

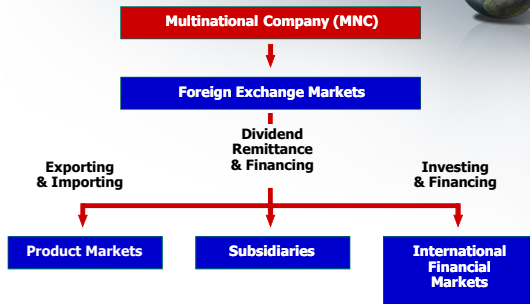
Ch. 1 Multinational Financial Mgmt: Overview



Topics

- Goal of the MNC
- Theories of International Business
- International Business Methods
- International Opportunities
- Exposure to International Risk
- MNC's Cash Flows & Valuation Model for an MNC

International Financial Environment

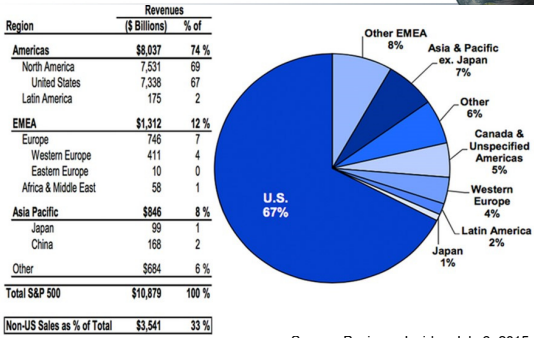


How Business Disciplines Are Used to Manage the MNC

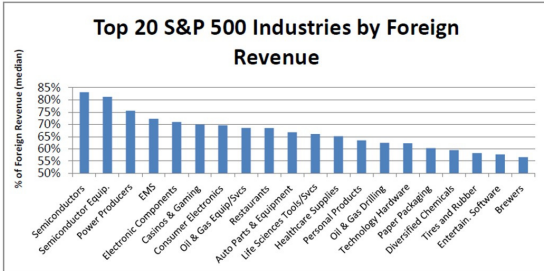


- Common finance decisions include:
 - Whether to discontinue operations in a particular country
 - Whether to pursue new business in a particular country
 - Whether to expand business in a particular country
 - How to finance expansion in a particular country
- Finance decisions are influenced by other business discipline functions:
 - Marketing
 - Management
 - Accounting and information systems

S&P 500: Global Sales Breakdown



S&P 500: Degree of Foreign Business



Source: S&P Capital IQ as of 4/3/2015. Past performance is not an indication of future results. Indexes are unmanaged, statistical composites and it is not possible to invest directly in an index.

Distribution of Corporate Power

- Who has power?
- Structure of MNCs
 - Current public MNCs have evolved into a very specific type of structure. → Ownership is highly fragmented and most power is in the hand of managers.
 - There is no doubt that the technology and investor demands have affected on the structure of the corporations.
 - More importantly, the political and legal constraints also have a significant impact. (e.g. Sarbanes-Oxley Act (SOX) of 2002)

Advantages of Common Stock



- Common stock residual claims of open corporations are unrestricted in the sense that
 - stockholders assume no other role,
 - their residual claims are freely tradable,
 - and the residual claims are rights in net cash flows for the life of the firm.
- **Risk-bearing efficiencies:** Separability and tradability of common stock lead to the efficiencies in risk bearing through diversification.

Disadvantages of Common Stock



- Problem of separation of ownership from control
 - An **agency relationship** is a contract in which the principals engage the agent to take actions on behalf of the principals which involves the delegation of some decision-making authority to agents.
 - **Agency costs:** the sum of the out-of-pocket costs of structuring, administering and enforcing contracts, plus residual loss.
 - Sources of conflict
 - Choice of effort
 - Differential risk exposure
 - Differential horizons

Goals of The MNCs



- Shareholders desire wealth maximization.
- Do managers (i.e. agents) maximize shareholder value?
- What is the major challenge for managers of MNCs?
 - Challenge: Constantly changing worldwide competitive environment.
 - Intense competition is caused by global **excess capacity**.

Causes of Excess Capacity



- Typical Causes of Excess Capacity
 1. Demand reduction
 2. Capacity-expanding technological change
 3. Obsolescence-creating technological change
 4. Many competitors simultaneously rush to implement new, highly productive technologies
- Current Forces Leading to Excess Capacity
 1. Macro policies
 2. Technology
 3. Organizational innovation
 4. Globalization of trade
 5. Revolution in political economy
 6. Demographics
 7. Social changes

Difficulty of Exit

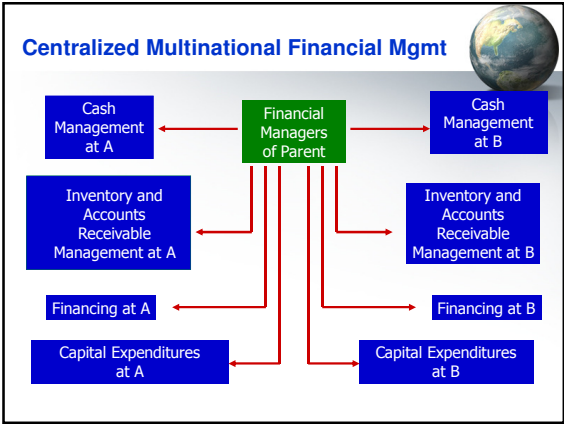


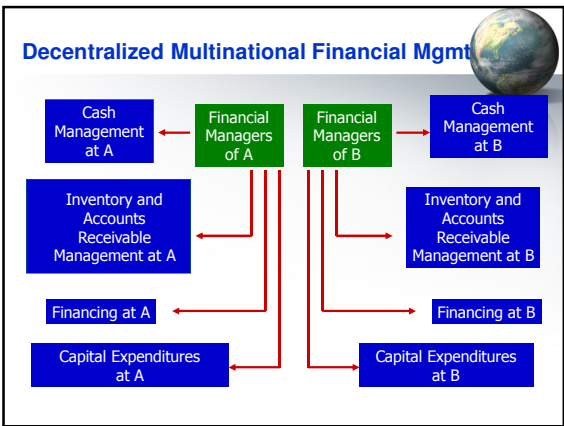
- The asymmetry between growth and decline
- Information problem
- Contracting problem

Conflicts Against the MNC Goal



- 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.
- 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.





- ### Impact of Corporate Control
- Various forms of corporate control can reduce agency costs.
 - Pay for performance
 - Internal monitoring system
 - Market for corporate control
 - Specialist monitoring / Auditors
 - Product Market
 - Lawsuit
 - As MNC managers attempt to maximize their firm's value, they may be confronted with various constraints.
 - Environmental constraints
 - Regulatory constraints
 - Ethical constraints

Theories of International Business



Why are firms motivated to expand their business internationally?

1. **Theory of Comparative Advantage**
 - Specialization by countries can increase production efficiency.
2. **Imperfect Markets Theory**
 - The markets for the various resources used in production are "imperfect."
3. **Product Cycle Theory**
 - As a firm matures, it may recognize additional opportunities outside its home country.

International Business Methods



1. **International trade** is a relatively conservative approach involving exporting and/or importing.
2. **Licensing** allows a firm to provide its technology in exchange for fees or some other benefits.
3. **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.
4. Firms may also penetrate foreign markets by engaging in a **joint venture** (joint ownership and operation) with firms that reside in those markets.

International Business Methods



5. **Acquisitions of existing operations** in foreign countries allow firms to quickly gain control over foreign operations as well as a share of the foreign market.
6. Firms can also penetrate foreign markets by **establishing new foreign subsidiaries**.
 - In general, any method of conducting business that requires a direct investment in foreign operations is referred to as a **direct foreign investment (DFI)**.
 - The optimal international business method may depend on the characteristics of the MNC.

International Opportunities



- **Investment opportunities:** The marginal return on projects for an MNC is above that of a purely domestic firm because of the expanded opportunity set of possible projects from which to select.
- **Financing opportunities:** An MNC is also able to obtain capital funding at a lower cost due to its larger opportunity set of funding sources around the world.

International Opportunities

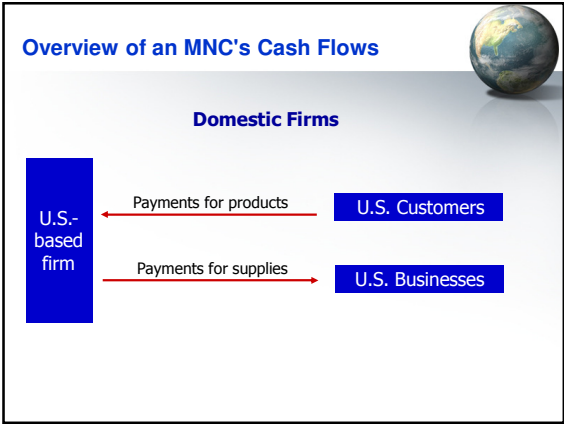


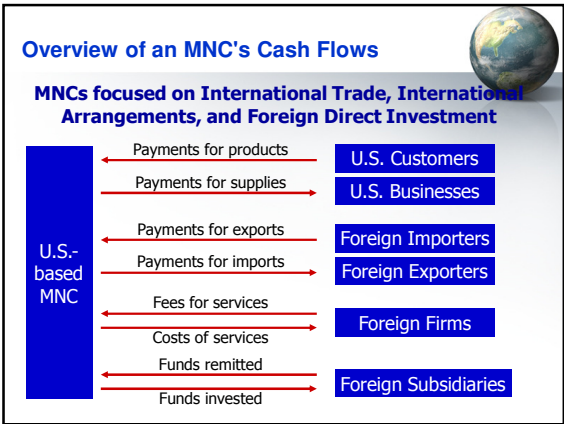
- **Europe**
 - Struggle in the Eurozone
 - Russia's disruptive influence
 - Migrant crisis
- **Latin America**
 - Mexico's illegal drug industry
 - Brazil's political unrest and economic problems
- **Asia**
 - Growing influence of China's military power
 - Rise of India
- **Middle East & Africa**
 - Ongoing conflicts and weakened commodity markets
 - Africa's dependence on China

Exposure to International Risk



- International business usually increases an MNC's exposure to:
 1. Exchange rate movements
 2. Foreign economic conditions
 3. Political risk





Managing for Value

- Like domestic projects, foreign projects involve an investment decision and a financing decision.
 - how much business to conduct in each country
 - how much financing to obtain in each currency
- MNC's financial decisions determine its exposure to the international environment.
- Maximize NPVs of projects → Maximize firm value → Maximize shareholder value

Valuation Model for an MNC



Value of Domestic CFs = $\sum_{t=1}^n \frac{E(CF_{\$,t})}{(1+k)^t}$

- $E(CF_{\$,t})$ = 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

Valuation Model for an MNC



Value of International CFs = $\sum_{t=1}^n \left\{ \frac{\sum_{j=1}^m [E(CF_{j,t}) \times E(ER_{j,t})]}{(1+k)^t} \right\}$

- $E(CF_{j,t})$ = 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

Valuation Model for an MNC



Impact of New International Opportunities on an MNC's Value

