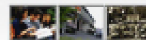
Managing Finance in Foreign Subsidiaries: An Overview



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Corporate Finance Abroad

Multinational Corporation (MNC)

Foreign Exchange Markets

Exporting & Importing

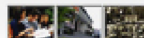
Dividend Remittance & Financing

Investing & Financing

Product Markets

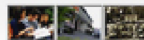
Subsidiaries

International Financial Markets



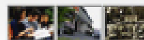
Multinational Financial Management

- Factors that make multinational financial management different
- Exchange rates and trading
- International monetary system
- International financial markets
- Specific features of multinational financial management



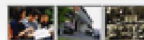
What is a multinational corporation?

- A multinational corporation is one that operates in two or more countries.
- At one time, most multinationals produced and sold in just a few countries.
- Today, many multinationals have world-wide production and sales.



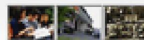
Why do firms expand into other countries?

- To seek new markets.
- To seek new supplies of raw materials.
- To gain new technologies.
- To gain production efficiencies.
- To avoid political and regulatory obstacles.
- To reduce risk by diversification.

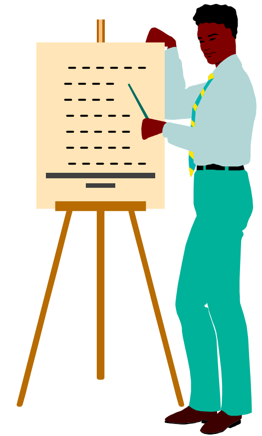


What are the major factors that distinguish multinational from domestic financial management?

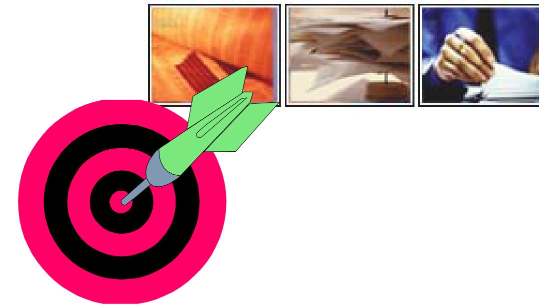
- Currency **differences**
- Economic **and** legal **differences**
- Language **differences**
- Cultural **differences**
- Government **roles**
- Political **risk**



Chapter Objectives



- To identify the main goal of the multinational corporation (MNC) and potential conflicts with that goal;
- To describe the key theories that justify international business; and
- To explain the common methods used to conduct international business.



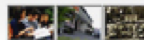
MNC Goals

- The commonly accepted goal of an MNC is to maximize shareholder wealth.
- We will focus on MNCs that wholly own their foreign subsidiaries.

⇒ Financial managers throughout the MNC have a single goal of maximizing the value of the entire MNC.

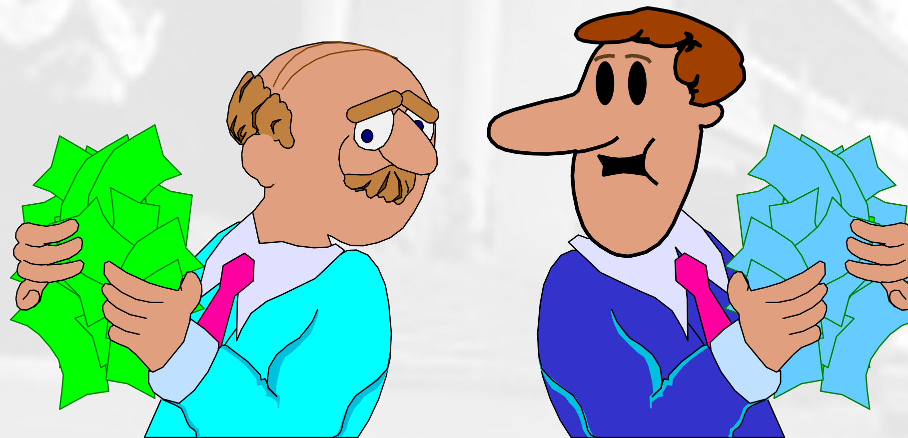
Conflicts with the MNC Goal

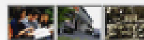
- **When a corporation's shareholders differ from its managers, a conflict of goals can exist—the agency problem.**
- **Agency costs are normally larger for MNCs than for purely domestic firms, due to:**
  - ¤ the difficulty in monitoring distant managers,
  - ¤ the different cultures of foreign managers,
  - ¤ the sheer size of the larger MNCs, and
  - ¤ the tendency to downplay short-term effects.



Conflicts with the MNC Goal

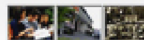
- Subsidiary managers may be tempted to make decisions that maximize the values of their respective subsidiaries.

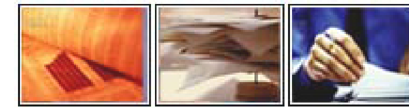




Impact of Management Control

- The magnitude of agency costs can vary with the management style of the MNC.
- A centralized management style reduces agency costs. However, a decentralized style gives more control to those managers who are closer to the subsidiary's operations and environment.

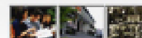


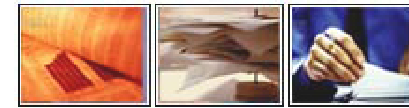


Centralized Multinational Financial Management

for an MNC with two subsidiaries, A and B

Financial Managers of Parent →
- Cash Management at A
- Inventory and Accounts Receivable Management at A
- Financing at A
- Capital Expenditures at A
- Cash Management at B
- Inventory and Accounts Receivable Management at B
- Financing at B
- Capital Expenditures at B



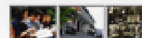


Decentralized Multinational Financial Management

for an MNC with two subsidiaries, A and B

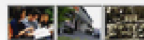
Financial Managers of A → Cash Management at A
Financial Managers of A → Inventory and Accounts Receivable Management at A
Financial Managers of A → Financing at A
Financial Managers of A → Capital Expenditures at A

Financial Managers of B → Cash Management at B
Financial Managers of B → Inventory and Accounts Receivable Management at B
Financial Managers of B → Financing at B
Financial Managers of B → Capital Expenditures at B



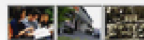
Impact of Management Control

- Some MNCs attempt to strike a balance – they allow subsidiary managers to make the key decisions for their respective operations, but the parent's management monitors the decisions.
- Today, electronic networks make it easier for the parent to monitor the actions and performance of its foreign subsidiaries.



Impact of Corporate Control

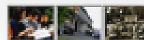
- **Various forms of corporate control can reduce agency costs:**
  - ¤ stock options
  - ¤ hostile takeover threat
  - ¤ investor monitoring



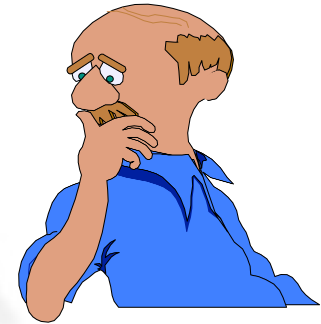
Constraints Interfering with the MNC's Goal

- **MNC managers are confronted with various constraints:**
  - ¤ environmental constraints
  - ¤ regulatory constraints
  - ¤ ethical constraints

A recent study found that investors assigned a higher value to firms that exhibit high corporate governance standards and are likely to obey ethical constraints.



International Business: Theories



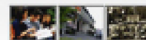
Why are firms motivated to expand their business internationally?

❶ **Theory of Comparative Advantage**

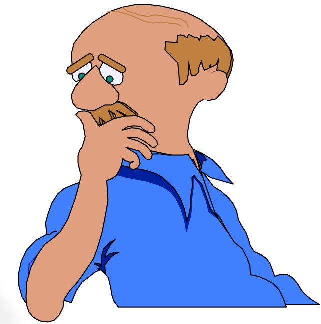
¤ Specialization by countries can increase production efficiency.

❷ **Imperfect Markets Theory**

¤ The markets for the various resources used in production are "imperfect."



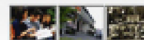
International Business: Theories



Why are firms motivated to expand their business internationally?

❸ Product Cycle Theory

- As a firm matures, it may recognize additional opportunities outside its home country.



The International Product Life Cycle

❶ Firm creates product to accommodate local demand

→ ❷ Firm exports product to accommodate foreign demand

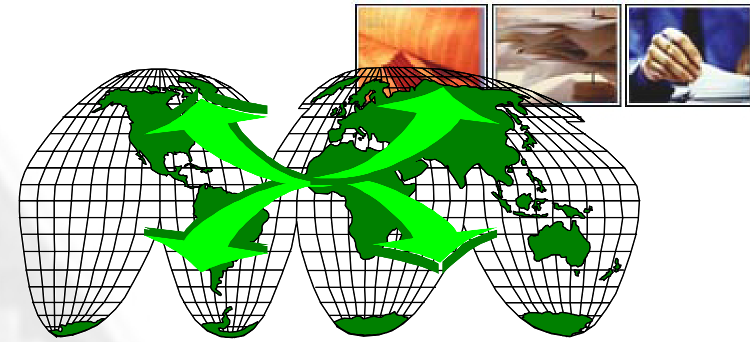
→ ❸ Firm establishes foreign subsidiary to establish presence in foreign country and possibly to reduce costs

→ ❹a. Firm differentiates product from competitors and/or expands product line in foreign country

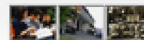
or

→ ❹b. Firm's foreign business declines as its competitive advantages are eliminated

International Business Methods



- ❶ **International trade** involves exporting and/or importing.
- ❷ **Licensing** allows a firm to provide its technology in exchange for fees or some other benefits.
- ❸ **Franchising** obligates a firm to provide a specialized sales or service strategy, support assistance, and possibly an initial investment, in exchange for periodic fees.



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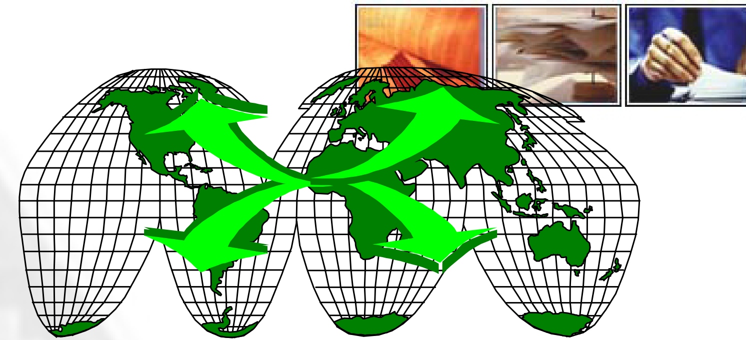
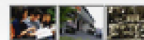
International Business Methods

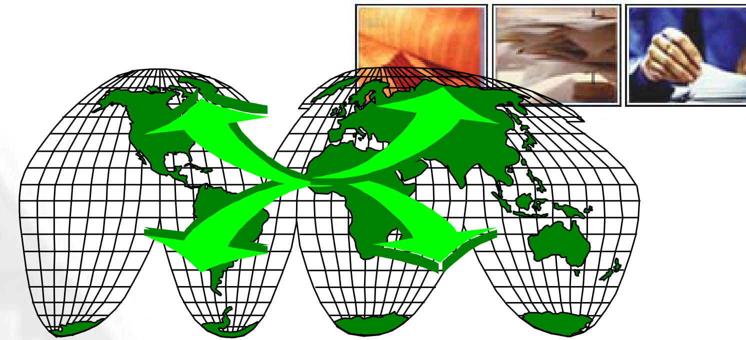


❹ Firms may also penetrate foreign markets by engaging in a joint venture (joint ownership and operation) with firms that reside in those markets.

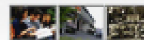
❺ Acquisitions of existing operations in foreign countries allow firms to quickly gain control over foreign operations as well as a share of the foreign market.

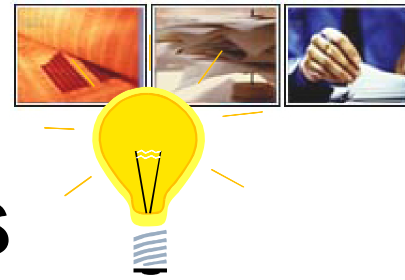


International Business Methods



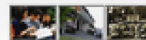
- ❻ Firms can also penetrate foreign markets by **establishing new foreign subsidiaries**.
- Many MNCs use a combination of methods to increase international business.
- In general, any method of conducting business that requires a direct investment in foreign operations is referred to as a **direct foreign investment (DFI)**.





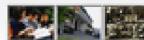
International Opportunities

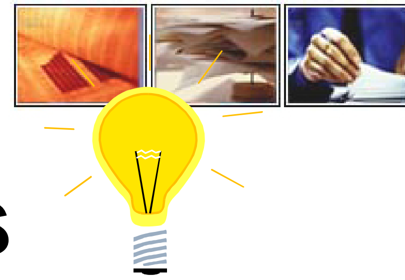
- **Investment opportunities**
  - ¤ The marginal returns on MNC projects are above those of purely domestic firms since MNCs have expanded opportunity sets of possible projects from which to select.
- **Financing opportunities**
  - ¤ MNCs can obtain capital funding at a lower cost due to their larger opportunity set of funding sources around the world.



International Opportunities

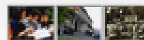
Cost-Benefit Evaluation for Purely Domestic Firms versus MNCs

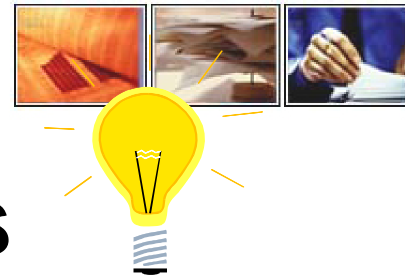




International Opportunities

- **Opportunities in Europe**
  - ¤ the Single European Act of 1987
  - ¤ the removal of the Berlin Wall in 1989
  - ¤ the inception of the euro in 1999
  - ¤ the expansion of the European Union



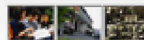


International Opportunities

- **Opportunities in Latin America**
  - ¤ the North American Free Trade Agreement (NAFTA) of 1993
  - ¤ the removal of investment restrictions
- **Opportunities in Asia**
  - ¤ the removal of investment restrictions
  - ¤ the impact of the Asian crisis in 1997-1998

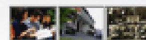
International Risk Exposure

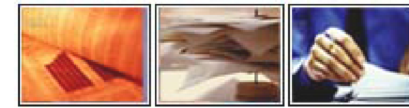
- **International business usually increases an MNC's exposure to:**
  - ❶ exchange rate movements
  - ❷ foreign economies
  - ❸ political risk



MNC's Cash Flows: An Overview

Profile A: MNCs Focused on International Trade



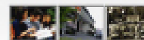


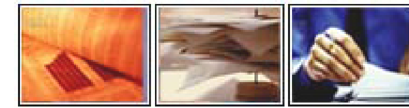
MNC's Cash Flows: An Overview

Profile B: MNCs Focused on International Trade and International Arrangements

U.S.-based MNC

- Payments for products ← U.S. Customers
- Payments for supplies → U.S. Businesses
- Payments for exports ← Foreign Importers
- Payments for imports → Foreign Exporters
- Fees for services provided ← Foreign Firms
- Fees for services received → Foreign Firms





MNC's Cash Flows: An Overview

Profile C: MNCs Focused on International Trade, International Arrangements, and Direct Foreign Investment

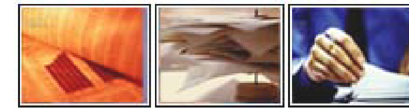
U.S.-based MNC	Cash flow	Direction	Counterparty
U.S.-based MNC	Payments for products	←	U.S. Customers
U.S.-based MNC	Payments for supplies	→	U.S. Businesses
U.S.-based MNC	Payments for exports	←	Foreign Importers
U.S.-based MNC	Payments for imports	→	Foreign Exporters
U.S.-based MNC	Fees for services provided	←	Foreign Firms
U.S.-based MNC	Fees for services received	→	Foreign Firms
U.S.-based MNC	Funds remitted back	←	Foreign Subsidiaries
U.S.-based MNC	Investment funds	→	Foreign Subsidiaries

MNC Valuation Model

- **Domestic Model**

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

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



MNC Valuation Model

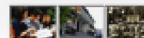
- **Valuing International Cash Flows**

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

$E(CF_{j,t})$ = expected cash flows denominated in currency j to be received by the U.S. parent at the end of period t

$E(ER_{j,t})$ = expected exchange rate at which currency j can be converted to dollars at the end of period t

k = the weighted average cost of capital of the MNC



Impact of Financial Management and International Conditions on Value

- An MNC will decide how much business to conduct in each country and how much financing to obtain in each currency.
- The MNC's financial decisions determine its exposure to the international environment.

⇒ An MNC can control its degree of exposure to exchange rate effects, economic conditions, and political conditions with its financial management.