

## Lecture Notes for International Finance (FIN 435)

### CH 1. GLOBALIZATION AND THE MULTINATIONAL FIRM

#### \* WHY BUSINESS?

To make money

#### \* WHAT NEEDED?

2) Money = Capital = Resources

Need money to make money? Sounds contradictory? Capitalism – Capital = Ism according to Rev Jesse Jackson. In Communism, the government provides resources, but less incentive to do a project. Here, strong incentives, but difficult to get started.

1) Idea(s) = Project(s)

#### \* MAJOR FINANCIAL DECISIONS?

1) Examine whether the idea(s) you have is “good” or which one(s) is the best = Capital Budgeting. Capital Budgeting techniques: NPV (take +NPV projects or the highest NPV), IRR (or MIRR) (take if  $IRR > WACC$ , or the one with the highest IRR(?)), Payback Period (take if  $PB <$  the maximum period allowed or the one with the shortest PB).

2) How to come up with the money = how to finance (fund) the project(s) = how much from Equity (owner’s contribution) and Debt = Capital Structure

Ex. \$50 million, 40% equity => \$30 million from debt.

3) Short-term (working capital) and long-term (investment) management

Working capital management is for day to day activities like A/R, A/P, Inventory, etc  
Strategic investment is M&As, issuing new shares, etc

4) What to do with profits (net earnings)? Dividends or addition to retained earnings? = Dividend Policy

Ex. \$5 million net earnings, \$3 million dividends => 60% dividend payout ratio

Aside) (Net)Sales=Revenue > Gross Margin>EBIT>EBT>Net earnings(=Net income)

Aside) EBITDA=EBIT+DA or GM-Cash Expenses. Ex. GM=\$10m, Cash exp=\$6m, Non-cash exp=\$1m, then EBIT=\$10-(\$6+\$1)=\$3m. EBITDA=\$3+\$1=\$4m

or \$10-\$6=\$4m. This is similar to have a discounted price or regular price + a rebate.

\*finance.yahoo.com

#### \* WHY INTERNATIONAL BUSINESS?

- MORE OPPORTUNITIES: INCREASED REVENUE AND/OR REDUCED COSTS => MULTI-NATIONAL CORPORATIONS (MNCs)

## \* WHAT MAKES INTERNATIONAL BUSINESS UNIQUE?

### 1. EXPANDED OPPORTUNITY SET and COMPARATIVE ADVANTAGE (David Ricardo)

- Gains from trade are from the Absolute Advantage (which country is more efficient in the production of a particular product - one industry at a time) according to Adam Smith vs. Gains are from the Comparative Advantage based on the production efficient across industries. Eg., Country A may be more efficient in both textiles and food. Yet, gains of trade exist as Country A is much stronger in textiles. Another example can be found in the relationship between a lawyer and a secretary as the lawyer may be better in both legal expertise and typing.

### 2. ADDITIONAL RISKS

2.1 EXCHANGE RISK: AN ELEMENT OF CASHFLOW VARIABILITY THAT IS DUE TO CURRENCY FLUCTUATIONS. \$ VALUE OF FOREIGN CURRENCY DENOMINATED CASHFLOWS CHANGES (amount of money in FC (#TWs) is unchanged, but the \$ amount changes)

ASIDE: EXCH. RATE? : Relative value of two currencies

Also note the difference between American terms (\$/FC) and European terms (FC/\$)

Example: 800 won/\$ IN NOVEMBER 1997 AND 1600 won/\$ IN DECEMBER 1997. IF A US FIRM MADE A \$ 1M SALE (=800 MILLION won) IN NOVEMBER, 1997 AND RECEIVED AN A/R DENOMINATED IN won THAT MATURED IN DECEMBER 1997, THEN HOW MUCH DID THE COMPANY LOSE?

2.2 POLITICAL RISK: ARISES SINCE A SOVERIGN COUNTRY CAN CHANGE THE "RULES OF THE GAME"

3. MARKET IMPERFECTIONS: INTERNATIONAL MARKET IS NOT PERFECT IN THE SENSE THERE ARE MANY MARKET FLICTIONS SUCH AS TRANSACTIONS COSTS (E.G., TRANSPORTATION COSTS), GOVERNMENT REGULATIONS, DIFFERENT TAXES, TARIFFS, AND RESTRICTIONS ON FOREIGN INVESTMENTS.

Example: Nestlé HAS BEARER SHARES AND REGISTERED SHARES.

## \* MNC GOAL: MAXIMIZING THE VALUE OF THE ENTIRE MNC!

- AGENCY CONFLICTS: The agent (managers) may not work in the best interest of the principal (owners)

-What to do to mitigate the conflict? 1) active monitoring=direct shareholder intervention, performance based incentives such as stock shares or stock options (to buy shares), hostile takeover threats when market value (price) is less than the intrinsic value.

#### \* WORLD ECONOMY: RECENT TRENDS

- EMERGENCE OF GLOBALIZED MARKETS
- LIBERALIZATION
- ECONOMIC INTEGRATION
- PRIVATIZATION
- TECHNOLOGY (Internet)

\* **MNC: A most advanced form of the multinational enterprise, incorporated in one country and doing business in several other countries via global coordination by a single centralized management. Examples: GE, FORD, ROYAL DUTCH/SHELL, - - -**

#### \* MULTINATIONAL FINANCIAL MGT

- FIRMS HAVE TO MAKE THE FOLLOWING DECISIONS: CAPITAL BUDGETING AND INVESTMENTS, CAPITAL STRUCTURE, WORKING CAPITAL MGT, DIVIDEND POLICY AND REINVESTMENT. **MNCs DO THE SAME, BUT ALL SUBJECT TO UNIQUE ASPECTS OF INTERNATIONAL BUSINESS:**

#### \* MNC PATTERNS:

1. RAW-MATERIALS SEEKERS:

2. MARKET SEEKERS: OFTEN IN RESPONSE TO ANY RESTRICTIONS ON THEIR EXPORTS TO THE MKT.

3. COST MINIMIZERS: PRODUCE GOODS IN LOWER-COST AREAS OVERSEAS IN ORDER TO BE COST-COMPETITIVE.

#### \* EVOLUTION:

INTL TRADE (IMPORT/EXPORT) => SETTING UP A FOREIGN SALES SUBSIDIARY FOR DISTRIBUTION => SECURING LICENSING AGREEMENTS => FRANCHISING => JOINT VENTURES => EVENTUALLY ESTABLISHING A FOREIGN SUBSIDIARY

REF) MOVING TO NEXT STAGE => RISKIER, BUT MORE OPPORTUNITIES