



JAPANESE INVESTMENTS IN SOUTHEAST ASIA: WHAT RISKS TO EXPECT IN 2019

Commercial relations between Japan and Southeast Asia continue to expand, though Japanese firms still face persistent issues, together with emerging risks as they invest in the region. Pervasive corruption, regulatory uncertainty, poor corporate governance and opaque supply chains are some of the problems Japanese investors should expect to deal with in Southeast Asia.

Japanese Push Across Southeast Asia

According to the Japan External Trade Organization, direct investment in Southeast Asia by Japanese companies totaled USD\$22 billion in 2017, twice as much as in 2012. By contrast, Japanese investment in China decreased by 30 percent over the same period, to USD\$9.6 billion.

Japanese manufacturers have long been setting up parts of their supply chains in Southeast Asia to complement facilities in mainland China. This so-called “China Plus One” strategy appears set to continue to expand in 2019 in the context of trade tensions between the U.S. and China.

The Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) that entered into force in December 2018 further contributes to the location of Japanese investments in Southeast Asia. The CPTPP includes Japan, Vietnam, Malaysia, Singapore and Brunei with Thailand considering joining. The treaty provides mutual trade and investment benefits to its members through the reduction of tariff and non-tariff trade barriers, which incentivises Japanese corporations to expand their supply chains in CPTPP member countries.

A November 2018 report by Mizuho highlights not only the expansion but also the sectoral and geographic diversification of Japanese investments across the ten countries that belong

to the Association of Southeast Asian Nations (ASEAN). In 2017 and 2018, Thailand and Indonesia saw significant increase in Japanese investments in the automotive sector; Vietnam in machinery and retail; Malaysia in chemicals and pharmaceuticals; and the Philippines in semiconductor manufacturing.

Among the low-cost labour countries of ASEAN, namely Laos, Cambodia and Myanmar, the latter has seen continuous and significant growth in Japanese investments since 2014 according to Mizuho. Most are located in the Thilawa Special Economic Zone and targeting domestic demand including steel and pesticides.

Politics in Flux

There are significant political changes for Japanese investors to look out for in Southeast Asia in 2019. The adversarial stance adopted by President Trump against China resonates with Southeast Asian countries that have watched Beijing’s expansion into the South China Sea with concern. However, China is already ASEAN’s main trade partner, a relationship that is expected to grow due to infrastructure projects under the Belt and Road Initiative (BRI), as well as investments by Chinese e-commerce firms into a region enthusiastic about technology. How to balance the U.S. and China without having to choose one superpower over the other is an existential question for a region that was deeply affected by the Cold War.

Against this geopolitical backdrop, there will be several national elections in 2019. The first took place in Thailand in late March, where a new monarch has been asserting his status, the military junta has had difficulty relinquishing its power and Thaksin Shinawatra continues to hope that favourable polls will allow for his long exile to end.

The general election, together with a new constitution aimed at securing the interests of the royal, military and business establishment against those of Thaksin and his supporters, neither upended the country's order nor provided a lasting solution to the deep political divisions that have affected Thailand since the mid-2000s. It distracted however from steering ASEAN in a year where Bangkok holds the Association's chairmanship, and from making progress on certain economic projects such as the Eastern Economic Corridor.

Another Southeast Asian poll took place in mid-April in Indonesia where, for the first time, presidential and general elections were held on the same day. President Joko Widodo is expected to be re-elected for a second mandate, one during which he should continue his focus on the development of infrastructure aimed at improving connectivity in the Indonesian archipelago.

Infrastructure development is also a key component of President Rodrigo Duterte's agenda in the Philippines, in the form of the "Build, Build, Build" program. A general election mid-May is expected to strengthen the hand of the Philippines' leader, whose domestic popularity remains high despite concerns over the extent of his violent crackdown on drugs.

Politics in Flux

Even considering these geopolitical tensions and upcoming polls, political risks to Japanese investors remain relatively subdued in Southeast Asia. Political transitions that upend economic policies are few and far between. Pakatan Harapan's victory in Malaysia last year was the first change in ruling party since the country gained independence in the 1960s.

The economic and political rise of China has led to an emergence of an alternative model of development to that offered by the West. This has in part led to a reduction of punitive actions by the U.S. and the EU in retaliation to human rights abuses in Southeast Asia. After the violence against the Rohingya minority in Myanmar, the U.S. and European Union adopted targeted sanctions that did not hit the military's leadership and conglomerates, while consumer

boycotts against multinational corporations doing business in the country did not gain traction.

Regulatory uncertainty poses a more significant threat to Japanese firms. Politicians, state-owned companies and well-connected businesspersons regularly push policy changes that favour local players to the detriment of foreign investors. An example of this can be found in the oil & gas and mining sectors in Indonesia, where resource nationalism is a decade-long trend. Emerging regulatory risks increasingly affect trade and the digital economy, for instance through data localisation requirements outlined in Vietnam's recent cybersecurity law.

Poor corporate governance also creates significant legal, business and reputational risks to Japanese investors in Southeast Asian countries. Corruption and fraud remain most prominent and persistent among those risks, as illustrated by the scale and political ramifications of the IMDB scandal in Malaysia. Japanese corporations rely on a multitude of agents and suppliers in Southeast Asia that provide them with manufacturing components, workers or government permits. These third parties can pose significant risks if they are found to engage in bribery to secure licenses, or to mistreat migrant workers.

Strategies to Mitigate Risks

Assessing and mitigating regulatory risks is challenging in ASEAN, a group of ten countries with different political and legal systems that engage in minimal coordination and harmonisation of their economic and trade policies. FTI Consulting provides political and regulatory intelligence to assist clients to prepare for and influence upcoming reforms that impact their bottom line.

We also support our clients undertake in-depth due diligence in the context of their M&A transactions in ASEAN. As part of the broader offering we can assess and, where necessary, help enhance compliance programs in the Southeast Asian subsidiaries of our clients as well as, post transaction, in acquired entities and joint ventures.

Precautions can also be extended to broader supply chains in Southeast Asia to mitigate legal and reputational risks posed by third party unethical behaviour. Conducting measured due diligence on suppliers and agents is an effective step, combined with localised training and regular auditing being undertaken, particularly in high-risk sectors.

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