FIN 444

OVERVIEW OF INTERNATIONAL FINANCE
CHAPTER 1

ANY FIRM THAT ENGAGES IN SOME FORM OF INTERNATIONAL BUSINESS can be considered an MNC. Examples – Coca Cola Co. – 160 countries and 40 different currencies – 60 % of annual operating income is generated outside the US.

What is the AGENCY ISSUE?

- Any manager who does not own 100 % of the company is an agent of the owners of the company.
- The agency issue is the idea that while financial managers recognize the goal of shareholder wealth maximization, they are also concerned with personal wealth, job security and fringe benefits. Such concerns may make a manager reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might jeopardize their jobs or reduce their personal wealth.
- THE RESULT is less than maximum return and a potential loss of wealth for the owners.

What is the AGENCY PROBLEM?

- The likelihood that financial managers may place personal gorals ahead of corporate goals.

How can corporations solve the AGENCY PROBLEM? – Market force and Agency costs.

- MARKET FORCE
  - MAJOR shareholders can exert pressure on management to perform. When necessary they can use their voting rights to replace management.
  - Threat of takeover – motivates management to act in the best interests of the firm's owners.
- AGENCY COSTS
  - The cost of monitoring management behavior, ensuring against dishonest acts of management AND giving managers the financial incentive to maximize share price.
  - COMPENSATION PLANS
    - INCENTIVE PLANS – tie management compensation to share price. E.g. grand stock options to management. Managers can buy stock at market price at **time of the grant**, and if the market price rises they can sell their shares for a higher price.
    - PERFORMANCE PLANS – tie management compensation to EPS and growth in EPC. Performance shares – shares of stock given to management as a result of meeting the stated performance goals are used in these plans.
    - CASH BONUSES – cash payments tied to the achievement of certain performance goals.

Q. **HOW IS THE AGENCY PROBLEM DIFFERENT FOR MNCs?**

Agency costs are normally larger for MNCs than for purely domestic firms.

- The sheer size of the MNC.
- The scattering of distant subsidiaries.
- The culture of foreign managers.
- Subsidiary value versus overall MNC value.

Impact of Management Control

- The magnitude of agency costs can vary with the management style of the MNC.
- A *centralized* management style reduces agency costs. However, a *decentralized* style gives more control to those managers who are closer to the subsidiary's operations and environment.
- Some MNCs attempt to strike a balance - they allow subsidiary managers to make the key decisions for their respective operations, but the decisions are monitored by the parent's management.

Constraints Interfering with the MNC's Goal

As MNC managers attempt to maximize their firm's value, they may be confronted with various constraints.

- Environmental constraints. – e.g. building codes, disposal of production waste materials, pollution – CARBON FINANCE
- Regulatory constraints – e.g. taxes, changes in political environment, excessive protection of employees
- Ethical constraints – US firms loose over $50 billion to international business transactions because of bribes paid by foreign competitors. Should firms follow a worldwide code of ethics?

Why are firms motivated to expand their business internationally?

- To Expand Sales
- To Acquire Resources
    - Financial Resources
    - Human Resources
    - Technological Resources
    - Natural Resources
- To Minimize Risk
    - Expansion of Technology
    - Liberalization of Cross-Border Movements
    - Development of Supporting Institutions
    - Consumer pressures
    - Increase in Global Competition

THEORIES OF INTERNATIONAL BUSINESS

1. Theory of Comparative Advantage – Certain countries have certain advantages (e.g. Japan and technology) and these advantages cannot be easily transported. When a country specializes in some products, it may not produce other products, so trade between countries is essential. This is the argument made by the theory of comparative advantage – it allows MNCs to penetrate foreign markets, e.g. telecom, tourism.
2. The Imperfect Markets theory – An imperfect market is a Market in which some of the producers and/or consumers are significant enough to affect the price and quantity of goods by their actions alone. Even with comparative advantages, the volume of international business would be limited if all resources could be easily transferred among countries. The perfect market, as defined in economic textbooks, is not a truly achievable goal, but is still a beneficial model that provides a starting point for observation of our present market status. Practically, the imperfect market is the only kind that really exists. Even in the United States, the most advanced financial market in the world, there are still numerous cases of price corruption, improperly disseminated information and other market inefficiencies. Because of this firms often capitalize on a foreign country's resources. Imperfect markets provide an inventive for firms to seek out foreign opportunities.
3. The Product Cycle theory – the most popular theory. Theory suggesting that a firm initially establish itself locally and expand into foreign markets in response to foreign demand for its product; over time, the MNC will grow in foreign markets; after some point, its foreign business may decline unless it can differentiate its product from competitors.

INTERNATIONAL BUSINESS METHODS

MNCs use several methods to conduct international business.

INTERNATIONAL TRADE – Relatively conservative approach that can be used by MNCs to penetrate markets by exporting or to obtain supplies at a low cost by importing. This approach entails minimal risk because the firm does not place any of its capital at significant risk. Most MNCs generate income through sales from exporting.

- Internet and international trade.

LICENSING – Obligates a firm to provide its technology (copyrights, patents, trademarks etc.) in exchange for fees or some other specified benefits. E.g. AT&T and Verizon Communications have licensing agreements to build and operate parts of India's telephone system, COSTCO. Licensing allows firms to use their technology in foreign markets without a major investment in foreign countries and without the transportation costs that result from exporting. Disadvantage – quality control in foreign production process.

FRANCHISING – obligates a firm to provide a specialized sales or service strategy, support assistance, and possibly an initial investment in the franchise in exchange for periodic fees. E.g. KFC, PIZZA HUT etc. Franchising allows firms to penetrate foreign markets without a major investment in foreign countries.

JOINT VENTURE – jointly owned and operated by two of more firms. Examples?

ACQUISITIONS OF EXISTING OPERATIONS – subject to the risk of large losses, because of the large investment required. Some firms engage in partial international acquisitions in order to obtain a stake in foreign operations. This requires a smaller investment than full international acquisitions and therefore exposes the firm to less risk. Disadvantage – less control.

ESTABLISHING NEW FOREIGN SUBSIDIARIES – Involves a large investment. Smaller investment may be required than would be needed to purchase existing operations. However the firm will not reap any rewards from the investment until the subsidiary isbui8lt and a customer base established.

SUMMARY OF METHODS – DFI

Any method of increasing international business that requires a direct investment in foreign operations normally is referred to as a DIRECT FOREIGN INVESTMENT. International trade and licensing usually are not considered to be DFI because they do not involve direct invest in foreign operations. Franchising and joint ventures tend to require some investment in foreign operations, but a limited degree. Foreign acquisitions and the establishment of new foreign subsidiaries require substantial investment in foreign operations and represent the largest portion of DFI.

WHICH METHOD IS THE BEST FOR BANGLADESH?

INTERNATIONAL OPPORTUNITIES

Because of possible cost advantages from producing in foreign countries or possible revenue opportunities from demand by foreign markets, the growth potential becomes much greater for firms that consider international business.

INTERNATIONAL OPPORTUNITIES IN TERMS OF INVESTMENTS – the marginal returns on projects for the MNC are above those of the purely domestic firm because the MNC has an expanded opportunity set of possible projects from which to select.

INTERNATIONAL OPPORTUNITIES IN TERMS OF FINANCING – Growth in assets size requires increased debt, which forces a business to increase its periodic interest payments to creditors. Consequently, the firm has a greater probability of being unable to meet its debt obligations. To the extent that creditors and shareholders a higher return for a more highly indebted firm, the cost of capital to the firm rises with its volume of assets. An MNC can obtain capital funding at a lower cost than the purely domestic firm can. This advantage is due to the MNCs larger opportunity set of funding sources around the world.

OPPORTUNITIES & GROWTH OF MNCs IN EUROPE

- Single European Act 1987 – Industrialized countries in Europe agreed to make regulations more uniform and to remove many taxes on goods traded between these countries.
- Removal of the Berlin Wall 1989 – symbolic of new relations between east and West Germany. Encouraged free enterprise in ALL eastern European countries and the privatization of businesses that were owned by the government. E.g. Coca Cola Co, GM, etc.
- Inception of the Euro 1999 – MNCs no longer had to face the costs and risks associated with converting one currency to another. Use of single currency also allowed for a single monetary policy in those countries.
- Expansion of the EU 2004 – more opportunities at more countries.

OPPORTUNITIES IN LATIN AMERICA

- NAFTA 1993
- GATT 1993

OPPORTUNITIES IN ASIA

- Removal of investment restrictions 1990s
- Impact of the Asian Crisis 1997

EXPOSURE TO INTERNATIONAL RISK

- Exchange rate movements – Since exchange rates fluctuate over time, the cash outflows required to make payments change accordingly. Consequently, the number of units of a firm's home currency needed to purchase foreign supplies can change even if the suppliers have not adjusted their prices. When the home currency strengths, products denominated in that currency become more expensive to foreign customers, which may case a decline in demand and therefore a decline in cash inflows. FOR MNCs WITH SUBSIDIARIES IN FOREIGN COUNTRIES, EXCHANGE RATE FLUCTUATIONS AFFECT THE VALUE OF CASH FLOWS EMITTED BY SUBSIDIARIES TO THE PARENT. WHEN THEPARENT'S HOME CURENCY IS STRONG THE REMITTED FUNDS WILL CONVERT TO A SMALLER AMOUNT OF THE HOME CURENCY.
- Exposure to foreign economies when MNCs enter foreign markets to sell products, the demand for these products is dependent on the economic conditions in those markets. E.g. the Asian financial crisis.
- Exposure to political risk – country risk analysis, terrorism, etc.

<u>Valuation Model for an MNC</u>

Domestic Model

$$\text{Value} = \sum_{t=1}^{n} \frac{\mathrm{E}\left(\mathrm{CF}_{\$,t}\right)}{(1+k)^t}$$

where E (CF$,*t*) = expected cash flows to be received at the end of period *t*
n = the number of periods into the future in which cash flows are received
k = the required rate of return by investors

Valuing International Cash Flows

$$\text{Value} = \sum_{t=1}^{n} \left\{ \frac{\sum_{j=1}^{m} \left[\mathrm{E}\left(\mathrm{CF}_{j,t}\right) \times \mathrm{E}\left(\mathrm{ER}_{j,t}\right)\right]}{(1+k)^t} \right\}$$

where E (CF*j,t*) = expected cash flows denominated in currency *j* to be received by the U.S. parent at the end of period *t*
E (ER*j,t*) = expected exchange rate at which currency *j* can be converted to dollars at the end of period *t*
k = the weighted average cost of capital of the U.S. parent company

Q. BAT had expected cash inflows of $100,000 from local business and 1,000,000 Bangladeshi taka from business in Bangladesh at the end of period t. Assuming that Taka's value is expected to be $.0125, what is the expected dollar cash flow for BAT?