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Political Risk Assessment of Malaysian Based Multinational Corporations

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Abstract

This paper examines the political risk assessment strategies of 22 Malaysian based Multinational Corporations (MNCs). First we investigate the importance of various risk elements. Next we assess the political risk process and finally the implementation of political risk reduction process. Our results show that the perceptions of political risk elements among the firms vary according to the location of their investments. For example, firms investing in developing countries were most concerned about expropriations of assets, social and political unrest and price fixing. On the other hand, firms in developed countries were more concerned about restrictions on profits, unfair competition from local competitors due to government subsidy, frequent unilateral change of agreement and ownership restriction. Concerning the assessment process, Malaysian MNCs tend to rely more on subjective unstructured qualitative approaches. Finally, in terms of implementing the political risk reduction process, most Malaysian based MNC opted for "good citizen policy" strategies.

Key word: political risk assessment, multinational corporations from developing country, foreign investments.
JEL Classifications: F21, F23.

1. Introduction

Investments in foreign countries can take the form of portfolio capital and/or foreign direct investment (FDI). Portfolio capital is mobile and is reallocated frequently among financial markets based on returns offered by these markets. FDI involves a long-term commitment of capital in a foreign country by multinational corporations (MNC). Besides being exposed to various forms of risks faced by national corporations, Multinational corporations are exposed to foreign exchange rate risk and political risk. Foreign exchange risk is the risk of exchange rate changes between the currency of the host country and the currency of the multinational's country of origin, such that the gains generated in the host country translate into losses when converting into the currency of the home country. Political risk is the risk of actions taken by the host country that have negative implications on the performance of the business in the host country. Host government intervention in MNC operation such as restricting ownership, control over the remittance of profit back to parent country and the confiscation of MNC assets are some examples of events that have negative implications on MNC operation as well as their profitability.

Overholt (1982) associated political risk with possible instability and violence. He also includes factors such as constraints upon operations such as nationalization, expropriation, ownership constraint and discriminatory taxation. Similar associations of political risk were done by Mutinelli and Piscitello (1997) when they analyzed the political risk assessment among multinationals originated in Italy. Robock and Simmonds (1983) categorized political risk into macro risk and micro risk. Macro risk occurs when all foreign enterprises are affected in much of the same way by politically motivated actions initiated either by the host government or the public as a whole. Micro risk occurs when changes affect only selected industries, firm or even projects. Examples of macro risk are revolutions, civil wars, nation wide strikes, protests and mass expropriations. Examples of micro risk on the other hand are selective expropriations, discriminatory taxes and import restrictions on raw materials needed for processes directed at specific firms.

Accordingly, political risk can also be in the form of a unilateral change of contract, rules or standards (Lorimo, 2003). These problems occur when the host government demands to change the original contract, sets new rules and introduces new standards without proper consideration to the MNC and this might disrupt their long term plans and profitability.

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Repatriation of funds by subsidiaries of MNCs in the form of loan repayments, purchases of supplies, administrative fees, remitted earnings, dividends or several other possible purposes (Madura, 1999) might be restricted and force the MNC to invest locally even when the projects are sub-optimal. Lankes and Venables (1996) documented such phenomena in their study (a survey) of European firms foreign investments in former Soviet Union.

Yasumuro (1984), Mortanges and Aller (1996) and Kobrin et al. (1980), suggested that managers of MNC are aware of and do assess and incorporate political risk factors into their foreign investment decisions. In general, although studies on political risk assessment are abundant, unfortunately there are none that have focused on MNC originating from developing markets. In order to substantiate evidence with respect to political risk assessment, this study focuses on MNC based in Malaysia.

The objective of this paper was to investigate the political risk assessment and management practices of Malaysian MNC. The paper focuses on four topics, namely:

1. Which political risks are important?
2. How is political risk assessed?
3. How is political risk measured?
4. Risk reduction strategies for political risk.

This paper emphasizes political risk assessment rather than other forms of risk assessment (i. e. foreign exchange risk assessment) related to foreign investment activities because to our best knowledge it is the first study that utilizes data on political risk assessment from south East Asia country especially Malaysia. Hence such study should be able to contribute towards the literature in political risk assessment of multinational firms as a whole. Secondly, Bala (1999) argued that for most of the business transaction that derived from prior Malaysian MNC investment in developing countries, the transactions were basically executed in US dollar instead of target country. Because the exchange value of the US dollar in relation to the local currency (Ringgit Malaysia) are rather stable over time, except for the recent Asian currency crisis period (Shamsher Annuar, 2001), the issue of exchange rate risk in our opinion is minimally important with regard to Malaysian MNC. This former point and the fact that majority of the foreign investments conducted by Malaysian MNC were in North east Asia and Asian countries (developing countries) as shown later in the text (Table 1), strengthen our argument even more in emphasizing political risk assessment instead of other forms of international risk assessments for this study.

Table 1

Spread of Malaysian MNC Foreign Subsidiaries according to region

Region	Number of foreign Subsidiaries
ASEAN:	
Singapore	9
Indonesia	15
Thailand	9
Philippines	9
Europe:	
United Kingdom	15
Netherlands	8
Germany	7
France	6
North East Asia:	
China	22
Hong Kong	24

Table 1 (continuous)

Region	Number of foreign Subsidiaries
Taiwan	4
Japan	3
Korea	2
North America:	
USA	17
Canada	5
South Pacific:	
Australia	20
New Zealand	1
Papua New Guinea	6

Source: Kuala Lumpur Stock Exchange (KLSE).

2. Evidence of Malaysian Based Multinational Corporations (MNC)

Bala (1999) conducted a survey of firms listed at Kuala Lumpur Stock Exchange (KLSE) in order to identify MNC originating from Malaysia. The requirements used by him to identify Malaysian MNC were as follows. The company: 1) Has operations in at least two countries; 2) Controls assets in an overseas subsidiary; 3) Has subsidiaries involved in value adding activities; and 4) Exerts management control over its international subsidiary.

From the 436 listed firms (as at October 1997), he discovered that 207 firms fulfilled these requirements and they can be considered as Malaysian based MNC. In that survey, it was also discovered that seventeen companies *have more* than 20 ongoing foreign investment projects in various countries. Top of the list was Sime Darby with 110 ongoing foreign investment activities spanning 19 countries. Second was Amsteel with 70 ongoing foreign investment activities and this was followed by MBF holding with 60 (Bala, 1999). The geographical spread of Malaysia's MNC investment activities was also wide. The top MNC, in total, had ongoing foreign investments in 63 countries around the world. The spread of these investments according to region is shown in Table 1. Malaysian MNCs are at a disadvantage when competing against firms in developed countries, but there are still some foreign investment made by the MNC in those respective countries (see Table 1). Bala (1998) pointed out that majority of the investment of Malaysian MNC in countries such as United States, Europe and Australia are in the form of fixed assets with less technology requirements, for example, investments in hotels chain, restaurants, marketing chains. Since the technology requirements are less for such investments, this give an opportunity for Malaysian MNC to compete more competitively with local firms.

Different from investment in developed countries, foreign investments in developing countries are perceived to have higher business risk. Malaysian MNC therefore may also be investing in developed countries in order to diversify their total investments. For example a project undertaken in developing countries, is said to be in a more volatile operating environment than a project in a larger developed economy. The volatility is due potentially greater infrastructure risk, customer risk, banking system/payment risk, labor risk and political risk (Madura, 1999). This move is to diversify investments into developing markets to reduce risk.

Heenan and Keegan (1979) surveyed on Malaysian MNC. The objective of their survey was to identify MNC originating from the third world. They found only one company that fitted for their definition of MNC and it was the Sime Darby Holdings. Annuar et al. (1996) considered companies like Technology Resources Industries (TRI), Sapura Telecommunications Berhad, Telekom Malaysia and Petronas as Malaysia's major MNC.UNCTAD (1999) to identify Third World Transnationals listed Petronas and Sime Darby in their top 50 Transnationals from developing countries based on foreign assets.

3. Assessment of political risk

When company's management acknowledges the value of political risk, there are various unstructured and structured methods to assess this risk (Madura, 1999). The unstructured methods involve formal and informal inspection visits to the host country and use of the checklist approach. The visit approach has limitations in the sense that only selective information might be investigated. The information may reflect only the positive aspect of the country and does not account for factors that may be disastrous for the company. The checklist approach involves listing of all the possible political risk elements in the host country that could have adverse implications on the performance of the MNC with different weights assigned to different factors according to their importance. Countries with the least number of risk elements are then short-listed for investment.

The most frequently used structured method of assessing political risk is the Delphi technique. This approach seeks the opinion of a group of independent consultants on factors affecting the political environment of a country. Their opinions will focus on aspects of political stability, attitude toward foreign investors, whether restrictions apply on profit remitted or input, consumers' behavior, marketability of product, economic growth of the country and many more. The statistical distribution of opinions is then used in the investment decision.

4. Measuring political risk

Measurement of political risk elements is based on the impact they have on the firm's projected cash flow in a particular country. Firms normally apply sensitivity analysis and the maximum probability of loss to measure the impact of political risk on MNC performance. The sensitivity analysis approach first predicts the probability of certain events occurring. For example, the probability of an increase in national income, increase in per capita education expenditure, increase in available food supply (measured in terms of calories per capita) is predicted. Second, this technique determines how much change will take place in the firm's cash flow if one of the events mentioned above occurs. If a particular event leads to a significant change in the firm's cash flow, than that event is thought to carry significant amounts of political risk. The approach based on maximum probability of loss also involves the estimation of the probability of certain events occurring, and then measurement of the impact of change in this event on the firm's cash flows, followed by estimation of maximum loss to the firm due to the changes in the cash flow. The size of loss indicates the extent of political risk in the investment.

5. Managing political risk

If political risk exists, the MNC can decide not to invest in the country or withdraw from the market in which the MNC is currently operating, and/or use the "counteractive response", that is, try to gain a competitive advantage based on MNC strengths and the needs of the host government (Mortanges and Aller, 1996).

The "counteractive response" means that the relevant MNC utilizes its bargaining power vis-à-vis the host government in order to alter its position with regard to other multinationals and thus gain a competitive advantage. The bargaining power can be in the form of unique supplies or technology from the home country that cannot be duplicated locally; establishing a joint venture with local firms and hiring local employees; borrowing from local financial institutions; use of a short-term horizon when investing in equipment and machinery; and purchasing insurance.

6. Research Method

In May 2000, 96 questionnaires were mailed to firms classified as Malaysian based Multinational Corporations. The selection of these multinationals was based on the definitions used by Bala (1999) but with some addition. The additional requirement is firm's size. According to Madura (1999) to be a multinational firm, a firm must have adequate size. With adequate size, multinationals then should have enough resources to help them in venturing into foreign markets. The size of a firm, normally can be measured in terms of total assets or market capitalization. Based on this argument (Madura, 1999), we believe that only large Malaysian firms should be classified as multinationals. Therefore in coming up with the list of potential MNC, we ranked all of the firms listed on the Kuala Lumpur Stock Exchange (KLSE) based on their market capitalization. From the ranking we choose the top two hundred firms. Based on these two hundred firms, we then used the requirements originally developed by Bala (1999) to select potential Malaysian MNC. Using Bala's MNC requirements we managed to classify ninety-six firms listed on the KLSE as a multinational. We then mailed the questionnaires to all of these ninety-six firms. The questionnaires were intended to be filled out by company financial managers, managers of international divisions, group accountants and international marketing managers, all of whom were expected to have a thorough understanding of their firm's political risk assessment and management. The questionnaire, that was used in this study was developed based on questionnaire used in Mortenges and Aller's (1996) study. This was done to ensure the validity of the study. The questionnaires were also number coded. The coding would help us eventually to identify firms that responded.

After four months, twenty-two usable responses (22.9%) were received and analyzed. Since the number of responses obtained is relatively small, caution should be made in comparing our results with results from the previous studies. Tables 2 and 3 show the characteristics of foreign investments made by the Malaysian MNC.

Table 2

Malaysian MNC and their Foreign Investments

Number of foreign Investments	Percentage of MNC (total = 22 MNC)
1-5	13.60%
5-10	18.18%
10-20	36.30%
20-50	9.09%
More than 50	22.70%
Total	100.00%

Note: From the total number of foreign investment, 31.80% are intended for developed countries and 68.20% are for developing countries.
Source: Kuala Lumpur Stock Exchange (KLSE).

7. Which Political Risks Elements are Important?

The survey first sourced information on the elements of the political risk regarded as important by managers. Respondents were asked to indicate the four most important political risk elements in terms of possible impact on their business operations (Mortanges and Allers, 1996). They had to consider elements mentioned earlier, mainly: political and social unrest, risk of expropriation, local ownership requirements, risk of expropriation, contract problem, competition from public enterprise, import restriction, and taxation.

When making their assessment the respondents also had to make a distinction between developed and developing countries. The results support that the idea is desirable to distinguish between developed and developing countries when assessing political risk (Table 3 and Table 4). This is consistent with the finding made by Larimo (2003) who discovered that there are variations in political risk assessment by Nordic MNC based on the development of the target country.

Table 3

Percentage of MNC mentioning most Important Political Elements in Developed Countries

Political Risk Elements	Percentage of MNC
Price fixing by host government	20.00%
Input restriction	33.30%
Host government subsidizing local competitors	6.70%
Expropriations of assets without proper compensations	40.00%
Restrictions on profit, dividend and interest remittances	33.30%
Ownership restriction	33.30%
Frequent unilateral changes in agreement	33.30%
Discriminatory taxation practices	26.70%
Political unrest	53.30%
Social unrest	49.00%

Results from both tables seem to indicate that all political risk elements were important but the importance of each element varied between groups. For instance, in the case of MNCs that have operations in developing countries, the political risk element of the host government subsidizing local competitors was the least important compared to that of developed countries. Conversely, the element of political and social unrest is more important in developing countries compared to developed countries. The difference in the importance of the stated elements can help guide investors to distinguish the different level of political risk in these countries.

Table 4

Percentage of MNC mentioning most Important Political Elements in Developing Countries

Political Risk Elements	Percentage of MNC
Price fixing by host government	14.30%
Input restriction	28.60%
Host government subsidizing local competitors	28.60%
Expropriations of assets without proper compensations	42.90%
Restrictions on profit, dividend and interest remittances	71.40%
Ownership restriction	28.60%
Frequent unilateral changes in agreement	26.20%
Discriminatory taxation practices	21.30%
Political unrest	27.00%
Social unrest	11.20%

8. How is Political Risk Assessed?

The questionnaire also identified several techniques commonly used by Malaysian MNC to assess the political risk level in each country of investment. The result (Table 5) shows that almost all of the respondents used subjective *qualitative unstructured methods* like judgments of managers and formal and informal visits in evaluating country political risk. However 54.60% of the companies also used the *qualitative structured method* (hiring external consultants). These findings are consistent with those reported by Mortanges and Aller (1996) and Yasumura (1984).

Table 5

Methods used by MNC to asses political risk

Method to access political risk	Percentage of MNC
Secondary data and subjective personal judgment	68.10%
Hiring external consultant	54.60%
Formal inspection visit	81.80%
Informal inspection visit	68.20%
Combination of techniques above	86.40%

In terms of the timing or frequency of political risk analysis is conducted by participating firms, only a small fraction of the respondents emphasized the use of political risk assessment on a continuing basis to guide and protect already established operations. A majority of the respondents (91%) used political risk analysis only in relation to initial investments in targeted countries (see Table 6). Similar results were documented by Larimo (2003), Mutinelli and Piscitello (1997).

Table 6

Timing of Political Risk Analysis by Malaysian MNCs

Time of Analysis	Percentage of MNC
Before investment in certain country	91%
When a certain problem occurs (i.e. social unrest)	68%
Ongoing and Strategic Planning	30%

The respondents were also asked whether they incorporated the political risk information into their capital budgeting process of foreign investments. Almost all respondents incorporated the political risk information into their capital budgeting process, through either increasing the discount rate (72%) or shortening the payback period (68%) of a project to be implemented in that country.

9. How is Political Risk Measured?

The majority of the respondents used a combination of techniques to measure the impact of political risk (Table 7). Besides the significant use of cash flow sensitivity and maximum probability of loss analysis, Malaysian-based MNCs also apply their own techniques of measurement, which are classified in the undisclosed evaluation technique category (63.7%). Mutinelli and Piscitello (1997) found similar results for Italian MNCs.

Table 7

Techniques Used to Measure the Impact of Political Risk

Technique to measure political risk	Percentage of MNC
Undisclosed firm's evaluation technique	63.70%
Cash flow sensitivity analysis	81.86%
Maximum loss analysis	63.70%
Combination of techniques	86.80%

10. Risk Reduction Strategies for Political Risk

The Malaysian based MNC opted for "a good citizen policy" approach to mitigate political risk. Table 8 shows some of the strategies used: establishing joint venture with foreign competitors and hiring as many locals as possible (81%) and using credit facilities from local bank in the host country (63%).

Table 8

MNC Political Risk Reduction Strategies

Strategies	Percentage of MNC
Buy risk insurance for foreign project	45.50%
Investment with short term horizon	40.90%
Establishing joint venture with local firm and hiring local labor	81.80%
Using credit facilities from local bank in the host country	63.60%
Rely on unique supplies from home country	40.90%
Using state of the art technology not accessible by local competitors	50.00%
Combination of techniques	91.30%

11. Conclusion

The objective of this study was to provide a preliminary insight into the assessment, measurement and incorporation of political risk by Malaysian based multinational corporations. The findings are consistent in many aspect with those multinationals in developed countries (Yasumuro 1984; Mortanges and Aller, 1996; Kobrin et al., 1980; Mutinelli and Piscitello, 1997; and Larimo, 2003).

For MNCs with operations in developing countries, in terms of political risk what concerned them the most were incidences such as expropriations of assets, social unrest and political unrest and price-fixing. However MNCs that operate in developed countries were most concerned about restriction on profits, unfair competition from local competitors due to government subsidy, frequent unilateral change of agreement and ownership restriction.

Concerning the assessment process, Malaysia MNC tended to rely more on subjective unstructured qualitative approaches, as evidenced by the frequent use of personal judgment, formal and informal inspection visits techniques. Hence the use of simple and qualitative methods, seems to dominate over more sophisticated methods of political risk assessments. This could be due to a combination of reasons such as costs, lack of expertise to implement and effectiveness of incumbent methods. Consistent with the practices of other multinationals (Mortanges and Aller, 1996; and Kobrin et al., 1980), the Malaysian based multinationals mitigated political risks by going into joint ventures, sourcing local financing, employing local staff and making whatever changes the host governments require of them.

In interpreting the findings, caution should be given by readers. This is because of the low number of responses obtained from the survey. Despite this obvious lack of power in the model developed, however we still believe that this study contributes to the literature of political risk assessment as it is the first to our knowledge that uses data of MNC from developing market.

As for future research, similar study can be carried out but this time with wider scope. The scope of the study can be extended by incorporating potential Malaysian MNC listed on the second board of the Kuala Lumpur Stock Exchange. By incorporating them, this will not only confirm our findings but at the same time improve the generalizibility of the results. To our knowledge, some of the largest firms that are listed on the second board, are equally large in size as those companies in the middle tiers of the KLSE main board. Because size as mentioned earlier is one of the essential factors to be a multinational firm (Madura 1999), such survey on the KLSE second board if carried out, may bound to be fruitful

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