Long-Term International Asset and Liability Management

SILESIAN
UNIVERSITY
SCHOOL OF BUSINESS
ADMINISTRATION IN KARVINA

Ing. Jana Šimáková, Ph.D.
simakova@opf.slu.cz

Multinational Capital Budgeting

- Like domestic capital budgeting, this focuses on the cash inflows and outflows associated with prospective long-term investment projects

- Capital budgeting follows same framework as domestic budgeting
  - Identify initial capital invested or put at risk
  - Estimate the future cash flows generated by the project, including the terminal value or salvage value of the investment
  - Identify appropriate discount rate for NPV calculation
  - Apply traditional capital budgeting decision criteria such as NPV and IRR to determine the acceptability or ranking of potential projects

Complexities of Budgeting for a Foreign Project (1)

- Several factors make budgeting for a foreign project more complex

- Parent cash flows must be distinguished from project

- Parent cash flows often depend on the form of financing, thus cannot clearly separate cash flows from financing – this changes the meaning of NPV

- Additional cash flows from new investment may in part or in whole take away from another subsidiary; thus as a stand alone a project may provide cash flows but overall may add no value to the entire organization

Complexities of Budgeting for a Foreign Project (2)

- Parent must recognize remittances from foreign investment because of differing tax systems, legal and political constraints

- Non-financial payments can generate cash flows to parent in the form of licensing fees, royalty payments, etc. – relevant for parent's perspective

- Managers must anticipate differing rates of national inflation which can affect cash flows

- Use of segmented national capital markets may create opportunity for financial gains or additional costs
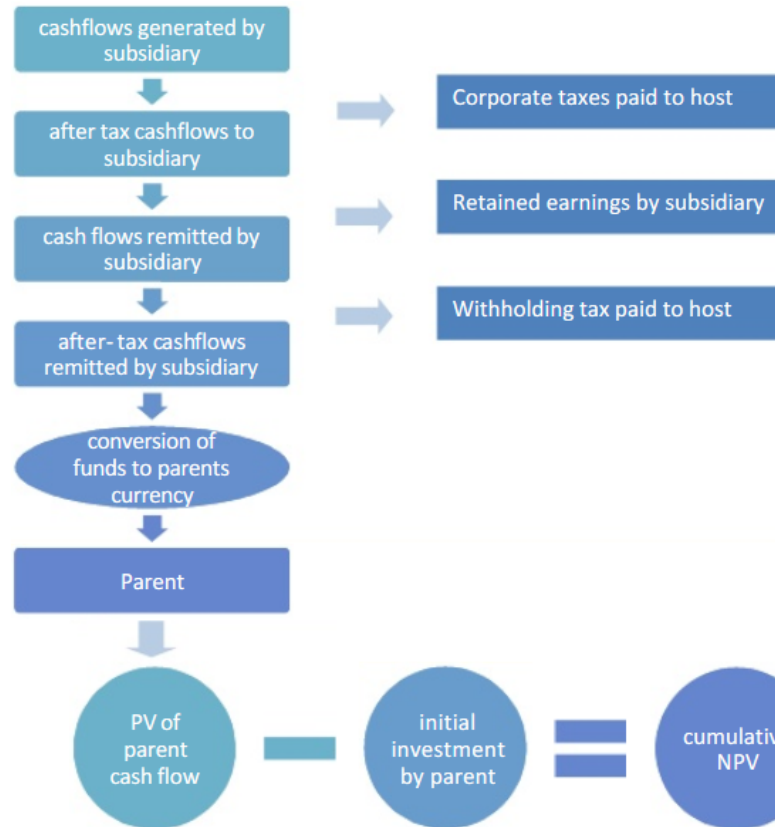
Complexities of Budgeting for a Foreign Project (3)

- Use of host government subsidies complicates capital structure and parent's ability to determine appropriate WACC

- Managers must evaluate political risk

- Terminal value is more difficult to estimate because potential purchasers have widely divergent views

Scheme of Multinational Capital Budgeting

Input for Multinational Capital Budgeting

- The following forecasts are usually required
  - Initial capital investment
  - Consumer demand over time
  - Product price over time
  - Fixed and variable cost over time
  - Project lifetime
  - Salvage (liquidation) value
  - Restrictions on fund transfers
  - Tax payments and credits
  - Exchange rate forecasts
  - Required rate of return
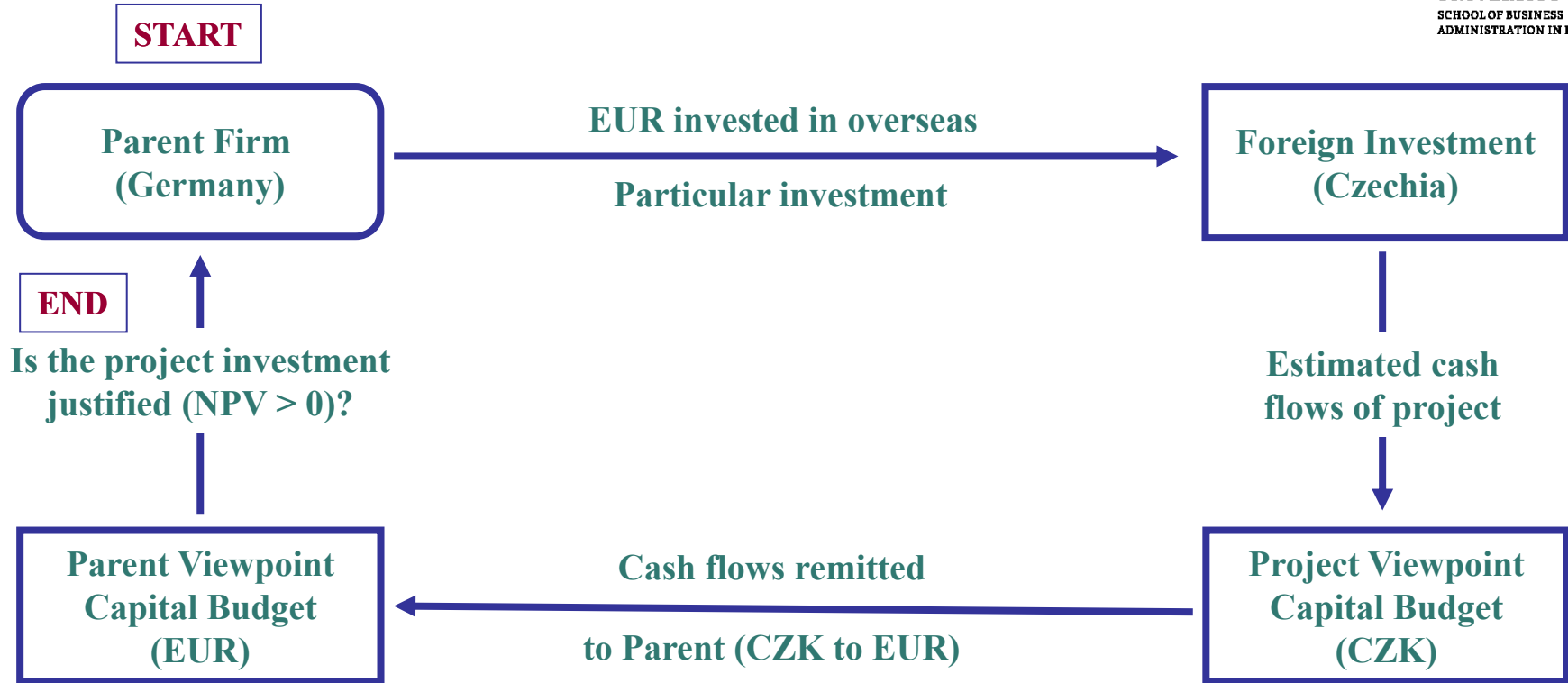
Project versus Parent Valuation

- Strong arguments exist in favor of analyzing any foreign project from the viewpoint of the parent

- Since most of the project's cash flows to the parent are financing cash flows, this violates the capital budgeting concept that financing cash flows should not be mixed with operating cash flows

- The evaluation of a foreign project from the project viewpoint is useful in determining its competitiveness compared to local firms

- Multinationals should invest only if they can earn a risk-adjusted return greater than that of local competitors, otherwise investors are better off investing in the local firms

Project versus Parent Valuation

- Most firms evaluate foreign projects from both parent and project viewpoints
    - The parent's viewpoint analyzes investment's cash flows as operating cash flows instead of financing due to remittance of royalty or licensing fees and interest payments
    - Funds that are permanently blocked from repatriation are excluded
- The parent's viewpoint gives results closer to traditional NPV capital budgeting analysis
- Project valuation provides closer approximation of effect on consolidated EPS

Project versus Parent Valuation

START

Parent Firm (Germany)

EUR invested in overseas

Particular investment

Foreign Investment (Czechia)

END

Is the project investment justified (NPV > 0)?

Estimated cash flows of project

Parent Viewpoint Capital Budget (EUR)

Cash flows remitted

to Parent (CZK to EUR)

Project Viewpoint Capital Budget (CZK)

Foreign Currency Cash Flows

- Foreign projects generate foreign currency cash flows that must be appriprimately taken into account in cross-border capital budgeting

- Recipe 1
  - Discount in the foreign currency and convert the foreign currency NPV to a domestic currency value at the spot exchange rate

- Recipe 2
  - Convert foreign cash flows into the domestic currency at expected future spot rates and then discount in the domestic currency

Valuation when the Intl. Parity Conditions do not Hold

- The project's (local) perspective
  - Let NPV(i^f) represent the value of a foreign project when discounted in the foreign currency
- The parent's (domestic) perspective
  - Let NPV(i^d) represent the value of a foreign project when discounted in the domestic currency
- These two NPVs may not be equal when the international parity conditions do not hold
  - NPV(i^f) > 0: The project has value from the perspective of a foreign investor (that is, relative to local financial market alternatives)
  - NPV(i^d) > 0: The project has value from the perspective of the parent

Valuation when the Intl. Parity Conditions do not Hold

Parent's perspective

	$NPV(i^d) < 0$	$NPV(i^d) > 0$
$NPV(i^f) < 0$	Reject	Look for better projects in the foreign currency
$NPV(i^f) > 0$	Try to lock in the time 0 value of the project	

Project's perspective

Alternatives for Capturing the time t=0 Value of a Project

- In the asset markets
  - Sell the project to a local investor
  - Bring in a joint venture partner from the local market

- In the financial markets
  - Hedge the cash flows from the project against currency risk
  - Finance the project with local currency debt or equity

Structuring the Deal

Parent's perspective

	$NPV(i^d) < 0$	$NPV(i^d) > 0$
$NPV(i^f) < 0$	Reject	Look for better projects in the foreign currency
$NPV(i^f) > 0$	Try to lock in the time 0 value of the project	Accept, then structure the deal

Project's perspective

Comparison of NPVs

- $NPV(i^f) > NPV(i^d) > 0$
  - The project has more value locally than it does from the parent's perspective
  - You should hedge
  - Hedging provides the parent with higher expected value and lower exposure to currency risk

- $NPV(i^d) > NPV(i^f) > 0$
  - The project has more value from the parent's perspective than it does to local investors
  - Whether you hedge will depend on the firm's hedging policy
  - Hedging the project cash flows lowers currency exposure risk but also lowers the expected NPV of the project

Capital Structure

- The proportion of long-term debt and equity capital and the particular forms of capital chosen to finance the assets of the firm

- Management must choose
  - The proportions of debt and equity
  - The currency of denomination
  - Fixed or floating rate interest payments
  - Indenture provisions
  - Conversion features
  - Callability
  - Seniority
  - Maturity

Project Valuation and Cost of Capital

- Approaches to project valuation
  - WACC = Weighted average cost of capital
  - APV = Adjusted present value

- Use an asset-specific discount rate
  - Nominal (real) cash flows should be discounted at nominal (real) discount rate
  - Domestic (foreign) currency cash flows should be discounted at a domestic (foreign) discount rate

Questions and Applications

As a financial manager of the company with exceeded liquidity, you have two investment opportunities. Their characteristics are as follows:

Project A: The initial investment is EUR 80 000, the projected annual net cash flow for 3 years is EUR 30 000, the residual value of the project after three years is EUR 0.

Project B: The initial investment is EUR 80 000, the projected annual net cash flow is 1st Year EUR 23 000; 2nd Year EUR 30 000; 3rd Year EUR 37 100, the residual value after three years is EUR 0.

Which investment do you prefer at the required fixed rate of return 2.6% p. a.? Why?

Questions and Applications (1)

$$NPV = -I + \sum_{t=1}^{n} \frac{CF_t}{(1+k)^t} + \frac{RV_n}{(1+k)^n}$$

$$NPV_A = -80000\ EUR + \frac{30000\ EUR}{(1+0.026)^1} + \frac{30000\ EUR}{(1+0.026)^2} + \frac{30000\ EUR}{(1+0.026)^3} + \frac{0\ EUR}{(1+0.026)^3}$$

$$NPV_A = \mathbf{5\,515.17\ EUR}$$

Questions and Applications (2)

$$NPV = -I + \sum_{t=1}^{n} \frac{CF_t}{(1+k)^t} + \frac{RV_n}{(1+k)^n}$$
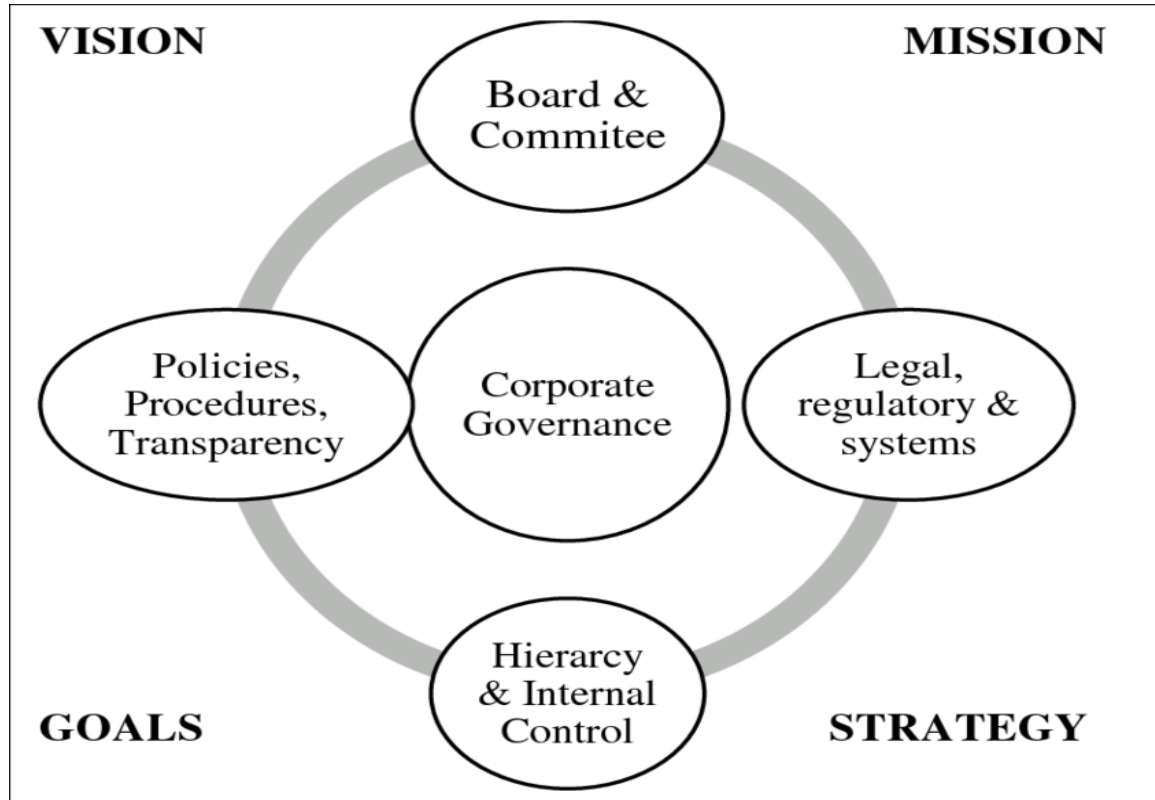
Corporate Governance

- Corporate governance is the structure of rules, practices, and processes used to direct and manage a company.

- A company's board of directors is the primary force influencing corporate governance.

- Bad corporate governance can cast doubt on a company's reliability, integrity, and transparency, which can impact its financial health.

Corporate Governance Position

Anglo-Saxon vs. Continental European Model

Corporate governance mechanisms		Anglo-Saxon Model	Continental European Model
Internal Mechanisms	Ownership	Dispersion of ownership	Concentration of ownership
		The dominant type of owner - financial institutions as agents	Dominant type of owner - private companies and individuals
	Board of directors	Unitary or one-tier board	Dual or two-tier board
		Management and control functions are integrated	Management and control functions are separated
External Mechanisms	Market for corporate governance	The primary role of market for corporate governance	Secondary role of market for corporate governance
		Climate that stimulate frequent hostile takeovers	Aversion to hostile takeovers
	Legal Framework	Legal regulation directed to financial markets as an external mechanisms is dominant	EU Directives
			OECD principles
			Corporate governance codes directed to the internal mechanisms

THANK YOU FOR YOUR ATTENTION

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