

Executive Summary

ICA Global Performance Index 2007: Investment Globalization Impervious to the Foreign Profitability Cycle

A study by Investment Consulting Associates –ICA Ltd.

Foreign direct investment (FDI) has been the driving force behind globalization, far outpacing virtually any other measure of global economic activity over the past decade. Most of the analysis of globalization leaves a general impression of inevitability, a sense that multinational enterprises (MNEs) have been expanding their international operations at will and, in the view of skeptics, with impunity.

However, this popular conception underpins one of the most common misunderstandings about globalization and offshoring. In fact, as the present study shows, international expansion or global sourcing is often a losing proposition. And yet, at the same time given competitive pressures, it is a forced proposition. Much like a professional game of poker, the surest way of losing, albeit perhaps not the fastest, is never to bet. The question is, can we learn something from the best (and worst) players sitting at the table? The conclusion of this study is that we can.

The table shows the top-10 performers over 2006 measured along the ICA – Global Performance Index (GPI), the return on foreign assets.

| Rank | Company | ROFA |
|------|---------------------|---------|
| 1 | Cisco Systems | 1382.1% |
| 2 | Microsoft | 870.3% |
| 3 | Apple | 688.1% |
| 4 | McKesson | 397.4% |
| 5 | Accenture | 320.4% |
| 6 | Nike | 256.3% |
| 7 | Cardinal Health | 221.0% |
| 8 | Hewlett-Packard | 175.9% |
| 9 | Paccar | 125.1% |
| 10 | United Technologies | 121.1% |

This study is based upon a unique database that was developed specifically to study the performance of the foreign operations of the world's leading MNEs. It is structured as a panel, following firms over time. The coverage includes 230 firms (all Fortune Global 500 companies), up to 133 different variables, and up to 20 years of data.

One third of Globalization of trade and FDI driven by large multinationals

The foreign assets of the firms in this sample are equivalent to 35 per cent of global FDI stocks (not flows), their revenues generated by foreign operations (which can be viewed as an alternative to exports) are equal to about 34 per cent of global trade, their profits directly contribute just under 1 per cent to global GDP, and their international operations employ the equivalent of 2.5 per cent of the total OECD labor force. Roughly, the international strategies of this sample of firms represents a third of the global economy in terms of FDI and trade.

Scope for globalization remains significant

Approximately one third of companies in the Fortune Global 500 (the annual ranking published by Fortune Magazine upon which the database itself is based) are purely domestic. In other words, despite the generally high average levels of globalization characterizing this group of companies, the scope for further corporate globalization remains significant.

Frontrunners of globalization have half their economic activities abroad

The sample of firms in this study maintain roughly half of their economic activity outside of their home countries. This shows that even for a group of frontrunners in the globalization of economic activity this share is not at all extremely high.

The existence of an optimal level of globalization

The study shows that there seems to exist something approximating an optimal level of corporate globalization (between 35 and 50 per cent FATA), beyond which the returns to globalizing the firm diminish and below which insufficient economies of international scale and scope seem to detract from international profitability.

Infants: paying the price for globalization. Dino's: managing international overstretch

Firms that are still in a more infant stage of globalization need to pay the price of exploring foreign markets, while the Dino's of globalization are paying an increased price for managing a global network – a situation that can be qualified as *international overstretch*.

Pace of globalization: Slow is better

Slow levels of positive globalization seem to be associated with the highest levels of foreign profitability, while more rapid globalization would seem to detract from performance. Especially, when foreign investment takes place in the form of cross-border M&As rapid globalization is achieved, however, perhaps not always in line with anticipated performance levels

De-globalization strategies: in search for the optimal level of globalization

Significant number of firms pursuing de-globalization strategies (at least during the most recent three years), while not the best performers have not necessarily been the worst performers either, as one might have expected. Firms that realize that they have gone too far in their international expansions can respond by pulling back and reducing their international exposure which, in turn, could be expected to have a positive effect on foreign performance as they shut down or cut back their problematic foreign operations. These retreat strategies can be seen, in the light of this report, as a search for the firm's optimal level of globalization.

Emerging management of globalization process

The report demonstrated that some companies just outperform others and hence it is crucial to learn what these companies are doing well even those who are not operating in the same industry. This feeds the idea that there is an *emerging management of globalization*. One crucial element in this management process is the pace of globalization or international

expansion. Slow is better seems to be the driving factor behind successful international expansion strategies.

Steady Globalization but greater, volatility in foreign investment profits

In the figure below the lines representing the share of foreign in total assets (FATA) and revenues (FRTR), show an unmistakable globalization trend, but a divergent trend in the share of foreign profits versus total corporate profits .

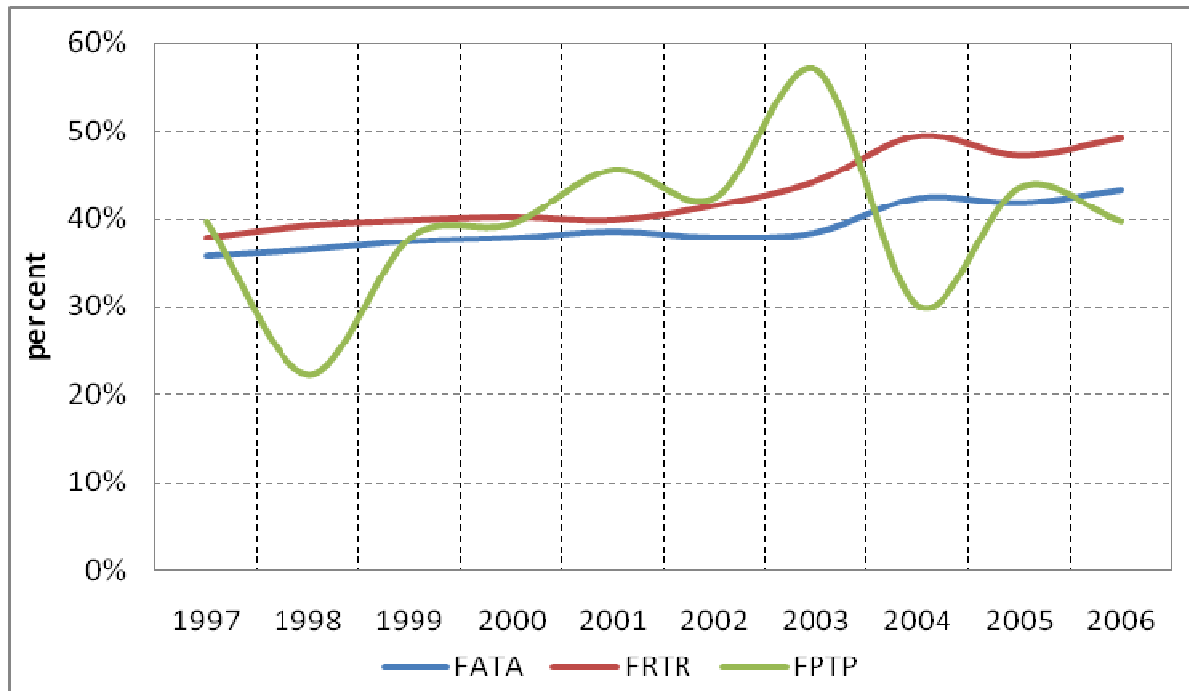


Figure 1: The Foreign Investment Profitability Gap, 1997-2006
 (Source: ICA-Global Performance Index Database www.ic-associates.com)

Three important globalization stories can be gleaned from this figure:

1. Contrary to much of the hyperbole surrounding globalization, the process has been – on average - *quite steady and gradual*, with the share of foreign in total assets increasing from 36 to 43 per cent and the share of foreign in total revenues increasing from 38 to 49 per cent over ten years.
2. A second story, found in these two same trends, has been the growing divergence between these lines, *with foreign assets generating an increasingly disproportionate share of firms’ total revenues*. In other words, MNEs have been increasing the sales intensity of their foreign operations over the past 10 years. Indeed, to the extent that foreign assets have consistently been generating a higher proportion of sales than domestic assets, this constitutes a powerful explanation as to why MNEs continue to expand their international operations. In short one may conclude that a large foreign consumer market, driven by exceptional double digit economic growth numbers in many emerging economies, may be a key factor in driving the global strategies of these MNEs.
3. The third story concerns the profit line. As might be expected, this line is more variable than the other two, reflecting the more general tendency of profit series to show greater variability over time. The share of foreign in total profits dropped significantly in 2004 and has struggled to stay above the foreign asset line ever since. Here the story is the opposite of what we see in the revenue line. *On average, foreign assets and foreign revenues – growing gradually over time have been generating a volatile level of foreign profits.*

For more information to access the ICA-GPI Database please see www.ic-associates.com
The report by Investment Consulting Associates Ltd. (ICA): "ICA Global Performance Index 2007: Investment Globalization Impervious to the Foreign Profitability Cycle" can be downloaded on this website as well.

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ICA specializes in Location Effective Supply Chain Optimization, location selection, economic development strategies and foreign investment software development. The company is based in Amsterdam, The Netherlands and has alliances in all major markets around the world. The authors of this report are Dr. Michael V. Gestrin, Senior Economist, Investment Division, OECD, and Dr. Douglas van den Berghe, CEO, Investment Consulting Associates Ltd. The views expressed in this paper are the sole responsibility of the authors. Not for quotation without permission. Inquiries should be directed to: douglas@ic-associates.com