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Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues by
the Vale Columbia Center on Sustainable International Investment
No. 111 December 23, 2013
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Minority rules: State ownership and foreign direct investment risk mitigation strategy

by

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Business researchers, executives and regulators may assume that state ownership in firms raises risk for private co-investors. After all, private investors are seeking profits while states are seeking welfare. Giving them both equity only confuses the aims of an investment project, complicates the job of investment project managers and raises the overall risk of investment project failure. But these assumptions do not fit the evidence as demonstrated by a well-known risk indicator observable in hundreds of investment projects located in dozens of countries: in countries where initial investment terms are more vulnerable to renegotiation by host country governments, we found that “minority rules” apply whereby a non-controlling, but still substantial equity investment by a host country government can play a risk-mitigating role.

One of the oldest political risks facing foreign (and domestic) private investors is that initial, often quite favorable, terms for long-term investment projects in mining, manufacturing and power generation industries can be unilaterally upended by host country governments. A government official may decide that initial terms setting low tax rates on project profits were too generous, or that local hiring targets were too low. In demanding renegotiation, host country governments have an advantage. Private investors often have substantial plant, property and equipment vulnerable to hold-up, maybe even outright expropriation, if demands are not met.

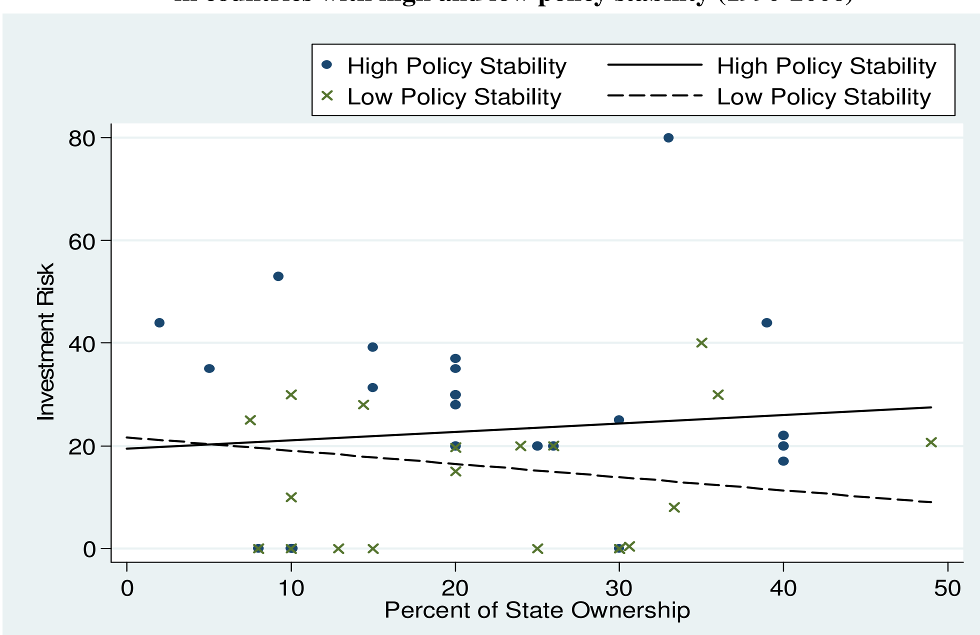
In response, private investors should consider enlisting the host country government as a minority co-investor, but only where the broader risk of an investment policy change is substantial. Our contingent recommendation follows from analysis of more than 900 project finance-based foreign direct investment (“project”) deals announced in 53 countries from 1990-2006. These were typically not previously state-owned enterprises undergoing privatization; rather, they were more likely new, greenfield projects like Acciona’s wind farm project in Mexico, dubbed the 2012 Deal of the Year by *Project Finance Magazine*, or Enron’s Dabhol power project disaster in India during the 1990s. In the Acciona and Enron examples and others, project capital structure provides a window on project risk. Where there was more equity as a percentage of overall capital funding a project, we inferred more project risk in the near term. That is because project creditors, large commercial banks such as Barclays, Citibank and the Bank of Tokyo, usually lend less to projects more vulnerable to near-term failure.

In the projects we reviewed, equity as a percentage of overall capital tended to increase for projects announced in countries given to sudden policy changes. Increasing project risk with increasing policy instability was interesting. Perhaps more interesting was the contingent risk-mitigating role of state ownership we observed. Project equity as a percentage of overall capital and, thus, project risk *decreased* in countries with low policy stability, but *only* when the government entity held a *minority* (less than 50%) equity stake. Project equity percentages and risk went back up when there was no government equity stake or when government held a majority (greater than 50%) equity stake. The risk-decreasing effect of minority equity holding by the government was greatest when the equity stake was in the 21-30% range.

State ownership in projects sends at least two signals to private investors. One signal is assurance that original policy terms will not be reversed lest the state share in losses from the policy reversal. Another signal relates to possible state interference in the project to achieve broader welfare-oriented goals, such as decreasing unemployment. In countries where policy reversal is more likely, minority co-investment by the state sends private investors this mix of signals: a strong signal assuring private investors that original deal terms will be upheld; but also a weak signal of state interference under those original deal terms. The overall signal is favorable and decreases project risk.

What about projects located in countries with substantial policy stability? There, initial project terms are less likely to change significantly over a project's life. In this context, state equity stakes only add to overall project risk even at relatively low (less than 5%) equity levels. Here, a stronger signal of assurance is redundant. Stable policies provide the same assurance to private investors. All that is left is a stronger signal of state interference in project management under the original terms. The overall signal is unfavorable and increases project risk.

Figure 1. Relationship between investment risk and the percentage of state ownership in countries with high and low policy stability (1990-2006)



Take-aways from our study include the following: 1) countries given to sudden policy shifts impose greater risks for investors leading projects located there; 2) in these sudden-change countries, a host country government equity stake in a project may decrease overall project risk by giving the state a reason *not* to demand a renegotiation; 3) the risk-mitigating effects of state ownership are contingent on limiting the state to a substantial but still minority stake in a project with a "sweet spot" of somewhere from 21-30% of overall project equity; and 4) giving states majority equity stakes in less stable (often developing) countries may prompt them to maintain original investment terms, but still prompt some threat of interference with project management under those original terms. Our minority rules can help mitigate project risk, but they cannot make it disappear altogether.

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