The Role of International Financial Institutions in Supporting European SME Foreign Direct Investment

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Abstract

This paper addresses the impact of International Financial Institutions (IFI) in supporting European Small and Medium Enterprises (SME) Foreign Direct Investment (FDI). IFI's programs are predicated upon the assumption that their funding significantly fosters the creation of value chains in internationalized SMEs. This paper challenges such assumption, and argues that the extent and effectiveness of IFI's investments in European SMEs depends upon certain key aspects of the industrial structure, and the business model adopted by internationalized SMEs. On this background, this paper then focuses on the Italian case and discusses the role of the government and regional funding policies supporting development.

1. Introduction

Programs and specialized agencies supporting FDI in emerging markets have long been a salient feature of the development work carried out by the multilateral development industry. A wide array of advanced and specialized financial products and services are provided by development banks and multilateral and bilateral investment guarantee agencies, and are made available to the global banking system and to internationalized enterprises worldwide.

Typically, financial strictures put political pressure on governments and ultimately on multilateral development institutions programs and performance. As a case in point, under the current economic crisis, multilateral agencies are confronted with a pattern of shrinking contributions on the part of several European shareholders. The economics of institutional governance is, as a consequence, becoming increasingly more pressing: the complex governance of multilateral organizations is strained by requests for greater efficiency on the part of the shareholders, who tend to threaten to divert their contributions away from multilateral investments, towards more visible and manageable bilateral development activities. European donors administer their relationship with multilateral development institutions - and convey their respective governments' policies requirements - through a governance mechanism that involves several ministries and relations across different levels of government (and with a varying degree of compactness according to country and agency-specific arrangements[2]).

While governance styles vary across countries, European shareholders have consistently shown to be vocal about their need to justify their Government's funding to their domestic political constituencies: they expect to show that contributions to multilateral agencies are utilized to undertake investments which directly advance the Country' s geo-political priorities – and, most noticeably, domestic employment creation policies. FDI support activities are in general perceived as being congruous with real sector support policies, and are therefore overall endorsed and encouraged by the European shareholders. Donors assume that financing the internationalization of companies bears a positive impact on the real sector in the parent country as well as in the host country, and that these development activities will eventually generate employment.

Italian companies (and Italian SMEs in particular) however seem to under-utilize the multilateral funding available to FDI investment. This paper attempts to provide an explanation for this occurrence,

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[2] These mostly include the Ministry of Treasury, the Ministry of Foreign Affairs and Development Cooperation, the Central Bank and the National Development Cooperation Agency – as well as a series of more theoretically operational figures (such as, for instance, the Executive Director, usually an emanation of one of the above-mentioned agencies).

and highlights the importance of matching SME support policies undertaken by multilateral institutions with market characteristics.

2. FDI Support Funding and Multilateral Development Institutions

As patterns of corporate legal forms and financial accounting change over time, definitions of FDI have been modified to incorporate new types of investment and improve upon the accuracy of definition and measurement[3]. For the purpose of this discussion, we look at FDI consisting of direct debt or equity investment from an enterprise in a EU (parent) country to a company in the (host) – emerging market – country.

FDI could thus be broadly defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (host country enterprise). EU outward FDI stock[4] has increased steadily over the past 10 years, rising from 35% to 59% of aggregate GDP during 2005-2015[5].

The modality of FDI has been increasingly shifting away from traditional forms associated with either extractive activities or labor-intensive manufacturing for exports, and it now mainly consists of investments such as mergers and acquisitions (most recently purchasing privatized assets in Latin America and Eastern Europe, or assets underlying non-performing bank loans in Asia or currently in Europe). *Noticeably, FDI differs from portfolio investments, as it is undertaken within a long-term investment strategy – implying the acquisition of control or at least of an effective representation in the lasting interest of the parent company.* This feature informs the inherent stability of FDI (a backbone justification for multilateral agencies support programs, as discussed below).

3. Rationale for International Financial Institutions s' investments in FDI

FDI support programs in emerging markets are an important component of the multilateral agencies' development work for a variety of reasons. In the first place, FDI has been widely proven a driver for technology and know-how transfer to domestic enterprises and to the labor force, enhancing productivity and often providing a preferential access for exports abroad. Most relevantly and from a macro-accounting host country perspective, FDI is non debt-generating, and is therefore a preferred source of capital for financing a current account deficit. Moreover - and yet again in a macro-economic perspective - relatively long term FDI has shown to act as an automatic stabilizer in response to short-term crises. With the world economy increasingly globalized and intrinsically more unstable, FDI flows to emerging markets have in fact consistently shown to be resilient during the financial emergencies occurred over the past 40 years. No significant FDI withdrawals were in fact recorded during the Latin American debt crisis (1980s), the Mexican currency crisis (1994-95) , the East Asia financial crisis (1997-98) (Loungani and Razi, 2001) and the 2008 global financial crisis (Alfaro and Chen, 2010).

FDI support programs implemented by multilateral development institutions take stock of the vast literature and best policy practice databases on FDI determinants. These are related to: i) the market size and growth trends of the host country: market seeking investments in fact focus on countries with large markets and promising growth prospects; ii) the wage-adjusted productivity of labor (correlated, in turn, with availability of technology and innovation); iii) the availability of infrastructure; and iv) the stability of the fiscal system. Other relevant - and broader - macro determinants refer to the host country's political stability, to the conditions that support physical and personal security to the level of corruption and quality of governance, as well as to the legal framework and rule of law.

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[3] This paper utilizes OECD BMD4 definition of FDI.

[4] FDI stock is herein defined as gross border expenditures to acquire or expand corporate control of productive assets.

[5] OECD (2008).

FDI support investment activities undertaken by multilateral investment agencies are therefore enacted in the framework of investment programs addressing the following themes:

- monitoring and mitigation of disruptions in the banking and capital market chain supporting FDI in emerging markets, which could result in higher spreads and withdrawal of subsidiaries.
- Strengthening the policy dialogue on issues related to the investment regime (such as legal and regulatory framework on basic rights, rule of law, regulatory efficiency and property rights, as well as issues such as enforcing contracts and starting and conducting a business, with focus on latent risk, so as to improve risk management by foreign investors).
- Developing local capital markets in order to provide a wider range of financing sources, such as allowing nonbank financial institutions (i.e., pension funds and insurance companies) participate in the provision of long-term financing to FDI.
- Improving infrastructure quality, and strengthening the local supply chains

4. International Financial Corporation and FDI Programs

While addressing FDI-background reform issues in host countries, the World Group provides specialized market support to parent companies via the international Financial Corporation (IFC), which is the largest global development institution – with 108 offices worldwide - focused exclusively on the private sector in its developing member countries. IFC has a total disbursed investment portfolio of $37.6 bn (as of FY 2016) consisting mainly in loans (63.7% of total portfolio), equity (28.7%) and debt securities (7.6% of total disbursements).

IFC operates on a risk-sharing model with the private sector, making available a maximum of 25% of total project cost for each investment undertaken. The group of industries included in IFC investment strategy is fairly wide and includes: infrastructure and natural resources, financial markets, chemical industries[6], manufacturing industries including machinery and construction materials (such as cement, metals, glass), agribusiness including forestry (pulp and paper, plantations), commodities, livestock, beverages, dairy, food processing, services including health (hospitals), education, tourism, retail, property and life sciences (pharmaceuticals).

The IFC operates by extending senior debt finance, structured and mezzanine finance (the latter including convertible and subordinated debt and Tier II instruments) and private equity finance. In addition, it offers sustainable finance funding programs, to support global trade finance and to strengthen supply chains. The latter instruments have proven to be especially crucial at responding to investors' concerns on markets' responsiveness to outward FDI, and have been designed to a wide degree of detail.

The decreasing availability of lending from trade and commodity finance in emerging markets is in fact threatening to impact the overall value of global commerce (estimated at $14 trillion in 2016)[7] , with potentially dangerous consequences in strategic sectors such as agriculture and energy. Multilateral development agencies are seeking to offset scarcity of financial resources in such crucial areas by offering various instruments in trade portfolio solutions. IFC programs cover pretty much the entire economic value chain, supporting exporters across industries and addressing all productive stages: pre and post-harvest financing, inventory and warehouse receipts financing, working capital and supply chain financing and pre-export financing.

Global trade and supply chain activities are designed as public-private partnerships (i.e., with a risk-sharing mechanism), and account for about 35% of IFC's total commitment, where IFC contributes with its own funds and mobilizes other entities to support the emerging market trade portfolios of banks, by channeling liquidity or guarantees.

[6] Such as: refining and distribution, petrochemicals, fertilizers, inorganics and specialty chemicals.
[7] IFC (2016).

In summary:

- IFC is the largest single lender financing FDI in development economies, with a global presence.
- It provides a comprehensive, innovative and well-targeted range of financial instruments, geared at supporting FDI – including international trade and supply chain finance facilities.
- It has statuary obligations to fund private sector entities.
- IFC works in partnership with the private sector, adopting a risk-sharing lending strategy - thus mitigating risks of institutional distortions in designing investment strategies.

5. Italian FDI and IFC Support

IFC may not invest directly in Italian companies, due to statuary constraints, since Italy is a Part I (donor) country. It will, however, participate Italian companies' FDI operations in developing markets – such as, for example, the incorporation of a foreign subsidiary or the acquisition of a foreign supplier. The IFC Italian portfolio has historically focused (a) on the financial sector vis-à-vis the non-financial industries and b) target larger concerns, as opposed to SME companies. This imbalance across industries in favor of the financial sector has given rise, over the recent years, to complaints on the part of the Italian Authorities involved in the governance of the institution. It was in fact felt that IFC was making its portfolio choice simply by picking larger, easier transactions with the financial industry, thus letting out non-financial companies in need of support to enact FDI operations. The underlying argument is that, by investing in the financial sector as opposed to the non-financial industries, the impact of IFC funding on the real economy of the parent, Italian economy, will not be optimized, as these investments will ultimately not generate jobs in the domestic market. In other words, Italy as a shareholder of the Institution would not receive the expected returns on equity (in this case in the form of generation of domestic employment), which are central to the Italian political debate on the economics of governance of multilateral institutions.

IFC overall committed Italian portfolio was about $1 billion in 2016, approximately 50% of which invested in the financial sector; this ratio was down from 86% of total portfolio committed to the financial sector in 2013. Commitments undertaken during the 2014-2016 periods consist of[8]:

- **Unicredit Bank**, Bosnia and Herzegovina. In May 2016 IFC committed a €2.5 mill straight senior loan from IFC's own account and a €2 million straight senior loan from the IFC-Canada Climate Change Program to Unicredit Bank d.d.in Bosnia and Hezegovina, a subsidiary of Unicredit., to support onlending activities for energy projects.
- **Maccaferri**, Falcon P.V, Jordan. In September 2014, IFC committed a $13 million loan from IFC's own account and mobilized up to $20 million from other investors to support Falcon Maan, a 21 MW solar PV power plant located in Amman, Jordan. The project was financed by the Jordan-based Catalyst Private Equity Fund, a regional fund specialized in the energy and water technology sector, IFC and two Italian companies subsidiaries of the Italian Maccaferri Industrial Group. The Group's total revenue was € 465 million in 2016, with an EBITDA of 40 million.
- **Recordati Ilaç** . In June 2014, IFC committed a $34 million local currency corporate A loan to Recordati Ilaç, the Turkish subsidiary of Recordati S.p.A., a listed multinational company involved in specialty pharmaceutical, to finance the new production facility in the Istanbul region
- **Enel Wind, Brazil.** In May 2014, IFC committed a $200 million A loan to Enel Brasil Participaçoes, a wholly owned subsidiary of Enel Green Power, to support the development, construction and operation of 12 wind power plants located in Brazil's northeast region

Former commitments were made with the following partner companies: Colacem (for a $28.7 million project in the Dominican Republic and Faber Industries, for a $26.1 million investment in Thailand.

[8] IFC, 2017.

Disclosed investments include CLN and Proma Group (producing motor-vehicle parts), for a $20 million investment in Serbia and Piaggio Diesel (producers of diesel and turbo diesel engines for light commercial vehicles and two wheelers), for a FDI operation in a Vietnam two-wheeler manufacturing facility.
While not attempting to carry outs an actual portfolio analysis of IFC participation to Italian SMEs, which would require a thorough analysis of disclosed investments as opposed to committed amounts, this discussion would like to highlight the following general traits:

1) The overall portfolio is small when compared for example to the portfolio of France (whose 4.25% shareholding quota in the World Bank Group is however higher than Italy's 3.17%), where IFC commitments in FDI amount to approximately $1.7 billion, plus $2.1 billion provided in the form of Syndicated B loans and parallel loans with French financial institutions.
2) It remains biased towards the banking sector.
3) It is geared towards large, public-participated companies: the 2014-2016 increase in investment to the non-banking industries could most probably be ascribed to the relatively large ($200 million) loan extended to Enel Wind Brazil in 2014).
4) When co-investing with private sector companies whose public participation is lower than 20% of the total, these are large size enterprises as opposed to SMEs
5) Funding is mainly carried out under a loan investment, as opposed to equity deals.

6. Structure of the Italian Non-Financial Sector and IFC Policies

The characteristics of Italy's industrial structure could partly explain the pattern of IFC investment described above. It should be underscored that financial institutions ordinarily have statutory limits on the minimum size of the equity investment deals. In the case of the IFC, the agency will not provide financing smaller than $5 million, and is allowed to fund an average of 25% of total project cost, which makes the minimum possible equity deal not smaller than $20 million. Other pre-requisites of IFC investment policies are that the partner company, which should in turn provide strong equity participation to the project within a long-term strategy should have a successful track record in the industry (with strong financials), be at least 50% privately owned and meet IFC environment and social standards.

The above requirements rule out possible co-investment with small companies, which account for about 150,000 Italian enterprises and collectively produce approximately €97 billion of trade value, who would hardly be able to engage in a +$20 million operation.

With reference to medium-sized enterprises, FDI is moreover limited by different factors related to the low propensity for FDI. The number of Italian medium-sized companies, at about 9,800 in 2016, is 14% higher than the French market (with about 7,000), and generates 16% more trade value.

Furthermore, Italian SME export figures have been consistently exceeding French exports by 16-17% over the past 10 years[9]. However, Italy's FDI stock for the entire industrial sector as recorded in 2015 remains less than one third lower than the corresponding French financial stock.

Italy's outward FDI calculated as a percentage of GDP is at 26% (again much lower than the French, calculated at 50%). With FDI propensity increasing with the average size of firms, it could be inferred that Italian FDI will mostly be carried out by large companies (as opposed to SMEs). In essence, building a large enough pipeline with Italian SMEs proves to be simply impossible for multilateral

[9] OECD, 2008.

investment institutions, since SMEs are internationalized mainly via the export (as opposed to the FDI) model. The most plausible targets for IFC co-investment pipeline would thus appear to be Italy's large enterprises, which account for a total trade value of €83.4 billion (15% lower than French trade value generated by large companies). Yet again, when analyzing Forbes' global ranking for the 2000 largest companies for Italy and France. It can be remarked that the portfolio of the largest Italian companies included in this sample produce a much lower market value (400% less on average) than French companies, with similar differentials in terms of combined asset values[10]. Most noticeably, the overall revenue/profit figures see Italian companies with $822.8 billion and €6.4 billion negative profits, with French companies generating $ 2.185 trillion in revenues and $72.5 billion profits.

It could thus be argued that that the potential portfolio of a multilateral global financial player in Italian larger size companies might be limited by two main factors. These are: 1) Italian large companies are smaller in number if compared to, i.e., French large companies; and 2) within that smaller potential investment pipeline, companies fulfilling the requisites of having healthy financial accounts might be less in number, comparatively to a smaller pipeline extracted from the French (larger) enterprise ranking.

Another factor which might be of obstacle to IFI's support to Italian large companies' FDI is the propensity among the healthy, large companies, to resort to the market in order to raise capital - consistently lower in Italy than in the other EU G7 Countries. Borsa Italiana's capitalization, with 328 listed companies, is thinner than the Paris and Berlin stock exchanges (with 600 and 750 listed companies respectively).

7. Conclusions

Programs providing support to outward flows of FDI from EU countries have long been part of multilateral agencies' activities, who tackle the complex issues underlying FDI from a variety of angles, i.e., through development programs addressing institutional robustness and by extending financial and guarantee facilities to investors. This paper has reviewed the comprehensive set of financing instruments provided by the largest multilateral agency dedicated to co-investing in developing economies with private partners on a risk-sharing basis. It has then looked at the pattern of IFC portfolio in Italy, and has attempted to draw a few suggestions to explain why it is focused on the financial sector with relatively few, large and occasionally Government-participated non-financial private partners. In conclusion, this analysis suggests that, given the policy guidelines informing IFC investment, Italy's industrial structure provides several constraints to developing a robust portfolio.

It remains to be seen whether some adjustments on the part of the Italian Authorities on the policies priorities set out by Italy (as a shareholder) for multilateral investment agencies can be identified, so as to enhance the effectiveness of funding for Italian SMEs. This issue is however beyond the scope of the present paper, and is best left as a topic for future research.

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[10] Italian combined asset value is at $4.703 trillion and French is at $11.651 trillion.

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