Chapter 6
Evaluating Foreign Direct Investment Projects

ABSTRACT

As explained in the foregoing chapter, once the relevant cash outflows and inflows associated with a foreign direct investment project are estimated so as to calculate the net cash flows, the desirability of the investment project should then be determined in terms of its economic profitability. Therefore, in this chapter the methods widely used in evaluating investment projects are discussed and their advantages as well as shortcomings are highlighted. Later in the chapter, evaluating foreign direct investment projects from the viewpoint of the parent company is elaborated in terms of profit and/or income transferred to the home country. The same investment evaluation techniques were applied to the net cash flows transferred to the home country of the parent company. The possible income and/or dividends to be remitted to the home country of a parent company are identified and discussed so as to reflect the viewpoints of investing parent companies when planning foreign direct investments. This two-level evaluation approach is generally followed in practice to make sure that direct investments are profitable at both host and home country levels, since an investment project that is not profitable at host country level would not be profitable at home country level either or a project that is profitable at host country level may not be profitable at home country level.
EVALUATION OF INVESTMENT PROJECTS
AT HOST COUNTRY (PROJECT) LEVEL

A direct investment project, above all, is a proposal for establishing a company in a selected country (host country) and then expecting it to operate within the surrounding conditions of that country. Accordingly, its profitability should first be evaluated from the viewpoint of the host country just like a local investment proposal per se. In other words, evaluation at host country level is an appraisal of the investment project per se within the socio-economic and political conditions of the country selected for investment. If the investment project is determined to be profitable at host country level in the sense that it creates profit worthwhile for local investors in case of selling it in the future; then it would be evaluated in terms of income to be transferred to the home country of the parent company to see if it fulfills the investor’s expectations. The reason for this consecutive evaluation is that some of the profit may not be allowed to be remitted to the parent company at home. This two level evaluation is generally accepted in the literature (Eithman, Stonehill, & Moffet, 2015; Van Horne, & Wachowicz, 2009).

For evaluating a direct investment project at the host country level, all cash outflows and inflows should be denominated in the local currency of the country selected for investment. Thus, cash flows in foreign currency must be converted into national or local currency. In fact, most of the cash flows would possibly be denominated in the local currency since purchasing production factors and sales would most likely be through the local currency. However, when there are cash flows denominated in foreign currencies, they should be converted to the local currency through appropriate exchange rates. There are several classical methods that are widely used to evaluate investment projects at local country level. These methods are explained in the following subsections step by step.

The Method of the Simple Rates of Return

This method aims at calculating a rate of return which is simply the ratio of the average annual profit to the total initial investment made during the establishment (set-up) period. However, in practice, rather than computing the average annual profit over the operating period, the method simply considers the annual profit in a so-called “normal year”, which represents the operation of the project best; that is, a year in which neither revenues nor
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