Chapter 15
Multinational Restructuring

J. Gaspar: Adapted from Jeff Madura, International Financial Management
Corporate Restructuring

The business environment in most countries is never static and firms that adapt to the changing economic realities are likely to succeed while those who don’t will fail.

The strategic actions that firms take to adapt to the changing business environment is termed corporate restructuring.

Multinational corporate restructuring may take the form of organic growth, growth through acquisitions, or slimming down operations through divestiture.
Chapter Objectives

- To introduce international acquisitions by MNCs (e.g., Nokia-Alcatel/Lucent, AB InBev-SAB Miller) as a form of multinational restructuring;
- To explain how MNCs conduct valuations of foreign target firms;
- To explain why the valuations of a target firm may vary among MNCs; and
- To identify other methods of multinational restructuring.
Multinational Restructuring

• Building a new subsidiary, acquiring a company, selling an existing subsidiary, downsizing operations, and shifting production among subsidiaries, are all forms of multinational restructuring -- to maximize shareholder wealth.

• MNCs continually assess possible forms of multinational restructuring to capitalize on the changing economic, political, and industrial conditions across countries.
International Acquisitions

- International acquisitions enable firms to quickly expand their international business operations since the target is already in place. The firm also benefits from the established customer/supplier relationships.

- However, establishing a new subsidiary usually costs less (no market premium), and there will not be a need to integrate the parent’s management style with that of the target.
Trends in International Acquisitions

- The volume of foreign acquisitions by U.S. firms has increased consistently since the 1990’s. However, more recently (since 2005) emerging market multinationals have been acquiring firms increasingly in the U.S., EU and Africa.

- The rise of emerging market MNCs is a reflection of the strong growth and confidence in these countries as they liberalize and reform their economies to release pent up entrepreneurship.
Model for Valuing a Foreign Firm

• Like in all long-term projects, capital budgeting analysis can be used to determine whether a firm should be acquired.

• Hence, the acquisition decision can be based on a comparison of the benefits and costs as measured by the project’s net present value (NPV).
Model for Valuing a Foreign Firm

- NPV = – initial outlay
  \[ + \sum_{t=1}^{n} \text{cash flow in period } t \times (1 + k)^t \]
  \[ + \text{salvage value} \times (1 + k)^n \]

  \( k = \) the acquisition’s required rate of return
  \( n = \) the lifetime of the acquired firm

- If NPV > 0, the firm can be acquired.
Assessing Potential Acquisitions After the EU Sovereign Debt Crisis

• Although the European Union’s debt crisis is having devastating effects in several member countries, it has created opportunities for aggressive MNCs (especially from emerging economies) to pursue new business in Europe (e.g., Tata Steel-Corus).

• In Europe, property values have declined, the euro has weakened, and many firms face bankruptcy and are ripe targets for acquisition.
Assessing Potential Acquisitions in Europe

• However, MNCs must also consider the prospects for lower economic growth rates in the EU as a whole.

• Since many countries in Europe have adopted the euro as their national currency this simplifies analysis for MNCs as they try comparing NPV of possible target firms in the Eurozone.

• Not all EU countries are alike, so MNCs need to be selective.
Factors that Affect the Expected Cash Flows of the Foreign Target

Target-Specific Factors

1. Target’s previous cash flows – These may serve as an initial base from which future cash flows can be estimated.

2. Managerial talent of the target – The acquiring firm may allow the acquired firm (the target) to be managed as it was before the acquisition, downsize the firm, or restructure its operations.
Factors that Affect the Expected Cash Flows of the Foreign Target

Country-Specific Factors

1. Target’s local economic conditions – Demand is likely to be strong when the economic conditions are favorable.

2. Target’s local political conditions – Cash flow shocks are less likely when the political conditions are stable.

2. Target’s domestic social conditions – The risk of strikes and plant shut down are lower when social harmony exists.
Factors that Affect the Expected Cash Flows of the Foreign Target

Country-Specific Factors

3. Target’s industry conditions – Industries with high growth potential and non-excessive competition are preferred.

4. Target’s currency conditions – A currency that is expected to strengthen over time will usually improve the target’s remitted earnings in reporting currency to the parent.
Factors that Affect the Expected Cash Flows of the Foreign Target

Country-Specific Factors

5. Target’s local stock market conditions – When the local stock market is depressed, the target’s acceptable bid price is also likely to be low.

6. Taxes applicable to the target – What matters to the acquiring firm is the after-tax cash flows that it will ultimately receive in the form of remitted funds.
Example of The Valuation Process

- Lincoln Co., a U.S. MNC is considering plans to expand its operations to either Latin America or Canada.

- International screening process – Lincoln Co., must first identify the prospective targets and then conduct an initial screening to pick out those that deserve a closer assessment.
Example of Process Used to Screen Foreign Targets

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

Based on this screening process, Lincoln decides that the only target worth further consideration is the target in Canada.
Example of the Valuation Process

- Estimating the target’s value – Once Lincoln Co. has completed its initial screening, it conducts a valuation (based on capital budgeting analysis) of all the targets that passed the screening process.

- Only those targets that are priced lower than their estimated present values should be acquired.
## Valuation of the Canadian Target (millions of US dollars)

<table>
<thead>
<tr>
<th></th>
<th>Last Year</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$90</td>
<td>$100</td>
<td>$93.3</td>
<td>$121</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>$45</td>
<td>$40</td>
<td>$37.3</td>
<td>$48.4</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$45</td>
<td>$60</td>
<td>$56</td>
<td>$72.6</td>
</tr>
<tr>
<td>Selling &amp; administrative expenses</td>
<td>$20</td>
<td>$15</td>
<td>$15</td>
<td>$15</td>
</tr>
<tr>
<td>Depreciation</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Earnings before taxes</td>
<td>$15</td>
<td>$35</td>
<td>$31</td>
<td>$47.6</td>
</tr>
<tr>
<td>Tax (30%)</td>
<td>$4.5</td>
<td>$10.5</td>
<td>$9.3</td>
<td>$14.28</td>
</tr>
<tr>
<td>Earnings after taxes</td>
<td>$10.5</td>
<td>$24.5</td>
<td>$21.7</td>
<td>$33.32</td>
</tr>
<tr>
<td>+ Depreciation</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>– Funds to reinvest</td>
<td>$5</td>
<td>$5</td>
<td>$5</td>
<td>$5</td>
</tr>
<tr>
<td>Sale of firm</td>
<td>___</td>
<td>___</td>
<td>___</td>
<td>$230</td>
</tr>
<tr>
<td>Cash flows in C$</td>
<td>$29.5</td>
<td>$26.7</td>
<td>$268.32</td>
<td></td>
</tr>
<tr>
<td>Exchange rate of C$</td>
<td>$.80</td>
<td>$.80</td>
<td>$.80</td>
<td></td>
</tr>
<tr>
<td>Cash flows in $</td>
<td>$23.6</td>
<td>$21.36</td>
<td>$214.66</td>
<td></td>
</tr>
<tr>
<td>PV (20% discount rate)</td>
<td>$19.67</td>
<td>$14.83</td>
<td>$124.22</td>
<td></td>
</tr>
<tr>
<td>Cumulative PV</td>
<td>$19.67</td>
<td>$34.50</td>
<td>$158.72</td>
<td></td>
</tr>
</tbody>
</table>
Example of The Valuation Process

• Suppose the target’s shares are currently worth C$170 ($136) million, and Lincoln is willing to pay a 10% premium (C$187/$150 million) to persuade the target’s board of directors to approve the acquisition.

• The target may reject the offer and ask for a higher premium. However, Lincoln will not pay more than its estimate of the target’s PV (C$199/$159 million).
Example of The Valuation Process

- If Lincoln Co. decides not to bid for the target at this time, it will have to redo its analysis if it later reconsiders acquiring the target.

- The value of the target will change as the expected cash flows and required rate of return change. In addition, stock market and exchange rate conditions will change as well.
Why Valuations of a Target May Vary Among MNCs

Estimated cash flows of the foreign target

- Each MNC will manage the target’s operations differently.
- Each MNC will have a particular way of fitting the target within the current structure of the MNC.
- Acquirers based in certain countries may be subjected to lower taxes on remitted earnings (based on bilateral tax treaties).
Why Valuations of a Target May Vary Among MNCs

1. Exchange rate effects on remitted funds
   - Each MNC has its own strategic schedule for remitting funds.

2. Required rate of return of the acquirer
   - Since perceived risk is relative (country risk premium), and MNCs may have their own plans for integrating the target within their global operations, each MNC’s required rate of return could vary significantly from another.
   - The local risk-free interest rate and WACC may differ for MNCs based in different countries.
Other Types of Multinational Restructuring

International Partial Acquisitions

• MNCs may purchase a substantial portion of the existing stock of a foreign firm, so as to gain some control over the target’s management and operations to enhance shareholder wealth.

• A firm’s valuation depends on whether the MNC plans to acquire enough shares to control the firm (and hence influence its cash flows).
Other Types of Multinational Restructuring

International Acquisitions of Privatized Businesses

- Many MNCs have acquired businesses from foreign governments, e.g. Arcelor-Mittal’s acquisition of privatized Ukrainian steel company.

- Businesses that are in the process of being privatized are usually difficult to value because those transactions entail many uncertainties—input/output pricing, cash flows, benchmark data, economic and political conditions, exchange rates, financing costs, etc.
Other Types of Multinational Restructuring

International Alliances

- MNCs commonly engage in alliances, such as joint ventures and licensing agreements, with foreign firms.
- Strategic alliances, e.g., in airline industry partners aim at maximizing capacity utilization and cost economies.
- The initial outlay in alliances is typically small, and the incremental cash flows received is correspondingly small.
Other Types of Multinational Restructuring

International Divestitures

• MNCs periodically reassess their FDIs to determine whether to retain those assets or to sell (divest) them (e.g., GM-Volvo, Ford-Jaguar/Land Rover).

• The MNC should compare the present value of cash flows from the project if it is to be continued, with the proceeds that would be received (after taxes) if the project is divested.
Divestiture Analysis: Spartan, Inc.

<table>
<thead>
<tr>
<th></th>
<th>End of Year 2 (Today)</th>
<th>End of Year 3 (One Year from Today)</th>
<th>End of Year 4 (Two Years from Today)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$S$ remitted after withholding taxes</td>
<td></td>
<td>$6,840,000</td>
<td>$19,560,000</td>
</tr>
<tr>
<td>Selling price</td>
<td>$13,000,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exchange rate</td>
<td>$.46</td>
<td>$.44</td>
<td>$.40</td>
</tr>
<tr>
<td>Cash flow received from divestiture</td>
<td>$5,980,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash flows forgone due to divestiture</td>
<td>$3,099,600</td>
<td>$7,824,000</td>
<td></td>
</tr>
<tr>
<td>PV of forgone cash flows (15% discount rate)</td>
<td>$2,617,044</td>
<td>$5,916,068</td>
<td></td>
</tr>
<tr>
<td>$NPV_d = 5,980,000 − (−2,617,044 + 5,916,068)</td>
<td>$5,980,000 − $8,533,112</td>
<td>$−2,553,112</td>
<td></td>
</tr>
</tbody>
</table>