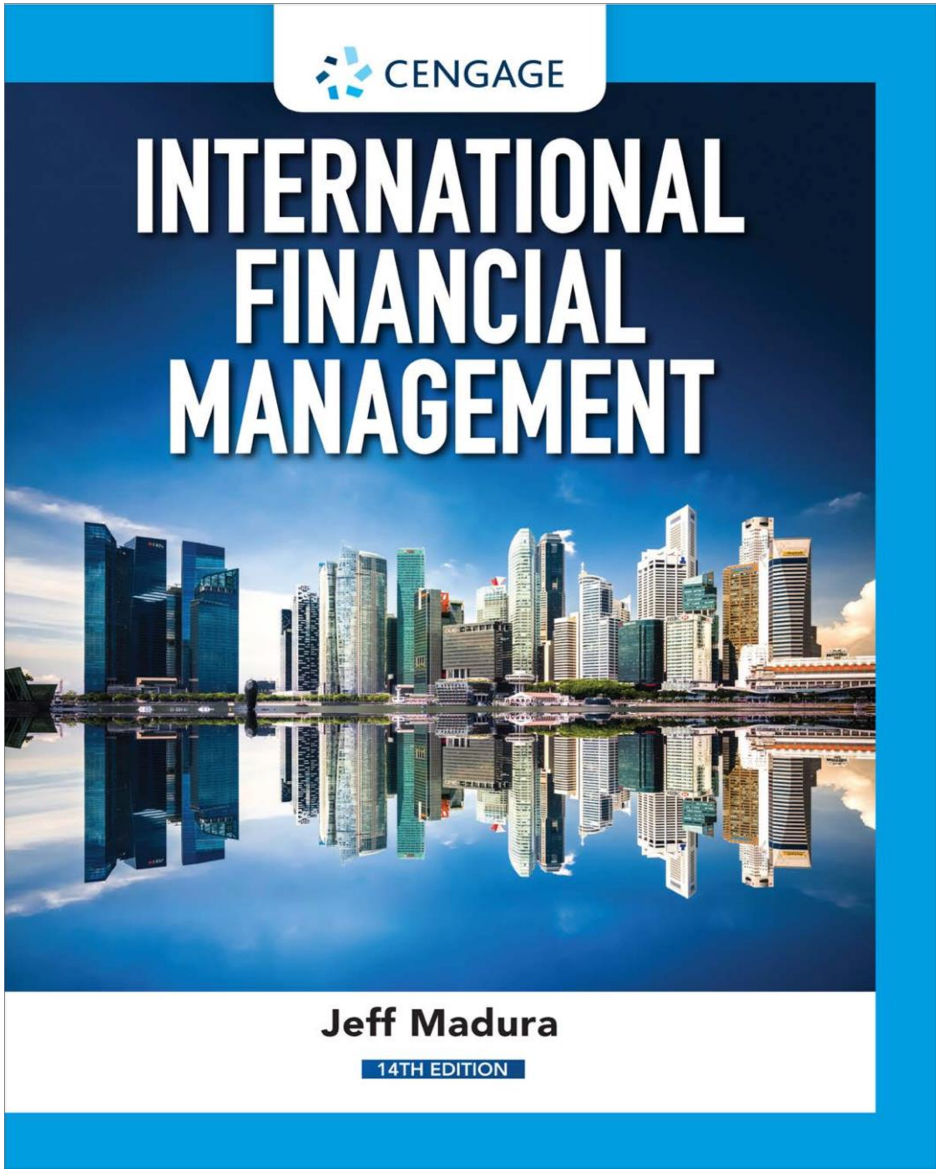

TCHE425 INTERNATIONAL FINANCIAL MANAGEMENT

INTERNATIONAL FINANCIAL MANAGEMENT

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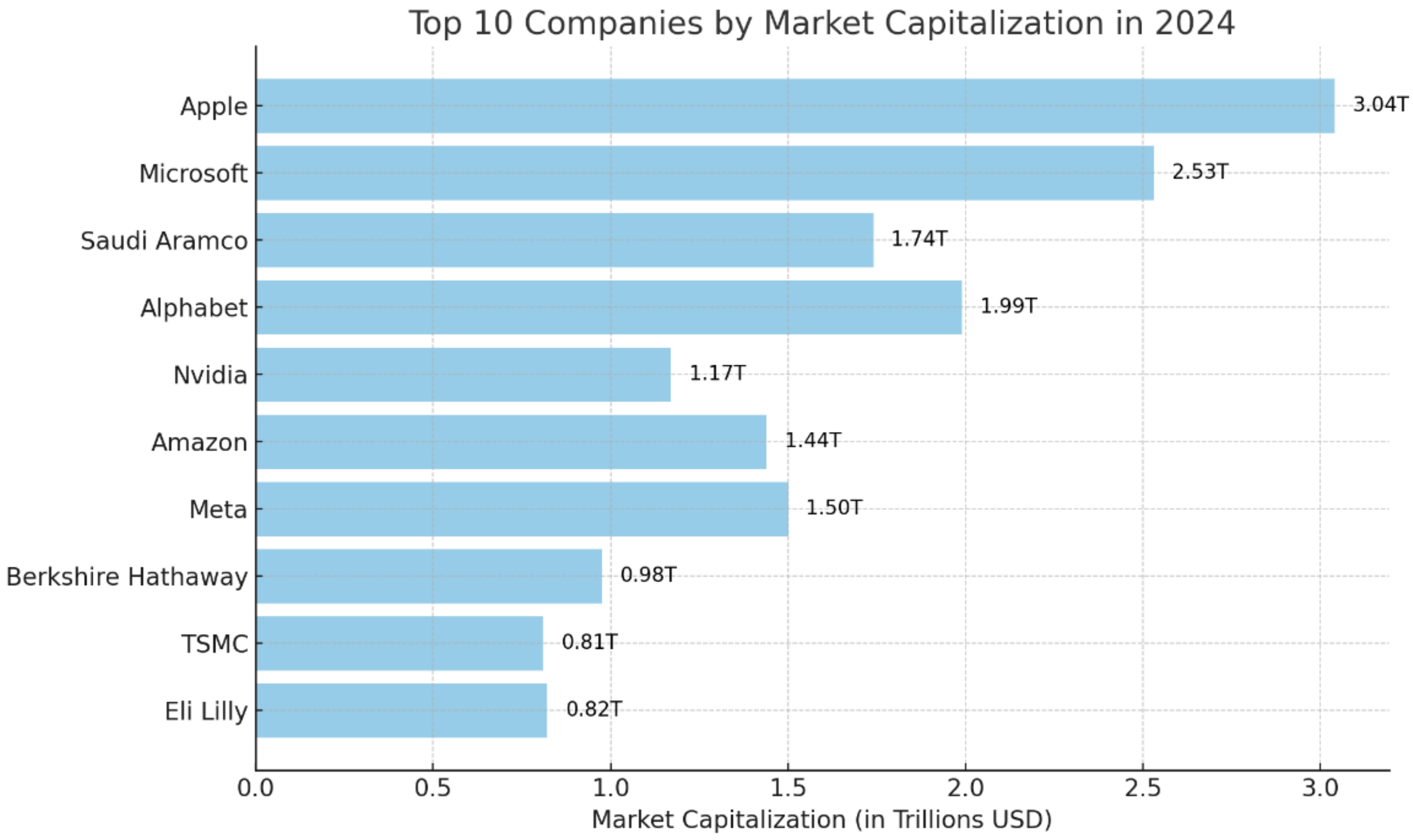
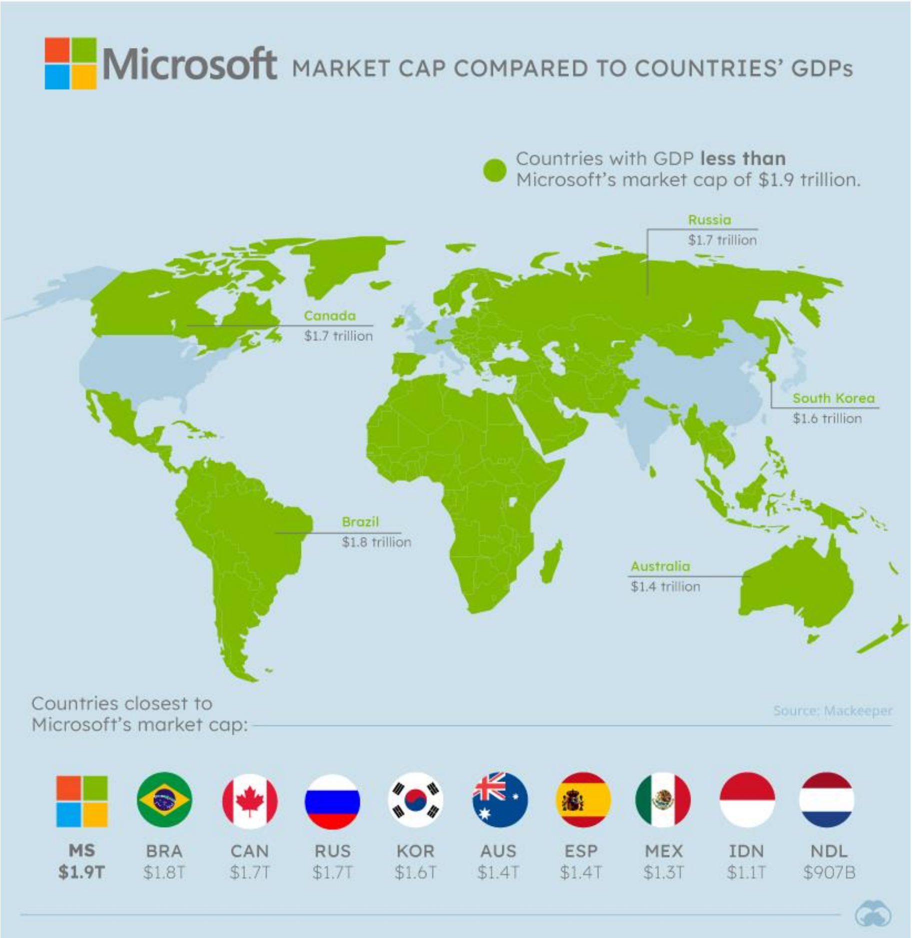
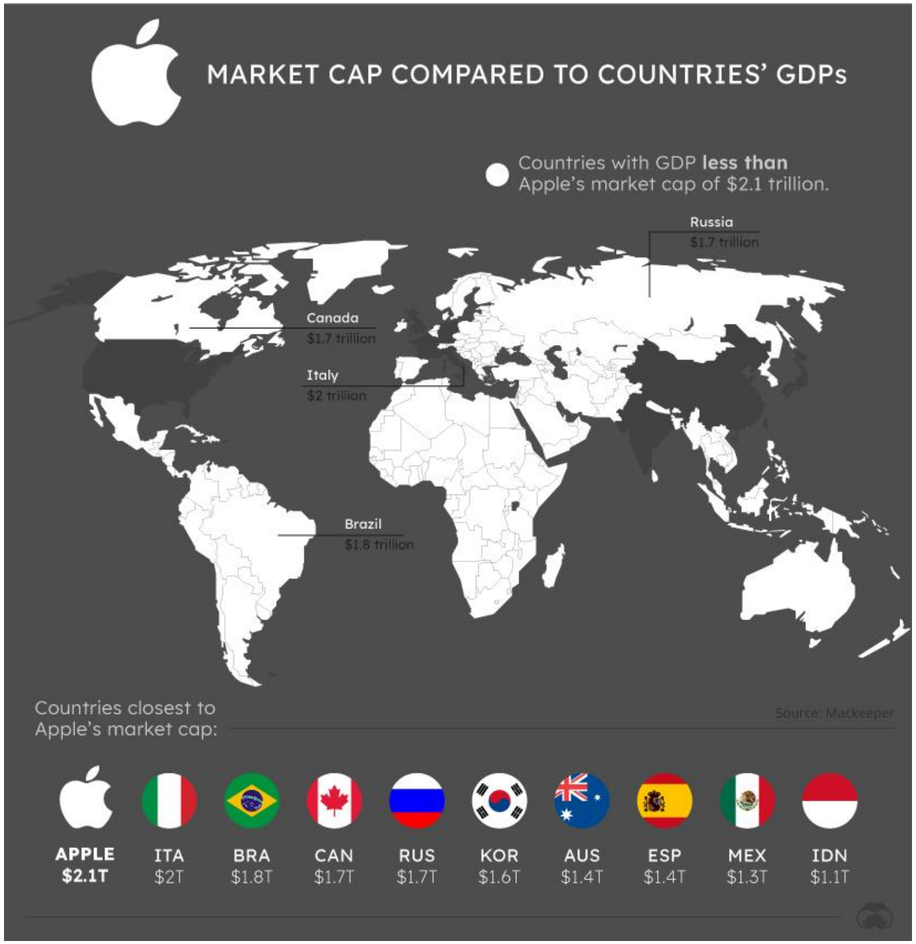
Why International Financial Management?

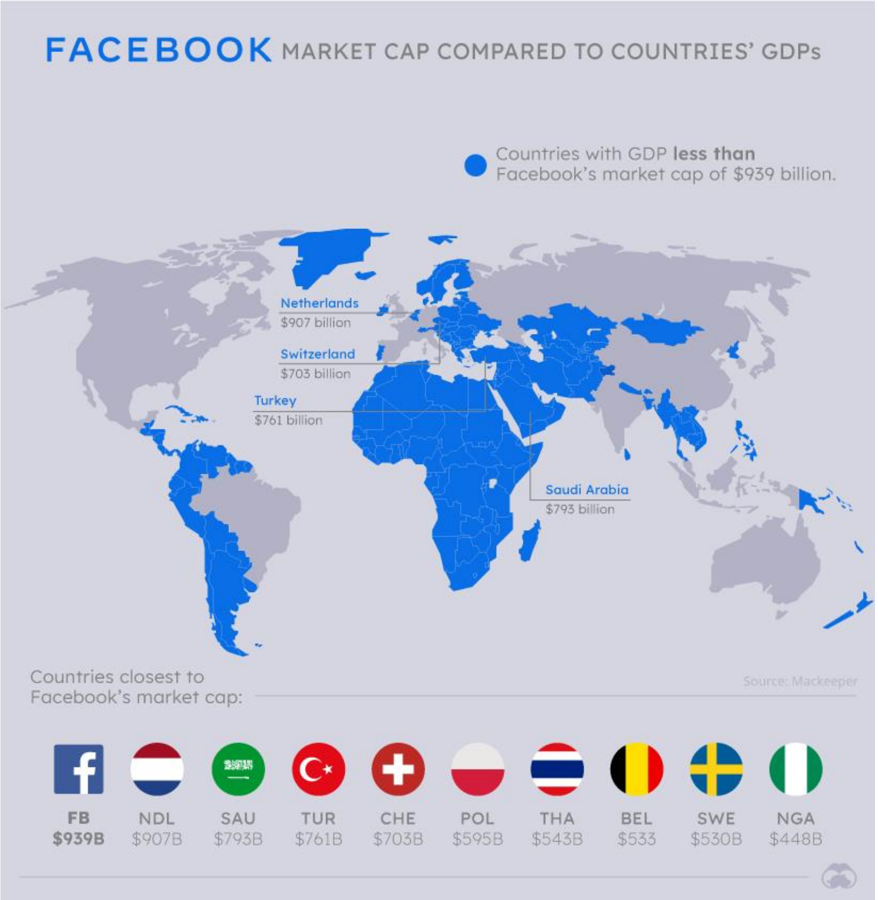


Why International Financial Management?





Why International Financial Management?



Why International Financial Management?

What special about “International Financial Management?”

Three major dimensions set internaitonal finance apart from domestic finance

1. Foreign exchange risk and political risks
2. Market imperfections
3. Expanded opportunity set

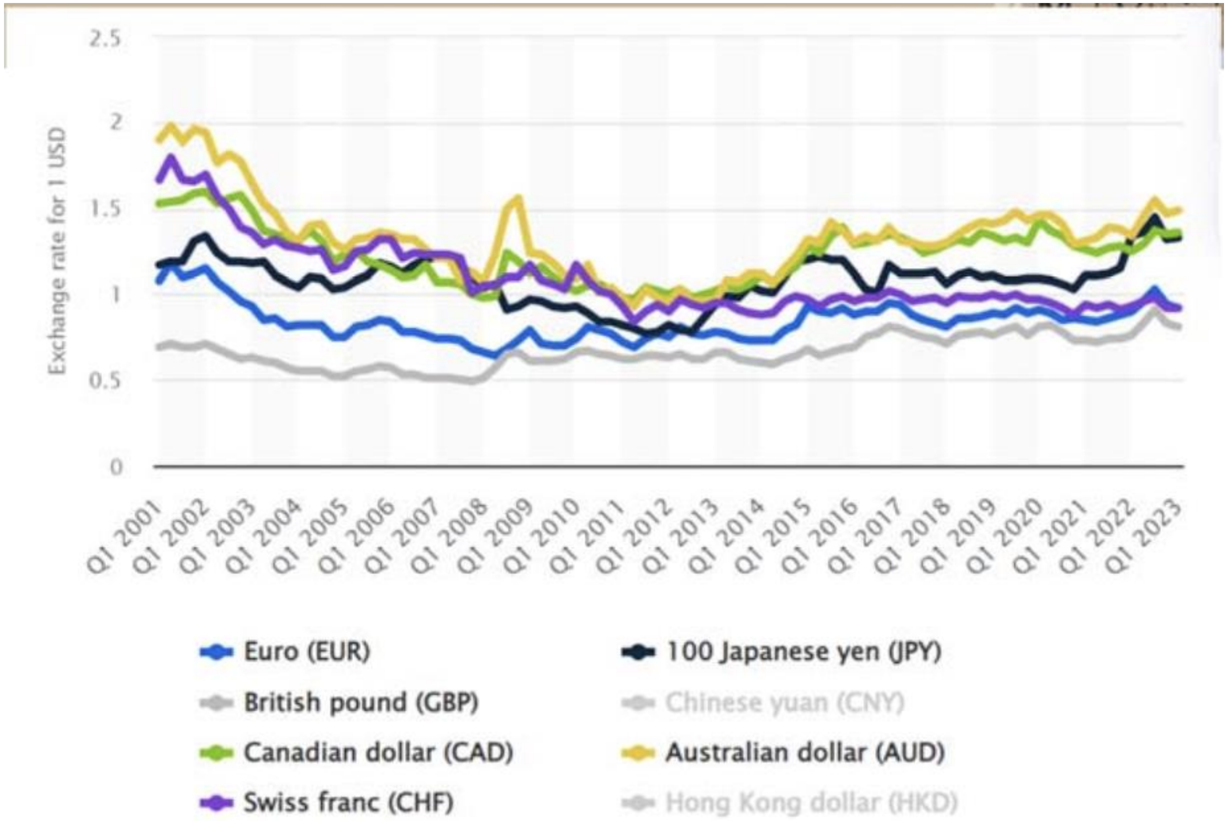
Sovereign nations have the right to issue currencies, impose taxes, and regulate movements of people, goods and capital across their borders.

What special about “International Financial Management?”

Foreign exchange risk is the risk of facing uncertain future exchange rates

- Businesses, individuals and households may also be seriously exposed to uncertain exchange rates
- Exchange rates among major currencies (e.g. U.S. dollar, Japanese yen, Bristish pound and Euro) fluctuate continously in an unpredictable manner.
- Exchange rate uncertainty influences all major economic functions, including consumption, production and investment.

What special about "International Financial Management?"



Source: Statista, 2023

What special about “International Financial Management?”

Political risk arises from potential losses to the parent firm resulting from adverse political developemnts in the host country.

- Ranges from unexpected changes in tax rules to outright expropoiration of assets held by foreigners.
- Arises from the fact that a sovereign country can change the ”rules of the game” and the afftected parties may not have effective resource.
- Especially relevant in those countries without a traditional rule of law.

What special about "International Financial Management?"

Market imperfections may be described as various frictions, such as transaction costs and legal restrictions, that prevent the markets form functioning perfectly.

- World markets are highly imperfect
  - Numerous barriers hamper the free movement of people, goods, services, and capital across national boundaries (e.g. legal restrictions, excessive transaction and transportation costs, information asymmetry and discriminatory taxation)
- Restrict the extent to which investors can diversify their portfolios.

What special about “International Financial Management?”

Firms may benefit from an **expanded opportunity set** when they venture into the arena of global markets.

- Firms can gain from greater economies of scale when their tangible and intangible assets are deployed on a global basis.
- True for corporations, as well as individual investors.
- “It just doesn’t make sense to play in only one corner of the sandbox”

Goals for International Financial Management

- The focus is to provide today's financial managers with an understanding of the fundamental concepts and the tools necessary to be effective global managers.
- Fundamental goal of sound financial management is **shareholder wealth maximization,** which means the firm makes all business decisions and investments with an eye toward making the owners of the firm (i.e. shareholders) better off financially.

International vs. Domestic Financial Management

EXHIBIT 1.3 What Is Different about International Financial Management?

Concept	International	Domestic
Culture, history, and institutions	Each foreign country is unique and not always understood by MNE management	Each country has a known base case
Corporate governance	Foreign countries' regulations and institutional practices are all uniquely different	Regulations and institutions are well known
Foreign exchange risk	MNEs face foreign exchange risks due to their subsidiaries, as well as import/export and foreign competitors	Foreign exchange risks from import/export and foreign competition (no subsidiaries)
Political risk	MNEs face political risk because of their foreign subsidiaries and high profile	Negligible political risks
Modification of domestic finance theories	MNEs must modify finance theories like capital budgeting and the cost of capital because of foreign complexities	Traditional financial theory applies
Modification of domestic financial instruments	MNEs utilize modified financial instruments such as options, forwards, swaps, and letters of credit	Limited use of financial instruments and derivatives because of few foreign exchange and political risks

Aims of the course

- This course is designed to provide students with a comprehensive introduction and overview with **focus on the international environment** in which Multinational Corporations (MNCs) operate, the conceptual framework within which MNCs make key financial decisions.
- Throughout the course students will be equipped with knowledge about the international financial environment, the internaitonal financial management, and MNCs; explore issues relating to the exchange rate risk management; and have a comprehensive understanding and be able to make financial decisions on long-term and short-term capital management in the international financial environment and in Vietnam.

Aims of the course

- This course will help you understand the issues facing the modern corporate manager. Since managers of MNCs will need to understand the environment before they can manage their company, a background on the international environment is first provided, and then the text builds on the managerial aspects from a corporate perspective.
- The course presumes **an understanding of basic corporate finance.**

Syllabus Plan

Session	Date	Topics covered
1	21/10	Internatinal Financial Management: An Overview
2	23/10	Internaitonal Financial Markets
3	30/10	Foreign Direct Investment
4	2/11	Exchange Rate Determination
5	6/11	Multinational Capital Budgeting
6	9/11	International Arbitrage and International Parity Condition
7	13/11	Multinational Capital Structure and Cost of Capital
8	16/11	Currency Derivatives
9	18/11	Measuring Exposure to Foreign Exchange Fluctuations
10	20/11	Managing Transaction Exposure
11	25/11	Managing Economic Exposure and Translation Exposure
12	27/11	Long-term Debt Financing
13	02/12	Short-term Debt Financing
14	04/12	International Cash Management
15	09/12	Revision

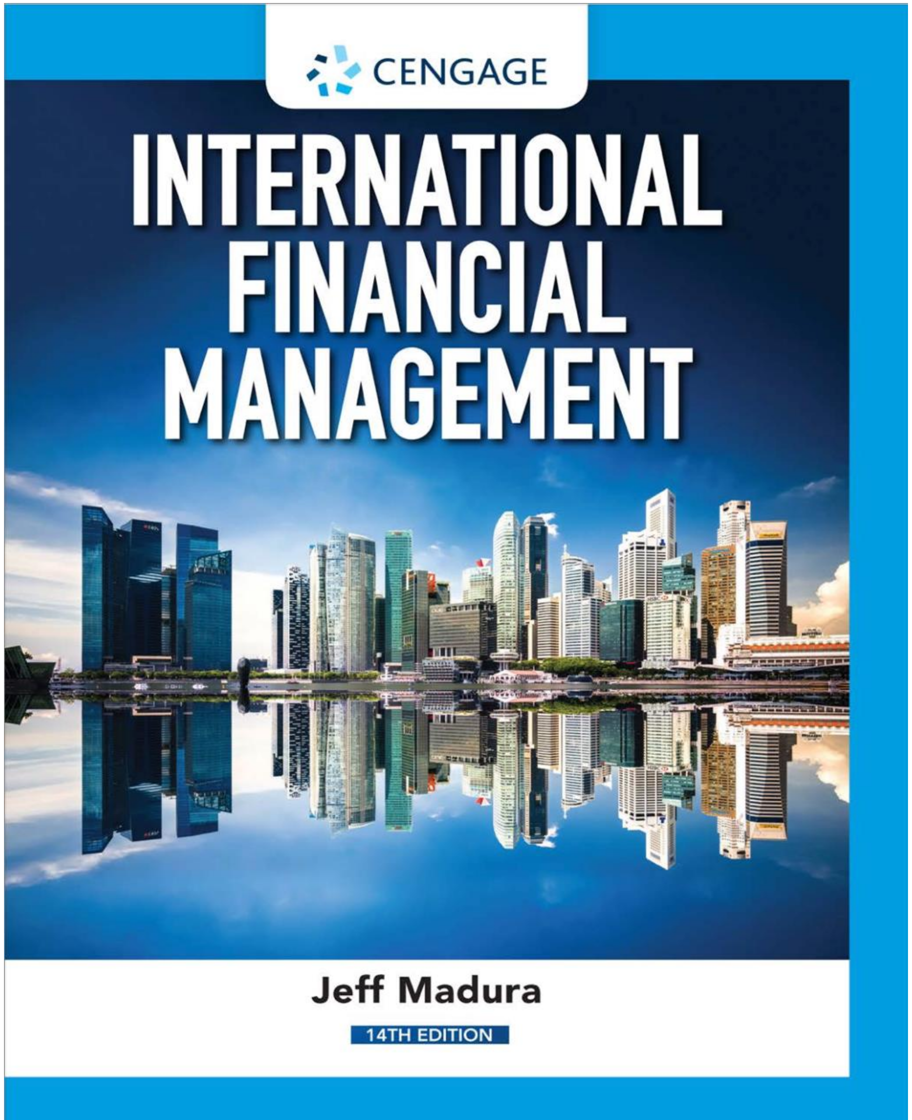
Assessment

	Proportion	Form of Assessment
Class Participant	10%	
Group Assignment	30%	Quizzes (10%) Group Assignment (20%)
Final test	60%	MCQs and short answer/ essay questions

Readings

- Madura, Jeff, 2021, *International Financial Management*, 14th edition, Cengage Learning.
- Eiteman, David K., Stonehill, Arthur I., and Moffett, Michael H., 2021, *Multinational Business Finance*, 15th edition, Pearson.

INTERNATIONAL FINANCIAL MANAGEMENT



CHAPTER 1 INTERNATIONAL FINANCIAL MANAGEMENT – AN OVERVIEW

Lecture Objectives

- Identify the management goal and organizational structure of the Multinational Corporation (MNC).
- Describe the key theories that justify international business.
- Explain the common methods used to conduct international business.
- Provide a model for valuing the MNC.

Multinational Corporations

Multinational Corporations

- **A multinational corporation (MNC)** is a firm that has been incorporated in one country and has production and sales operations in other countries.
  - Approximately 60,000 MNCs in the world with over 500,000 foreign affiliates.

Managing the MNC

- Managers are expected to make decisions that **maximize the shareholders' wealth.**
- Multinational companies whose parents fully own 100% of the capital of foreign subsidiaries (the parent company in the U.S. is the sole owner of the subsidiary), which is a common form of ownership of multinational companies based in the U.S.
- In this course, we'd discover multinational companies based in countries other than the United States.

Managing the MNC

How Business Disciplines Are Used to Manage the MNC

- Common finance decisions include:
  - Whether to discontinue operations in a particular country
  - Whether to pursue new business in a particular country
  - Whether to expand business in a particular country
  - How to finance expansion in a particular country

- Finance decisions are influenced by other business discipline functions:
  - Marketing
  - Management
  - Accounting and information systems

Managing the MNC

Agency Problems

- The conflict of goals between managers and shareholders
- Agency Costs:
  - Definition: Cost of ensuring that managers maximize shareholder wealth.
  - Costs are normally higher for MNCs than for purely domestic firm for several reasons:
    - Monitoring managers of distant subsidiaries in foreign countries is more difficult.
    - Foreign subsidiary managers raised in different cultures may not follow uniform goals.
    - Sheer size of larger MNCs can create large agency problems.

Managing the MNC

Agency problem

- **Parent control of agency problems**

Parent corporation of an MNC should clearly communicate the goals for each subsidiary to ensure managers focus on maximizing the value of the subsidiary.

- **Corporate control of agency problems**

Entire management of the MNC must be focused on maximizing shareholder wealth.

- **Sarbanes-Oxley Act (SOX)**

Ensures a more transparent process for managers to report on the productivity and financial condition of their firm.

SOX Methods to improve reporting

Enacted in 2002, the Sarbanes-Oxley Act (SOX) ensures a more transparent process for managers to report on the productivity and financial condition of their firm.

How SOX Improved Corporate Governance of MNCs?

- Establising a centralized database of information
- Ensuring that all data are reported consistently among subsidiaries
- Implementing a system that automatically checks for unsual discrepancies relative to norms
- Speeding the process by which all departments and subsidiaries have access to all the data they need
- Making executives more accountable for financial statements

Management Structure of MNC

The magnitude of agency costs varies with the MNC's management style.

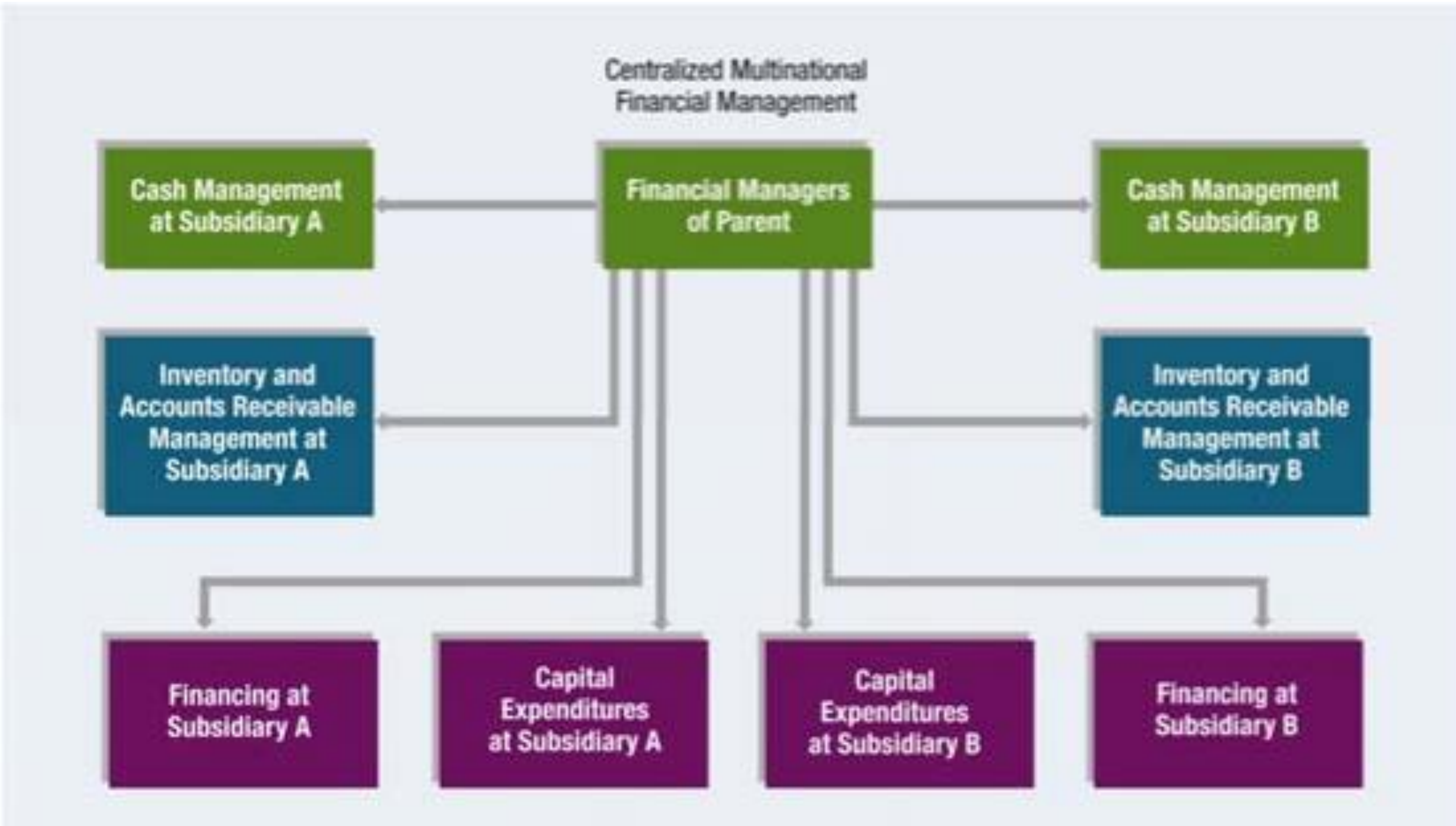
Centralized management style:

- Allows managers of the parent to control foreign subsidiaries and therefore redue the power off subsidiary managers.
- Reduce agency costs.

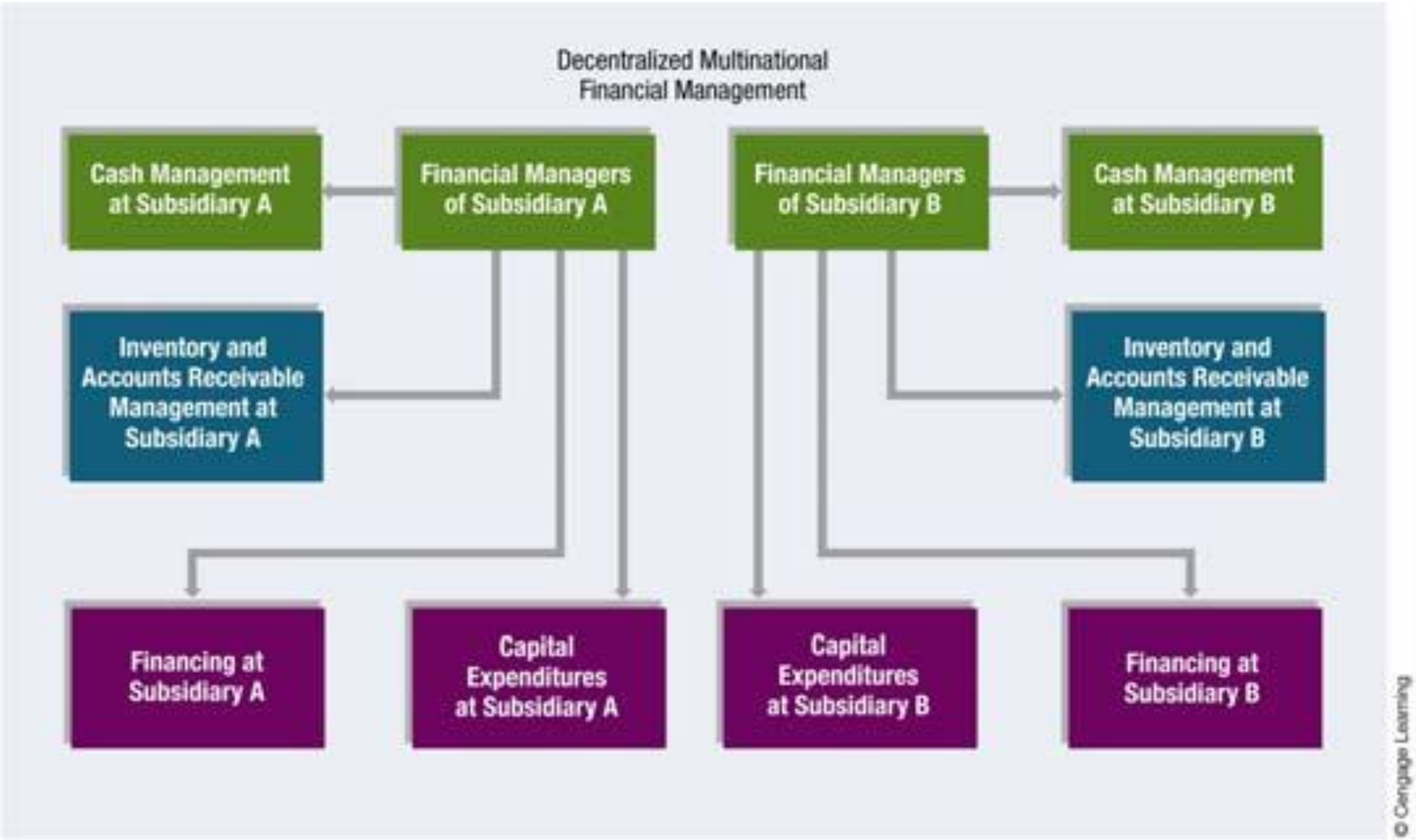
Decentralized management style:

- Gives more control to subsidiary managers who are closer to the subsidiary's operation and environment.
- Increase agency costs.

Centralized management style



Decentralized management style



Why MNCs Pursue International Business?

- **Theory of Competitive Advantage:** specialization increases production efficiency.
- **Imperfect Markets Theory:** factors of production are somewhat immobile, providing incentive to seek out foreign opportunities.
- **Product Cycle Theory:** as a firm matures, it recognizes opportunities outside its domestic market.

Why MNCs Pursue International Business?

Theory of Competitive Advantage

- Some countries have a technology advantage and other countries have an advantage in the cost of basic labor.
- Countries tend to use their advantages to specialize in the production of goods that can be produced with relative efficiency.
- A country that specializes in some products may not produce other products, so trade between countries is essential.
- Comparative advantages allow firms to penetrate foreign market.
- Policy implication is that liberalization of international trade will enhance the welfare of the world’s citizens.

Why MNCs Pursue International Business?

Imperfect Markets Theory

- If each country's markets were closed to all other countries: there would be no international business
- In extreme case, if markets are perfect then the factors of productions are easily trandsferdable:
  - ✓This eliminates the comparative cost advantage which is rationale for international trade.
- In real world, market are imperfect where factors of production are somewhat immobile:
  - ✓Costs and often other restrictions effect the transfer of labor and other resources used for production
  - ✓Provide an incentive for firms to seek out foreign opportunities

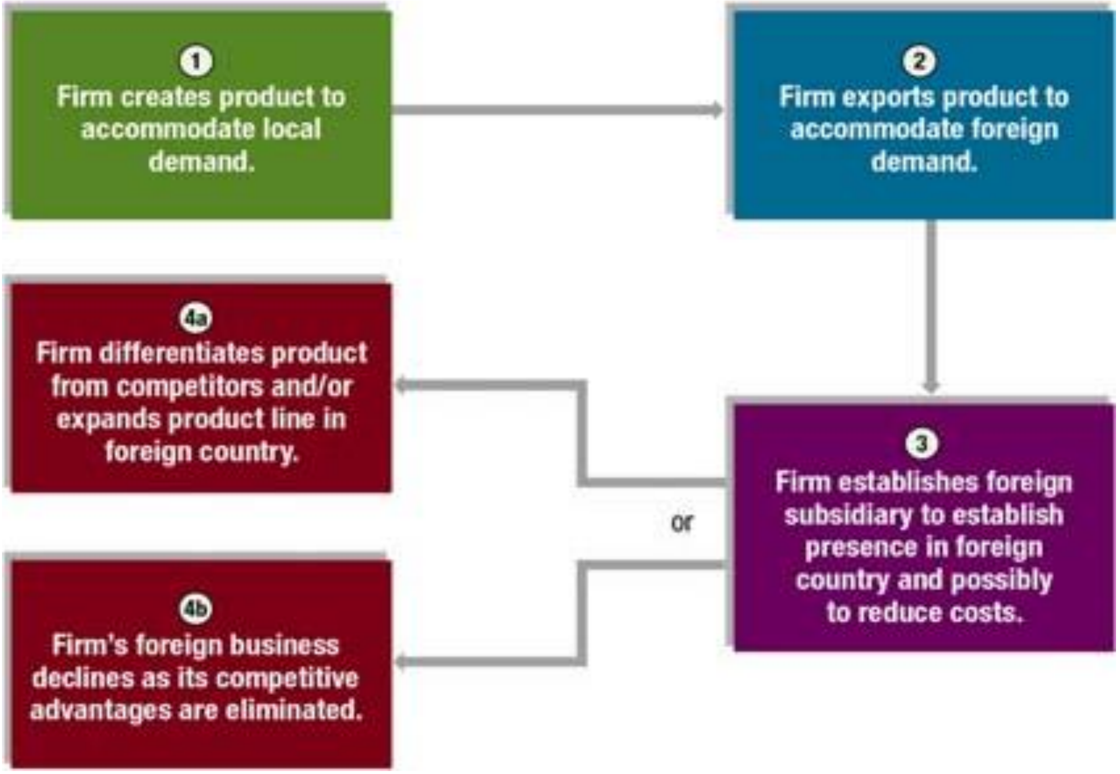
Why MNCs Pursue International Business?

Product cycle theory

- According to this theory, firm first established its operation in home market
- Because information about home markets and competition is more readily available.
- Firm’s product is perceived by foreign consumers to be superior to that available within their own countries, the firm may accommodate foreign consumers by exporting.
- If the firm’s product becomes very popular in foreign countries, it may produce the product in foreign markets, thereby reducing its transportation costs.
- Firm’s foreign business diminishes or expands over time will depend on how successful it is at maintaining some advantage over its competition.

Why MNCs Pursue International Business?

International Product Life Cycle



How Firms Engage in International Business?

MNCs use several methods to conduct international business:

- International Trade
- Licensing
- Franchising
- Joint Ventures
- Acquisitions of Existing Operations
- Establishment of new

Why MNCs Pursue International Business?

International Trade

- Relatively conservative approach that can be used by firms to:
  - ✓Penetrate markets (by exporting)
  - ✓Obtain supplies at a low cost (by importing)
- Minimal risk – no capital at risk.

Why MNCs Pursue International Business?

Licensing

- Obligates a firm to provide its technology (copyrights, patents, trademarks, or trade names) in exchange for fees or some other specified benefits).
- Firm able to generate more revenue from foreign countries without establishing any production plants in foreign countries or transporting goods to foreign countries.
- Licensing allows firms to use their technology in foreign markets without a major investment in foreign countries and without the transportation costs that result from exporting.
- It is difficult for the firm providing the technology to ensure quality control in the foreign production process.

Why MNCs Pursue International Business?

Franchising

- Obligates firm to provide a specialized sales or service strategy, support assistance, and possibly an initial investment in the franchise in exchange for periodic fees.
- Franchising by an MNC often requires a direct investment in foreign operations, it is referred to as a **direct foreign investment**.

Why MNCs Pursue International Business?

Joint Ventures

- A venture that is jointly owned and operated by two or more firms.
- A firm may enter the foreign market by engaging in a joint venture with firms that reside in those markets.
- Allows two firms to apply their respective cooperative advantages in a given project.

Why MNCs Pursue International Business?

Acquisitions of Existing Operations

- Acquisitions of firms in foreign countries allows firms to have full control over their foreign businesses and to quickly obtain in a large portion of foreign market share.
- Subject to the risk of large losses because of larger investment.
- It may be difficult to sell the operations if the foreign subsidiary performs poorly.
- Partial international acquisitions requires a smaller invesment and limits the potential loss to the firm if the project fails.
- Firm will not have complete control over operations that are only partially acquired.

Why MNCs Pursue International Business?

Establishment of New Foreign Subsidiaries

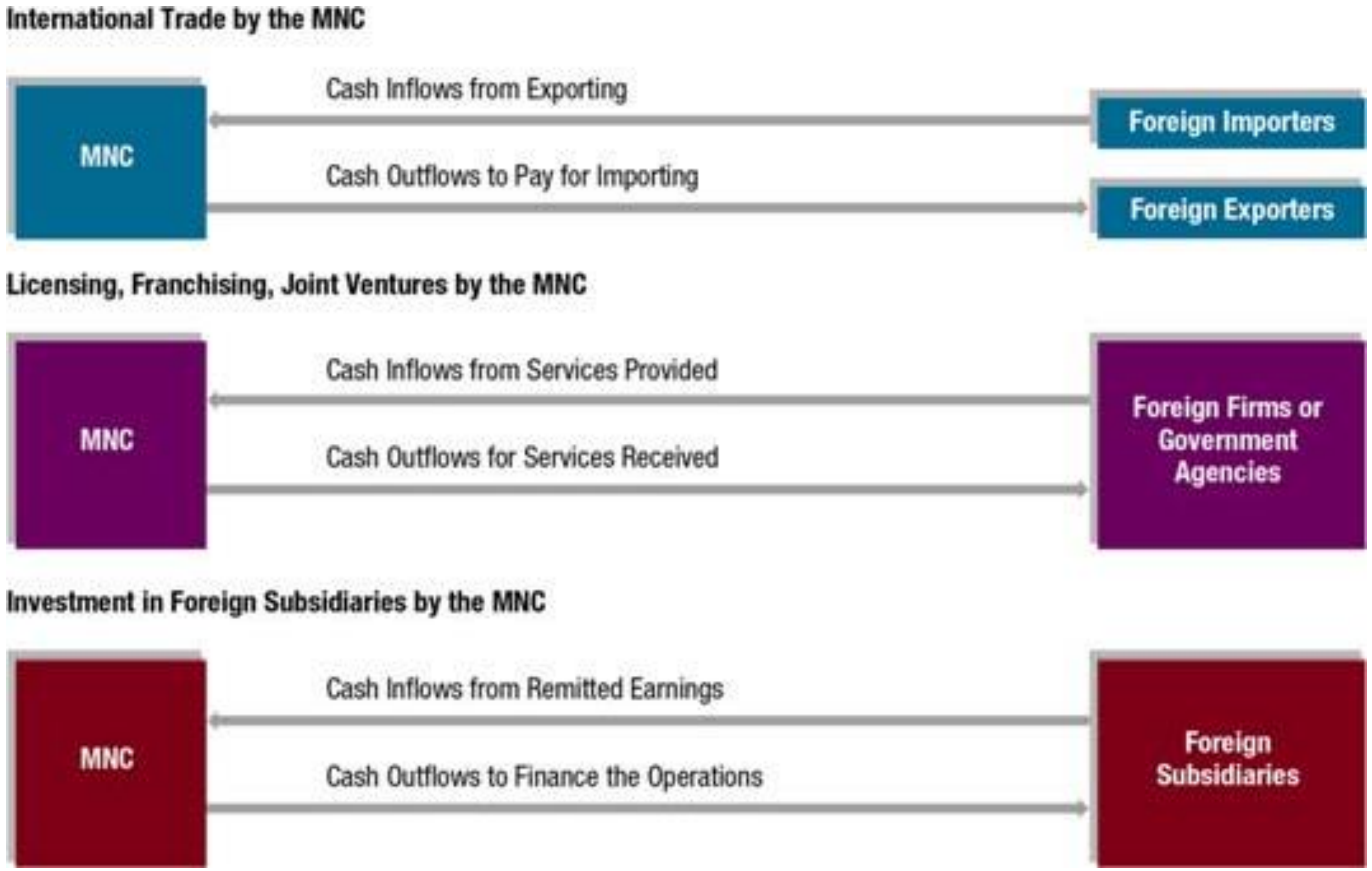
- Firms can penetrate markets by establishing new operations in foreign countries.
- Large investment required.
- Firm will not reap any rewards from the investment until the subsidiary is built and a customer base established.

Why MNCs Pursue International Business?

Summary of Methods

- Any method of increasing international business that requires a direct investment in foreign operations is referred to as **direct foreign investment (DFI).**
- International trade and licensing usually not included.
- Foreign acquisitation and establishment of new foreign subsidiaries represent the largest portion of DFI.

Cash Flows Diagram for MNCs



Valuation Model for an MNC

Domestic Model

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

Where:

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

Valuation Model for an MNC

Domestic Model

Dollar Cash flows

- The dollar cash flows in period t represent funds received by the firm minus funds needed to pay expenses or taxes to reinvest in the firm.

Cost of Capital

- The required rate of return (k) in the denominator of the valuation equation.
- A weighted average of the cost of capital on all the firms projects.

Valuation Model for an MNC

Multinational Model

$$E\left(CF_{\$,t}\right)=\sum_{j=1}^{m}\left[E\left(CF_{j,t}\right)\times E\left(S_{j,t}\right)\right]$$

Where:

- $CF_{j,t}$ represents the amount of cash flow denominated in a particular foreign currency j at the end of period t,
- $S_{j,t}$ represents the exchange rate at which the foreign currency (measured in dollars per unit of the foreign currency) can be converted to dollars at the end of period t.

Valuation Model for an MNC

Multinational Model

- **Valuation of an MNC that uses two currencies:**

Could measure its expected dollar cash flows in any period by multiplying the expected cash flow in each currency by the expected exchange rate at which that currency would be converted to dollars and then summing those two periods.

- **Valuation of an MNC that uses multiple currencies:**

$$E\left(CF_{\$,t}\right)=\sum_{j=1}^{m}\left[E\left(CF_{j,t}\right)\times E\left(S_{j,t}\right)\right]$$

  - Drive an expected dollar cash flow value for each currency
  - Combine the cash flows among currencies within a given period

Valuation Model for an MNC

Multinational Model

Carolina Co. expects cash flow of $100,000 from its local business and 1 million Mexican pesos from its business in Mexico at the end of period t. Assuming that the peso's value is expected to $0.09 when converted into dollars, how much is the expected dollar cash flows?

$$E\left(CF_{\$,t}\right)=\sum_{j=1}^{m}\left[E\left(CF_{j,t}\right)\times E\left(S_{j,t}\right)\right]$$

Valuation Model for an MNC

Multinational Model

Valuation of an MNC's cash flows over multiple periods

- Apply single period process to all future periods
- Discount the estimated total dollar cash flow for each period at the weighted cost of capital

$$V = \sum_{j=1}^{N} \left\{ \frac{\sum_{j=1}^{m} [E(CF_{j,t}) \times E(S_{j,t})]}{(1+k)^{t}} \right\}$$

Valuation Model for an MNC

Uncertainty Surrounding MNC Cash Flows

Exposure to international economic conditions: if economic conditions in a foreign country weaken, purchase of products decline and MNC sales in that country may be lower than expected.

Exposure to international political risk: a foreign government may increase taxes or impose barriers on the MNC's subsidiary.

Exposure to exchange rate risk: if foreign currencies related to the MNC subsidiary weaken against the U.S. dollar, the MNC will receive a lower amount of dollar cash flows than was expected.

Valuation Model for an MNC

How an MNC's valuation is exposed to uncertainty

Uncertain foreign currency cash flows due to uncertain foreign economic and political conditions

Uncertainty surrounding future exchange rates

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

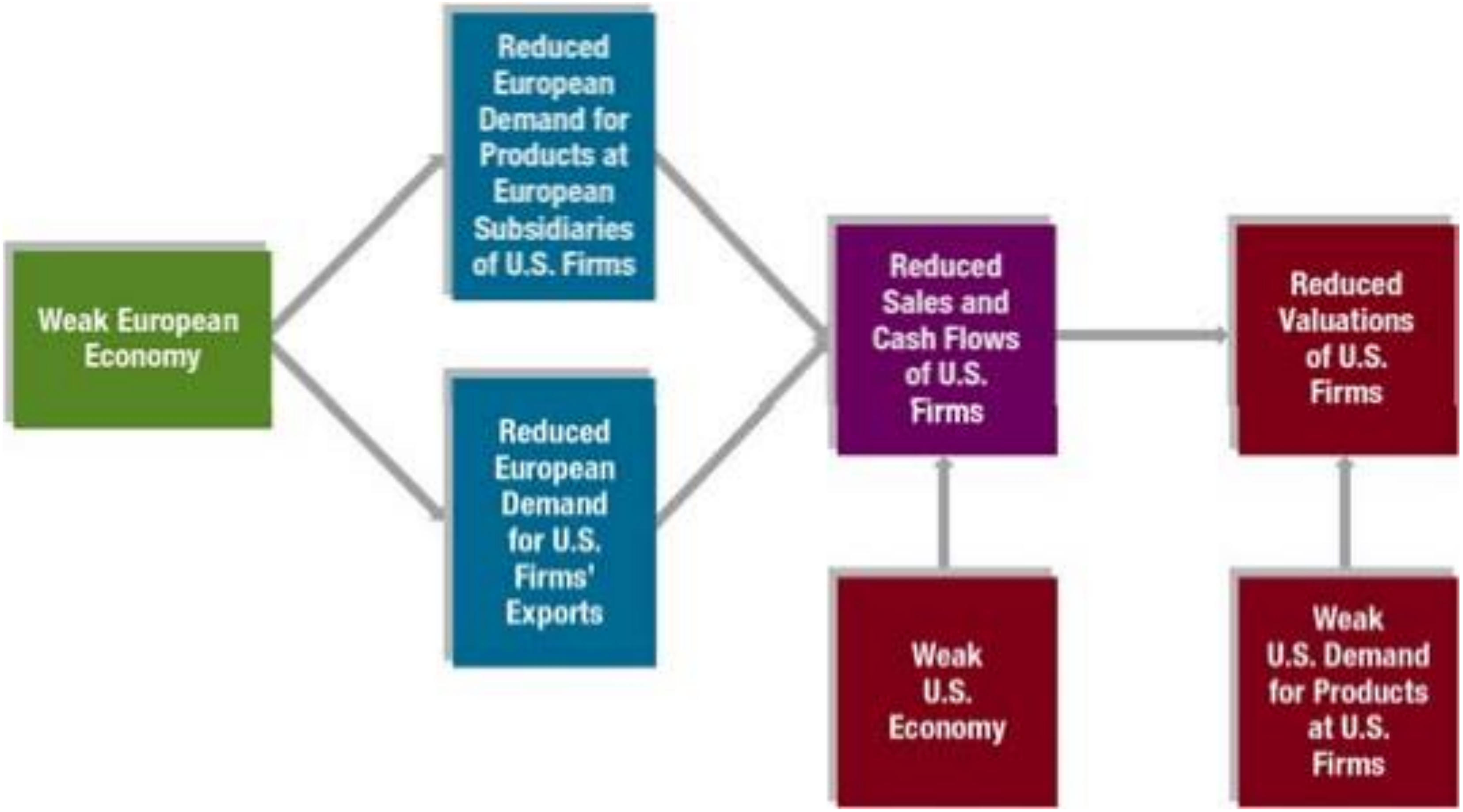
Uncertainty Surrounding an MNC's Valuation:

Exposure to Foreign Economies: If $[CF_{j,t} < E(CF_{j,t})] \rightarrow V\downarrow$

Exposure to Political Risk: If $[CF_{j,t} < E(CF_{j,t})] \rightarrow V\downarrow$

Exposure to Exchange Rate Risk: If $[S_{j,t} < E(S_{j,t})] \rightarrow V\downarrow$

Potential Effects of International Economic Conditions



How Uncertainty Affects the MNC's Cost of Capital

How Uncertainty Affects the MNC's cost of capital

- Due to increase in uncertainty of an MNC's future cash flows, investors may only be willing to invest in the MNC if they can expect to receive a higher rate of return (increasing MNC's cost of obtaining capital) and the MNC's valuation decreases.
- The uncertainty surrounding economic conditions that influence cash flows declines, the uncertainty surrounding cash flows of MNCs also declines and results in a lower required rate of return and cost of capital for MNCs, valuation of MNCs increases.