Notes

1 Globalization: A Cautionary Tale


3. See the case study, W. J. Henisz and B. A. Zelner, “AES-Telasi: Power Trip or Power Play?” (The Wharton School, 2006); or Paul Devlin’s film Power Trip (2003), for more in-depth coverage of AES and its failed entry to Georgia.


11. Another way to think about the increase in the pace of globalization is by looking at the growth of the World Trade Organization (WTO), whose member states commit to broadly liberalizing cross-border trade. In 1995, its founding year, there were 128 WTO members; there are currently 160. China became a member in 2001 and Russia in 2011. As of this writing, WTO members account for approximately 96 percent of all global trade and 97 percent of the world’s GDP.


13. For the purposes of this book, political institutions also refer to legal and regulatory institutions. For more, see chapter 4.


2 The Globalization Process


2. A maquiladora is a manufacturing facility located within a free trade zone in Mexico. The principal purpose of a maquiladora is to manufacture products for export. The benefits of locating a maquiladora in Mexico are the tax benefits. Imported equipment and inputs as well as exported outputs are generally not subject to tax.


4. For more on what I mean by currency risk, see chapter 5.

5. I continue with assumption no. 5, above (there is no residual value of the assets in which the company invests for its expansion to Newlandia—that is, the entire value of the Newlandia venture goes to $0 in year 6). I also continue with assumptions no. 6 (no currency risk) and no. 7 (no tax considerations).

6. Clearly, I am simplifying quite a bit for analytical convenience. For detailed information on how to calculate discount rates, I refer you to Aswath Damodaran’s website (http://people.stern.nyu.edu/adamodar/). One common technique for generating the cost of capital that is appropriate to use as the discount rate in present value calculations comes from the capital asset pricing model (CAPM). CAPM can be expressed as $K_c = R_f + \beta_i (R_m - R_f)$, where $K_c$ stands for the cost of capital used for discounting purposes; $R_f$ is the risk-free rate (typically that associated with local US government bonds); $\beta_i$ is the specific market beta of the company; and $R_m$ is the market return (typically the return on some index like the S&P 500).

7. The generic present value formula can be expressed as $\{FV_n/(1+r)^n\}$ where $FV_n$ is the future value (in this case, profit) in time period $n$, $r$ is the discount (interest) rate, and $n$ is the period (month, year, etc.).
3 The Impact of National Institutions on Globalization

1. Just a reminder that, throughout this book, when I refer to political institutions, I include legal and regulatory institutions as well. See chapter 4 for more explanation.


5. Chapter 4 addresses individual kinds national institutions.

6. Typically, measures of institutional distance are calculated using Euclidean or Mahalanobis distance approaches. I will come back to measurement issues in later chapters.


4 Political Institutions and Globalization

1. That is to say, when I speak of political institutions in this book, I refer generically to political, legal, and regulatory institutions as a set. It is perfectly reasonable to treat and measure political, governmental, legal, and regulatory institutions as distinct and separate institutional constructs. I simply collapse them here for analytical convenience and because they share significant theoretical and empirical overlap.


19. As I mentioned above, I make no value judgment about whether those numbers indicate better or worse political institutions. The absolute numbers mean very little to me; I leave such evaluations to political pundits.
5 Economic Institutions and Globalization

1. For more on the Kellogg’s case, see M. Haig, *Brand Failures: The Truth about the 100 Biggest Branding Mistakes of All Time* (London: Kogan Page, 2003), chap. 5, 32–35.


4. Of course, in instances where a country officially adopts the currency of another (as Panama recognizes the US dollar [USD]) or pegs its currency to another (as Hong Kong does with the USD), exchange rates can remain relatively fixed by design.


6. There are a variety of ways to hedge currency risk, but currency hedging mechanisms are outside the scope of this book. I will leave that to international finance texts, which focus on a whole host of issues related to currency regimes, systems, differences, and risks as well as the management/hedging of those risks.


8. Of course, a country’s economy and economic development is also influenced by its political, legal, regulatory, and cultural institutions. However, when it comes to measuring institutions in terms of their level of risk to a company seeking to globalize, it is important to distinguish between institutions that serve a specific economic function and those that serve a political, legal, regulatory, and cultural function. Although the lines between institutions can be blurred from time to time, I tend to distinguish economic institutions from other institutions by their more narrow relation to economic activity in a society.

9. Although I single out capitalism and command economies as prototypical economic systems since they are the most widely adopted the world over, they are not the only kinds of economic systems that currently exist or have existed.

10. The extent to which these systems are similar or different to capitalist/command economies is outside the scope of this book.


See, for example, the Heritage Foundation’s Index of Economic Freedom (http://www.heritage.org/index/) or the Fraser Institute’s Economic Freedom of the World Index (http://www.freetheworld.com/).

See, in particular, development indicators from the United Nations, the World Bank, and the International Monetary Fund.

See Aswath Damodaran’s website (http://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html), where he explains how he calculates cross-country economic risk spreads from sovereign bond ratings.

6 Cultural Institutions and Globalization

13. This is not to say that individuals within a country are homogenous; there is tremendous cultural variation within a country, and especially so in a large country like the United States. Some groups within a country may even relate more readily to the culture of another country. People who live close to the Canadian border in Michigan, for example,
might have more in common with Canadians who live just on the other side of the border than with some Americans who live in New Mexico. But this is more the exception than the norm.


16. See Hofstede, Cultures and Organizations, for a summary.

17. This raises a kind of “chicken or the egg” problem in terms of which came first: cultural institutions or political, legal, regulatory, and economic institutions. Attempting to answer that question is beyond the scope of this book.

7 Using Global Acumen to Account for Risk

1. These numbers are random and for illustrative purposes only. They are not drawn from any actual institutional data sources.

2. With a single institutional dimension, Euclidean distance approaches yield solutions that are equivalent to those that absolute value generates. It is easy to see this by applying the Euclidean distance technique to our simple example of the United States and China. Comparing the United States and China on simply one dimension—economic—results in a situation where the number of dimensions (n) is set to 1, and so the problem simplifies to \( \sqrt{(5-2)^2} = 3 \).

3. With a single institutional dimension, Mahalanobis distance approaches likewise yield solutions that are equivalent to those that absolute values generate. It is easy to see this by applying the Mahalanobis distance technique to our simple example of the United States and China. Comparing the United States and China on simply one dimension—economic—results in the following simplified calculation: \( \sqrt{(5-2) \times 1 \times (5-2)} = 3 \).


5. Two countries that share the same institution scores will be indistinguishable on a scale of institutional distance, meaning it would be equally easy for a company from one country to do business in the other and vice versa.

6. “The discount rate . . . refers to the interest rate used in discounted cash flow (DCF) analysis to determine the present value of future cash flows. The discount rate in DCF analysis takes into account not just the time value of money, but also the risk or uncertainty of future cash flows; the greater the uncertainty of future cash flows, the higher the discount rate.” See http://www.investopedia.com/terms/d/discountrate.asp (accessed March 9, 2015).


9. As I discussed in chapter 5, this is in part because countries with more stable underlying economic institutions inspire more confidence in economic projections, and certain capital-market structures and interest-rate environments make it easier to raise capital.

10. You will recall that I consider political, legal, and regulatory institutions under the umbrella of political institutions. See chapter 4 for the rationale.

11. Although the Global Acumen approach is nuanced, the Euclidean and Mahalanobis distance approaches I describe above are generic, and you can apply them to any set of institutional measures. I describe the algorithmic procedures built into Global Acumen simply as a benchmark. Given the many ways to create risk spreads from country-specific measures of institutions, I would encourage anyone with a deep interest in data and measurement to experiment with various ingredients (individual institutional measures) and recipes (distance/risk formulas).

12. As of the writing of this book, I have developed version 2.1 of Global Acumen. The schematic does not vary much from version 2.0, though there are some slight differences. Work on version 3.0 is currently underway; it substitutes the standard Mahalanobis distance approach for the modified Euclidean distance approach I used in earlier models. So far, the output has been remarkably consistent with what I obtained from version 2.0.

13. I generated the Global Acumen spreads reported herein in January 2014. Because the sovereign debt component of Global Acumen changes instantaneously as sovereign debt is traded in real-time treasury markets, the exact Global Acumen spreads vary on a daily basis. GDP volatility (the other economic factor) changes annually, as do the political measures. The cultural measures are static (at least over the span of time for which I have data).


8 Global Acumen in Practice

1. You will recall that a more nuanced discussion in chapter 7 explained the specific (political, economic, and cultural) institutional elements that comprise Global Acumen; the algorithmic approach that combines those institutional elements to generate cross-country risk spreads; and how these risk spreads accurately and faithfully reflect cross-country institutional risk. I mentioned there how Global Acumen is only one approach to cross-country risk, and I therefore equipped interested readers to experiment with a variety of alternative approaches, merging other institutional measures in various ways using different distance and difference formulas.

2. See pages XX–XX and tables 2.1 through 2.3 for a reminder.

3. As before, we are assuming that business is conducted in USD and that there are no taxes, no depreciation expenses, and no debt. We also assume that the assets will have no residual value, which means that, at the end of the five-year period, the value of the initial investment (and the entirety of the business enterprise) is $0.

4. You will recall from chapters 2 and 7 that the discount rate is an interest rate based on some “reasonable” opportunity cost of capital—typically calculated using CAPM techniques that take into account the long-run average return (more or less) of the US stock market minus a “risk-free” rate of return on government bonds. CAPM can be expressed as $K_c = R_f + \beta_i (R_m - R_f)$, where $K_c$ stands for the opportunity cost of capital; $R_f$ is the risk-free rate (typically that associated with local US government bonds); $\beta_i$ is the specific
market beta of the company; and $R_m$ is the market return (typically the return on some index such as the S&P 500).

5. There is nothing inherently global about the original CAPM formula. $R_f$ is typically the risk-free rate associated with local domestic government bonds; $\beta_i$ is the market beta of the company in the domestic market; $R_m$ is market return in the domestic market. It is therefore unclear if CAPM is appropriate for use in global settings. Some scholars have made an attempt to modify CAPM for global markets, but CAPM has been subject to criticism for generating arbitrary values. See P. Fernandez, “CAPM: An Absurd Model,” SSRN (Social Science Research Network) working paper (2014).

6. I use 2014 Weighted Average Cost of Capital (WACC) calculations generated by http://www.stockresearching.com/ as my estimates for the opportunity cost of capital for Apple Inc. and Cisco Systems Inc. Given that WACC outputs are incredibly sensitive to their inputs and underlying assumptions, I present WACCs for illustrative purposes only. These WACCs are not necessarily the de facto WACCs for Apple Inc. and Cisco Systems Inc. Moreover, Apple Inc. and Cisco Inc. are likely to use their own internally generated discount rates for NPV and discounting purposes.

7. Although investors typically expect to receive returns in line with basic domestic cost of capital requirements (specific to the company and the industry) when companies expand globally, this assumption is admittedly an oversimplification. For example, in some cases industry risk profiles can change quite significantly from one country to another. I discuss variants to the Global Acumen model that address country-specific variation in chapter 9.

8. You will recall that, using the Global Acumen tool, I generated risk spreads that were approximately 19 percent for Russia, 15.5 percent for India, 14.5 percent for China, 10.5 percent for Japan, 4.5 percent for the United Kingdom, 4 percent for Canada, and 3 percent for Australia. See page XX.

9. You will recall the present value formula from chapter 2 as $\frac{FV_n}{(1+r)^n}$, where $FV_n$ is the future value (profit) in time period $n$, $r$ is the discount (interest) rate, and $n$ is the period (month, year, etc.).

10. Slight modifications to the revenue projections in tables 8.2 and 8.3 help drive home the point. Slightly lower revenue projections of $980 ( instead of $1,000), for example, in table 8.2 result in a negative NPV, even with a 10 percent Global Acumen risk spread and a 18.5 percent Newlandia-specific discount rate. Similarly, slightly higher revenue projections of $1,020 (instead of $1,000) will yield positive NPV results in Table 8.3, even with a 20 percent Global Acumen risk spread and a 28.5 percent Newlandia-specific discount rate.

11. Based on foreign direct investment flow data from the UN and OECD.

12. Belarus is not one of the 55 countries included in the Global Acumen database.

13. The Global Acumen database does not include Sudan, but see the Fragile States Index (FSI) (http://library.fundforpeace.org/fsi).


9 Using Global Acumen in Other Contexts

1. Stonewall Kitchen’s product lines include jams and jellies; baking mixes for breads, desserts, and pancakes/waffles; dressings and sauces; candy and confectionary; and condiments. See www.hoovers.com for sales estimates.

2. You will recall that, as in earlier chapters, political risk also includes legal and regulatory risk.


5. Nonequity alliances are those in which neither party takes an equity stake in its partner firm. Equity alliances involve some sort of equity arrangement; one or both of the companies might take an ownership stake in the other. Joint ventures are a special kind of equity alliance that forms a new, separate legal corporate entity, in which each of the partners to the alliance take an ownership stake.

6. Under the terms of the joint venture arrangement, GM and SAIC each own 50 percent of the equity in Shanghai GM, the newly created corporate enterprise.


8. This fifty-fifty split in investment costs and profitability is a simplifying assumption. There are many ways in which joint venture partners can split investment costs and profitability. Joint venture partners need not, and often do not, split the investment costs and profitability precisely by the percentage of equity interest.

9. This application is more of an art than a science, and so managers need to use some intuition and think carefully about what level of correction to implement when conducting a financial analysis of exporting. The more a company is involved in the export market—exporting directly to foreign customers—the higher the risks it bears. The less a company is involved in the export market—using an import agent and distributor to reach foreign customers—the lower the risks it bears.

10. In a real-world situation, the revenues and costs would vary substantially for different entry modes. For example, shipping costs are typically greater when companies export than when they produce goods in the local market via a wholly owned subsidiary. Prudent managers would therefore be wise to generate precise revenue and cost projections for each entry mode scenario.

11. Although I discuss here only 100-percent equity subsidiaries, joint ventures, and exporting alternatives, it is important to note that we can also tailor Global Acumen to importing, franchising, licensing, and equity and nonequity alliances. Importing in many ways mirrors exporting, and so the appropriate Global Acumen adjustment is similar to that for exporting. Franchising, licensing, and alliances other than joint ventures fall somewhere along the spectrum between exporting and joint ventures; that is, the Global Acumen risk adjustment should fall somewhere between 10 and 50 percent.

12. The equal weighting of 33.3 percent is simply for expository purposes. I based the actual weights in the baseline Global Acumen algorithm on a combination of academic research findings and the underlying correlation structure among the constituent political, economic, and cultural variables.
13. You will recall from the previous discussion that Bayer North America currently generates about $12–13 billion in sales from the Canadian and US markets.


15. Although this section discusses a company’s experience in a particular country, individual managers of that company might also have experience in a particular country—having spent extensive amounts of time working, studying, or living there. An individual manager might also be a native of the country to which the company seeks to expand. To the extent that managers believe an individual’s personal experience is relevant to a venture in a particular country, that experience can be factored into Global Acumen using a similar process.


17. Of course, if a company has been operating in a certain country for a number of years, the managers might want to use the experience-adjusted risk spread for evaluation and performance benchmarking purposes.

10 The End of the Beginning for Global Acumen

1. You will recall from throughout the book that my references to political institutions subsume legal and regulatory institutions as well.

2. Symmetric risks are those in which the distance from country A to country B is equivalent to the distance from country B to country A. Refer to chapter 7 for a reminder about why this is important in generating useful institutional risk metrics.

3. Although I describe version 2.0 in this book, the most current version of Global Acumen is version 2.1. It is similar in many respects to version 2.0, except that I made some slight changes to the measures included as inputs, which modifies slightly the risk spread outputs. As I mentioned in chapter 7, work on version 3.0 of Global Acumen is currently underway. This substitutes Mahalanobis distance techniques for the modified Euclidean distance techniques used in versions 1 and 2 of Global Acumen.

4. As one example, Global Acumen currently assumes symmetry between countries for political and cultural dimensions and asymmetry for economic institutions. It need not. One could certainly explore other formulations assuming different levels of symmetry and asymmetry. Future algorithms could possibly allow for asymmetry in both economic and political institutions, or they could accommodate asymmetry across all institutional dimensions.

5. For example, Global Acumen currently expresses risk spread output in interest rate terms in a range of 0 to 30 percent, but it need not. We could tweak the algorithm to generate spreads in another form or over a different range. A manager could use these new spreads to generate liability of foreignness cost contingencies that are applied as a percentage of revenues or costs. Moreover, we could change the design to generate spreads over just about any range. Exploring these new uses of Global Acumen’s risk spreads can yield insights into a host of real-world globalization problems.


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