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SINGAPORE SUMMIT
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IS THE GOLDEN AGE FOR MNCs OVER?

HOW CAN MNCs THRIVE IN AN INWARD-LOOKING WORLD?

MARSH & McLENNAN COMPANIES | Asia Pacific Risk Center

Introduction

Recent political and societal developments have led to a backlash against a prevailing world order that for nearly four decades has favoured globalisation and the free movement of goods, capital, innovation, and people. This will challenge the economics, business models and governance structures of established multinational corporations (MNCs).

However, while we are clearly facing a rise in "nationalism", "protectionism" and "de-globalisation", the pace of change and the end-state is unclear. There is hope that the current flux settles in an equilibrium that still allows favourable terms for global business models, but there also is a clear risk that current waves of populism could swell. MNCs need to prepare for and respond to these developments.

> " Just because you do not take an interest in politics doesn't mean politics won't take an interest in you. "
>
> – Pericles

A new world economic order

Rising protectionism and a retreat from West-led internationalism

Over the past 40 years, the world has gone through an unprecedented era of globalisation. People, capital, goods, and ideas have moved around the world with freedom not seen since the late 19th century. MNCs have been instrumental in this process. The beginnings of this transformation focused on optimising costs, as MNCs shifted production to countries with cheaper labour and spread advanced production techniques and management practices around the world. As a result, both MNC and global productivity have improved dramatically.

International collaboration and global trade deals have also greatly benefited Asian economies in the last decade, with this region becoming an important launch pad for some of the world's largest MNCs. Shareholders of MNCs have benefited from this tailwind too, as bigger markets, lower production costs, and judicious use of head office domiciles to reduce tax bills have all improved the bottom line. Our analysis shows that between 1990 and 2015, the market capitalisation of the top 50 MNCs[1] grew more than three times faster than the average publicly traded company.[2]

However, this advantageous position is now under threat. Political discourse, in part driven by more profound shifts in public sentiment and rising domestic inequality, is questioning globalisation and the political and economic policies that promoted it.

In recent years, this dynamic has played out through a growing number of political leadership changes around the world, towards groups that harbour more populist and nationalistic tendencies.

The Global Financial Crisis of 2008 proved to be the flashpoint that propelled many to re-examine the benefits and trade-offs brought about by a globally integrated economic system. In many countries, the economic consensus has shifted back towards a preference for a stronger role for the state in the oversight of markets and of corporate behaviour.

As national policies are veering away from an emphasis on international free trade, there has been a clear rise in the introduction of protectionist measures by the world's leading economies.[3] With momentum behind "de-globalisation" increasing, some

Exhibit 1: Shift in market environment assumptions

POLITICISATION OF NATIONAL AND BUSINESS AGENDA	
Distinct roles for business and government	"Bolt from the blue" government demands, but also special favours
Stability of political environment	Uncertainty with political policy continuity
Central bank independence	Political influence on central bank policy
LESS GLOBALISATION AND MORE NATIONALISM	
International co-operation, FTAs	National sovereignty and tariff impositions
Expansion of cross-border trade and investment	Slowing or contraction of cross-border flows of goods, services, and capital
Trust in international institutions	Rejection of international institutions and policies
MAJOR CHANGES IN ECONOMIC CONDITIONS	
Relatively predictable economic policies	Frequent economic experimentation with more volatile outcomes
Relatively stable financial markets	High market volatility, both short and long term
Low expected real returns	High demanded real returns to offset higher risks

Source: Adapted from Oliver Wyman Point of View "Financial Institutions in an Age of Populism" (2017)

market environment assumptions of recent decades may be reversed, as shown in Exhibit 1.

Although the current shift is unambiguously towards greater protectionism, the degree to which it will persist is not clear. A few of the liberal democracies in the West that championed free trade are starting to push back against the free movement of capital, goods and labour, with a pivotal shift in their politico-economic agendas.

On the other hand, despite similar emerging populist sentiment in parts of Asia, efforts are still being made towards greater regional banding (intra-Asian or intra-ASEAN), triggered in part by the withdrawal of the US from the Trans-Pacific Partnership.

Moreover, with economic powerhouses China, Japan and India closer home, developing economies in Asia have alternative sources of foreign direct investment (FDI) at attractive terms (the most notable being China's $900 Billion Belt and Road Initiative) and are less hesitant to steer away from Western FDI and MNCs. For example, while US FDI into ASEAN fell by 50 percent in 2016, Chinese FDI into the region increased by 44 percent the same year.[4]

One cannot discount the possibility of a return to some new version of globalisation with more favourable terms for MNCs, or a reversal in the trend towards increased populism. Our assumptions in this article are: (a) Protectionism will rise at least in the short term, and MNCs must take heed and plan for the consequences; and (b) We cannot exclude a potential rapid acceleration into populism which should be considered a crisis scenario for most global operators.

Understanding the impacts on MNCs

MNCs have increasingly become targets of attention and criticism by this new wave of nationalism. Specific events linked to tax avoidance, executive compensation, local market infractions (such as environmental standards, health safety, labour laws), accounting scandals, and government bailouts have been cited by the populists as examples of MNCs' abuse of the system.

However, not all bearings have been idiosyncratic. Trade barriers directly impacting MNCs businesses and products are being raised at a record rate – in 2017 alone, 376 discriminatory trade interventions were implemented as compared to 111 liberalising measures.[5]

Further, as developing economies mature, governments are getting smarter in supporting the local economy and businesses, and pressurising MNCs to commit more towards the local economy and broader society.

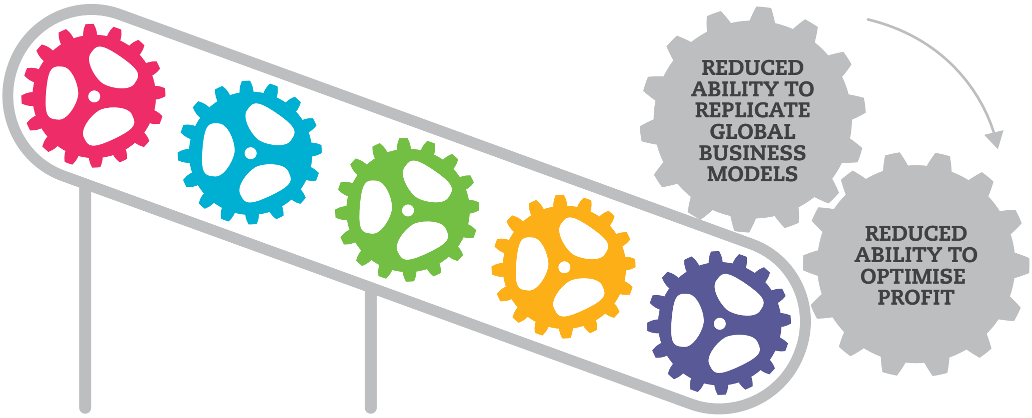
MNCs thus face a new operating environment and set of constraints – business models that delivered superior performance by tapping into multiple growth opportunities while keeping costs and financial resources lean and geographically mobile may no longer be efficient.

Unattended to, MNCs will face depressed business growth and profitability. This is already being seen: The FTSE has found that the profits of the top 700 MNCs have dropped by about 25 percent in the past five years,[6] as has the rate of return on FDI.[7]

MNCs' strategic planning and risk analyses thus need to explore many different contingent scenarios, including adverse geopolitical events. MNCs need to better understand the specific drivers and transmission mechanisms by which political shifts trickle down to impact business models and profitability. We focus on five drivers in Exhibit 2.

The impact of each of these drivers on MNCs will differ by country of incorporation, industry of operation, and geographic footprint. Here, we highlight the transmission mechanisms and likely impact of each of the drivers in the next pages.

Exhibit 2: Framework for assessing the drivers and impact of rising protectionism on MNCs' operating model



Driver 1: Increasing friction and costs in supply chains

Protectionist measures by countries lead to reduction of cost arbitrage opportunities and talent shortages across regions for MNCs

Driver 2: Tougher local competition

Increasingly, countries are establishing industrial strategies, whereby specific sectors are earmarked for overt government support, favourable regulatory treatment, and/or protection from foreign acquirers. Often, this implies conferment of national champion status, or national favouritism in tit-for-tat litigation

Driver 3: Growing political risk and uncertainty around foreign investments

Political risk has increased, across both developing and developed economies. As a result, portfolio allocation decisions have become more complex and challenging for MNCs

Driver 4: Increasing expectations of local management and governance accountability

As political systems evolve, domestic governments are increasingly putting the spotlight on MNCs' local management and boards with increasing demands for local accountability and adherence to local regulations

Driver 5: Increasing expectations to conform with broader societal demands

MNCs could increasingly become more "part of society" and behave in ways consistent with local culture and norms both in their domiciled country and in their foreign operations. This can take many flavours depending upon the country in question

Source: Oliver Wyman analysis

Drivers and transmission mechanisms of protectionist policies on MNCs

Driver 1: Increasing friction and costs in supply chains

FINANCIAL TARIFFS

Application of tariffs on imported goods and services increases production costs by adding costs at each step of the supply chain

China

- Raises tariffs on US-produced cars (including German brands) in retaliation to US tariffs
- Requires co-ownership and transfer of IP for manufacturing in China of German brands (or 25% tariffs on imports)[8]

United States

Imposes tariffs on Europe-produced car imports

European Union

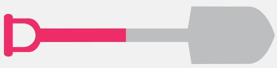
Proposes levies on 10% UK-produced models after Brexit[9]

With deeply intertwined global value chains, even those MNCs not directly impacted by tariffs, are facing disrupted supply networks and additional costs – the **NAFTA renegotiation** is threatening supply chains in North America, while in Asia, Taiwan, Korea and Malaysia supply chains are most likely to suffer from indirect impact through trade with China

RESTRICTIVE IMMIGRATION POLICIES

Barriers to legal immigration and work visa issuance lead to tighter labour markets and higher costs in attracting skilled labour

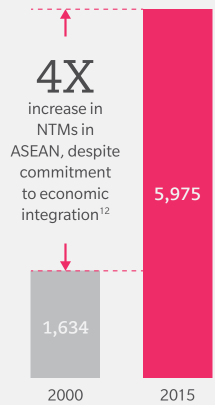
25% of US companies reported delayed projects and having to move work overseas due to H-1B visa restrictions[10]



45% of Singapore companies face serious business challenges from shrunken foreign labour supply. Construction, marine, technology and retail sectors hardest hit[11]

NON-TARIFF MEASURES (NTMs)

Outright restrictions on certain goods and services creates shortages and price volatility for important supply chain components



Driver 2: Tougher local competition

POLICY FAVOURING NATIONAL CHAMPIONS

Federal programmes or policies enacted to directly favour national players help them reach scale much faster and build defensible networks

$15 billion contract value for aircraft procurement by Indian government but with the condition to partner with domestic players for partial local manufacturing[13]

Large domestic players in the aviation sector benefit from protectionism and restriction of any significant foreign competition[14]

<5% assets represented by foreign banks in China, despite aggressive moves, due to strict regulatory requirements that are not imposed on domestic banks[15]

The Chinese and Southeast Asia ride-sharing market dominated by local players, partly due to the rules that favour them even though much larger global competitors had a head start[16]

POLICY FAVOURING LOCAL SMEs

Special protection programmes, subsidies and tax rebates provide local SMEs an extra advantage

20% of total lending provided by foreign banks in Indonesia needs to go to local SMEs, which increases the risk of non-performing loan ratios[17]

Priority to Bumiputra-controlled SMEs in Malaysia to be awarded contracts by government-linked companies

To protect SMEs in retail, India for a long time restricted FDI in the retail sector, effectively blocking global retail players

Post-GFC, pressure has been put on banks to relax lending conditions for SMEs which may lead to lower cost-efficiency for banks

30% of local procurement requirement imposed by government of India on a leading furniture retailer, thus forcing it to change its global business model[18]

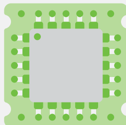
Driver 3: Growing political risk and uncertainty around foreign investmentst

POLITICAL TENSION BETWEEN COUNTRIES

Political risk has increased, across both developing and developed economies. As a result, portfolio allocation decisions have become more complex and challenging for MNCs

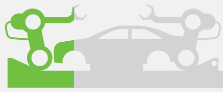
$1.3 billion
acquisition bid of an Indian drug maker by a Chinese pharmaceutical firm rejected by the Indian government in 2017 amidst rising political tensions[19]

$121 billion
acquisition bid by Singapore-based Broadcom for US chipmaker Qualcomm rejected by US government on national security concerns[20]



VOLATILE POLITICAL ENVIRONMENT

Radical shifts in government philosophy due to leadership changes or populist sentiments result in higher investment hurdle rates to account for political risk



33% fall in Britain's car industry production investment (from $3 billion to $2 billion annual) after the Brexit vote[21]

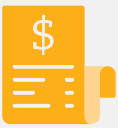
50% reduction in foreign investment pledges to the Philippines following the government change in last election[22]

$13 billion
worth of foreign infrastructure programmes put on hold in Malaysia following the change in government[23]

Driver 4: Increasing expectations of local management & governance accountability

LOCALISED DATA AND COMPLIANCE

Data laws which designate customers as a national asset increase local compliance costs, and in extreme cases reduce viability of business models



$7 billion estimated annual fines for FTSE 100 companies for non-compliance with EU General Data Protection Regulation[24]

Increased costs and operating model changes for MNCs operating in China to comply with 2017 Cybersecurity law requiring local data servers[25]

INCREASED SUBSIDIARISATION

Companies are forced to incorporate in local countries which increases costs and management layers and introduced risks of ringfencing

As domestic regulations tighten, financial institutions have to create subsidiaries in different countries, which creates diseconomies of scale, greater complexity, and inefficiencies

With Brexit, UK's financial institutions will lose their "passporting" rights into EU. Fully authorised subsidiaries inside the EU will have to be established to continue EU-related activities

Driver 5: Increasing expectations to conform with broader societal demands

INCREASING STAKEHOLDER EXPECTATIONS OF GOOD "CITIZENSHIP"

Shareholders, governments and local customers are increasingly expecting companies go beyond "adhering to regulation" and to show leadership in demonstrating corporate responsibility

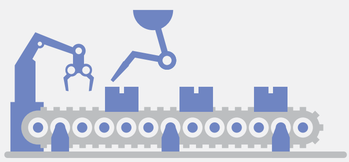
<1% assets devoted to ESG investing in Asia compared to 26% of total managed assets globally. Pension funds under greater scrutiny to align portfolio with ESG investing[26]

Several Asian and international banks have faced reputational risk of being lenders to companies contributing to environmental damage

2% of annual net profits required to be spent by corporates in India on local CSR activities[27]

INCREASING RISK OF BECOMING TARGETS OF PUBLIC PROTEST

Public backlash can influence political decisions impacting MNC operations



Protest movements against MNCs growing in number and impacting policy

$0.5 billion estimated loss for a MNC food manufacturer in India when backlash by media and public led to government ordering a product recall and halt of production of instant noodles[28]

How should MNCs adapt to the new world order
Watchpoints for boards

To successfully navigate against these headwinds, MNCs will need to fundamentally rethink their business models and governance principles. Boards need to steer away from stretched global footprints to deeper country connections, achieving greater local scale, accountability, recognition, and resilience, while still benefitting from global capabilities to the extent possible. Successful MNCs will bear four hallmarks.

Hallmark 1: From profit-driven shareholder value to full stakeholder accountability

As traditional short-term profit maximisation efforts come under fire, the emphasis will shift towards medium-term strategies incorporating requirements of local markets and governments.

Responsible and sustainable corporate behaviour must be built into the business and operating model for all markets the MNCs operate in, rather than being a global philanthropic appendage.

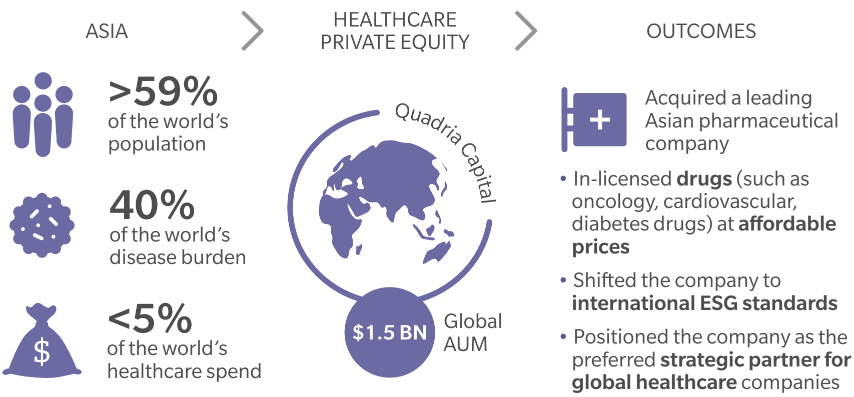
There can be no universal prescription as to how social accountability can be met, as this is specific to each enterprise, the market it operates in, and the local stakeholder priorities.

It embraces responsible behaviour in a many different situations, through stronger focus on customer protection and good conduct, environmental-friendly production, transparency on tax and remuneration policies, and retraining of employees whose jobs have been made obsolete by automation.

MNCs in Asia that have demonstrated a successful balance between their core businesses and social responsibility have created competitive advantage through customer trust and general stakeholder goodwill. A few examples include:

- **LG Electronics** evaluates its 4,000 suppliers across several markets, not only on commercial aspects but also on compliance with human rights, employee safety and health, as well as quarterly evaluations on a CSR performance index to ensure that its suppliers are also contributing back to their local regions[29]
- **Quadria Capital,** one of Asia's largest private healthcare investors, leverages its financial

Exhibit 3: Quadria and its ESG investment in Asia



Source: APRC analysis

capital to develop sustainable and profitable business models that create equitable healthcare access. For example, Quadria acquired a leading pharma company in Asia and in-licensed, at an affordable price point, life-saving drugs that were previously not available in the emerging Asian markets[30]

- Japan's **Sumitomo Forestry's** "Timber Procurement Philosophy" promotes sustainable tree planting in its source markets such as Indonesia, Papua New Guinea, and New Zealand, and provides technical expertise as a service to local governments and communities in Asia, for the preservation and restoration of degraded forests[31]
- 99 percent of coffee sold by **Starbucks** in Japan is ethically sourced, with the company engaging local suppliers and communities, and accelerating investment in sustainable farming where it operates. Similarly, **Fraser & Neave**, a leading Asia-Pacific consumer group, committed to source only sustainable palm oil for its food and beverage operations to support the regional efforts to combat the haze problem[32]

Hallmark 2: From global to glocal business and governance models

MNCs now need to pay greater attention to shifting local political and regulatory landscapes. They need to have strategic agility with business model fluidity and compartmentalisation that enables them to respond to changes faster and play in markets until obliged to exit. They can streamline their risk monitoring, reporting and management frameworks to have greater real-time visibility of emerging risks.

Standard Chartered Bank for instance, has announced plans to consolidate as many as 10 Southeast and South Asian countries under its new Singapore subsidiary to allow the bank to manage its capital and liquidity more efficiently and to potentially reduce the size of the emergency buffers regulators require the bank to maintain.[33]

Alternatively, MNCs can also consider more localised and tailored business models in which subsidiaries are strengthened and granted greater autonomy and local decision-making power, creating strong controls locally. In this case, MNCs would need to evolve from a model of globally integrated enterprises to a tightly managed federation of quasi-independent subsidiaries that are united by specific areas in which economies of scale are still possible.

From an operational perspective, this may include deepening relationships with local supply chains and production processes in their subsidiaries.

For example, **General Electric (GE)** in 2015 announced dramatic plans for localising production in national markets, citing the rising risks of "a protectionist global environment."[34] GE's plan was to spread out by building new factories in different emerging markets to give it increased flexibility to shift production between different locations if required.

As Jeffrey Immelt, then-CEO explained, "We used to have one site to make locomotives. Now we have multiple global sites. A localisation strategy can't be shut down by protectionist policies."[35]

At the extreme end of this spectrum, a private equity-like model may emerge as a real alternative to current incorporations.

The decentralised model for most MNCs means pushing back against a decades-long move towards globalised organisational structures with "ambassadorial" local management and accountability. Also, there are potential trade-offs between the centralised and de-centralised operating models such as the speed and quality of decision making versus investment required to build up the local governance framework (in terms of manpower, processes and the like).

For example, **Uber** and **AirBnB** had a period of explosive growth when they drove their global expansion via a central platform, and then quickly responded by increasing investments in local offices when their business model came under scrutiny and governments asked for more local compliance.

In the context of proliferating geopolitical risks, global boards need to engage more with management, especially in politically volatile markets. It is critical to have directors who possess deep political sensibility and local contacts in key markets and regions to provide valuable insights and guidance to management. Geographic diversity on boards adjusts the lens through which strategy and risk are examined and provides insights into political risk that can be quite nuanced.[36]

Hallmark 3: Intellectual property as the new organising principle

Boards need to re-examine their firms' competitive advantage, and determine whether it is scalable and sustainable in a world with more borders.

The new competitive high ground will be occupied by firms that capture the value of intellectual property (IP), the one corporate asset that cannot easily be stopped or taxed at borders.

With investments in digital technology, MNCs can preserve key elements of competitive advantage, such as spreading innovations and benefitting from global scale. Outperformance will come from organisations that can capitalise on their IP to support global innovation and agility, demonstrating the ability to renew, adapt, change quickly, and succeed in changing environments.

The IP can take several forms depending upon the nature of business. In addition to product patents, trademarks and copyrights, the innovation could be in technology-based platforms, digital solutions as well as new business model and ecosystem design.

As businesses transition into the digital world, the ability to fully capitalise on valuable IP increases: IP creation and tailoring to local social accountability requirements rely on big data techniques for insights.

Technology firms have successfully disrupted traditional businesses by ensuring that the IP embedded in their technology platforms could be scaled globally, tailored quickly to local market needs, and subsequently fine-tuned to adapt to emerging client demands.

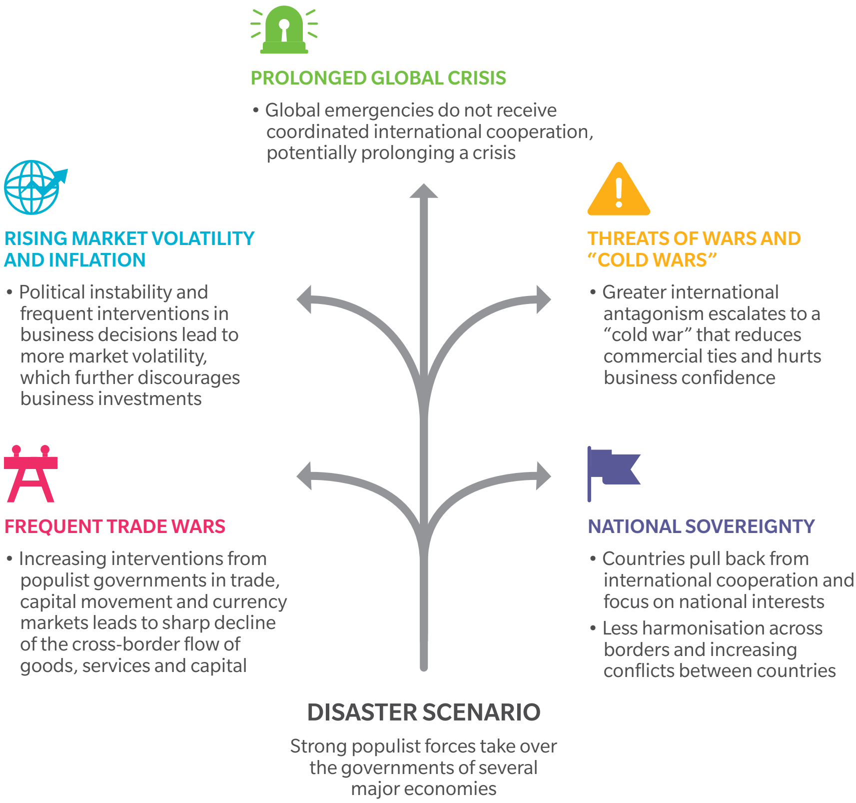
Asian MNCs from China such as Alibaba, Tencent, Baidu, Ping An, and BYD, as well as the Korean conglomerates such as Samsung and LG, have heavily leveraged their IP to break into markets with accelerated time-to-market, fast propagation of best practices, innovation and insights across the global network, despite traditional organisational rigidities.

Hallmark 4: Hope for the best, prepare for the worst

There is a possibility that MNCs could face a disastrous scenario in which strong populist forces take over the governments of several major economies, ushering a wave of strong nationalism and protectionism.

Although the current direction of change towards protectionism is clear, neither the pace of this change nor the long-term ability to deliver on its promises is given. But increasing populism could potentially play a much larger role in several markets in the next several decades and upend the global economic order. (See Exhibit 4 next page).

Exhibit 4: Potential crisis scenario driven by populism



Source: APRC analysis

Assuming the shift to populism accelerates, the five drivers we described earlier could all come into play together with greater magnitude of impact and synergistic effects, and the potential consequences for an unprepared MNC could be disastrous.

Most mature companies use scenario testing to assess strategic plans and evaluate how to best mitigate potential downturns. However, much of this tends to be done using individual scenarios on a global business portfolio, or multi-scenario on a single business.

An analytical approach that is both creative and pragmatic is essential for respecting the inherent messiness of complex uncertainties.

The risk identification process needs to be explorative and iterative. Boards need to switch to a war game mindset and stress test a wider range of potential conditions for globally connected impacts. It is important to design strategies that are more robust and provide more options to alter if adverse conditions are encountered.

How should MNCs adapt to the new world order The way forward for management

Management will face significant complexities managing profits and balance sheets across increasingly hardened national borders, and evolving their business models to better fit the four hallmarks we describe previously.

The greatest strategic challenge will be to ensure that the corporation's mission balances the conduct of its core business with its social responsibilities in each of its countries of operation.

Management should track how social accountability initiatives create competitive advantage through better talent retention, customer trust, and general stakeholder goodwill, to balance the higher costs with potential business benefits.

Boards will play an important role in challenging the business model and governance arrangements, including seeking assurance that local subsidiaries are empowered to fine-tune local strategies but that robust corporate governance is not impaired.

Senior management of MNCs will therefore place a premium on understanding and manoeuvring multiple challenges and cultural perspectives, while corporate governance charters create more accountability for local management.

This could mean leaner headquarters and stronger subsidiaries in terms of financial resources, skills, and operating platforms – combined with leaner corporate headquarters fostering effective collaboration, best-practice sharing, and exchange of experiences/IP.

MNCs will need to emulate IP-spreading practices and organisational principles that are found in fully-digital business models to satisfy client, product, and regulatory trends, fine-tuning supply chains and production processes.

MNCs will need to assess how their brand is perceived in local contexts, whether it still carries the foreign persona or is perceived as being an integral part of the local culture.

Brand perception often paves the way to build a distinct market-specific cultural legacy by telling a story about why the company does what it does and the value it brings not only to global customers but to local customers, country agendas and the wider community.

Finally, all MNCs will need to re-think their strategic planning and risk management practices.

Significant onus must be put on collaboration between the Strategy, Finance and Risk functions.

This can provide the board with clear and feasible plans relating to increasingly complex cost-benefit analyses of the strategic options available. Additionally, it can also provide the board with contingency plans for scenarios that can become embedded in one country, but have global impact.

Protectionism is upon us and currently looks like gathering pace. MNCs need to be awake to the challenge and adapt.

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