Moving Targets

Higher taxes and stricter regulations may be the trigger for financial institutions to reconsider where they base their operations. But, say **Jack Anderson, Marc Miles** and **Michael Segalla**, there are many other factors which they should take into account and it is possible to measure the benefits offered by the competing financial centres.

Changes in the American and British tax and regulatory regimes are imposing excessive burdens on financial institutions. In the United States, hedge funds and private equity could lose up to $50 billion, while the British government also plans to raise capital gains tax rates on alternative investment management to a level which will potentially equal the amount of the US burden.

These factors alone would be enough to make these organisations reconsider where they base their business, and particularly where they expand them. But it should only be one of the factors affecting the decision. There are additional – and potentially more important – components.

There is now an analytical model which will help managers decide which location offers the best opportunity in light of a tax and regulatory environment that is telling them not to follow the herd to New York or London. There are promising new markets with substantial and growing trillion-dollar-plus pools for investment – and they are looking for local management of their funds.

First it is necessary to examine what today governs the decisions of the executives and managers of alternative investment management companies when they are deciding whether to stay where they are, move to a new location, or just try something new.

The simple answer is incentives. Business people respond to incentives that improve their lives. That decision usually focuses on increasing profits by enlarging the bottom line. This is patently under threat from American and British tax and regulatory changes.

Today, managers do not have to grin and bear this pain. In this internet age investment managers are very mobile. Buying and selling most securities can be done quickly and easily on a wide choice of global trading platforms. Money for investing in specific locations can come from almost any corner of the world. So the revenue will be pretty much the same regardless of where the business is located.

But profits can be quite different. Borders create opportunities. This

is true whether comparing Hong Kong with Qatar, countries within the European Union, cantons within Switzerland or states within the United States. Regulations and other costs differ, and business people look for opportunities that will provide the best profit with the least hassle.

Costs reduce net profits, and the costs of workers, land, office space and meals can differ greatly across borders. Out-of-pocket costs are only part of the equation. Once these are subtracted, there is still the question of how much of the remainder managers and executives get to keep. Taxes can include payroll taxes for workers' health or retirement, on the business's gross profit, on executives' income, on managers' assets, VAT on purchases, or other fees.

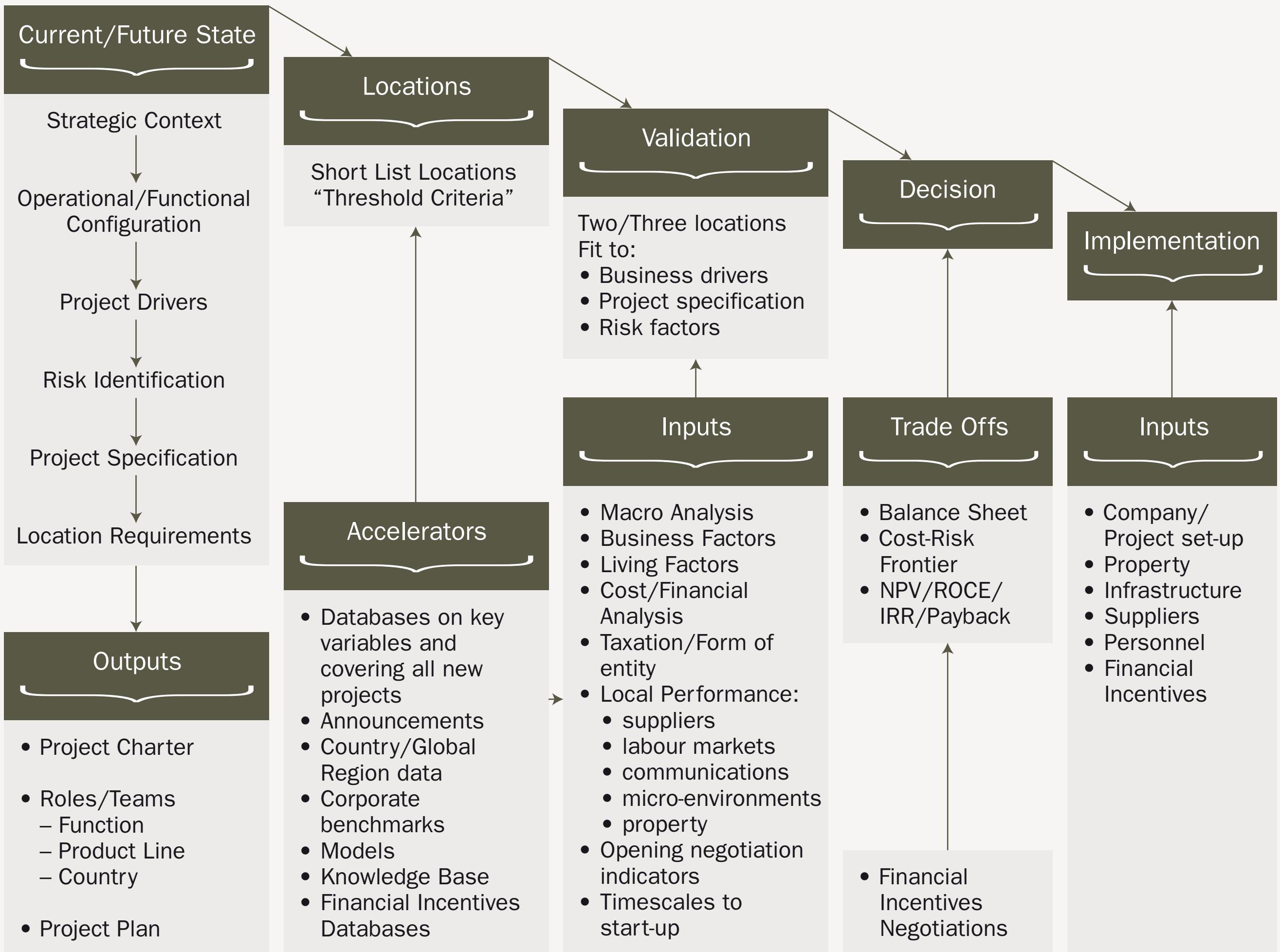
The prudent manager will check out differences in these costs through sources like the Forbes Magazine Tax Misery Index. In the most recent index, Qatar was second only to the United Arab Emirates in terms of lowest total tax rates – and Qatar's tax reform will bring it to levels even lower than the UAE in 2008.

These costs are having an identifiable impact. The low, flat-tax revolution in Central and Eastern Europe, for example, is putting competitive pressure on the Western European countries. Ireland has flourished in the decade since it adopted a flat 12.5 per cent tax on all corporations. Feeling the competitive heat from Slovakia's 19 per cent rate, in 2005 Austria lowered its corporate tax rate from 34 per cent to 25 per cent to discourage businesses from slipping across the border.

There are also competitive pressures on labour costs. German workers at both Volkswagen and Siemens agreed to longer work weeks at the same pay to prevent their jobs from moving to lower cost Eastern Europe. This year Proctor and Gamble announced plans to shift skincare product production from Ireland to Poland because pay differentials were just too enticing.

Equally important are regulations on labour, financial markets, ownership and other areas. They are legitimate laws to some, but they also raise the cost of doing business. Of particular

LOCATION DECISION MATRIX



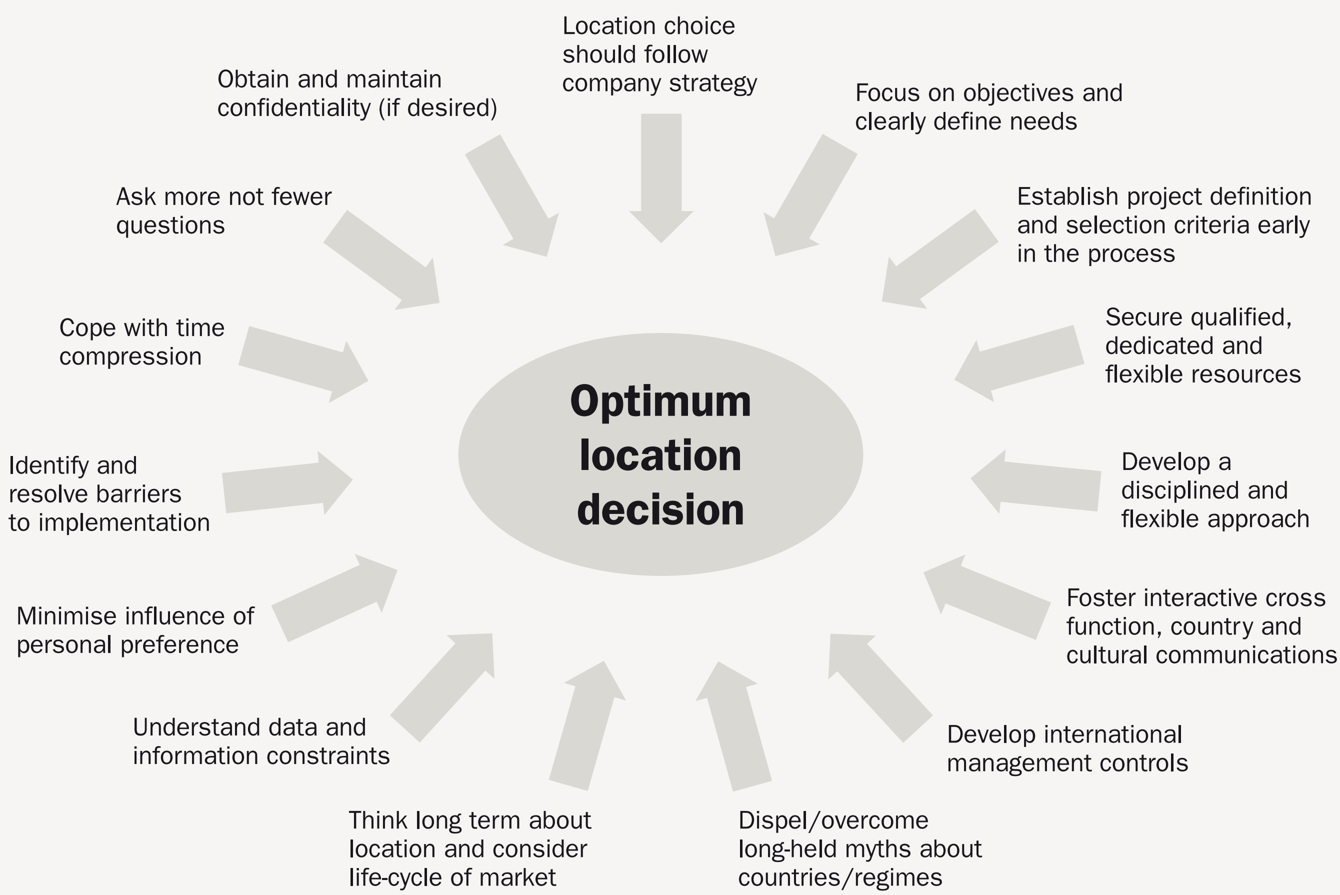
importance is whether a company can own its business outright or must find a local partner. Too often regulations are adopted without considering how the law of unintended consequences can boomerang. To many Frenchmen the maximum 35-hour working week and right to retain their jobs are part of a “civilised” life. Yet to employers they are handcuffs discouraging both hiring and investment.

But there are also the less tangible hassle factors. Of course, the number of days it takes to start a business is important, but what happens once you are registered? It is important to understand what other bureaucratic hoops must be jumped through in setting up or conducting business. Manufacturers need to know how long their products are delayed at borders.

Uncertainty is a cost that must be covered by insurance, derivatives or leaving investments at risk. Bribes subtract from the bottom line. So strong, rigorously enforced laws are essential to ensure others keep their word and to protect profitable investments. A strong tradition of private property protection may explain why financial markets thrive in Hong Kong but are only just emerging in Shanghai.

This is far from the first time that financial institutions have been prepared to relocate. Some three decades ago, the initial catalyst for the rapid growth of the Eurodollar market was triggered by restrictions on the interest America-domiciled banks could pay on deposits, and the reserves they had to hold to back them up. The Eurodollar market was a convenient avenue to get around

KEY SUCCESS FACTORS



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those regulations. As American and other regulators tried to rein in this new financial market with more regulations, the market simply fled to more receptive countries. The same thing happened when the Bundesbank tried to control Euromark activity in 1968. Germany's regulations became Luxembourg's gain.

For the last two decades there has been much academic research focusing on identifying and studying the variables that affect their decisions on where to locate – and multinationals routinely use these results to analyse and guide their own strategic location decisions.

This objective and independent analysis is complemented by annual opinion surveys of the chief executives of the 500 largest companies in the world. These studies identify and verify the key factors important for location decisions and they are constantly updated to reflect changing economic and political conditions. In addition, leading alternative investment management firms are surveyed for their unique and more highly-weighted strategic factors.

Extra useful information comes from the many national, regional and city governments which actively promote the benefits of their own jurisdictions. Usually they also provide data about how tax and regulatory factors are offset by other criteria.

This approach to site location analysis was further developed with the HEC School of Management (Paris) through detailed analysis of site location decisions of over 170 US, European and Asian multinational companies. As a result, a detailed analysis of key location factors emerges, and this can be presented in three categories on which companies can base their decisions.

ASSESSING THE QUALITY OF GOVERNANCE

The consistency of governance is affected by a measure of political risk faced by each company. The quality of public institutions is compared to the overall competitiveness of the location, creating a ranking by strength in these areas.

Political stability measures wastefulness of government spending, public trust of politicians and effectiveness of law-making bodies. Security is measured in terms of reliability of police service, business cost of crime and violence and business cost of terrorism.

The policy and regulatory environment is determined by property rights, foreign ownership restriction and effectiveness of anti-trust policy. Bureaucracy is measured by prevalence of trade barriers and burden of government regulation.

Financial institutions robustness is composed of financial market sophistication, soundness of banks and strength of auditing and reporting standards. Financial environment requires an analysis of the rates, number and effect of taxation, ease of access to loans and venture capital availability.

The legal environment is determined by the efficiency of the legal framework and the independence of the judiciary. Transparency and ethics are shown by favouritism in the decisions of government officials, the ethical behaviour of firms and the freedom of press.

The first step is to make an initial comparison of locations in terms of their competitiveness, growth competitiveness, technology availability, public institution quality and reliability. The pace of GDP change and inflation creates growth opportunities and risks, as does population growth. The quality of life and cost of living must be compared as this is important for attracting skilled top alternative investment management talent.

Then we make a more detailed comparison, focusing on institutions, infrastructure, macro economy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication, innovation and cost of living. Also important are country-specific problems for business, including quality of infrastructure, availability of financing, workforce skills, restrictive labour restrictions, government bureaucracy, and the presence of the rule of law.

This makes it possible to do a quick SWOT analysis of alternative locations and should then be

OTHER FACTORS AFFECTING THE FINAL DECISION

Infrastructure quality depends on the quality of roads and transportation links and the quality of telephone and internet infrastructures.

The strength of human resources is determined by hiring and firing practices, private sector employment of women, the flexibility of wages and the ease of hiring and firing. Operations costs are then monetised and ranked by comparing base salary, increases and office rents.

Innovation and diffusion of technology are measured by technological readiness, quality of scientific research institutions and availability of scientists and engineers. Related education and training factors are measured by the quality of the education system, quality of management schools and local availability of specialised research and training.

QUALITY AND COST OF LIVING

A. Political and social environment (relationship with other countries, internal stability, crime, law enforcement, and ease of entry and exit for immigration); economic environment (currency exchange regulations, banking services, etc); socio-cultural environment (limitations on personal freedom, media and censorship, arts and institutional support of arts); medical and health considerations (hospitals, medical, infectious diseases, water, waste removal and air pollution); schools and education; public service and transportation (electricity, water, telephone, web and internet connections, mail, public transport, traffic congestion and airport service); recreation (restaurants, theatres, concerts, cinemas and sport and leisure activities); consumer goods (food, consumables, automobiles, etc); housing; and natural environment (climate and natural disasters).

B. Cost of living is measured in terms of general costs, schools and education, medical and heath, food and drink, household goods and services and consumer goods.

followed by an economic analysis which examines GDP, trade and consumption and saving rates. Insights to the future are gained by comparing the macro-economic performance to growth potential. Future potential is contrasted to economic risk in terms of sovereignty, currency stability, openness and strength of banking sector, and political and economic structure risk. The result is a benchmark of economic strength for each location.

A critical element of this process is an assessment of governance, whose attractiveness is determined by a series of factors, other factors such as the operational costs of infrastructure and the quality and cost of living (see sidebars).

The next challenge is to put this information into a form that can help the decision-making process. A matrix is constructed using these three measures of relative attractiveness, First, the location decision matrix illustrates the key steps in moving from the current state to implementation. Then, based on our experience, a timeline for each step is created. This is followed by creating a range of comparative variable location factors, and then accelerators for completing the analysis more quickly are shown in terms of support tools and knowledge bases to be used in deciding on a location.

Implementation steps are detailed from company set-up to realising, if any, government-negotiated financial incentives. Ultimately it is up to each company's location decision team to keep in mind the key success factors shown. The message for alternative investment management companies is clear – they need to engage in strategic thinking about the location of their operation. **Q**