Chapter 1- International Finance - Overview – (30%)

❖ Overview of International Financial Management:

Multinational Corporations (MNCs) are defined as firms that engage in some form of international business. Their managers conduct international financial management, which involves international investing and financing decisions that are intended to maximize the value of the MNC. The goal of their managers is to maximize the value of the firm, which is similar to the goal of the managers employed by domestic companies.

Initially, firms may merely attempt to export products to a particular country or import supplies from a foreign manufacturer. Overtime, however, many of them recognize additional foreign opportunities and eventually establish subsidiaries in foreign countries.

International financial management, also known as international finance, is the management of finance in an international business environment; that is, trading and making money through the exchange of foreign currency. The international financial activities help the organizations to connect with international dealings with overseas business partners-customers, suppliers, lenders etc.

❖ Why Firms Pursue International Business?

OR

❖ Reasons for Pursuing International Business

The commonly held theories as to why firms become motivated to expand their business internationally are:

1) Theory of Comparative Advantage

Multinational business has generally increased over time. Part of this growth is due to the heightened realization that specialization by countries can increase production efficiency. Some countries, such as Japan and the United States, have a technology advantage, while other countries, such as Jamaica, Mexico, and South Korea, have an advantage in the cost of basic labor. Since these advantages cannot be easily transported, countries tend to use their advantages to specialize in the production of goods that can be produced with relative efficiency. This explains why countries such as Japan and the United States are large producers of computer components, while countries such as Jamaica and Mexico are large producers of agricultural and hand- made goods.

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 classical theory of **comparative advantage.** Comparative advantages allow firms to penetrate foreign markets. Many of the Virgin Islands, for example, specialize in tourism and rely completely on international trade for most products. Although these islands could produce some goods, it is more efficient for them to specialize in tourism. That is, the islands are better off using some revenues earned from tourism to import products rather than attempting to produce all the products that they need.

2) Imperfect Markets Theory:

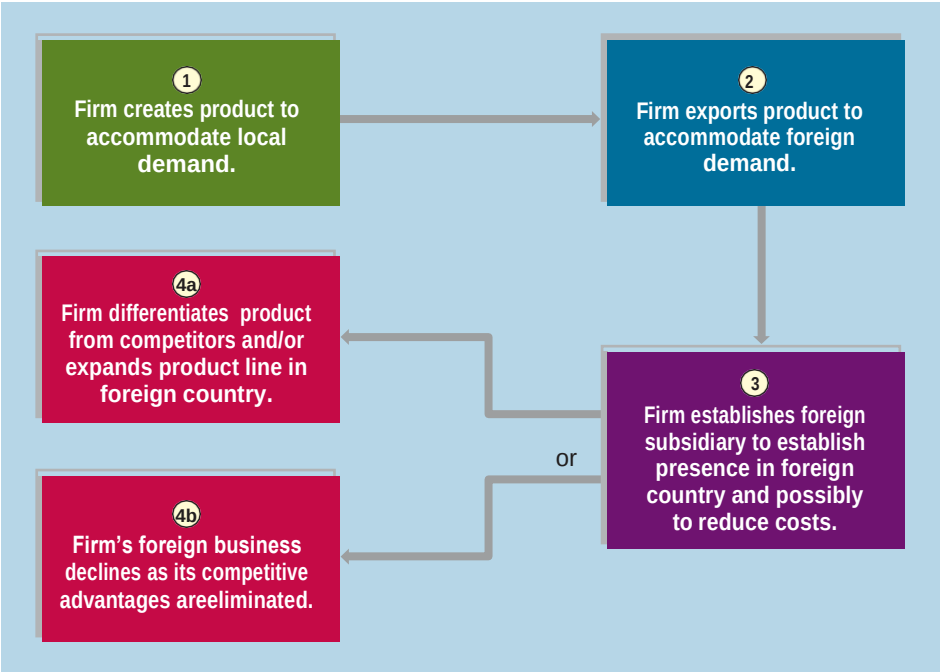
If each country‘s markets were closed from all other countries, there would be no international business. At the other extreme, if markets were perfect, so that the factors of production (such as labor) were easily transferable, then labor and other resources would flow wherever they were in demand. The unrestricted mobility of factors would create equality in costs and returns and remove the comparative cost advantage, the rationale for international trade and investment.

However, the real world suffers from **imperfect market** conditions where factors of production are somewhat immobile. There are costs and often restrictions related to the transfer of labor and other resources used for production. There may also be restrictions on transferring funds and other resources among countries. Because markets for the various resources used in production are ―imperfect,‖ MNCs often capitalize on a foreign country‘s resources. Imperfect markets provide an incentive for firms to seek out foreign opportunities.

3) Product Cycle Theory:

One of the more popular explanations as to why firms evolve into MNCs is the **product cycle theory.** According to this theory, firms become established in the home market as a result of some perceived advantage over existing competitors, such as a need by the market for at least one more supplier of the product. Because information about markets and competition is more readily available at home, a firm is likely to establish itself first in its home country. Foreign demand for the firm‘s product will initially be accommodated by exporting. As time passes, the firm may feel the only way to retain its advantage over competition in foreign countries is to produce the product in foreign markets, thereby reducing its transportation costs. The competition in the foreign markets may increase as other producers become more familiar with the firm‘s product. The firm may develop strategies to prolong the foreign demand for its product.

A common approach is to attempt to differentiate the product so that other competitors cannot offer exactly the same product. These phases of the cycle are illustrated in Exhibit 1.2. As an example, 3M Co. uses one new product to penetrate foreign markets. After entering the market, it expands its product line.



It shows that as a firm matures, it may recognize additional opportunities outside its home country. Whether the firm‘s foreign business diminishes or expands over time will depend on how successful it is at maintaining some advantage over its competition.

❖ How Firms Engage in International Business

OR

❖ Methods/Modes of Conducting International Business

Firms use several methods to conduct international business. The most common methods are these:

- International trade
- Licensing
- Franchising
- Joint ventures
- Acquisitions of existing operations
- Establishing new foreign subsidiaries

1) International Trade/Export-Import:

International trade is a relatively conservative approach that can be used by firms 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 risk. If the firm experiences a decline in its exporting or importing, it can normally reduce or discontinue this part of its business at a low cost.

Many large U.S.-based MNCs, including Boeing, DuPont, General Electric, and IBM, generate more than $4 billion in annual sales from exporting. Nonetheless, small businesses account for more than 20 percent of the value of all U.S. exports.

2) Licensing:

Licensing obligates a firm to provide its technology (copyrights, patents, trademarks, or trade names) in exchange for fees or some other specified benefits.

For example, AT&T and Verizon Communications have licensing agreements to build and operate parts of India‘s telephone system. Sprint Nextel Corp. has a licensing agreement to develop telecommunications services in the United Kingdom. Eli Lilly & Co. has a licensing agreement to produce drugs for Hungary and other countries. IGA, Inc., which operates more than 3,000 supermarkets in the United States, has a licensing agreement to

operate supermarkets in China and Singapore. 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. A major disadvantage of licensing is that it is difficult for the firm providing the technology to ensure quality control in the foreign production process.

3) Franchising:

Franchising obligates a firm to provide specialized sales or service strategy, support assistance, and possibly an initial investment in the franchise in exchange for periodic fees.

For example, McDonald‘s, Pizza Hut, Subway Sandwiches, Blockbuster Video, and Dairy Queen have franchises that are owned and managed by local residents in many foreign countries. Like licensing, franchising allows firms to penetrate foreign markets without a major investment in foreign countries. The recent relaxation of barriers in foreign countries throughout Eastern Europe and South America has resulted in numerous franchising arrangements.

4) Joint Ventures:

A **joint venture** is a venture that is jointly owned and operated by two or more firms. Many firms penetrate foreign markets by engaging in a joint venture with firms that reside in those markets. Most joint ventures allow two firms to apply their respective comparative advantages in a given project.

For example, General Mills, Inc., joined in a venture with Nestlé SA, so that the cereals produced by General Mills could be sold through the overseas sales distribution network established by Nestlé. Xerox Corp. and Fuji Co. (of Japan) engaged in a joint venture that allowed Xerox Corp. to penetrate the Japanese market and allowed Fuji to enter the photocopying business. Joint ventures between automobile manufacturers are numerous, as each manufacturer can offer its technological advantages.

5) Acquisitions of Existing Operations:

Firms frequently acquire other firms in foreign countries as a means of penetrating foreign markets.

For example, American Express recently acquired offices in London, while Procter & Gamble

purchased a bleach company in Panama. Acquisitions allow firms to have full control over their foreign businesses and to quickly obtain a large portion of foreign market share.

An acquisition of an existing corporation is normally riskier than the other methods previously mentioned because of the large investment required. In addition, if the foreign operations perform poorly, it may be difficult to sell the operations at a reasonable price.

6) Establishing New Foreign Subsidiaries:

Firms can also penetrate foreign markets by establishing new operations in foreign countries to produce and sell their products. Like a foreign acquisition, this method requires a large investment. Establishing new subsidiaries may be preferred to foreign acquisitions because the operations can be tailored exactly to the firm‘s needs. In addition, a 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 is built and a customer base established.

❖ Balance of Payment (BOP)

- **Meaning of Balance of Payment:**

  The BOP defines as systematic record of all economic transaction between resident of the country and rest of the world in a particular period (over a quarter of a year or more commonly over a year).

  Economic transactions include receipt and payment for the country‘s exports and imports of goods and services. It is prepared in a single currency typically the domestic currency for the country concerned.

- **Elements of Balance Of Payment:**

  1) Sources of Fund:

  Sources of fund for a nation such as export or receipt of loans and investment are recorded as positive or surplus items. Thus transaction is counted as credit.

  2) Usage of Fund:

  Such as imports or to invest in foreign countries are recorded as negative or deficit items. Thus transaction is counted as debit.

- **Characteristics of Balance Of Payment:**
    1. It is a statement of systematic record of all economic transactions between one country and rest of the world.
    2. Usually it is annual statement.
    3. It adopts double entry keeping system. It has two sides i.e. debit and credit. Payment is recorded on debit side and receipt is recorded on credit side.
    4. It contains two sets of account i.e. current account and capital account. Short term transaction is recorded under current account. Capital account records all financial and long term transaction.

- **Components of Balance Of Payment:**

  There are three components of balance of payment:
    1. Current Account
    2. Capital Account
    3. Official Reserve Account

  1) Current Account:

  It is typically divided into four sub categories:

  i) Visible Merchandise:

  It refers to export and import of tangible goods such as automobile, computers, machinery and so on.

  ii) Invisible:

  It refers to services export and import. It includes legal, insurance, and consulting services provided for customers based in other countries. Service exports by the US result in an inflow of funds to the US, while service imports by the US result in an outflow of funds.

  iii) Factor Income:

  Factor income represents income (interest and dividend payments) received by investors on foreign investments in financial assets (securities). Thus factor income received by U.S. investors reflects an inflow of funds into the US. Factor income paid by the US reflects an outflow of funds from the US.

iv) Transfer Payment:

Transfer payment represents aid, grants and gifts from one country to another.

2) Capital Account:

It can be divided into three categories:

i) Direct Investment:

It is related with FDI flow. Direct Investment occurs when investors acquire equity such as purchase of stock, acquisition of entire firms etc. FDI occurs when expected return from foreign profit can be higher than those from domestic projects due to lower material and labour cost, subsidizing financing etc.

ii) Portfolio Investment:

It represents sales and purchase of foreign financial assets such as stocks and bonds that do not involve a transfer of management control. It involves FII (Foreign Institutional Investors).

iii) Capital Flow:

It represents a claim with a maturity of less than one year. Such claim includes bank deposit, short term loan, short term securities, money market investment etc. These are quite sensitive for interest rate and exchange rate.

3) Official Reserve Account:

Official Reserves are government owned assets. It represents only purchase and sale by Central Bank of country.

Example: If there is deficit, the central bank borrows reserve assets such as gold, foreign exchange etc from foreign Central Bank.

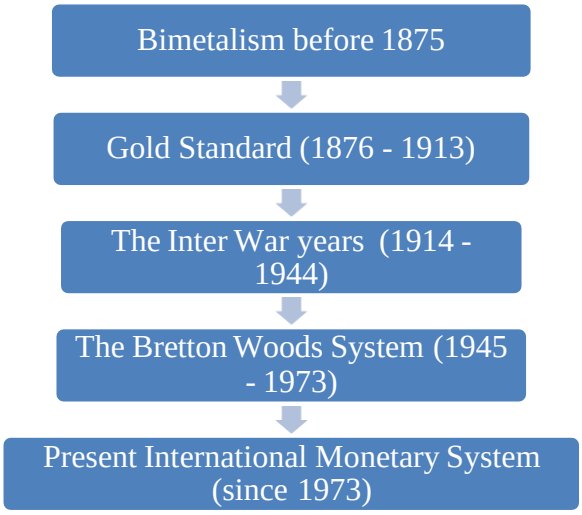
❖ International Monetary System (IMS)

- **Meaning of International Monetary System (IMS):**

  IMS refers to the system and rules that govern the use and exchange of money around the world and between countries. Each country has its own currency as money and the International Monetary System govern the rules for valuing and exchanging these currencies.

- **Stages in evolution of International Monetary system (IMS)**

There are five stages in the evolution of IMS:



1) Bimetalism before 1875:

The IMS at the global level before the 1870 was bimetallism double standard. Duble standard in the sense that both gold and silver were used as money. Some countries were on the gold standard, some countries on the silver standard, some on both. Both gold and silver were used as international means of payment and exchange rate among countries were determined by either their gold or silver content.

2) Gold Standard (1876 – 1913):

The gold standard is a monetary system in which each country fixed the value of its currency in terms of gold. The exchange rate is determined accordingly.

Example: If the dollar is pegged to Gold at US dollar $30 = 1 ounce of gold and British pound is pegged to gold at £6 = 1 ounce of gold. It must be the case that the exchange rate is determined by the relative gold content.

That is, $30 = £6

Therefore, $5 = £1.

The gold standard worked adequately until the outbreak of World War – I, which interrupted trade flows and the free movement of gold and led to suspend operations of the gold standard.

3) The Inter War Years (1914 – 1944)

During World War - I and the early 1920s, currencies were allowed to fluctuate over fairly wide range in terms of gold and each other. During this period, the United States replaced

Britain as the dominant financial power of the world. The United States return to a gold standard in 1919. From 1934 to the end of World War – II, exchange rate was theoretically determined by each currency‘s value in terms of gold.

4) Bretton Wood System (1945 – 1973):

In 1944, representatives of 44 nations met at bretton woods, New Hampshire, and designed new post-war International Monetary System. The bretton woods created a dollar based fixed exchange rate system. In the bretton woods system, only the US fixed the value of its currency to gold. The initial peg was dollar $35 = 1 ounce of gold and other currencies were converted to the US dollar.

5) Present International Monetary system since 1973:

The bretton woods system collapsed in 1971. The United State had to stop the convertibility to gold due to high inflation and trade deficit in the economy. Inflation leads to increase in the price of gold. Hence US could not maintain the fixed value of $35 to 1 ounce of gold. In 1973, the world moves to flexible or floating exchange rate system. In 1976, the countries met in Jamaica to formalize the new system. Floating Exchange Rate system means that the exchange rate of a currency is determined by market forces of demand and supply.

❖ International Parity Relationship

There are three International Parity Relationships for determination of exchange rate:

1) Purchasing Power Parity (PPP)
2) Interest Rate Parity
3) Fisher Effect

1) Purchasing Power Parity (PPP):

Purchasing Power Parity is a theory about exchange rate determination based on plain idea that two currencies involved in the calculation of exchange rate have the same purchasing power for the same goods sold in two countries.

There are two version of purchasing power parity:

a) Absolute version of PPP
b) Relative version of PPP

a) Absolute version of PPP:

It is based on the law of one price. The law state that when there are no costs or other barriers associated with moving goods or services between markets, then the price of each product should be the same in each market. The identical goods must sell at the same price in different markets, after adjusting for exchange rate.

In absolute term, PPP states that the exchange rate between the currencies of two countries equal the ratio between the prices of goods in these countries.

Symbolically,

e= Pd/ Pf

Where e= Exchange rate for the foreign currency in terms of domestic currency.

Pd= Price of domestic currency.

Pf= Price of Foreign currency.

Example: Suppose 10 grams of gold cost INR 29250 and same cost USD 450, the spot exchange rate would be:

e = Pd/ Pf

= INR 29250/ $ 450

= INR 65/ $1.

b) Relative version of PPP:

The absolute version of PPP is based on unrealistic assumption of free trade, no transportation cost and identical commodities. In relative term PPP state that exchange rate between currencies of the two countries will adjust to reflect changes in the inflation rate of two countries.

Example: When cost of basket of commodities is INR 9,000 in India and $ 200 in USA, the market may quote INR 45 /$ 1. What is expected is that the exchange rate will move along with the relative changes in prices in the two countries. If the price of basket of commodities increases to INR 9900 in India and $ 212 in USA, the rupee will suffer depreciation in relation to dollar. The extent to which the rupee will depreciate is the differences in the inflation rate in the two countries during the period. In the given example, the inflation rate was 10% in India and 6% in USA. The rupee will depreciate approximately by 4% to quote about INR 46.70/$1.

Symbolically,

et = e * (1+Id)/(1+If)

Where,

et = expected exchange rate after period t.

e = Spot exchange rate

Id = rate of inflation in domestic country

If = rate of inflation in foreign country

et = 45 x (1 + 0.10) / (1 + 0.06)

= 45 x (1.1/1.06)

= INR 46.70 / $.

2) Interest Rate Parity:

Introduction

There is a strong relationship between the forex market and money market. The relative interest rates and expected change in interest rates will influence the exchange rates.

Meaning

The interest rate parity condition states that the forward premium or discount for a currency quoted in terms of another currency is approximately equal to the difference in interest rates prevailing between the two countries.

Suppose, if interest rates in India are higher than in U.S., investors will prefer to switch funds from U.S. to India and the dollars will be used to buy rupees, and the buying pressure should strengthen the rupee against U.S. dollar. When currency and money markets are in equilibrium and difference in interest rates should correspond to the differential between the spot rate and forward rate. The currency with higher interest rate will be sold at a discount in the forward market against the currency with the lower rate of interest. The reason that these relationships hold is that operators in the money market are free to invest or borrow in the currency that offers them most favourable interest rates.

The interest rate parity relationship can be expressed in the formula given below:

$\frac{F}{} = \frac{1 + rh}{}$

So 1 + rf

Where, F = Direct quote for forward rate

S0 = Direct quote spot rate

rh = Interest rate of home country

rf = Interest rate of foreign country

Example: Let us assume that interest rate prevailing in India is 8% per year while in USA it is 3% per year. Suppose the spot rate INR 65/USD. The interest parity says, that one year forward rate would be governed by the interest rate differential.

This indicates as on today, the 1 year forward rate will be as follows:

$$\frac{F1}{65.0} = \frac{1 + 0.08}{1 + 0.03}$$

Therefore one year forward rate would be INR 68.15/$.

It holds when there are no covered interest arbitrage opportunities.

Example: Suppose that the interest rate of one year bond in India is 8% and the same bond in US is at 3%. The spot rate for INR/$ is 65 and the 1 year forward rate is 68.15.

Trader having 1000$ will have two options:

Option 1: Invest in US. He would invest 1000$ in US and earn 1030$ at the end of one year. (1000+3% interest)

Option 2: Exchange 1000$ for Indian Rupee and receive Rs 65,000. Invest 65,000 for one year in 8% bond. At the end of one year the trader would receive Rs. 70,200. (65,000 + 8%). Convert the INR into dollar at forward rate i.e. 65.15/$, he would receive 1030$. (70200/68.15.) Both the option earns equal profit. What is earned on the interest rate differential, one loses on the exchange rate differential.

Both the option earns equal profit. What is earned on the interest rate differential, one loses on the exchange rate differential.

Conclusion: Thus, interest rate parity states that the high interest rate on a currency is offset by the forward discount and the low interest rate is offset by forward premium.

3) International Fisher Effect:

This theory was developed by U.S. Economist Irving Fisher. IFE states that the difference between the nominal interest rates in two countries is directly proportional to the changes in the exchange rate of their currencies at any given time**.**

IFE is based on current and future nominal interest rates and it is used to predict spot and future currency movements.

- **How IFE was conceptualized:**

  IFE theory was recognized on the basis that interest rates are independent of other monetary variables and that they provide a strong indication of how the currency of a specific country is performing. According to Fisher, changes in inflation do not impact real interest rates, since the real interest is simply the nominal rate minus inflation. The theory assumes that a country with lower interest rates will see lower level of inflation, which will translate to an increase in the real value of the country‘s currency in comparison to another country‘s currency. When interest rates are high, there will be higher levels of inflation, which will result in the depreciation of the country‘s currency.

Formula:

$E = (I_1 – I_2) / (1 + I_2)$

$= (I_1 – I_2)$

Where, E = % change in the exchange rate of the country‘s currency

I_1 = Country A‘s Interest rate

I_2 = Country B‘s Interest rate

For Eg. Interest rates are 4% and 2% for I_1 and I_2 respectively. Based on this, we derive E as approximately 2%, what the calculation means is that currency of I_2 will appreciate by 2% against the currency of I_1.

Example: There are two currencies, the USD (US dollar) and INR. The USD / INR spot exchange rate is 65 and the interest rate of the US is 5% while that of India is 6%. The future spot rate is calculated by taking the spot rate and multiplying it by the ratio of the domestic

interest rate to the foreign interest rate, as shown below:

$e_t = e * (1 + Id) / (1 + If)$

$= 65 * (1 + 0.06) / (1 + 0.05)$

$= 65 * (1.06) / (1.05)$

$= 65 * 1.0095$

$=$ INR 65.6190

Given the future spot rate, the IFE assumes that the INR currency will depreciate against USD. 1 USD will exchange into 65.6190 INR, up from the original rate of INR 65

On one hand, investors will receive lower interest rate on the USD currency but on the other hand, they will gain from an increase in the value of the US currency.

❖ Foreign Exchange Market

Introduction:

The foreign exchange market, also known as the forex, FX, or currency market, involves the trading of one currency for another. The places where currencies of different countries are bought and sold against each other are called _foreign exchange market‘.

Large commercial banks serve this market by holding inventories of each currency, so that they can accommodate requests by individuals or MNCs. Some MNCs based in the United States exchange dollars for Mexican pesos when they purchase supplies in Mexico that are denominated in pesos, or euros when they purchase supplies from Italy that are denominated in euros. Other MNCs based in the United States receive Japanese yen when selling products to Japan and may wish to convert the yen to dollars.

For one currency to be exchanged for another currency, there needs to be an exchange rate that specifies the rate at which one currency can be exchanged for another. The exchange rate of the Mexican peso will determine how many dollars you need to stay in a hotel in Mexico City that charges 500 Mexican pesos per night. The exchange rate of the Mexican peso will also determine how many dollars an MNC will need to purchase supplies that are invoiced at 1 million pesos. The system for establishing exchange rates has changed over time.

❖ Foreign Exchange Transactions

The ‒foreign exchange market‖ should not be thought of as a specific building or location where traders exchange currencies. Companies normally exchange one currency for another through a commercial bank over a telecommunications network.

Foreign exchange transaction is an agreement between two parties to exchange one currency for another at an agreed exchange rate on agreed date. It also provides currency protection for another against at unfavorable exchange rate

Foreign exchange transaction may be useful in managing the currency risk associated with exporting or importing goods denominated in foreign currency, investing or borrowing overseas, converting foreign currency denominated dividends or settling other foreign currency arrangements.

Types of transaction:

There are different types of foreign exchange transactions:

l) Spot Transactions:

A spot transaction is an outright purchase and sale of foreign currency for cash settlement not more than two business days after the date the transaction is recorded. **The two-day period is known as immediate delivery.** By convention, the settlement date is the second business day after the date on which the transaction is agreed to by the two traders. The two-day period provides ample time for the two parties to confirm the agreement and arrange the clearing and necessary debiting and crediting of bank accounts in various international locations.

2) Forward Transaction:

A forward transaction regards a deal which is conducted today and actual effect will take place on a fixed future date. One way to deal with the FX risk is to engage in a forward transaction. In this transaction, **money does not actually change hands until some agreed upon future date. Buyer and seller agree on an exchange rate for any date in the future and the transaction occurs on that date regardless what market rates are then**. The date can be a few days, months, or years in the future.

i) Futures:

Foreign currency futures are forward transactions with **standard contract sizes** and **maturity dates** — e.g. 5,00,000 British pounds for next November at an agreed rate. These contracts are traded on a separate exchange set up for that purpose.

For example, in August, a U.S. importer may arrange for a special Christmas season shipment of Japanese radios to arrive in October. The agreement with the Japanese manufacturer may call for payment in yen on October 20. To guard against the possibility of the yen's becoming more expensive in terms of the dollar, the importer might contract with a bank to buy yen at a stipulated price, but not actually receive them until October 20 when they are needed. When the contract matures, the U.S. importer pays for the yen with a known amount of dollar.

ii) Swap:

The most common type of forward transaction is the current swap. **In a swap, two parties exchange currencies for a certain length of time and agree to reverse the transaction at a later date**. In all of these transactions, market rates might change. However, buyer and seller are locked into a contract at a fixed price that cannot be affected by any changes in the market rates.

For example, Chase Manhattan Bank may have an excess balance dollars but need pounds to meet the requirements of its corporate & clients. At the same time, Royal Bank of Scotland may have an excess balance of pounds and an insufficient amount of dollars. The bank could negotiate a swap agreement in which Chase Manhattan Bari agrees to exchange dollars for pounds today and pounds for dollars it the future. The key aspect is that the two banks arrange the swap as single transaction in which they agree to pay and receive stipulate amounts of currencies at specified rates.

iii) Option:

To address the lack of flexibility in forward transactions, the foreign currency option was developed. An option is similar to a forward transaction. It gives its owner the right to buy or sell a specified amount of foreign at a specified price at any time up to a specified expiration date.

❖ Foreign Exchange Quotations

Foreign exchange quotations are quoted in terms of other currencies. It means exchange rate is a relative price.

In other words, foreign exchange quotation is the amount of currency that exchanged for a unit of another currency**.**

Types of Foreign Exchange Quotations:

1) Bid/Ask Spread of Banks:

A currency exchange rate is typically given as a bid price and an ask price. Normally, two rates are published-one being the buying rate and the other the selling rate. The buying rate is also known as the bid rate. The selling rate is known as the ask rate or offer rate. The bid rate is always given first, followed by the ask rate quote. If the rupee-US dollar rate is Rs.65.00-65.30/US $, then the former is the buying rate and the letter the selling rate.

In other words, the buying rate is the rate at which the banks purchase a foreign currency from the customer. Suppose, in India, a customer exchange the US dollar for the rupee, the bank will buy the US dollar at the buying rate, which is at rupees Rs. 65.00 per US $. The selling rate, on the other hand, is the rate at which the banks sell foreign currency to their customers. For example, a bank in India selling one US dollar to customer, will charge the selling rate, that is Rs. 65.30 per US dollar. Since the banks need to make a profit in these transactions the selling quote is higher than the buying rate. The bid price is always lower than the ask price.

Commercial banks charge fees for conducting foreign exchange transactions. At any given point in time, a bank‘s **bid** (buy) quote for a foreign currency will be less than its **ask** (sell) quote. **The difference between Ask and Bid price (quotes) forms the banks‟ profit and is known as the spread**. In the above example, the spread is Rs. 0.30 per US dollar. The bid-ask spread is often started in percentage terms that can be computed as follows:

Spread = (Ask price – Bid price)/ Ask price × 100

Thus in the above example,

Spread = (65.30 – 65.00)/ 65.30 × 100 = 0.744%

The size of spread in respect of currency depends upon many factors, like its strengths, the type of transaction, and its supply and demand position with the transacting bank. The spread is smaller in a widely traded currency because it is easy for the blanks to transact in such a currency. In a scarcely traded currency, the banks have to face some difficulty, and hence the spread is large. if the bank is temporarily short of a foreign currency, the spread will be larger particularly if the demand for that foreign currency is high. On the contrary, if the supply position of that foreign currency is comfortable, the spread will be lower.

2) Direct versus Indirect Quotations:

The quotations of exchange rates for currencies normally reflect the ask prices for large transactions. Since exchange rates change throughout the day, the exchange rates quoted in a newspaper reflect only one specific point in time during the day.

Direct Quote:

Direct quote is when the price of 1 unit of foreign currency is expressed in terms of domestic currency.

Example: 1 $ = INR 74 is direct quote used in India.

It is also known as **European quotes.**

In a pair, the first currency is the ‒base‟ currency and the second currency is the „quoted‟ currency. The exchange rate quotation reflects the number of the units of quoted currency per unit of the base currency.

Indirect Quote:

It is when the price of 1 unit of domestic currency is expressed in terms of foreign currency.

Example: 1 INR = 0.0135 USD.

It is also known as **American quotes.**

3) Cross Exchange Rates:

Cross Rate is an exchange rate between the currencies of two countries that are not quoted against each other but are quoted against one common currency.

Most tables of exchange rate quotations express currencies relative to the dollar, but in some instances, a firm will be concerned about the exchange rate between two non-dollar currencies.

For example, if a Canadian firm needs Mexican pesos to buy Mexican goods, it wants to know the Mexican peso value relative to the Canadian dollar. The type of rate desired here is known as a cross exchange rate, because it reflects the amount of one foreign currency per unit of another foreign currency. Cross exchange rates can be easily determined with the use of foreign exchange quotations. The value of any non-dollar currency in terms of another is its value in dollars divided by the other currency‘s value in dollars.

Example: If the peso is worth $.07, and the Canadian dollar is worth $.70, the value of the peso in Canadian dollars (C$) is calculated as follows:

Value of peso in C$ = Value of peso in $ / Value of C$ in $

= $.07 / $.70

= C$.10

Thus, a Mexican peso is worth C$.10.

Example: The US Dollar – Thai Baht exchange rate is US $0.02339 / Baht. The Indian Rupee exchange rate is US $0.02538 / INR. Suppose that INR is not quoted against Thai Baht. What is Baht / INR exchange rate?

1 INR = US $ 0.02538

1 Baht = US $ 0.02339

$$\frac{\text{US \$ 0.02538}}{\text{US \$ 0.02339}} \times \frac{\text{Baht}}{\text{INR}}$$

= 1.085 Baht / INR

Thus 1 INR should cost is Baht 1.085.

❖ International Money Market

Introduction

In most countries, local corporations commonly need to borrow short-term funds to support their operations. Country governments may also need to borrow short-term funds to finance their budget deficits. Individuals or local institutional investors in those countries provide funds through short-term deposits at commercial banks. In addition, corporations and governments may issue short-term securities that are purchased by local investors. Thus, a domestic money market in each country serves to transfer short-term funds denominated in the local currency from local surplus units (savers) to local deficit units (borrowers).

The growth in international business has caused corporations or governments in a particular country to need short-term funds denominated in a currency that is different from their home currency.

1) They may need to borrow funds to pay for imports denominated in a foreign currency.

2) Even if they need funds to support local operations, they may consider borrowing in a currency in which the interest rate is lower. This strategy is especially desirable if the firms will have receivables denominated in that currency in the future.

3) They may consider borrowing in a currency that will depreciate against their home currency, as they would be able to repay the loan at a more favorable exchange rate over time. Thus, the actual cost of borrowing would be less than the interest rate of that currency.

Meanwhile, there are some corporations and institutional investors that have motives to invest in a foreign currency rather than their home currency.

1) The interest rate that they would receive from investing in their home currency may be lower than what they could earn on short-term investments denominated in some other currencies.

2) They may consider investing in a currency that will appreciate against their home currency because they would be able to convert that currency into their home currency at a more favorable exchange rate at the end of the investment period. Thus, the actual return on their investment would be higher than the quoted interest rate on that foreign currency.

Origins and Development

The international money market includes large banks in countries around the world. Two other important components of the international money market are the European money market and the Asian money market.

1) European Money Market:

The origins of the European money market can be traced to the Eurocurrency market that developed during the 1960s and 1970s. As MNCs expanded their operations during that period, international financial intermediation emerged to accommodate their needs. Because the U.S. dollar was widely used even by foreign countries as a medium for international trade, there was a consistent need for dollars in Europe and elsewhere. To conduct international trade with European countries, corporations in the United States deposited U.S. dollars in European banks. The banks were willing to accept the deposits because they could lend the dollars to corporate customers based in Europe. These dollar deposits in banks in Europe (and on other continents as well) came to be known as Eurodollars, and the market for Eurodollars came to be known as the Eurocurrency market. (–Eurodollars‖ and –Eurocurrency‖ should not be confused with the –euro,‖ which is the currency of many European countries today.) The growth of the Eurocurrency market was stimulated by regulatory changes in the United States.

Instruments

1. Euro notes

Euro notes are like promissory notes issues by companies for obtaining short term funds. They emerged in early 1980s with growing securitisation in the international financial market. They are denominated in any currency other than the currency of the country where they are issued. They represent low cost funding route. Documentation facilities are minimum. They can be easily tailored to suit the requirements of different kinds of borrowers. Investors too prefer them in view of short maturity.

2. Euro Commercial Paper

Another attractive from of short term debt instrument that emerged during mid-1980s cam to be none as euro commercial paper(ECP). It is promissory not like the short term euro notes all the it is different from euro notes in some ways it is not underwritten, while the euro notes

are underwritten. The reason is that ECP is issued only by that company‟s that process a high degree rating. Again, the capital ECP route for raising funds is normally investor-driven, while the euro note is said to be borrower driven.

ECP came up on the pattern of domestic market commercial papers that had a beginning in the in the USA and then Canada as back as in 1950s. The prefix ‒Euro‖ means that the ECP is issued outside the country in the current in which it is denominated. Most of the ECPs are denominated in US dollars, but they are different from US commercial papers in the since that the ECPs have longer maturity going up to one year. Moreover, ECPs are structured on the basis of all in costs, whereas in US commercial papers, various charges, such as front-end fee and commission are collected separately.

3. Medium term Euro notes

Medium term Euro notes are just an extension of short term euro notes as they fill the gap existing in the maturity structure of international financial market instruments. They are a compromised between short term euro

2) Asian Money Market:

Like the European money market, the Asian money market originated as a market involving mostly dollar-denominated deposits. Hence, it was originally known as the Asian dollar market. The market emerged to accommodate the needs of businesses that were using the U.S. dollar (and some other foreign currencies) as a medium of exchange for international trade. These businesses could not rely on banks in Europe because of the distance and different time zones. Today, the Asian money market, as it is now called, is centered in Hong Kong and Singapore, where large banks accept deposits and make loans in various foreign currencies. The major sources of deposits in the Asian money market are MNCs with excess cash and government agencies. Manufacturers are major borrowers in this market.

❖ International Bond/Debt Market

- **Meaning:**

The international debt market involves the buying and selling of corporate and government bonds issued by non-residents of the local debt market. In other words, an international debt market is a bond market where only foreign bonds are traded.

The international bond market may be defined as a market for bonds, which are sold anywhere in the world but not in the geographical territory of the country in which it is denominated.

The international bond market also known as the global bond market is similar to the stock market. The major difference is instead of trading stocks, investors' trade debt securities in the form of bonds. The international bond market trades bonds over electronic trading networks. There is no physical location for investors together such as the stock market.

MNCs may choose to issue bonds in the international bond markets for three reasons:

1) Issuers recognize that they may be able to attract a stronger demand by issuing their bonds in a particular foreign country rather than in their home country. Some countries have a limited investor base, so MNCs in those countries seek financing elsewhere.
2) MNCs may prefer to finance a specific foreign project in a particular currency and therefore may attempt to obtain funds where that currency is widely used.
3) Financing in a foreign currency with a lower interest rate may enable an MNC to reduce its cost of financing, although it may be exposed to exchange rate risk.

- **Types of Instruments in International Bond Market:**

1) Straight Fixed-rate Bonds
2) Medium Term Euro Notes
3) Equity Related Bonds
4) Floating Rate Bonds
5) Zero Coupon Bonds
6) Dual Currency Bonds
7) Cocktail Bonds

1) Straight Fixed-rate Bonds:

These are the traditional bonds which are debt instruments carrying a fixed interest with a fixed maturity period with interest payable at a fixed predetermined interval say in 6 months or 1 year. These bonds are issued for a face value with a certain percentage of interest payable at a certain periodicity and are redeemable after the expiry of the period specified. The period of such bonds vary from 5 to 25 years but commonly bonds are issued for a period of 15 years.

2) Medium Term Euro Notes:

These are fixed-rate notes issued by a corporation with maturities ranging from less than a year to about 10 years. Liked fixed-rate bonds, medium term euro notes have a fixed maturity and pay coupon interest on periodic dates. Unlike a bond issue, in which the entire issue is brought to market at once, a medium term euro notes issue is partially sold on a continuous basis through an issuance facility that allows the borrower to obtain funds only as needed on a flexible basis.

3) Equity Related Bonds:

There are two types of equity related bond:

i) Convertible Bonds:

These are similar to fixed rate bonds with an option to convert them at the discretion of the investor into the equity shares of the issuing company.

ii) Bonds with equity warrants:

Equity warrant bonds are debt securities that incorporate warrants which give the holder the option to purchase equity in the issuer, its parent company or another company during a predetermined period at a fixed contract price.

4) Floating Rate Bonds / Notes:

These are similar to the straight fixed rate bonds as far as maturity and denomination are concerned but the difference is that unlike the fixed rate bond, where the interest rate is fixed, in this the interest rate is varying in nature. The interest rate is linked to a base rate like LIBOR, and the interest payable on the bond for the next six months or one year is set with reference to the base rate. The rate of interest is adjusted every six months or one year depending on the terms for the issue.

5) Zero Coupon Bond:

Zero Coupon Bond are sold at a discount from face value and do not pay any coupon interest over their life. At maturity the investor receive the full face value. Zero Coupon Bonds are considered long-term investments with maturity dates typically starting at 10 to 15 years.

6) Dual Currency Bonds:

A dual currency bond is a straight fixed rate bond which is issued in one currency and pays

coupon interest in that same currency. At maturity, the principal is repaid in a second currency.

7) Cocktail Bonds

Bonds are often denominated in a mixture of currency. Such bonds are known as cocktail bonds. The SDR bonds represent a weighted average of four currencies. The investors purchasing the cocktail bonds get automatically the currency diversification benefits. The foreign exchange risk on account of depreciation of any one currency offsets by appreciation of another currency.

SDR-Special Drawing Rights

➢ LIBOR (London Inter Bank Offered Rate)

LIBOR is the average of interest rate estimated by each of the leading banks in London that it would be charged where it to borrow from other banks. Thus it is a rate that some of world's leading bank charge each other for short term loans.

LIBOR is administered by the ICE (Inter Continental Exchange) Benchmark Administration (IBA) and is based on 5 currencies i.e. US Dollar (USD), Euro (EUR), Pound Sterling (GBP), Japanese Yen (JPY) and Swiss Franc (CHF) and serves seven different maturities i.e. Overnight, One week and One, Two, Three, Six, Twelve Months.

The official LIBOR interest rate is announced once per working day at around 11 a.m. (London Time).

❖ International Banking

- **Meaning:**

  International Banking is a type of banking which has branches across the national border. It is same as the national bank but it also provides the same service to the international clients also. It covers both the type of clients like individuals and businesses.

- **Types of services offered:**

  1) To arrange trade finance:

  An international bank arranges the finance for the traders who want to deal with the foreign country.

2) To arrange foreign exchange:

The core services provided by the international bank are to arrange foreign exchange for the import-export purpose.

3) To hedge the funds:

The international bank hedge the funds by buying the securities at the lower price level and sell it when the price level rising.

- **Types of Risks:**

1) Currency Risk:

An international bank has to be familiar with the currency exchange rate while doing business internationally. The companies which choose to operate in a foreign country and at that time it has to deal with currency risk.

2) Political Risk:

Political risk also affects the business because business has to follow the rules and regulation of host country and each country has their political effect on the business. If political decisions are unfavourable, it affects the business.

3) Reputation Risk:

A bank faces reputation risks like rumors about the bank, data manipulation, bad customer service and experience. A bank‘s reputation is judged by the clients, investors, leaders etc.

4) Systematic Risk:

The systematic risk is not related to particular one bank but it affects the whole economy. A systematic risk is associated with failure of the big entity and it affects the whole economy.

- **Functions of International Banking:**

1) Taking deposits and making loans in domestic currency to foreign government, enterprises and individuals.

2) Taking deposits and lending in foreign currencies to domestic and foreign entities.

3) Foreign exchange transactions, dealing in gold and precious metals, international money transfers etc.

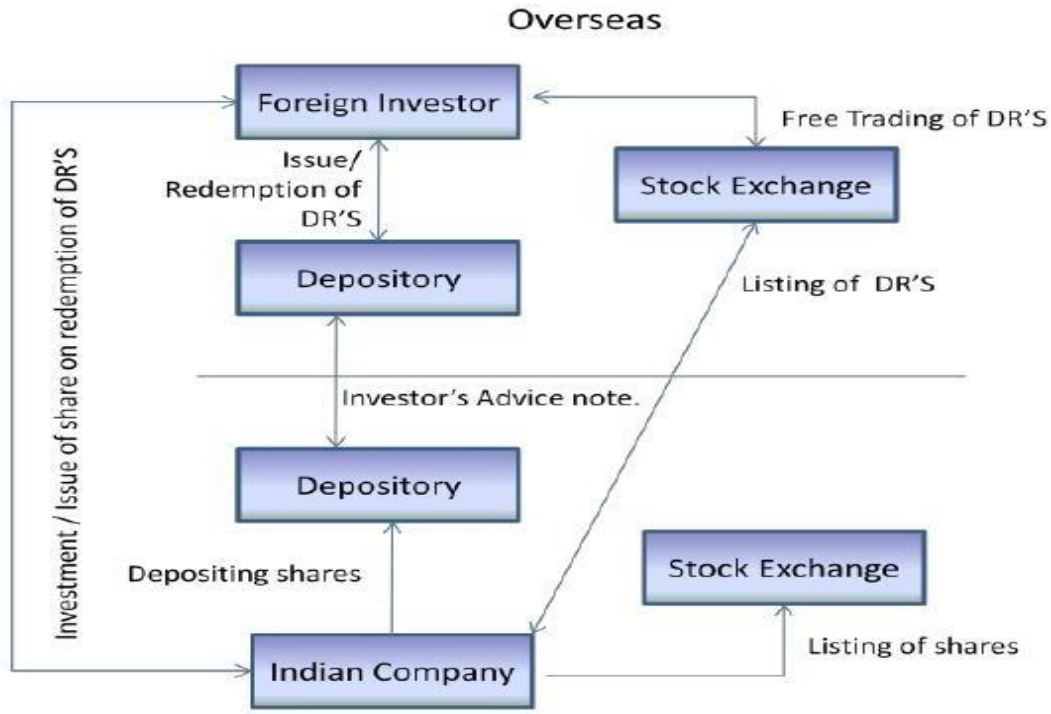
❖ International Stock Market / Equity Market

Introduction:

MNCs and domestic firms commonly obtain long-term funding by issuing stock locally. Yet, MNCs can also attract funds from foreign investors by issuing stock in international markets. The stock offering may be more easily digested when it is issued in several markets. In addition, the issuance of stock in a foreign country can enhance the firm‘s image and name recognition there.

Issuance of Stocks in Foreign Markets

Many publicly listed companies in India, trades their shares through Bombay Stock Exchange or National Stock Exchange. Many companies want to trade their shares in overseas stock exchange although these companies need to comply with some policies. In such a situation companies get itself listed through ADR or GDR. For this purpose, the company deposits its shares to the Overseas Depository Bank (ODB) and the bank issues receipts in exchange for shares. Now, every single receipt consists of a certain number of shares. These receipts are then listed on the stock exchange and offered for sale to the foreign investors. MNCs need to have their stock listed on an exchange in any country where they issue shares.



Depository Receipt is a mechanism through which a domestic company can raise finance from the international equity market. In this system, the shares of the company domiciled in one country are held by the depository i.e. Overseas Depository Bank, and issues claim against these shares. Such claims are known as Depository Receipts that are denominated in the convertible currency, mostly US$, but these can also be denominated in Euros. Now, these receipts are listed on the stock exchanges.

There are two depository receipts.

1. ADR 2. GDR

1. ADR

American Depository Receipt (ADR), is a negotiable certificate, issued by a US bank, denominated in US$ representing securities of a foreign company trading in the United States stock market. The receipts are a claim against the number of shares underlying. ADRs are offered for sale to American investors. By way of ADR, the US investors can invest in non-US companies. The dividend is paid to the ADR holders, is in US dollars.

ADRs are easily transferable, without any stamp duty. The transfer of ADR automatically transfers the number of shares underlying.

American Depository Receipts (ADRs) is a way of trading non-U.S. stocks on the U.S. exchange. Say Indian companies who are willing to raise funds from the U.S. can do so by issuing shares on American Stock exchange such as NYSE or NASDAQ.

Infosys Technologies was the first Indian company to issue American depositary receipts.

2. GDR

Global Depository Receipt is a negotiable instrument used to tap the financial markets of various countries other than USA with a single instrument. The receipts are issued by the depository bank, in more than one country representing a fixed number of shares in a foreign company.

Prior approval of Ministry of Finance and FIPB (Foreign Investment Promotion Board) is taken by the company planning for the issue of GDR.

A **global depository receipt** (**GDR**) is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDRs represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets.

GDRs are often listed in the Frankfurt Stock Exchange, Luxembourg Stock Exchange, and the London Stock Exchange.

Reliance Industries Limited was the first Indian company to issue Global Depositary Receipts.

How Stock Market Characteristics Vary among Countries:

The degree of trading activity in each stock market is influenced by legal and other characteristics of the country.

1) Shareholders in some countries have more rights than in other countries. For example, shareholders have more voting power in some countries than others. They can have influence on a wider variety of management issues in some countries.

2) The legal protection of shareholders varies substantially among countries. Shareholders in some countries may have more power to effectively sue publicly traded firms if their executives or directors commit financial fraud. In general, common law countries such as the United States, Canada, and the United Kingdom allow for more legal protection than civil law countries such as France or Italy.

3) The government enforcement of securities laws varies among countries. A country could have laws to protect shareholders but no enforcement of the laws, which means that shareholders are not protected.

4) The degree of financial information that must be provided by public companies varies among countries. The variation may be due to the accounting laws set by the government for public companies or reporting rules enforced by local stock exchanges. Shareholders are less susceptible to losses due to a lack of information if the public companies are required to be more transparent in their financial reporting.

Chapter 2- International Trade Financing – (20%)

❖ Introduction

The international trade activities of MNCs have grown in importance over time. This trend is attributable to the increased globalization of the world economies and the availability of trade finance from the international banking community. Although banks also finance domestic trade, their role in financing international trade is more critical due to the following complications involved.

- First, the exporter might question the importer's ability to make payment.
- Second, even if the importer is creditworthy, the government might impose exchange controls that prevent payment to the exporter.
- Third, the importer might not trust the exporter to ship the goods ordered.
- Fourth, even if the exporter does ship the goods, trade barriers or time lags in international transportation might delay arrival time.

Financial managers must recognize methods that they can use to finance international trade so that they can conduct exporting or importing in a manner that maximizes the value of an MNC.

❖ Payment Terms in International Trade

In general, five basic methods of payment are used to settle international transactions, each witha different degree of risk to the exporter and importer:

1. Prepayment
2. Letters of credit
3. Drafts (sight/time)
4. Consignment
5. Open account

1) Prepayment:

Under the prepayment method, the exporter will not ship the goods until the buyer has remitted payment to the exporter. Payment is usually made in the form of an international wire transfer to the exporter's bank account or foreign bank draft. As technology progresses, electronic commerce will allow firms engaged in international trade to make electronic credits and debits through an intermediary bank. This method affords the supplier the greatest degree of protection, and it is normally requested of first-time buyers whose creditworthiness is unknown or whose countries are in financial difficulty. Most buyers, however, are not willing to bear all the risk by prepaying an order.

2) Letters of Credit (L/Cs):

A letter of credit (L/C) is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of shipping documents in compliance with the terms stipulated therein. In effect, the bank is substituting its credit for that of the buyer. This method is a compromise between seller and buyer because it affords certain advantages to both parties. The exporter is assured of receiving payment from the issuing bank as long as it presents documents in accordance with the L/C. An important feature of an L/C is that the issuing bank is obligated to honor drawings under the L/C regardless of the buyer's ability or willingness to pay. On the other hand, the importer does not have to pay for the goods until shipment has been made and the documents are presented in good order. However, the importer must still rely upon the exporter to ship the goods as described in the documents, since the L/C does not guarantee that the goods purchased will be those invoiced and shipped.

3) Drafts:

A draft (or bill of exchange) is an unconditional promise drawn by one party, usually the exporter, instructing the buyer to pay the face amount of the draft upon presentation. The draft represents the exporter's formal demand for payment from the buyer. A draft affords the exporter less protection than an L/C because the banks are not obligated to honor payments on the buyer's behalf.

Most trade transactions handled on a draft basis are processed through banking channels. In banking terminology, these transactions are known as documentary collections. In a documentary collection transaction, banks on both ends act as intermediaries in the processing of shipping documents and the collection of payment. **If shipment is made under a sight draft**, the exporter is paid once shipment has been made and the draft is presented to the buyer for payment. The buyer's bank will not release the shipping documents to the buyer until the buyer has paid the draft. **This is known as documents against payment**. It provides the exporter with some protection since the banks will release the shipping documents only according to the exporter's instructions. The buyer needs the shipping documents to pick up the merchandise. Thebuyer does not have to pay for the merchandise until the draft has been presented.

If a shipment is made under a time draft, the exporter instructs the buyer's bank to release the shipping documents against acceptance (signing) of the draft. This method of payment is sometimes **referred to as documents against acceptance**. By accepting the draft, the buyer is promising to pay the exporter at the specified future date. This accepted draft is also known as a trade acceptance. In this type of transaction, the buyer is able to obtain the merchandise prior to paying for it.

4) Consignment:

Under a consignment arrangement, the exporter ships the goods to the importer while still

retaining actual title to the merchandise. The importer has access to the inventory but does not have to pay for the goods until they have been sold to a third party. The exporter is trusting the importer to remit payment for the goods sold at that time. If the importer fails to pay, the exporter has limited recourse because no draft is involved and the goods have already been sold. As a result of the high risk, consignments are seldom used except by affiliated and subsidiary companies trading with the parent company.

5) Open Account:

The opposite of prepayment is the open account transaction in which the exporter ships the merchandise and expects the buyer to remit payment according to the agreed-upon terms. The exporter is relying fully upon the financial creditworthiness, integrity, and reputation of the buyer. As might be expected, this method is used when the seller and buyer have mutual trust and a great deal of experience with each other.

❖ Documents in International Trade

The most important supporting document required in commercial bank financing of exports is the bill of lading. Of secondary importance are the commercial invoice, insurance certificate, andconsular invoice.

1) Bill of Lading:

One of the important shipping documents is the bill of lading (B/L). It serves three main and separate functions:

1. It is a contract between the carrier and shipper (exporter) in which the carrier agrees tocarry the goods from port of shipment to port of destination.

2. It is the shipper's receipt for the goods.

3. The negotiable B/L, its most common form, is a document that establishes control over the goods.

A bill of lading can be either a straight or an order B/L.

A straight B/L consigns the goods to a specific party, normally the importer, and is not negotiable. Title cannot be transferred to a third party merely by endorsement and delivery; therefore, a straight B/L is not good collateral and is used only when no financing is involved.

Most trade transactions do involve financing, which requires transfer of title, so the vast majority of bills of lading are **order B/Ls.** With an order B/L, the goods are consigned to the order of a named party, usually the exporter. In this way, the exporter retains title to the merchandise until it endorses the B/L on the reverse side. The exporter's representative may endorse to a specific party or endorse it in blank by simply signing his or her name.

The shipper delivers the cargo in the port of destination to the bearer of the endorsed order B/L, who must surrender it. An order B/L represents goods in transit that are probably readily marketable and fully insured, so this document is generally considered to be good collateral by banks. It is required under L/C financing and for discounting of drafts.

Bills of lading also can be classified in several other ways:

An on-board B/L certifies that the goods have actually been placed on board the vessel. By contrast, **a received-for-shipment B/L** merely acknowledges that the carrier has received the goods for shipment. It does not state that the ship is in port or that space is available. The cargo can, therefore, sit on the dock for weeks, or even months, before it is shipped. When goods are seasonal or perishable, therefore, the received-for-shipment B/L is never satisfactory to either theshipper or the importer. A received-for-shipment B/L can easily be converted into an on-board B/L by stamping it ‘‘on-board’’ and supplying the name of the vessel, the date, and the signature of the captain or the captain’s representative. A clean B/L indicates that the goods were received in apparently good condition. However, the carrier is not obligated to check beyond the external visual appearance of the boxes. If boxes are damaged or in poor condition, this observation is noted on the B/L, which then becomes a foul B/L. It is important that the exporter get a clean B/L—that is, one with no such notation—because foul B/Ls generally are not acceptable under a letter of credit.

2) Commercial Invoice:

A commercial invoice contains an authoritative description of the merchandise shipped, including full details on quality, grades, price per unit, and total value. It also contains the names and addresses of the exporter and importer, the number of packages, any distinguishing external marks, the payment terms, other expenses such as transportation and insurance charges, any fees collectible from the importer, the name of the vessel, the ports of departure and destination, and any required export or import permit numbers.

3) Insurance Certificate:

All cargoes going abroad are insured. Most of the insurance contracts used today are under an open, or floating, policy. This policy automatically covers all shipments made by the exporter, thereby eliminating the necessity of arranging individual insurance for each shipment. To evidence insurance for a shipment under an open policy, the exporter makes out an insurance certificate on forms supplied by the insurance company. This certificate contains information on the goods shipped. All entries must conform exactly with the information on the B/L, on the commercial invoice and, when required, on the consular invoice.

4) Consular Invoice:

A consular invoice is **a document specifying the contents and details of a shipment certified by the consul of the country the merchandise is being sent to**. Customs officials

use the invoice to confirm what's in the shipment, the number of goods, and the cost—and thus determine the import duty.

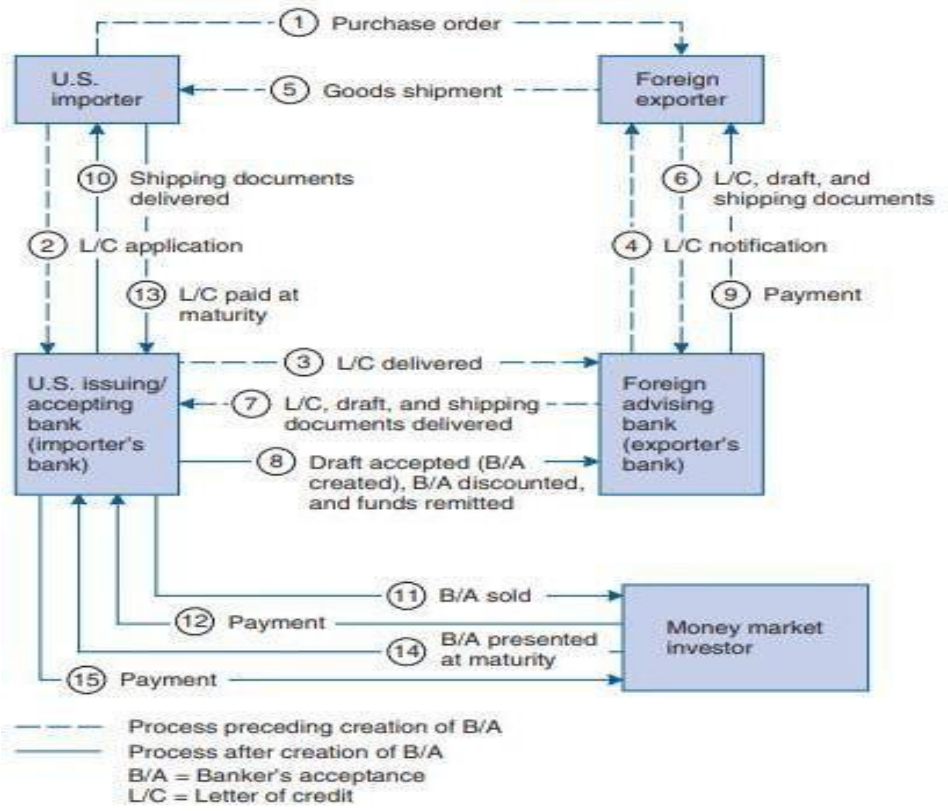
❖ Financing Techniques in International Trade

The following are some of the more popular methods or techniques of financing internationaltrade:

1) Banker's acceptances
2) Discounting
3) Factoring
4) Medium-term capital goods financing (forfaiting)
5) Accounts receivable financing
6) Letters of credit (L/Cs)

1) Banker's Acceptances:

Bankers' acceptances have played an important role in financing international trade for many centuries. A banker's acceptance is a time draft drawn on a bank. By ''accepting'' the draft, the bank makes an unconditional promise to pay the holder of the draft a stated amount on a specified day. Thus, the bank effectively substitutes its own credit for that of a borrower and in the process it creates a negotiable instrument that may be freely traded.



Creating an Acceptance:

A typical acceptance transaction is shown in above Exhibit. An importer of goods seeks credit to finance its purchase until the goods can be resold. If the importer does not have a close relationship with and cannot obtain financing from the exporter it is dealing with, it may request acceptance financing from its bank. Under an acceptance agreement, the importer will have its bank issue a letter of credit on its behalf, authorizing the foreign exporter to draw a time draft on the bank in payment for the goods. On the basis of this authorization, the exporter ships the goods on an order B/L made out to itself and presents a time draft and the endorsed shipping documents to its bank. The foreign bank then forwards the draft and the appropriate shipping documents to the importer's bank; the importer's bank accepts the draft and, by so doing, creates a banker's acceptance. The exporter discounts the draft with the accepting bank and receives payment for the shipment. The shipping documents are delivered to the importer, and the importer now may claim the shipment. The accepting bank may either buy (discount) the B/A and hold it in its own portfolio or sell (rediscount) the B/A in the money market.

2) Discounting:

Even if a trade draft is not accepted by a bank, the exporter still can convert the trade draft into cash by means of discounting. The exporter places the draft with a bank or other financial institution and, in turn, receives the face value of the draft less interest and commissions. By insuring the draft against both commercial and political risks, the

exporter often will pay a lower interest rate. If losses covered by the insurer do occur, the insuring agency will reimburse the exporter or any institution to which the exporter transfers the draft.

The discount rate for trade paper is often lower than interest rates on overdrafts, bank loans, and other forms of local funding. This lower rate is usually a result of export promotion policies that lead to direct or indirect subsidies of rates on export paper.

Discounting may be done with or without recourse. With recourse, the bank can collect from the exporter if the importer fails to pay the bill when due. The bank bears the collection riskif the draft is sold without recourse.

3) Factoring:

When an exporter ships goods before receiving payment, the accounts receivable balance increases. Unless the exporter has received a loan from a bank, it is initially financing the transaction and must monitor the collections of receivables. Since there is a danger that the buyerwill never pay at all, the exporting firm may consider selling the accounts receivable to a third party, known as a factor. In this type of financing, the exporter sells the accounts receivable without recourse. The factor then assumes all administrative responsibilities involved in collecting from the buyer and the associated credit exposure. The factor performs its own credit approval process on the foreign buyer before purchasing the receivable. For providing this service, the factor usually purchases the receivable at a discount and also receives a flat processing fee.

Factoring provides several benefits to the exporter. First, by selling the accounts receivable, the exporter does not have to worry about the administrative duties involved in maintaining and monitoring an accounts receivable accounting ledger. Second, the factor assumes the credit exposure to the buyer, so the exporter does not have to maintain personnel to assess the creditworthiness of foreign buyers. Finally, by selling the receivable to the factor, the exporter receives immediate payment and improves its cash flow.

4) Medium-term capital goods financing (Forfaiting):

Because capital goods are often quite expensive, an importer may not be able to make payment on the goods within a short time period. Thus, longer-term financing may be required here. The exporter might be able to provide financing for the importer but may not desire to do so since thefinancing may extend over several years. In this case, a type of trade finance known as forfaiting could be used. Forfaiting refers to the purchase of financial obligations, such as bills of exchangeor promissory notes, without recourse to the original holder, usually the exporter. In a forfait transaction, the importer issues a promissory note to pay the exporter for the imported goods over a period that generally ranges from 3 to 7 years. The exporter then sells the notes, without recourse, to the forfaiting bank.

In some respects, forfaiting is similar to factoring in that the forfaiter (or factor) assumes responsibility for the collection of payment from the buyer, the underlying credit risk, and the risk pertaining to the countries involved. Since the forfaiting bank assumes the risk of nonpayment, it should assess the creditworthiness of the importer as if it were extending a medium-term loan. Forfait transactions normally are collateralized by a bank guarantee or letter of credit issued by the importer's bank for the term of the transaction. Since obtaining financial information about the importer is usually difficult, the forfaiting bank places a great deal of reliance on the bank guarantee as the collateral in the event the buyer fails to pay as agreed. It is this guarantee backing the transaction that has fostered the growth of the forfait market, particularly in Europe, as a practical means of trade finance.

5) Accounts receivable financing:

In some cases, the exporter of goods may be willing to ship goods to the importer without an assurance of payment from a bank. This could take the form of an open account shipment or a time draft. Prior to shipment, the exporter should have conducted its own credit check on the importer to determine creditworthiness.

If the exporter is willing to wait for payment, it will extend credit to the buyer. If the exporter needs funds immediately, it may require financing from a bank. In what is referred to asaccounts receivable financing, the bank will provide a loan to the exporter secured by an assignment of the account receivable. The bank's loan is made to the exporter based on its creditworthiness. In the event the buyer fails to pay the exporter for whatever reason, the exporter is still responsible for repaying the bank.

6) Letters of credit (L/Cs):

A letter of credit (L/C) is an instrument issued by a bank on behalf of the importer (buyer) promising to pay the exporter (beneficiary) upon presentation of shipping documents in compliance with the terms stipulated therein. In effect, the bank is substituting its credit for that of the buyer. This method is a compromise between seller and buyer because it affords certain advantages to both parties.

The advantages of an L/C to the exporter are as follows:

1. An L/C eliminates credit risk if the bank that opens it is of undoubted standing. Therefore, the firm need check only on the credit reputation of the issuing bank.

2. An L/C also reduces the danger that payment will be delayed or withheld because of exchange controls or other political acts. Countries generally permit local banks to honor their letters of credit.

3. An L/C reduces uncertainty. The exporter knows all the requirements for payment because they are clearly stipulated on the L/C.

4. The L/C facilitates financing because it ensures the exporter a ready buyer for its

product. It also becomes especially easy to create a banker's acceptance—a draft accepted by a bank.

There are some advantages to the buyer as well:

1. Because payment is only in compliance with the L/C's stipulated conditions, the importer is able to ascertain that the merchandise is actually shipped on, or before, a certain date by requiring an on-board bill of lading. The importer also can require an inspection certificate.

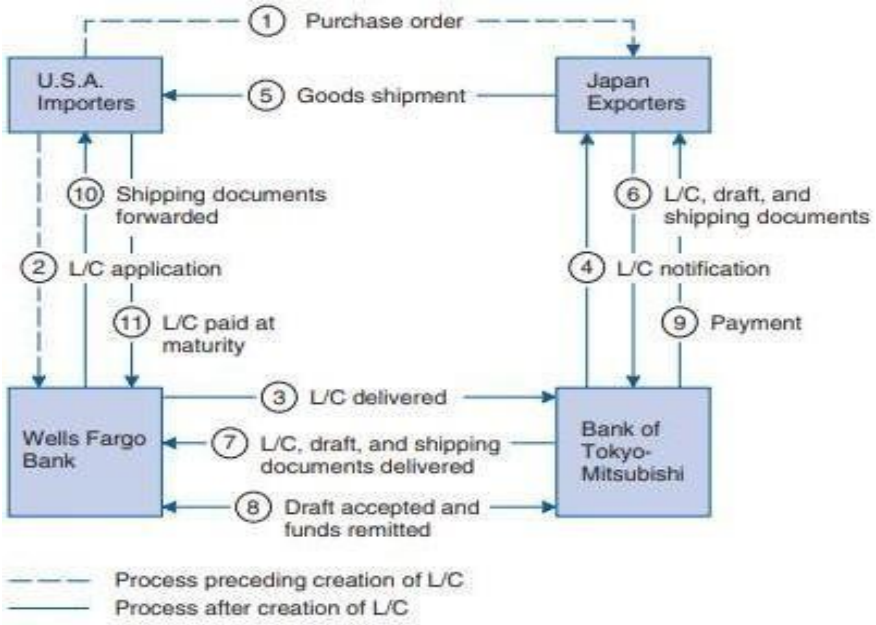
2. An L/C is about as good as cash in advance, so the importer usually can command more advantageous credit terms and/or prices.

3. Some exporters will sell only on a letter of credit.

4. An importer/buyer is concerned; he can plan his payment schedule properly by anticipating the requirements under letter of credit. This arrangement makes importer for easier planning.

5. Based on timely delivery schedule, buyer receives goods on time thereby he can execute his business plan smoothly and efficiently, in turn satisfying his clients promptly and effectively

Steps in Letter of Credit Transaction:



Types of Letter of Credit:

1) A **Revocable Letter of Credit** can be canceled or revoked at any time without prior notification to the beneficiary, and it is seldom used.

2) An **Irrevocable Letter of Credit** cannot be canceled or amended without the beneficiary'sconsent.

3) A **Confirmed Letter of Credit** is an L/C issued by one bank and confirmed by another,obligating both banks to honor any drafts drawn in compliance.

4) An **Unconfirmed Letter of Credit** is the obligation of only the issuing bank.

❖ Government Sources of Export Financing

Due to the inherent risks of international trade, government institutions offer various forms of export credit, export finance, and guarantee programs to reduce risk and stimulate foreign trade. There are main two government institutions of Export Financing in India.

1. Export Import Bank of India (EXIM Bank)

2. Export credit and guarantee corporation of India (ECGC)

EXIM Bank of India

EXIM Bank or Export-Import Bank of India is India's leading and apex export financing institute that engages in integrating foreign trade and investment with the country's economic growth. Export Import Bank of India (EXIM Bank) was established in 1982 under the Export-Import Bank of India Act 1981 as a purveyor of export credit. It is a wholly government owned financial institution regulated by RBI, set up for the purpose of financing, facilitating and promoting India's foreign trade. The Bank commenced its operations on the 1st March 1982.

Objectives of the EXIM Bank:

(a) To provide financial assistance to exporters and importers.

(b) To coordinate the working of institutions engaged in financing export and import of goods and services.

(c) To develop mutually beneficial relationships with the international community.

(d) To forge relationships with other export development and financing agencies.

(e) To be responsive to the problems of Indian exporters.

Role/Functions of EXIM Bank

EXIM bank plays a role of coordinator, financer, consultant and promoter with regard to India's foreign trade. These services of EXIM bank can be studied under two broad categories.

I. Fund based Assistance	II. Non Fund based Assistance
- Facilities for Indian Exporters	- Marketing Advisory Services
- Facilities for Commercial Banks	- Export Advisory Service
- Facilities for Overseas Entities	- International Consultant

I. Fund based Assistance

EXIM bank offers financial services to Indian exporters, commercial banks and also foreign entities.

(a) Facilities for Indian Exporters

1. Pre-shipment Credit: Pre-Shipment credit is provided in Indian and foreign currency to support the company with appropriate access to finance at the manufacturing stag. Pre-shipment credit is extended to Indian exporters in order to enable them to buy raw materials and other inputs for undertaking manufacturing of goods for export purpose.

2. Post-Shipment Credit: Post-Shipment credit finances the export bill after shipments have been made. At the post-shipment stage, this facility enables Indian exporters to extend term credit to overseas importers, of eligible Indian goods.

3. Finance for Consultancy and Technology Services: This facility enables Indian exporters of consultancy and technology services to extend term credit to overseas importers.

4. Finance for EOUs and Units in EPZs: This facility enables units situated in Export Oriented Units (EOUs) and Export Processing Zones (EPZs) to acquire indigenous and imported machinery and other assets for export production.

5. Export Marketing Finance: Under this facility, exporters are provided financial assistance for implementing market development programmes and export marketing activities.

6. Overseas Investment Finance: Under this scheme, Indian promoters are extended financial assistance for equity participation in joint ventures set up abroad.

7. Forfeiting: Forfeiting is a financing mechanism that enables a company to convert credit sale to cash sale on without recourse basis. In this way EXIM Bank acts as a facilitator for the Indian exporters.

(b) Facilities for Commercial Banks

1. Refinance of Export (Supplier's) Credit: It enables the commercial banks to offer credit to Indian exporters of eligible goods, who extend term credit over 180 days to the overseas importers.

2. Refinance of Indian Loans of EOUS: This facility enables the commercial banks to offer credit to eligible EOUS to acquire indigenous and imported machinery and other assets for export production.
3. Refinance of Term Loans for Computer Software Exports: This facility enables the commercial banks to extend finance for acquisition of imported and indigenous computer systems and project related assets.

4. Export Bills Rediscounting: Under this programme, the EXIM bank provides short term funds to the Indian commercial banks against export bills with usance not exceeding 180 days.

5. Bulk Import Finance: This facility enables the Indian commercial banks to extend finance to the overseas importers for import of consumable inputs in bulk.

(c) Facilities for Overseas Entities:

1. Line of Credit (LOC): Under this scheme, the EXIM bank offers credit to foreign governments and their agencies and overseas financial institutions to finance import of eligible goods from India. In this, the EXIM bank extends LOCs to overseas financial institutions, regional development banks, sovereign governments and other entities overseas, to enable buyers in those countries to import developmental and infrastructure projects, equipments, goods and services from India, on deferred credit terms.

2. Buyer's Credit: Under this scheme, the EXIM bank offers credit to overseas buyers to finance import from India on deferred credit terms. Through this programme, the overseas buyer can open a "letter of credit" in favour of the Indian exporter and can import goods and services from India on deferred payment terms.

II. Non-Fund based Assistance

Non-financial services of EXIM bank include Marketing Advisory Services, Export Advisory Services and role as an international consultant.

(a) Marketing Advisory Services

Exim Bank's Marketing Advisory Services (MAS) Group plays a promotional role to create and enhance export capabilities and international competitiveness of Indian companies. The Group leverages the Bank's high international standing, in-depth knowledge and understanding of the international markets and well established institutional linkages.

Key roles of Marketing Advisory Services:

- To help Indian exporting firms in their globalisation efforts by proactively assisting in locating overseas distributors/buyers/partners for their products/services
- To identify opportunities overseas for setting up plants or projects or for acquisition of overseas companies

(b) Export Advisory Service

The Export Advisory Services Group [EAS] offers a diverse range of information, advisory and support services, which enable exporters to evaluate international risks, exploit export opportunities and improve competitiveness. Value added information and support services are provided to Indian projects exporters on the projects funded by multilateral agencies.

These services are provided on a fee basis to Indian companies and overseas entities. The scope of services includes market-related information, sector and feasibility studies, technology supplier identification, partner search, investment facilitation and development of joint ventures both in India and abroad.

One of the key areas is **Multilateral Funded Projects Overseas (MFPO).** In this, The Bank provides a package of information and support services to Indian companies to help improve their prospects for securing business in projects funded by the World Bank, Asian Development Bank, African Development Bank, and European Bank for Reconstruction and Development.

(c) EXIM bank as an International Consultant

EXIM bank shares its expertise in the creation and operation of financial institutions in the developing countries. EXIM Bank also shares its experience and expertise through provision of on-site exchange of personnel programmes aimed at providing a first-hands experience to the employees of its institutional partners. The Bank has been sharing its experience and expertise by undertaking consultancy assignments. Some of the examples of such services are:

1. Feasibility study for establishment of an export credit and guarantee facility for Gulf Co-operation Council Countries.

2. Setting up of the Afriexim Bank, EXIM bank of Malaysia and the Export Credit Guarantee Company of Zimbabwe.

3. Designing and operationalising of Export Financing Programmes in Turkey and South Africa.

❖ Parallel Loans

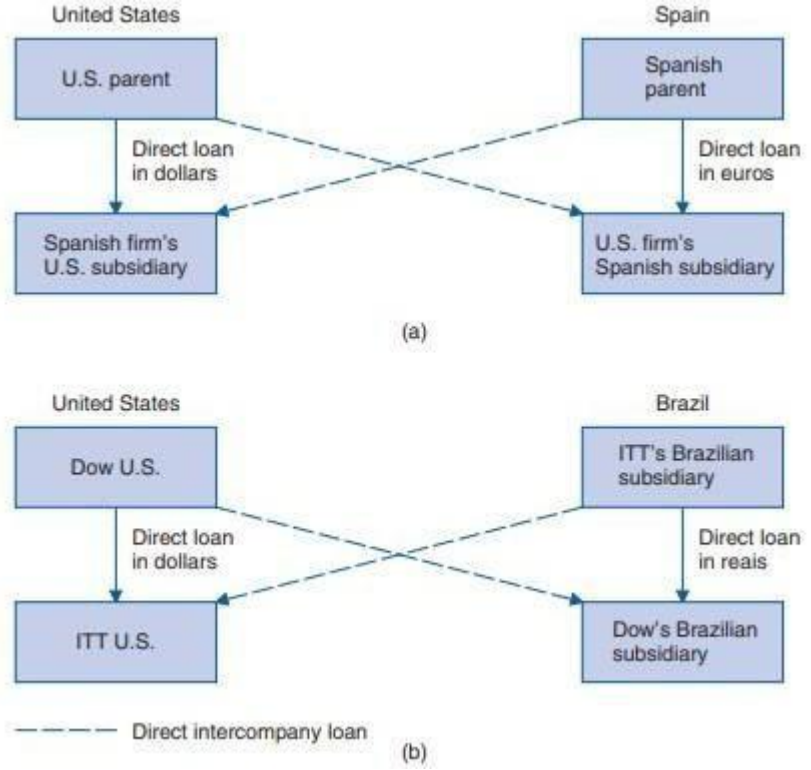
A parallel loan is a four-party agreement in which two parent companies in different countries borrow money in their local currencies, then lend that money to the other's local subsidiary. The purpose of a parallel loan is to avoid borrowing money across country lines with possible restrictions and fees.

A parallel loan is a type of loan in which two affiliate or parent companies in different countries borrow money in their local currencies, then lend the money to each other to reduce foreign exchange risk

A parallel loan is a method of effectively repatriating blocked funds (at least for the term of the arrangement), avoiding exchange control restrictions, avoiding a premium exchange rate for investments abroad, financing foreign affiliates without incurring additional exchange risk, orobtaining foreign currency financing at attractive rates.

As shown in below Exhibit, it consists of two related but separate—that is, parallel—borrowings and usually involves four parties in at least two different countries.

Exhibit – Structure of Parallel Loan



In Exhibit (a), a U.S. parent firm wishing to invest in Spain lends dollars to the U.S. affiliate of a Spanish firm that wants to invest in the United States. In return, the Spanish parent lends euros in Spain to the U.S. firm's Spanish subsidiary. Drawdowns, payments of interest, and repayments of principal are made simultaneously. The differential between the rates of interest on the two loans is determined, in theory, by the cost of money in each country and anticipated changes in currency values.

Exhibit (b) shows how a parallel loan can be used to access blocked funds. In this instance, the Brazilian affiliate of ITT is generating reals that it is unable to repatriate. It lends this money to the local affiliate of Dow Chemical; in turn, Dow lends dollars to ITT in the United States. Hence, ITT would have the use of dollars in the United States and Dow would obtain reals in Brazil. In both cases, the parallel transactions are the functional equivalent of direct intercompany loans.

Fees to banks brokering these arrangements usually run from 0.25% to 0.5% of the principal for each side.

Chapter 3- Short Term Financing – (20%)

T.Y.B.B.A. (Semester – VI)

Subject: 604 – International Financial Management

[Syllabus:

Sources of short term financing

International Cash Management: centralized cash management, techniques to optimize cash flow, Complications in optimizing cash flow]

❖ Introduction:

All firms make short-term financing decisions periodically. Beyond the trade financing discussed in the previous chapter, MNCs obtain short-term financing to support other operations as well. Because MNCs have access to additional sources of funds, their short-term financing decisions are more complex than those of other companies. Financial managers must understand the possible advantages and disadvantages of short term financing with foreign currencies so that they can make short-term financing decisions that maximize the value of the MNC.

❖ Sources of Short Term Financing

MNC parents and their subsidiaries typically use various methods of obtaining short term funds to satisfy their liquidity needs.

1) Short-Term Notes:

One method increasingly used in recent years is the issuing of short-term notes, or unsecured debt securities. In Europe, the securities are referred to as Euronotes. The interest rates on these notes are based on LIBOR (the interest rate Eurobanks charge on interbank loans). Short-term notes typically have maturities of 1, 3, or 6 months. Some MNCs continually roll them over as a form of intermediate-term financing. Commercial banks underwrite the notes for MNCs, and some commercial banks purchase them for their own investment portfolios.

2) Commercial Paper:

In addition to short-term notes, MNCs also issue commercial paper. In Europe, this is sometimes referred to as Euro-commercial paper. Dealers issue commercial paper for MNCs without the

backing of an underwriting syndicate, so a selling price is not guaranteed to the issuers. Maturities can be tailored to the issuer's preferences. Dealers may make a secondary market by offering to repurchase commercial paper before maturity.

3) Bank Loans:

Direct loans from banks, which are typically utilized to maintain a relationship with banks, are another popular source of short-term funds for MNCs. If other sources of short-term funds become unavailable, MNCs rely more heavily on direct loans from banks. Most MNCs maintain credit arrangements with various banks around the world. Some MNCs have credit arrangements with more than 100 foreign and domestic banks.

❖ Centralized Cash Management

A key component of working capital management is cash management. MNCs have large cash inflows and outflows in various currencies, and the cash inflows and outflows will not balance in any currency in any given month. An MNC may have consistent surpluses in cash for some currencies each month and consistent shortages for some other currencies. Many of its currencies will likely have surplus cash positions in some months and shortages in other months. For MNCs with foreign subsidiaries, cash management is even more complicated because every subsidiary may be short of cash in some currencies and have excess currency in others.

Each subsidiary's management may naturally focus on managing its own cash positions. However, such a decentralized management is not optimal because it will force the MNC overall to maintain a larger investment in cash than is necessary. Thus, MNCs commonly use centralized cash management to monitor and manage the parent- subsidiary and inter subsidiary cash flows. This role is critical since it can often benefit individual subsidiaries in need of funds or overly exposed to exchange rate risk.

Exhibit 21.1 Cash Flow of the Overall MNC

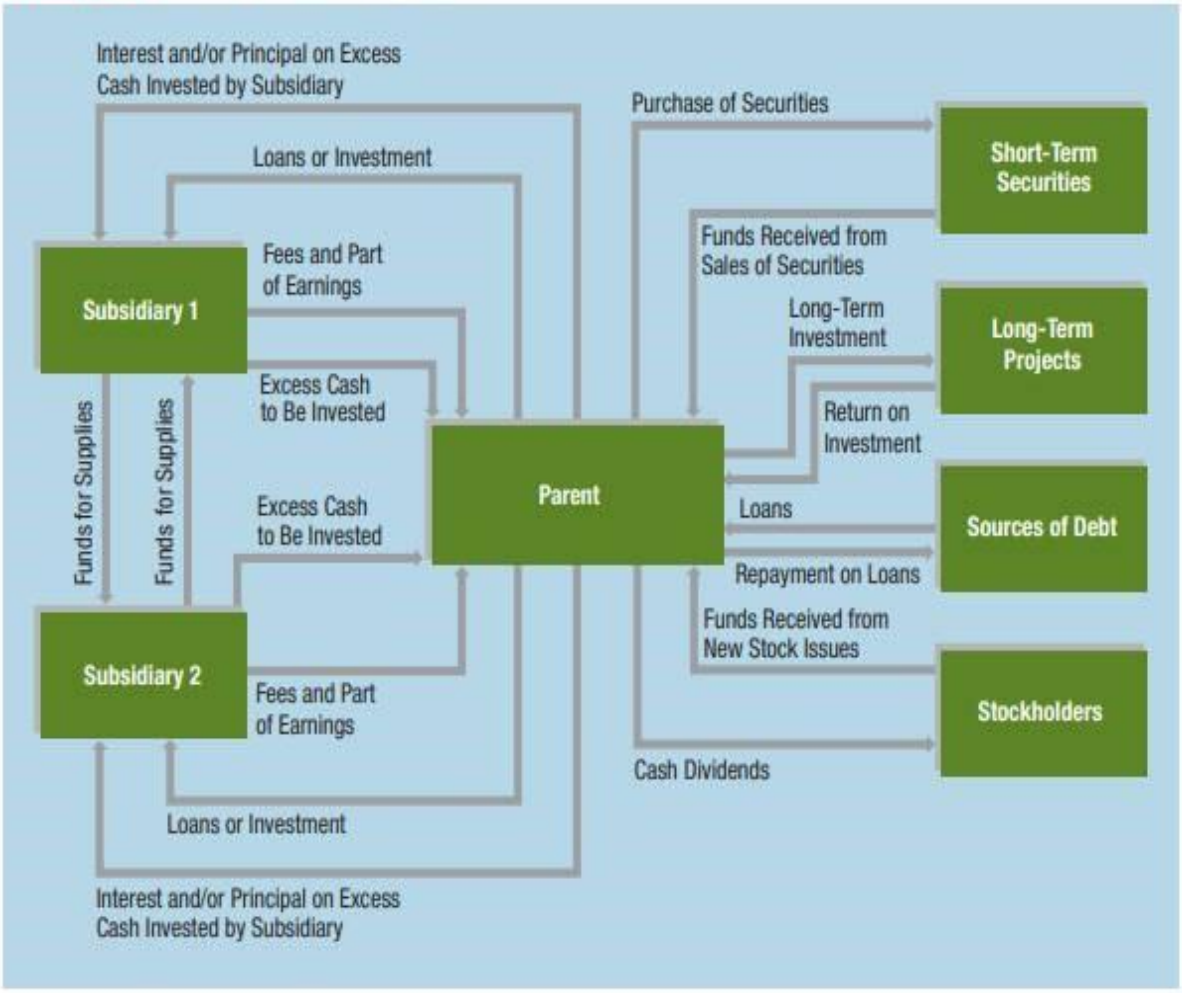


Exhibit 21.1 is a complement to the following discussion of cash flow management. It is a simplified cash flow diagram for an MNC with two subsidiaries in different countries. Although each MNC may handle its payments in a different manner, Exhibit 21.1 is based on simplified assumptions that will help illustrate some key concepts of international cash management. The exhibit reflects the assumption that the two subsidiaries periodically send loan repayments and dividends to the parent or send excess cash to the parent (where the centralized cash management process is assumed to take place). These cash flows represent the incoming cash to the parent from the subsidiaries. The parent's cash outflows to the subsidiaries can include loans and the return of cash previously invested by the subsidiaries. The subsidiaries also have cash flows between themselves because they purchase supplies from each other.

While each subsidiary is managing its working capital, there is a need to monitor and manage the cash flows between the parent and the subsidiaries, as well as between the individual subsidiaries. This task of international cash management should be delegated to a centralized cash management group. International cash management can be segmented into two functions: (1) optimizing cash flow movements and (2) investing excess cash. These two functions are discussed in turn.

The centralized cash management division of an MNC cannot always accurately forecast events that affect parent-subsidiary or inter subsidiary cash flows. It should, however, be ready to react to any event by considering (1) any potential adverse impact on cash flows and (2) how to avoid such an adverse impact. If the cash flow situation between the parent and subsidiaries results in a cash squeeze on the parent, it should have sources of funds (credit lines) available. On the other hand, if it has excess cash after considering all outflow payments, it must consider where to invest funds. This decision is thoroughly examined shortly.

❖ Techniques to Optimize Cash Flow

Cash inflows can be optimized by the following techniques:

1. Accelerating cash inflows
2. Minimizing currency conversion costs
3. Managing blocked funds
4. Managing intersubsidiary cash transfers

Each of these techniques is discussed in turn.

1) Accelerating Cash Inflows:

The first goal in international cash management is to accelerate cash inflows since the more quickly the inflows are received, the more quickly they can be invested or used for other purposes. Several managerial practices are advocated for this endeavor, some of which may be implemented by the individual subsidiaries.

First, a corporation may establish lockboxes around the world, which are post office boxes to which customers are instructed to send payment. When set up in appropriate locations, lockboxes can help reduce mailing time (mail float). A bank usually processes incoming checks at a lockbox on a daily basis.

Second, cash inflows can be accelerated by using preauthorized payments, which allow a corporation to charge a customer's bank account up to some limit. Both preauthorized payments and lockboxes are also used in a domestic setting. Because international transactions may have a relatively long mailing time, these methods of accelerating cash inflows can be quite valuable for an MNC.

2) Minimizing Currency Conversion Costs:

Another technique for optimizing cash flow movements, **netting**, can be implemented with the joint effort of subsidiaries or by the centralized cash management group. This technique optimizes cash flows by reducing the administrative and transaction costs that result from currency conversion.

Over time, netting has become increasingly popular because it offers several key benefits:

First, it reduces the number of cross-border transactions between subsidiaries, thereby reducing the overall administrative cost of such cash transfers.

Second, it reduces the need for foreign exchange conversion since transactions occur less frequently, thereby reducing the transaction costs associated with foreign exchange conversion.

Third, the netting process imposes tight control over information on transactions between subsidiaries. Thus, all subsidiaries engage in a more coordinated effort to accurately report and settle their various accounts.

Finally, cash flow forecasting is easier since only net cash transfers are made at the end of each period, rather than individual cash transfers throughout the period. Improved cash flow forecasting can enhance financing and investment decisions.

A **bilateral netting system** involves transactions between two units: between the parent and a subsidiary, or between two subsidiaries. A **multilateral netting system** usually involves a more complex interchange among the parent and several subsidiaries. For most large MNCs, a multilateral netting system would be necessary to effectively reduce administrative and currency conversion costs. Such a system is normally centralized so that all necessary information is consolidated. From the consolidated cash flow information, net cash flow positions for each pair

of units (subsidiaries, or whatever) are determined, and the actual reconciliation at the end of each period can be dictated. The centralized group may even maintain inventories of various currencies so that currency conversions for the end-of-period net payments can be completed without significant transaction costs.

MNCs commonly monitor the cash flows between their subsidiaries with the use of an inter subsidiary payments matrix. A U.S.-based MNC will normally translate the payments into dollars (based on the prevailing spot rate) so that the net payments can be easily determined. If the Canadian subsidiary of the MNC normally makes payments to the French subsidiary in euros, but the French subsidiary normally makes payments to the Canadian subsidiary in Canadian dollars, the payments need to be translated into a common currency to determine the net payment owed. The amounts can be translated into dollars to determine the net payment owed between each pair of subsidiaries. This allows the parent of a U.S.-based MNC to assess the relative size of each net payment owed between subsidiaries.

There can be some limitations to multilateral netting due to foreign exchange controls. Although the major industrialized countries typically do not impose such controls, some other countries do, and some countries prohibit netting altogether. Thus, an MNC with subsidiaries around the world may not be able to include all of its subsidiaries in its multilateral netting system. Obviously, this will limit the degree to which the netting system can reduce administration and transaction costs.

3) Managing Blocked Funds:

Cash flows can also be affected by a host government's blockage of funds, which might occur if the government requires all funds to remain within the country in order to create jobs and reduce unemployment. To deal with funds blockage, the MNC may implement the same strategies used when a host country government imposes high taxes. To make efficient use of these funds, the MNC may instruct the subsidiary to set up a research and development division, which incurs costs and possibly generates revenues for other subsidiaries.

Another strategy is to use transfer pricing in a manner that will increase the expenses incurred by the subsidiary. A host country government is likely to be more lenient on funds sent to cover expenses than on earnings remitted to the parent.

When subsidiaries are restricted from transferring funds to the parent, the parent may instruct the subsidiary to obtain financing from a local bank rather than from the parent. By borrowing through a local intermediary, the subsidiary is assured that its earnings can be distributed to pay off previous financing. Overall, most methods of managing blocked funds are intended to make efficient use of the funds by using them to cover expenses that are transferred to that country.

4) Managing Inter subsidiary Cash Transfers:

Proper management of cash flows can also be beneficial to a subsidiary in need of funds.

Example: Texas, Inc., has two foreign subsidiaries called Short Sub and Long Sub. Short Sub needs funds, while Long Sub has excess funds. If Long Sub purchases supplies from Short Sub, it can provide financing by paying for its supplies earlier than necessary. This technique is often called leading. Alternatively, if Long Sub sells supplies to Short Sub, it can provide financing by allowing Short Sub to lag its payments. This technique is called lagging.

The leading or lagging strategy can make efficient use of cash and thereby reduce debt. Some host governments prohibit the practice by requiring that a payment between subsidiaries occur at the time the goods are transferred. Thus, an MNC needs to be aware of any laws that restrict the use of this strategy.

❖ Complications in Optimizing Cash Flow

Most complications encountered in optimizing cash flow can be classified into three categories:

1. Company-related characteristics
2. Government restrictions
3. Characteristics of banking systems

Each complication is discussed in turn.

1) Company-Related Characteristics:

In some cases, optimizing cash flow can become complicated due to characteristics of the MNC. If one of the subsidiaries delays payments to other subsidiaries for supplies received, the other subsidiaries may be forced to borrow until the payments arrive. A centralized approach that monitors all inter subsidiary payments should be able to minimize such problems.

2) Government Restrictions:

The existence of government restrictions can disrupt a cash flow optimization policy. Some governments prohibit the use of a netting system, as noted earlier. In addition, some countries periodically prevent cash from leaving the country, thereby preventing net payments from being made. These problems can arise even for MNCs that do not experience any company-related problems. Countries in Latin America commonly impose restrictions that affect an MNC's cash flows.

3) Characteristics of Banking Systems:

The abilities of banks to facilitate cash transfers for MNCs vary among countries. Banks in the United States are advanced in this field, but banks in some other countries do not offer services. MNCs prefer some form of zero-balance account, where excess funds can be used to make payments but earn interest until they are used.

In addition, some MNCs benefit from the use of lockboxes. Such services are not available in some countries. In addition, a bank may not update the MNC's bank account information sufficiently or provide a detailed breakdown of fees for banking services. Without full use of banking resources and information, the effectiveness of international cash management is limited. In addition, an MNC with subsidiaries in, say, eight different countries will typically be dealing with eight different banking systems. Much progress has been made in foreign banking systems in recent years. As time passes and a more uniform global banking system emerges, such problems may be alleviated.

T.Y.B.B.A. (Semester – VI)
Subject: 604 – International Financial Management

Chapter 5- Long Term Assets and Liability Management – (30%)

[Syllabus: Direct Foreign Investment: Motives, Benefits and Host Government Views, Barriers; Multinational Capital Budgeting: Inputs, Simple Example and Factors; International Acquisitions: Background, Models for Valuing Target, Factors affecting Cash Flow Determination of Target, Valuation Process, Why Valuation Differ and Other Type of Multinational Restructuring]

❖ DIRECT FOREIGN INVESTMENT

MNCs commonly capitalize on foreign business opportunities by engaging in **direct foreign investment (DFI)**, which is investment in real assets (such as land, buildings, or even existing plants) in foreign countries. They engage in joint ventures with foreign firms, acquire foreign firms, and form new foreign subsidiaries. Any of these types of DFI can generate high returns when managed properly. However, DFI requires a substantial investment and can therefore put much capital at risk. Moreover, if the investment does not perform as well as expected, the MNC may have difficulty selling the foreign project it created. Given these return and risk characteristics of DFI, MNCs tend to carefully analyze the potential benefits and costs before implementing any type of DFI. Financial managers must understand the potential return and risk associated with DFI so that they can make investment decisions that maximize the MNC's value.

➢ Motives for Direct Foreign Investment:

MNCs commonly consider direct foreign investment because it can improve their profitability and enhance shareholder wealth. In most cases, MNCs engage in DFI because they are interested in boosting revenues, reducing costs, or both.

(A) <u>Revenue-Related Motives:</u>

The following are typical motives of MNCs that are attempting to boost revenues:

(1) Attract New Sources of Demand: A corporation often reaches a stage when growth is limited in its home country, possibly because of intense competition. Even if it faces little competition, its market share in its home country may already be near its potential peak. Thus, the firm may consider foreign markets where there is potential demand. Many developing countries, such as Argentina, Chile, Mexico, Hungary, and China, have been perceived as attractive sources of new demand. Many MNCs have penetrated these countries since barriers

have been removed. Because the consumers in some countries have historically been restricted from purchasing goods produced by firms outside their countries, the markets for some goods are not well established and offer much potential for penetration by MNCs.

For example, China has attracted MNCs. Motorola recently invested more than $1 billion in joint ventures in China. The Coca-Cola Co. has invested about $500 million in bottling facilities in China, and PepsiCo has invested about $200 million in bottling facilities. Yum Brands has KFC franchises and Pizza Hut franchises in China. Other MNCs, such as Ford Motor Co., United Technologies, General Electric, Hewlett-Packard, and IBM, have also invested more than $100 million in China to attract demand by consumers there.

(2) Enter Profitable Markets: If other corporations in the industry have proved that superior earnings can be realized in other markets, an MNC may also decide to sell in those markets. It may plan to undercut the prevailing, excessively high prices. A common problem with this strategy is that previously established sellers in a new market may prevent a new competitor from taking away their business by lowering their prices just when the new competitor attempts to break into this market.

(3) Exploit Monopolistic Advantages: Firms may become internationalized if they possess resources or skills not available to competing firms. If a firm possesses advanced technology and has exploited this advantage successfully in local markets, the firm may attempt to exploit it internationally as well. In fact, the firm may have a more distinct advantage in markets that have less advanced technology.

(4) React to Trade Restrictions: In some cases, MNCs use DFI as a defensive rather than an aggressive strategy. Specifically, MNCs may pursue DFI to circumvent trade barriers.

For example, Japanese automobile manufacturers established plants in the United States in anticipation that their exports to the United States would be subject to more stringent trade restrictions. Japanese companies recognized that trade barriers could be established that would limit or prohibit their exports. By producing automobiles in the United States, Japanese manufacturers could circumvent trade barriers.

(5) Diversify Internationally: Since economies of countries do not move perfectly in tandem over time, net cash flow from sales of products across countries should be more stable than comparable sales of the products in a single country. By diversifying sales (and possibly even production) internationally, a firm can make its net cash flows less volatile. Thus, the possibility of a liquidity deficiency is less likely. In addition, the firm may enjoy a lower cost of capital as shareholders and creditors perceive the MNC's risk to be lower as a result of more stable cash flows.

(B) Cost-Related Motives:

MNCs also engage in DFI in an effort to reduce costs. The following are typical motives of MNCs that are trying to cut costs:

(1) Fully Benefit from Economies of Scale: A corporation that attempts to sell its primary product in new markets may increase its earnings and shareholder wealth due to economies of scale (lower average cost per unit resulting from increased production). Firms that utilize much machinery are most likely to benefit from economies of scale.

For example, the removal of trade barriers by the Single European Act allowed MNCs to achieve greater economies of scale. Some U.S.-based MNCs consolidated their European plants because the removal of tariffs between countries in the European Union (EU) enabled firms to achieve economies of scale at a single European plant without incurring excessive exporting costs. The act also enhanced economies of scale by making regulations on television ads, automobile standards, and other products and services uniform across the EU. As a result, Colgate-Palmolive Co. and other MNCs are manufacturing more homogeneous products that can be sold in all EU countries. The adoption of the euro also encouraged consolidation by eliminating exchange rate risk within these countries.

(2) Use Foreign Factors of Production: Labor and land costs can vary dramatically among countries. MNCs often attempt to set up production in locations where land and labor are cheap. Due to market imperfections such as imperfect information, relocation transaction costs, and barriers to industry entry, specific labor costs do not necessarily become equal among markets. Thus, it is worthwhile for MNCs to survey markets to determine whether they can benefit from cheaper costs by producing in those markets.

For example, Mexico has attracted almost $8 billion in DFI from firms in the automobile industry, primarily because of the low-cost labor. Mexican workers at General Motors' subsidiaries who manufacture sedans and trucks earn daily wages that are less than the average hourly rate for similar workers in the United States. Ford is also producing trucks at subsidiaries based in Mexico.

Baxter International has established manufacturing plants in Mexico and Malaysia to capitalize on lower costs of production (primarily wage rates). Honeywell has joint ventures in countries such as Korea and India where production costs are low. It has also established subsidiaries in countries where production costs are low, such as Mexico, Malaysia, Hong Kong, and Taiwan.

(3) Use Foreign Raw Materials: Due to transportation costs, a corporation may attempt to avoid importing raw materials from a given country, especially when it plans to sell the finished product back to consumers in that country. Under such circumstances, a more feasible solution

may be to develop the product in the country where the raw materials are located.

(4) Use Foreign Technology: Corporations are increasingly establishing overseas plants or acquiring existing overseas plants to learn the technology of foreign countries. This technology is then used to improve their own production processes and increase production efficiency at all subsidiary plants around the world.

(5) React to Exchange Rate Movements: When a firm perceives that a foreign currency is undervalued, the firm may consider DFI in that country, as the initial outlay should be relatively low. A related reason for such DFI is to offset the changing demand for a company's exports due to exchange rate fluctuations. For example, when Japanese automobile manufacturers build plants in the United States, they can reduce exposure to exchange rate fluctuations by incurring dollar costs for their production that offset dollar revenues.

Exhibit 13.1 Summary of Motives for Direct Foreign Investment

	Means of Using DFI to Achieve This Benefit
Revenue-Related Motives	
1. Attract new sources of demand.	Establish a subsidiary or acquire a competitor in a new market.
2. Enter markets where superior profits are possible.	Acquire a competitor that has controlled its local market.
3. Exploit monopolistic advantages.	Establish a subsidiary in a market where competitors are unable to produce the identical product; sell products in that country.
4. React to trade restrictions.	Establish a subsidiary in a market where tougher trade restrictions will adversely affect the firm's export volume.
5. Diversify internationally.	Establish subsidiaries in markets whose business cycles differ from those where existing subsidiaries are based.
Cost-Related Motives	
6. Fully benefit from economies of scale.	Establish a subsidiary in a new market that can sell products produced elsewhere; this allows for increased production and possibly greater production efficiency.
7. Use foreign factors of production.	Establish a subsidiary in a market that has relatively low costs of labor or land; sell the finished product to countries where the cost of production is higher.
8. Use foreign raw materials.	Establish a subsidiary in a market where raw materials are cheap and accessible; sell the finished product to countries where the raw materials are more expensive.
9. Use foreign technology.	Participate in a joint venture in order to learn about a production process or other operations.
10. React to exchange rate movements.	Establish a subsidiary in a new market where the local currency is weak but is expected to strengthen over time.

➢ Host Government Views of Direct Foreign Investment (DFI):

Each government must weigh the advantages and disadvantages of direct foreign investment in its country. It may provide incentives to encourage some forms of DFI, barriers to prevent other forms of DFI, and impose conditions on some other forms of DFI.

Incentives to Encourage DFI:

The ideal DFI solves problems such as unemployment and lack of technology without taking business away from local firms.

For example, consider an MNC that is willing to build a production plant in a foreign country that will use local labor and produce goods that are not direct substitutes for other locally produced goods. In this case, the plant will not cause a reduction in sales by local firms. The host government would normally be receptive toward this type of DFI. Another desirable form of DFI from the perspective of the host government is a manufacturing plant that uses local labor and then exports the products (assuming no other local firm exports such products to the same areas).

In some cases, a government will offer incentives to MNCs that consider DFI in its country. Governments are particularly willing to offer incentives for DFI that will result in the employment of local citizens or an increase in technology. Common incentives offered by the host government include tax breaks on the income earned there, rent-free land and buildings, low-interest loans, subsidized energy, and reduced environmental regulations. The degree to which a government will offer such incentives depends on the extent to which the MNC's DFI will benefit that country.

While many governments encourage DFI, they use different types of incentives. France has periodically sold government land at a discount, while Finland and Ireland attracted MNCs in the late 1990s by imposing a very low corporate tax rate on specific businesses.

➢ Barriers to Direct Foreign Investment (DFI):

Governments are less anxious to encourage DFI that adversely affects locally owned companies, unless they believe that the increased competition is needed to serve consumers. Therefore, they tend to closely regulate any DFI that may affect local firms, consumers, and economic conditions.

(1) Protective Barriers: When MNCs consider engaging in DFI by acquiring a foreign company, they may face various barriers imposed by host government agencies. All countries have one or more government agencies that monitor mergers and acquisitions. These agencies

may prevent an MNC from acquiring companies in their country if they believe it will attempt to lay off employees. They may even restrict foreign ownership of any local firms.

(2) "Red Tape" Barriers: An implicit barrier to DFI in some countries is the "red tape" involved, such as procedural and documentation requirements. An MNC pursuing DFI is subject to a different set of requirements in each country. Therefore, it is difficult for an MNC to become proficient at the process unless it concentrates on DFI within a single foreign country. The current efforts to make regulations uniform across Europe have simplified the paperwork required to acquire European firms.

(3) Industry Barriers: The local firms of some industries in particular countries have substantial influence on the government and will likely use their influence to prevent competition from MNCs that attempt DFI. MNCs that consider DFI need to recognize the influence that these local firms have on the local government.

(4) Environmental Barriers: Each country enforces its own environmental constraints. Some countries may enforce more of these restrictions on a subsidiary whose parent is based in a different country. Building codes, disposal of production waste materials, and pollution controls are examples of restrictions that force subsidiaries to incur additional costs. Many European countries have recently imposed tougher antipollution laws as a result of severe problems.

(5) Regulatory Barriers: Each country also enforces its own regulatory constraints pertaining to taxes, currency convertibility, earnings remittance, employee rights, and other policies that can affect cash flows of a subsidiary established there. Because these regulations can influence cash flows, financial managers must consider them when assessing policies. Also, any change in these regulations may require revision of existing financial policies, so financial managers should monitor the regulations for any potential changes over time. Some countries may require extensive protection of employee rights. If so, managers should attempt to reward employees for efficient production so that the goals of labor and shareholders will be closely aligned.

(6) Ethical Differences: There is no consensus standard of business conduct that applies to all countries. A business practice that is perceived to be unethical in one country may be totally ethical in another. For example, U.S.-based MNCs are well aware that certain business practices that are accepted in some less developed countries would be illegal in the United States. Bribes to governments in order to receive special tax breaks or other favors are common in some countries. If MNCs do not participate in such practices, they may be at a competitive disadvantage when attempting DFI in a particular country.

(7) Political Instability: The governments of some countries may prevent DFI. If a country is

susceptible to abrupt changes in government and political conflicts, the feasibility of DFI may be dependent on the outcome of those conflicts. MNCs want to avoid a situation in which they pursue DFI under a government that is likely to be removed after the DFI occurs.

➢ Benefits of Foreign Direct Investment (FDI):

Foreign direct investment offers advantages to both the investor and the foreign host country. These incentives encourage both parties to engage in and allow FDI.

Below are some of the benefits for businesses:

- Market diversification
- Tax incentives
- Lower labor costs
- Preferential tariffs
- Subsidies

There are many ways in which FDI benefits the recipient nation:

1. Increased Employment and Economic Growth

Creation of jobs is the most obvious advantage of FDI. It is also one of the most important reasons why a nation, especially a developing one, looks to attract FDI. Increased FDI boosts the manufacturing as well as the services sector. This in turn creates jobs, and helps reduce unemployment among the educated youth - as well as skilled and unskilled labour - in the country. Increased employment translates to increased incomes, and equips the population with enhanced buying power. This boosts the economy of the country.

2. Human Resource Development

This is one of the less obvious advantages of FDI. Hence, it is often understated. Human Capital refers to the knowledge and competence of the workforce. Skills gained and enhanced through training and experience boost the education and human capital quotient of the country. Once developed, human capital is mobile. It can train human resources in other companies, thereby creating a ripple effect.

3. Development of Backward Areas

This is one of the most crucial benefits of FDI for a developing country. FDI enables the transformation of backward areas in a country into industrial centres. This in turn provides a boost to the social economy of the area. The Hyundai unit at Sriperumbudur, Tamil Nadu in India exemplifies this process.

4. Provision of Finance & Technology

Recipient businesses get access to latest financing tools, technologies and operational practices from across the world. Over time, the introduction of newer, enhanced technologies and processes results in their diffusion into the local economy, resulting in enhanced efficiency and effectiveness of the industry.

5. Increase in Exports

Not all goods produced through FDI are meant for domestic consumption. Many of these products have global markets. The creation of 100% Export Oriented Units and Economic Zones have further assisted FDI investors in boosting their exports from other countries.

6. Exchange Rate Stability

The constant flow of FDI into a country translates into a continuous flow of foreign exchange. This helps the country's Central Bank maintain a comfortable reserve of foreign exchange. This in turn ensures stable exchange rates.

7. Stimulation of Economic Development

This is another very important advantage of FDI. FDI is a source of external capital and higher revenues for a country. When factories are constructed, at least some local labour, materials and equipment are utilised. Once the construction is complete, the factory will employ some local employees and further use local materials and services. The people who are employed by such factories thus have more money to spend. This creates more jobs. These factories will also create additional tax revenue for the Government, that can be infused into creating and improving physical and financial infrastructure.

8. Improved Capital Flow

Inflow of capital is particularly beneficial for countries with limited domestic resources, as well as for nations with restricted opportunities to raise funds in global capital markets.

9. Creation of a Competitive Market

By facilitating the entry of foreign organisations into the domestic marketplace, FDI helps create a competitive environment, as well as break domestic monopolies. A healthy competitive environment pushes firms to continuously enhance their processes and product offerings, thereby fostering innovation. Consumers also gain access to a wider range of competitively priced products.

❖ MULTINATIONAL CAPITAL BUDGETING

Multinational corporations (MNCs) evaluate international projects by using multinational capital budgeting, which compares the benefits and costs of these projects. Given that many MNCs spend more than $100 million per year on international projects, multinational capital budgeting is a critical function. Many international projects are irreversible and cannot be easily sold to other corporations at a reasonable price. Proper use of multinational capital budgeting can identify the international projects worthy of implementation.

The most popular method of capital budgeting involves determining the project's net present value by estimating the present value of the project's future cash flows and subtracting the initial outlay required for the project. Multinational capital budgeting typically uses a similar process. However, special circumstances of international projects that affect the future cash flows or the discount rate used to discount cash flows make multinational capital budgeting more complex. Financial managers must understand how to apply capital budgeting to international projects, so that they can maximize the value of the MNC.

➢ Input for Multinational Capital Budgeting:

Regardless of the long-term project to be considered, an MNC will normally require forecasts of the economic and financial characteristics related to the project. Each of these characteristics is briefly described here:

1) Initial Investment: The parent's initial investment in a project may constitute the major source of funds to support a particular project. Funds initially invested in a project may include not only whatever is necessary to start the project but also additional funds, such as working capital, to support the project over time. Such funds are needed to finance inventory, wages, and other expenses until the project begins to generate revenue. Because cash inflows will not always be sufficient to cover upcoming cash outflows, working capital is needed throughout a project's lifetime.

2) Price and Consumer Demand: The price at which the product could be sold can be forecasted using competitive products in the markets as a comparison. A long-term capital budgeting analysis requires projections for not only the upcoming period but the expected lifetime of the project as well. The future prices will most likely be responsive to the future inflation rate in the host country (where the project is to take place), but the future inflation rate is not known. Thus, future inflation rates must be forecasted in order to develop projections of the product price over time.

When projecting a cash flow schedule, an accurate forecast of consumer demand for a product is quite valuable, but future demand is often difficult to forecast. For example, if the project is a plant in Germany that produces automobiles, the MNC must forecast what percentage of the auto market in Germany it can pull from prevailing auto producers. Once a market share percentage is forecasted, projected demand can be computed. Demand forecasts can sometimes be aided by historical data on the market share other MNCs in the industry pulled when they entered this market, but historical data are not always an accurate indicator of the future. In addition, many projects reflect a first attempt, so there are no predecessors to review as an indicator of the future.

3) Costs: Like the price estimate, variable-cost forecasts can be developed from assessing prevailing comparative costs of the components (such as hourly labor costs and the cost of materials). Such costs should normally move in tandem with the future inflation rate of the host country. Even if the variable cost per unit can be accurately predicted, the projected total variable cost (variable cost per unit times quantity produced) may be wrong if the demand is inaccurately forecasted. On a periodic basis, the fixed cost may be easier to predict than the variable cost since it normally is not sensitive to changes in demand. It is, however, sensitive to any change in the host country's inflation rate from the time the forecast is made until the time the fixed costs are incurred.

4) Tax Laws: The tax laws on earnings generated by a foreign subsidiary or remitted to the MNC's parent vary among countries. Under some circumstances, the MNC receives tax deductions or credits for tax payments by a subsidiary to the host country. Withholding taxes must also be considered if they are imposed on remitted funds by the host government. Because after-tax cash flows are necessary for an adequate capital budgeting analysis, international tax effects must be determined on any proposed foreign projects.

5) Remitted Funds: In some cases, a host government will prevent a subsidiary from sending its earnings to the parent. This restriction may reflect an attempt to encourage additional local spending or to avoid excessive sales of the local currency in exchange for some other currency. Since the restrictions on fund transfers prevent cash from coming back to the parent, projected net cash flows from the parent's perspective will be affected. If the parent is aware of these restrictions, it can incorporate them when projecting net cash flows. Sometimes, however, the host government adjusts its restrictions over time; in that case, the MNC can only forecast the future restrictions and incorporate these forecasts into the analysis.

6) Exchange Rates: Any international project will be affected by exchange rate fluctuations during the life of the project, but these movements are often very difficult to forecast. There

are methods of hedging against them, though most hedging techniques are used to cover short-term positions. While it is possible to hedge over longer periods (with long-term forward contracts or currency swap arrangements), the MNC has no way of knowing the amount of funds that it should hedge. This is because it is only guessing at its future costs and revenue due to the project. Thus, the MNC may decide not to hedge the projected foreign currency net cash flows.

7) Salvage (Liquidation) Value: The after-tax salvage value of most projects is difficult to forecast. It will depend on several factors, including the success of the project and the attitude of the host government toward the project. As an extreme possibility, the host government could take over the project without adequately compensating the MNC.

Some projects have indefinite lifetimes that can be difficult to assess, while other projects have designated specific lifetimes, at the end of which they will be liquidated. This makes the capital budgeting analysis easier to apply. It should be recognized that the MNC does not always have complete control over the life-time decision. In some cases, political events may force the firm to liquidate the project earlier than planned. The probability that such events will occur varies among countries.

8) Required Rate of Return: Once the relevant cash flows of a proposed project are estimated, they can be discounted at the project's required rate of return, which may differ from the MNC's cost of capital because of that particular project's risk. An MNC can estimate its cost of capital in order to decide what return it would require in order to approve proposed projects.

➢ Multinational Capital Budgeting Example:

Capital budgeting for the MNC is necessary for all long-term projects that deserve consideration. The projects may range from a small expansion of a subsidiary division to the creation of a new subsidiary.

Background

Spartan, Inc., is considering the development of a subsidiary in Singapore that would manufacture and sell tennis rackets locally. Spartan's management has asked various departments to supply relevant information for a capital budgeting analysis. In addition, some Spartan executives have met with government officials in Singapore to discuss the proposed subsidiary. The project would end in 4 years. All relevant information follows.

1. Initial Investment. An estimated 20 million Singapore dollars (S$), which includes funds to support working capital, would be needed for the project. Given the existing spot rate of $.50

per Singapore dollar, the U.S. dollar amount of the parent's initial investment is $10 million.

2. Price and Demand. The estimated price and demand schedules during each of the next 4 years are shown here:

	Year 1	Year 2	Year 3	Year 4
Price per Racket	S$350	S$350	S$360	S$380
Demand in Singapore	60,000 units	60,000 units	100,000 units	100,000 units

3. Costs. The variable costs (for materials, labor, etc.) per unit have been estimated and consolidated as shown here:

	Year 1	Year 2	Year 3	Year 4
Variable Costs per Racket	S$200	S$200	S$250	S$260

The expense of leasing extra office space is S$1 million per year. Other annual overhead expenses are expected to be S$1 million per year.

4. Depreciation. The Singapore government will allow Spartan's subsidiary to depreciate the cost of the plant and equipment at a maximum rate of S$2 million per year, which is the rate the subsidiary will use.

5. Taxes. The Singapore government will impose a 20 percent tax rate on income. In addition, it will impose a 10 percent withholding tax on any funds remitted by the subsidiary to the parent. The U.S. government will allow a tax credit on taxes paid in Singapore; therefore, earnings remitted to the U.S. parent will not be taxed by the U.S. government.

6. Remitted Funds. The Spartan subsidiary plans to send all net cash flows received back to the parent firm at the end of each year. The Singapore government promises no restrictions on the cash flows to be sent back to the parent firm but does impose a 10 percent withholding tax on any funds sent to the parent.

7. Salvage Value. The Singapore government will pay the parent S$12 million to assume ownership of the subsidiary at the end of 4 years. Assume that there is no capital gains tax on the sale of the subsidiary.

8. Exchange Rates. The spot exchange rate of the Singapore dollar is $.50. Spartan uses the spot rate as its best forecast of the exchange rate that will exist in future periods. Thus, the forecasted exchange rate for all future periods is $.50.

9. Required Rate of Return. Spartan, Inc., requires a 15 percent return on this project.

Analysis

The capital budgeting analysis will be conducted from the parent's perspective, based on the assumption that the subsidiary is intended to generate cash flows that will ultimately be passed on to the parent. Thus, the net present value (NPV) from the parent's perspective is based on a comparison of the present value of the cash flows received by the parent to the initial outlay by the parent. An international project's NPV is dependent on whether a parent or subsidiary perspective is used. Since the U.S. parent's perspective is used, the cash flows of concern are the dollars ultimately received by the parent as a result of the project.

The required rate of return is based on the cost of capital used by the parent to make its investment, with an adjustment for the risk of the project. For the establishment of the subsidiary to benefit Spartan's parent, the present value of future cash flows (including the salvage value) ultimately received by the parent should exceed the parent's initial outlay.

The capital budgeting analysis to determine whether Spartan, Inc., should establish the subsidiary is provided in below table.

Capital Budgeting Analysis: Spartan, Inc.

	Year 0	Year 1	Year 2	Year 3	Year 4
1. Demand		60,000	60,000	100,000	100,000
2. Price per unit		S$350	S$350	S$360	S$380
3. Total revenue = (1) × (2)		S$21,000,000	S$21,000,000	S$36,000,000	S$38,000,000
4. Variable cost per unit		S$200	S$200	S$250	S$260
5. Total variable cost = (1) × (4)		S$12,000,000	S$12,000,000	S$25,000,000	S$26,000,000
6. Annual lease expense		S$1,000,000	S$1,000,000	S$1,000,000	S$1,000,000
7. Other fixed annual expenses		S$1,000,000	S$1,000,000	S$1,000,000	S$1,000,000
8. Noncash expense (depreciation)		S$2,000,000	S$2,000,000	S$2,000,000	S$2,000,000
9. Total expenses = (5) + (6) + (7) + (8)		S$16,000,000	S$16,000,000	S$29,000,000	S$30,000,000
10. Before-tax earnings of subsidiary = (3) — (9)		S$5,000,000	S$5,000,000	S$7,000,000	S$8,000,000
11. Host government tax (20%)		S$1,000,000	S$1,000,000	S$1,400,000	S$1,600,000
12. After-tax earnings of subsidiary		S$4,000,000	S$4,000,000	S$5,600,000	S$6,400,000
13. Net cash flow to subsidiary = (12) + (8)		S$6,000,000	S$6,000,000	S$7,600,000	S$8,400,000
14. S$ remitted by subsidiary(100% of net cash flow)		S$6,000,000	S$6,000,000	S$7,600,000	S$8,400,000
15. Withholding tax on remitted funds (10%)		S$600,000	S$600,000	S$760,000	S$840,000

16. S$ remitted after withholding taxes		S$5,400,000	S$5,400,000	S$6,840,000	S$7,560,000
17. Salvage value					S$12,000,000
18. Exchange rate of S$		$.50	$.50	$.50	$.50
19. Cash flows to parent		$2,700,000	$2,700,000	$3,420,000	$9,780,000
20. *PV* of parent cash flows (15% discount rate)		$2,347,826	$2,041,588	$2,248,706	$5,591,747
21. Initial investment by parent	$10,000,000				
22. Cumulative *NPV*		—$7,652,174	—$5,610,586	—$3,361,880	$2,229,867

In our example, the cumulative NPV as of the end of the last period is $2,229,867. Because the NPV is positive, Spartan, Inc., may accept this project if the discount rate of 15 percent has fully accounted for the project's risk.

➢ Factors to Consider in Multinational Capital Budgeting:

There are a variety of factors that may affect the capital budgeting analysis, such as:

1. Exchange rate fluctuations
2. Inflation
3. Financing arrangement
4. Blocked funds
5. Uncertain salvage value
6. Impact of project on prevailing cash flows
7. Host government incentives
8. Real options

Each of these factors is discussed in turn.

1) Exchange Rate Fluctuations: Though the difficulty in accurately forecasting exchange rates is well known, a multinational capital budgeting analysis could at least incorporate other scenarios for exchange rate movements, such as a pessimistic scenario and an optimistic scenario. The large differences in cash flows received by the parent in the different scenarios illustrate the impact of exchange rate expectations on the feasibility of an international project.

2) Inflation: Capital budgeting analysis implicitly considers inflation, since variable cost per unit and product prices generally have been rising over time. In some countries, inflation can be quite volatile from year to year and can therefore strongly influence a project's net cash flows. In countries where the inflation rate is high and volatile, it will be virtually impossible for a subsidiary to accurately forecast inflation each year. Inaccurate inflation forecasts can lead to inaccurate net cash flow forecasts.

Although fluctuations in inflation should affect both costs and revenues in the same direction, the magnitude of their changes may be very different. This is especially true when the project involves importing partially manufactured components and selling the finished product locally. The local economy's inflation will most likely have a stronger impact on revenues than on costs in such cases.

The joint impact of inflation and exchange rate fluctuations on a subsidiary's net cash flows may produce a partial offsetting effect from the viewpoint of the parent. The exchange rates of highly inflated countries tend to weaken over time. Thus, even if subsidiary earnings are inflated, they will be deflated when converted into the parent's home currency (if the subsidiary's currency has weakened). Such an offsetting effect is not exact or consistent, though. Because inflation is only one of many factors that influence exchange rates, there is no guarantee that a currency will depreciate when the local inflation rate is relatively high. Therefore, one cannot ignore the impact of inflation and exchange rates on net cash flows.

3) Financing Arrangement: Many foreign projects are partially financed by foreign subsidiaries. Financing arrangement can be thought of by Subsidiary financing and Parent financing.

Subsidiary Financing: Domestic capital budgeting problems would not include debt payments in the measurement of cash flows because all financing costs are captured by the discount rate. Foreign projects are more complicated, however, especially when the foreign subsidiary partially finances the investment in the foreign project. Although consolidating the initial investments made by the parent and the subsidiary simplifies the capital budgeting process, it can cause significant estimation errors. The estimated foreign cash flows that are ultimately remitted to the parent and are subject to exchange rate risk will be overstated if the foreign interest expenses are not explicitly considered as cash outflows for the foreign subsidiary. Thus, a more accurate approach is to separate the investment made by the subsidiary from the investment made by the parent. The capital budgeting analysis can focus on the parent's perspective by comparing the present value of the cash flows received by the parent to the initial investment by the parent.

Parent Financing: Consider one more alternative arrangement, in which, instead of the subsidiary leasing the offices or purchasing them with borrowed funds, the parent uses its own funds to purchase the offices.

Comparison of Parent versus Subsidiary Financing: One reason that the subsidiary financing is more feasible than complete parent financing is that the financing rate on the loan is lower than the parent's required rate of return on funds provided to the subsidiary. If local

loans had a relatively high interest rate, however, the use of local financing would likely not be as attractive.

The parent's exposure is not as large when the subsidiary purchases the offices because the subsidiary incurs some of the financing expenses. The subsidiary financing essentially shifts some of the expenses to the same currency that the subsidiary will receive and therefore reduces the amount that will ultimately be converted into dollars for remittance to the parent.

Financing with Other Subsidiaries' Retained Earnings: Some foreign projects are completely financed with retained earnings of existing foreign subsidiaries. These projects are difficult to assess from the parent's perspective because their direct effects are normally felt by the subsidiaries. One approach is to view a subsidiary's investment in a project as an opportunity cost, since the funds could be remitted to the parent rather than invested in the foreign project. Thus, the initial outlay from the parent's perspective is the amount of funds it would have received from the subsidiary if the funds had been remitted rather than invested in this project. The cash flows from the parent's perspective reflect those cash flows ultimately received by the parent as a result of the foreign project.

Even if the project generates earnings for the subsidiary that are reinvested by the subsidiary, the key cash flows from the parent's perspective are those that it ultimately receives from the project. In this way, any international factors that will affect the cash flows (such as withholding taxes and exchange rate movements) are incorporated into the capital budgeting process.

4) Blocked Funds: In some cases, the host country may block funds that the subsidiary attempts to send to the parent. Some countries require that earnings generated by the subsidiary be re-invested locally for at least 3 years before they can be remitted. Such restrictions can affect the accept/reject decision on a project.

There may be other situations that deserve to be considered in multinational capital budgeting, such as political conditions in the host country and restrictions that may be imposed by a country's host government.

5) Uncertain Salvage Value: The salvage value of an MNC's project typically has a significant impact on the project's NPV. When the salvage value is uncertain, the MNC may incorporate various possible outcomes for the salvage value and re-estimate the NPV based on each possible outcome. It may even estimate the break-even salvage value (also called break-even terminal value), which is the salvage value necessary to achieve a zero NPV for the project. If the actual salvage value is expected to equal or exceed the break-even salvage value, the project is feasible.

6) Impact of Project on Prevailing Cash Flows: Some foreign projects may have a favorable impact on prevailing cash flows. For example, if a manufacturer of computer components establishes a foreign subsidiary to manufacture computers, the subsidiary might order the components from the parent. In this case, the sales volume of the parent would increase.

7) Host Government Incentives: Foreign projects proposed by MNCs may have a favorable impact on economic conditions in the host country and are therefore encouraged by the host government. Any incentives offered by the host government must be incorporated into the capital budgeting analysis. For example, a low-rate host government loan or a reduced tax rate offered to the subsidiary will enhance periodic cash flows. If the government subsidizes the initial establishment of the subsidiary, the MNC's initial investment will be reduced.

8) Real Options: A real option is an option on specified real assets such as machinery or a facility. Some capital budgeting projects contain real options in that they may allow opportunities to obtain or eliminate real assets. Since these opportunities can generate cash flows, they can enhance the value of a project.

The value of a real option within a project is primarily influenced by two factors: (1) the probability that the real option will be exercised and (2) the NPV that will result from exercising the real option.

❖ INTERNATIONAL ACQUISITIONS

Multinational corporations (MNCs) commonly engage in international acquisitions as a means of penetrating a foreign market or capitalizing on lower costs of production. International acquisitions involve the identification of possible foreign targets, valuation of targets, negotiating the deal, and revising the organizational structure.

➢ Background on International Acquisitions:

An international acquisition of a firm is similar to other international projects in that it requires an initial outlay and is expected to generate cash flows whose present value will exceed the initial outlay. Many international acquisitions are motivated by the desire to increase global market share or to capitalize on economies of scale through global consolidation.

MNCs may view international acquisitions as a better form of direct foreign investment (DFI) than establishing a new subsidiary. However, there are distinct differences between these two forms of DFI. Through an international acquisition, the firm can immediately expand its international business since the target is already in place. Establishing a new subsidiary requires

time.

For example, Yahoo! had successfully established portals in Europe and Asia. However, it believed that it could improve its presence in Asia by focusing on the Greater China area. China has much potential because of its population base, but it also imposes restrictions that discourage DFI by firms. Meanwhile, Kimo, a privately held company and the leading portal in Taiwan, had 4 million registered users in Taiwan. Yahoo! agreed to acquire Kimo for about $150 million. With this DFI, Yahoo! not only established a presence in Taiwan, but also established a link to mainland China.

When viewed as a project, the international acquisition usually generates quicker and larger cash flows than the establishment of a new subsidiary, but it also requires a larger initial outlay. International acquisitions also necessitate the integration of the parent's management style with that of the foreign target.

➢ Model for Valuing a Foreign Target:

The value of an MNC is based on the present value of expected cash flows to be received. When an MNC engages in restructuring, it affects the structure of its assets, which will ultimately affect the present value of its cash flows. For example, if it acquires a company, it will incur a large initial outlay this year, but its expected annual cash flows will now be larger.

An MNC's decision to invest in a foreign company is similar to the decision to invest in other projects in that it is based on a comparison of benefits and costs as measured by net present value. From an MNC's parent's perspective, the foreign target's value can be estimated as the present value of cash flows that it would receive from the target, as the target would become a foreign subsidiary owned by the parent.

The MNC's parent would consider investing in the target only if the estimated present value of the cash flows it would ultimately receive from the target over time exceeds the initial outlay necessary to purchase the target. Thus, capital budgeting analysis can be used to determine whether a firm should be acquired. The net present value of a company from the acquiring firm's perspective (NPVa) is;

$$NPV_a = -IO_a + \sum_{t=1}^{n} \frac{CF_{a,t}}{(1+k)^t} + \frac{SV_a}{(1+k)^n}$$

where

IO_a = initial outlay needed by the acquiring firm to acquire the target
$CF_{a,t}$ = cash flow to be generated by the target for the acquiring firm
k = required rate of return on the acquisition of the target
SV_a = salvage value of the target (expected selling price of the target at a point in the future)
n = time when the target will be sold by the acquiring firm

Estimating the Initial Outlay: The initial outlay reflects the price to be paid for the target. When firms acquire publicly traded foreign targets, they commonly pay premiums of between 10 and 40 percent above the prevailing stock price of the target in order to gain ownership. This type of premium is also typical for acquisitions of domestic targets. The main point here is that the estimate of the initial outlay must account for the premium since an MNC normally will not be able to purchase a publicly traded target at the target's prevailing market value.

For an acquisition to be successful, it means that the acquirer must substantially improve the target's cash flows so that it can overcome the large premium it pays for the target. Some international acquisitions backfire because the MNC overestimates the net cash flows of the target. That is, the MNC's managers are excessively optimistic when estimating the target's future cash flows, which leads them to make acquisitions that are not feasible.

The capital budgeting analysis of a foreign target must also account for the exchange rate of concern. For example, consider a U.S.-based MNC that assesses the acquisition of a foreign company. The dollar initial outlay ($IO_{U.S.}$) needed by the U.S. firm is determined by the acquisition price in foreign currency units (IO_f) and the spot rate of the foreign currency (S):

$$IO_{U.S.} = IO_f(S)$$

Estimating the Cash Flows: The dollar amount of cash flows to the U.S. firm is determined by the foreign currency cash flows ($CF_{f,t}$) per period remitted to the United States and the spot rate at that time (S_t):

$$CF_{a,t} = (CF_{f,t})S_t$$

This ignores any withholding taxes or blocked-funds restrictions imposed by the host

government and any income taxes imposed by the U.S. government. The dollar amount of salvage value to the U.S. firm is determined by the salvage value in foreign currency units (SV_f) and the spot rate at the time (period n) when it is converted to dollars (Sn):

$$SV_a = (SV_f)S_n$$

Estimating the NPV: The net present value of a foreign target can be derived by substituting the equalities just described in the capital budgeting equation:

$$NPV_a = -IO_a + \sum_{t=1}^{n} \frac{CF_{a,t}}{(1+k)^t} + \frac{SV_a}{(1+k)^n}$$

$$= -(IO_f)S + \sum_{t=1}^{n} \frac{(CF_{f,t})S_t}{(1+k)^t} + \frac{(SV_f)S_n}{(1+k)^n}$$

➢ Factors That Affect the Expected Cash Flows of the Foreign Target:

When an MNC estimates the future cash flows that it will ultimately receive after acquiring a foreign target, it considers several factors that reflect either conditions in the country of concern or conditions of the target itself.

(A) Target-Specific Factors:

The following characteristics of the foreign target are typically considered when estimating the cash flows that the target will provide to the parent.

1) Target's Previous Cash Flows: Since the foreign target has been conducting business, it has a history of cash flows that it has generated. The recent cash flows per period may serve as an initial base from which future cash flows per period can be estimated after accounting for other factors. Since the target firm has already been conducting business, it may be easier to estimate the cash flows it will generate than to estimate the cash flows to be generated from a new foreign subsidiary.

A company's previous cash flows are not necessarily an accurate indicator of future cash flows, however, especially when the target's future cash flows would have to be converted into the acquirer's home currency as they are remitted to the parent. Therefore, the MNC needs to carefully consider all the factors that could influence the cash flows that will be generated from a foreign target.

2) Managerial Talent of the Target: An acquiring firm must assess the target's existing management so that it can determine how the target firm will be managed after the acquisition. The way the acquirer plans to deal with the managerial talent will affect the estimated cash

flows to be generated by the target.

If the MNC acquires the target, it may allow the target firm to be managed as it was before the acquisition. Under these conditions, however, the acquiring firm may have less potential for enhancing the target's cash flows.

A second alternative for the MNC is to downsize the target firm after acquiring it. For example, if the acquiring firm introduces new technology that reduces the need for some of the target's employees, it can attempt to downsize the target. Downsizing reduces expenses but may also reduce productivity and revenue, so the effect on cash flows can vary with the situation. In addition, an MNC may encounter significant barriers to increasing efficiency by downsizing in several countries. Governments of some countries are likely to intervene and prevent the acquisition if downsizing is anticipated.

A third alternative for the MNC is to maintain the existing employees of the target but restructure the operations so that labor is used more efficiently. For example, the MNC may infuse its own technology into the target firm and then restructure operations so that many of the employees receive new job assignments. This strategy may cause the acquirer to incur some additional expenses, but there is potential for improved cash flows over time.

(B) Country-Specific Factors:

An MNC typically considers the following country-specific factors when estimating the cash flows that will be provided by the foreign target to the parent.

1) Target's Local Economic Conditions: Potential targets in countries where economic conditions are strong are more likely to experience strong demand for their products in the future and may generate higher cash flows. However, some firms are more sensitive to economic conditions than others. Also, some acquisitions of firms are intended to focus on exporting from the target's home country, so the economic conditions in the target's country may not be as important. Economic conditions are difficult to predict over a long-term period, especially for emerging countries.

2) Target's Local Political Conditions: Potential targets in countries where political conditions are favorable are less likely to experience adverse shocks to their cash flows. The sensitivity of cash flows to political conditions is dependent on the firm's type of business. Political conditions are also difficult to predict over a long-term period, especially for emerging countries.

If an MNC plans to improve the efficiency of a target by laying off employees that are not needed, it must first make sure that the government would allow layoffs before it makes the acquisition. Some countries offer protection of employees from layoffs, which may cause many

of their firms to be inefficient. An MNC might not be capable of improving the efficiency if it is not allowed to lay off employees.

3) Target's Industry Conditions: Industry conditions within a country can cause some targets to be more desirable than others. Some industries in a particular country may be extremely competitive while others are not. In addition, some industries exhibit strong potential for growth in a particular country, while others exhibit very little potential. When an MNC assesses targets among countries, it would prefer a country where the growth potential for its industry is high and the competition within the industry is not excessive.

4) Target's Currency Conditions: If an MNC plans to acquire a foreign target, it must consider how future exchange rate movements may affect the target's local currency cash flows. It must also consider how exchange rates will affect the conversion of the target's remitted earnings to the parent. In the typical case, ideally the foreign currency would be weak at the time of the acquisition (so that the MNC's initial outlay is low) but strengthen over time as funds are periodically remitted to the parent.

5) Target's Local Stock Market Conditions: Potential target firms that are publicly held are continuously valued in the market, so their stock prices can change rapidly. As the target firm's stock price changes, the acceptable bid price necessary to buy that firm will likely change as well. Thus, there can be substantial swings in the purchase price that would be acceptable to a target. This is especially true for publicly traded firms in emerging markets in Asia, Eastern Europe, and Latin America where stock prices commonly change by 5 percent or more in a week. Therefore, an MNC that plans to acquire a target would prefer to make its bid at a time when the local stock market prices are generally low.

6) Taxes Applicable to the Target: When an MNC assesses a foreign target, it must estimate the expected after-tax cash flows that it will ultimately receive in the form of funds remitted to the parent. Thus, the tax laws applicable to the foreign target are used to derive the after-tax cash flows. First, the applicable corporate tax rates are applied to the estimated future earnings of the target to determine the after-tax earnings. Second, the after-tax proceeds are determined by applying any withholding tax rates to the funds that are expected to be remitted to the parent in each period. Third, if the acquiring firm's government imposes an additional tax on remitted earnings or allows a tax credit, that tax or credit must be applied.

➢ Valuation Process:

Lincoln Co. desires to expand in Latin America or Canada. The methods Lincoln uses to

initially screen targets in various countries and then to estimate a target's value are discussed next.

International Screening Process:

Lincoln Co. considers the factors just described when it conducts an initial screening of prospective targets. It has identified prospective targets in Mexico, Brazil, Colombia, and Canada. The target in Mexico has no plans to sell its business and is unwilling to even consider an offer from Lincoln Co. Therefore, this firm is no longer considered. Lincoln anticipates potential political problems that could create barriers to an acquisition in Colombia, even though the Colombian target is willing to be acquired. Stock market conditions are not favorable in Brazil, as the stock prices of most Brazilian companies have recently risen substantially. Lincoln does not want to pay as much as the Brazilian target is now worth based on its prevailing market value

Based on this screening process, the only foreign target that deserves a closer assessment is the target in Canada. According to Lincoln's assessment, Canadian currency conditions are slightly unfavorable, but this is not a reason to eliminate the target from further consideration. Thus, the next step would be for Lincoln to obtain as much information as possible about the target and conditions in Canada. Then Lincoln can use this information to derive the target's expected cash flows and to determine whether the target's value exceeds the initial outlay that would be required to purchase it.

Estimating the Target's Value:

Once Lincoln Co. has completed its initial screening of targets, it conducts a valuation of all targets that passed the screening process. Lincoln can estimate the present value of future cash flows that would result from acquiring the target. This estimation is then used to determine whether the target should be acquired.

Continuing with our simplified example, Lincoln's screening process resulted in only one eligible target, a Canadian firm. Assume the Canadian firm has conducted all of its business locally. Assume also that Lincoln expects that it can obtain materials at a lower cost than the target can because of its relationships with some Canadian suppliers and that it also expects to implement a more efficient production process. Lincoln also plans to use its existing managerial talent to manage the target and thereby reduce the administrative and marketing expenses incurred by the target. It also expects that the target's revenue will increase when its products are sold under Lincoln's name. Lincoln expects to maintain prices of the products as they are.

The target's expected cash flows can be measured by first determining the revenue and expense levels in recent years and then adjusting those levels to reflect the changes that would occur after the acquisition.

Exhibit 15.1 Example of Process Used to Screen Foreign Targets

Target Based in:	Is the Target Receptive to an Acquisition?	Local Economic and Industry Conditions	Local Political Conditions	Local Currency Conditions	Prevailing Stock Market Prices	Tax Laws
Mexico	No	Favorable	OK	OK	OK	May change
Brazil	Maybe	OK	OK	OK	Too high	May change
Colombia	Yes	Favorable	Volatile	Favorable	OK	Reasonable
Canada	Yes	OK	Favorable	Slightly unfavorable	OK	Reasonable

➢ Why Valuations of a Target May Vary among MNCs:

Most MNCs that consider acquiring a specific target will use a somewhat similar process for valuing the target. Nevertheless, their valuations will differ because of differences in the way the MNC's estimate the key determinants of a given target's valuation: (1) cash flows to be generated by the target, (2) exchange rate effects on funds remitted to the MNC's parent, and (3) the required rate of return when investing in the target.

1) Estimated Cash Flows of the Foreign Target: The target's expected future cash flows will vary among MNCs because the cash flows will be dependent on the MNC's management or oversight of the target's operations. If an MNC can improve the production efficiency of the target without reducing the target's production volume, it can improve the target's cash flows.

Each MNC may have a different plan as to how the target will fit within its structure and how the target will conduct future operations. The target's expected cash flows will be influenced by the way it is utilized. An MNC with production plants in Asia that purchases another Asian production plant may simply be attempting to increase its market share and production capacity. This MNC's cash flows change because of a higher production and sales level. Conversely, an MNC with all of its production plants in the United States may purchase an Asian production plant to shift its production where costs are lower. This MNC's cash flows change because of lower expenses.

Tax laws can create competitive advantages for acquirers based in some countries. Acquirers based in low-tax countries may be able to generate higher cash flows from acquiring a foreign target than acquirers in high-tax countries simply because they are subject to lower

taxes on the future earnings remitted by the target (after it is acquired).

2) Exchange Rate Effects on the Funds Remitted: The valuation of a target can vary among MNCs simply because of differences in the exchange rate effects on funds remitted by the foreign target to the MNC's parent. If the target remits funds frequently in the near future, its value will be partially dependent on the expected exchange rate of the target's local currency in the near future. If the target does not remit funds in the near future, its value is more dependent on its local growth strategy and on exchange rates in the distant future.

3) Required Return of Acquirer: The valuation of the target could also vary among MNCs because of differences in their required rate of return from investing funds to acquire the target. If an MNC targets a successful foreign company with plans to continue the target's local business in a more efficient manner, the risk of the business will be relatively low, and therefore the MNC's required return from acquiring the target will be relatively low. Conversely, if an MNC targets the company because it plans to turn the company into a major exporter, the risk is much higher. The target has not established itself in foreign markets, so the cash flows that would result from the exporting business are very uncertain. Thus, the required return to acquire the target company will be relatively high as well.

If potential acquirers are based in different countries, their required rates of return from a specific target will vary even if they plan to use the target in similar ways. An MNC's required rate of return on any project is dependent on the local risk-free interest rate (since that influences the cost of funds for that MNC). Therefore, the required rate of return for MNCs based in countries with relatively high interest rates such as Brazil and Venezuela may differ from MNCs based in low-interest-rate countries such as the United States or Japan.

➢ Other Types of Multinational Restructuring:

Besides acquiring foreign firms, MNCs can engage in multinational restructuring through international partial acquisitions, acquisitions of privatized businesses, international alliances, and international divestitures. Each type is described in turn

1) International Partial Acquisitions: In many cases, an MNC may consider a partial international acquisition of a firm, in which it purchases part of the existing stock of a foreign firm. A partial international acquisition requires less funds because only a portion of the foreign target's shares are purchased. With this type of investment, the foreign target normally continues operating and may not experience the employee turnover that commonly occurs after a target's ownership changes. Nevertheless, by acquiring a substantial fraction of the shares,

the MNC may have some influence on the target's management and is in a position to complete the acquisition in the future. Some MNCs buy substantial stakes in foreign companies to have some control over their operations. For example, Coca-Cola has purchased stakes in many foreign bottling companies that bottle its syrup. In this way, it can ensure that the bottling operations meet its standards.

2) International Acquisitions of Privatized Businesses: In recent years, government-owned businesses of many developing countries in Eastern Europe and South America have been sold to individuals or corporations. Many MNCs have capitalized on this wave of so-called privatization by acquiring businesses being sold by governments. These businesses may be attractive because of the potential for MNCs to increase their efficiency.

MNCs such as IBM and PepsiCo have acquired privatized businesses as a means of entering new markets. Hungary serves as a model country for privatizations. More than 25,000 MNCs have a foreign stake in Hungary's businesses. Hungary's government has been quick and efficient at selling off its assets to MNCs.

3) International Alliances: MNCs commonly engage in international alliances such as joint ventures and licensing agreements with foreign firms. International alliances are quite different from international acquisitions. The initial outlay is typically smaller because the MNC is not acquiring a foreign firm, and the cash flows to be received are typically smaller as well.

4) International Divestitures: An MNC should periodically reassess its direct foreign investments to determine whether they should be retained or sold (divested). Some foreign projects may no longer be feasible as a result of the MNC's increased cost of capital, increased host government taxes, increased political risk in the host country, or revised projections of exchange rates. Many divestitures occur as a result of a revised assessment of industry or economic conditions.