Chapter 1

Multinational Financial Management: An Overview

J. Gaspar: Adapted from Jeff Madura, International Financial Management
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.
Goal of the MNC

- 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

Cash Management at A

Financial Managers of Parent

Cash Management at B

Inventory and Accounts Receivable Management at A

Inventory and Accounts Receivable Management at B

Financing at A

Financing at B

Capital Expenditures at A

Capital Expenditures at B
Decentralized Multinational Financial Management

for an MNC with two subsidiaries, A and B

Cash Management at A

Financial Managers of A

Financial Managers of B

Cash Management at B

Inventory and Accounts Receivable Management at A

Inventory and Accounts Receivable Management at B

Financing at A

Financing at B

Capital Expenditures at A

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.
Various forms of corporate control can reduce agency costs:

- stock options
- hostile takeover threat
- investor monitoring
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.
Why are firms motivated to expand their business internationally?

1. Theory of Comparative Advantage
   - Specialization by countries can increase production efficiency.

2. Imperfect Markets Theory
   - The markets for the various resources used in production are “imperfect.”
Why are firms motivated to expand their business internationally?

Product Cycle Theory

- As a firm matures, it may recognize additional opportunities outside its home country.
The International Product Life Cycle

1. Firm creates product to accommodate local demand
2. Firm exports product to accommodate foreign demand
3. Firm establishes foreign subsidiary to establish presence in foreign country and possibly to reduce costs
4a. Firm differentiates product from competitors and/or expands product line in foreign country
4b. Firm’s foreign business declines as its competitive advantages are eliminated

or

The diagram illustrates the stages of the International Product Life Cycle for a firm entering the international market. The cycle begins with the firm creating a product to meet local demand. This is followed by exporting the product to meet foreign demand. If the firm establishes a foreign subsidiary, it may do so to establish a presence in the foreign country and possibly reduce costs. The cycle can also involve differentiating the product from competitors or expanding the product line in the foreign country, but if the competitive advantages are eliminated, the foreign business may decline.

The cycle shows a continuous process of adapting the product to meet changing demands and conditions in both domestic and international markets.
1. International trade involves exporting and/or importing.
2. Licensing allows a firm to provide its technology in exchange for fees or some other benefits.
3. Franchising obligates a firm to provide a specialized sales or service strategy, support assistance, and possibly an initial investment, in exchange for periodic fees.
Firms may also penetrate foreign markets by engaging in a joint venture (joint ownership and operation) with firms that reside in those markets.

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.
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 foreign direct investment (FDI).
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

Investment Opportunities

- Marginal Return on Projects
- Marginal Cost of Capital

Financing Opportunities

- Appropriately sized for Purely Domestic Firm
- Appropriately sized for MNC

X Y Asset Level of Firm

Marginal Return on Projects

Marginal Cost of Capital

Purely Domestic Firm

MNC

XY
International Opportunities

- Opportunities in Europe
  - the Single European Act of 1987
  - the fall of the Berlin Wall in 1989
  - the inception of the euro in 1999
  - the enlargement of the European Union
  - the potential EU-US Free Trade Agreement
International Opportunities

- Opportunities in Latin America
  - the North American Free Trade Agreement (NAFTA) of 1993
  - Central America Free Trade Area (CAFTA-DR); MERCOSUR; and FTA Columbia

- Opportunities in Asia
  - the ASEAN Free Trade Area
  - ASEAN-China/India/South Korean FTA
  - the Trans Pacific Partnership (TPP)
Exposure to International Risk

- International business usually increases an MNC’s exposure to:
  1. exchange rate movements
  2. foreign economic risk
  3. political risk
Overview of an MNC’s Cash Flows

Profile A: MNCs Focused on International Trade

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
Overview of an MNC’s Cash Flows

Profile B: MNCs Focused on International Trade and International Arrangements

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

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
- Funds remitted back → Foreign Subsidiaries
- Investment funds → Foreign Subsidiaries
Valuation Model for an MNC

- Domestic Model

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

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

- Valuing International Cash Flows

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

- \( E(CF_{j,t}) \) = 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
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.
Organization of the Text

- Background on International Financial Markets (Chapters 2-5)
- Exchange Rate Behavior (Chapters 6-8)
- Long-Term Investment and Financing Decisions (Chapters 13-18)
- Short-Term Investment and Financing Decisions (Chapters 19-21)
- Exchange Rate Risk Management (Chapters 9-12)
- Risk and Return of MNC
- Value and Stock Price of MNC