and reliability of predictions and estimations related to inflation or exchange rate fluctuations.

Starting from the traditional capital budgeting models presented in Chapter 2, the most relevant risk factors affecting valuation in emerging countries have been discussed. The analysis has been divided into exogenous and endogenous risk factors. The former category encompassed the cultural/institutional barriers and forces likely to adversely affect the subsidiary's operations in the host market. Some of the issues examined involve the ways in which cultural distance prevents the subsidiary from gaining legitimacy in the host country as well as from gathering unflawed knowledge. Moreover, political and institutional actors have been reported to have a prominent role in shaping the subsidiary's business environment through the issuance of policies aimed at curbing and limiting foreign companies' local activity. One of the way foreign regulator can discourage foreign companies from investing locally is the imposition of higher taxes. These levies and their consequences have been analyzed dividing them into three groups: corporate taxes, withholding taxes on foreign dividends and taxes on personal income. As part of the institutional environment, local unions influence the subsidiary's investment policies and capital structure imposing restrictions based on conservative interests. Also, they can raise the cost of labor both in terms of retributions and layoff limitations, increasing the subsidiary's operational flexibility. Afterwards, the analysis focused on the endogenous risk factors, namely those features that are inherent to the specific firm and its decision makers. The extent to which the MNC is able to devise an appropriate response to the exogenous risks ultimately depends on the company's internal environment. Decision makers' personal characteristics and biases may pose additional risks and in the form of agency costs and behavioral distortions. Firm-specific resources and competences gathered in previous experiences might affect future investments' characteristics and success. Moreover, further insights have been provided as to the effects of home-country cultural elements embedded in the MNC's internal environment. Depending on their form and strength, endogenous risk factors shape the eventual and ultimate way in which the exogenous risk factors affect the subsidiary's operations in the emerging country, either mitigating or heightening them.

For every exogenous and endogenous risk factors discussed, special attention has been provided to the way valuation fundamentals are likely to be shaped and adjusted according to these threats. Overall, the

insights drawn from the analysis of external and internal variables have been included in a final framework encompassing the casual/statistic relationships between these variables and the fundamental composing the valuation formula. Starting from this framework, additional complexity has been provided to the framework by including more dynamic and subtle endogenous elements, namely managers' strategic directions. It has been discussed how two companies with the same valuation fundamentals might be attached a remarkably different value by the financial market because of the moderating effect of the specific direction undertaken by decision makers. In this sense, additional insights were provided about the interplay between strategic decision and the cost of capital. In fact, the former is expected to shape the relationships outlined in the first part of this last chapter, making them less linear and predictable as well as more dynamic and multifarious.

Fundamentally, the ultimate aim of the present work is not to provide an ultimate and ever-valid value for the discount rate to be applied (or for other variables constituting the valuation model), as it varies sensibly when different countries as well as different MNCs are considered, or when different levels, kinds and combinations of risks are evaluated. Conversely, the goal is to provide a tool and a framework to support the management in avoiding the pitfalls concealed in the valuation process when numerous (and often not straightforward) risk factors are considered.

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