



# INTERNATIONAL FINANCIAL RELATIONS

**Dr. Jamsheer Radjabov**

# PART I

## THE INTERNATIONAL FINANCIAL ENVIRONMENT

**Multinational Corporation (MNC)**

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graph TD; A[Multinational Corporation (MNC)] --> B[Foreign Exchange Markets]; B --> C[Dividend Remittance & Financing]; C --> D[Exporting & Importing]; C --> E[Investing & Financing]; D --> F[Product Markets]; E --> G[Subsidiaries]; E --> H[International Financial Markets];
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**Foreign Exchange Markets**

**Dividend  
Remittance  
& Financing**

**Exporting  
& Importing**

**Investing  
& Financing**

**Product Markets**

**Subsidiaries**

**International  
Financial  
Markets**

**Topic**

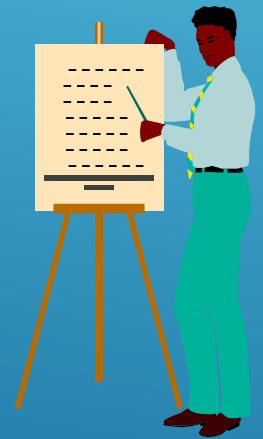
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# MULTINATIONAL FINANCIAL MANAGEMENT: AN OVERVIEW

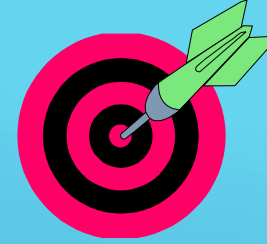


# CHAPTER OBJECTIVES

- ▶ To identify the main goal of the multinational corporation (MNC) and 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 are based in the United States and that wholly own their foreign subsidiaries.

- ▶ For corporations with shareholders who differ from their managers, a conflict of goals can exist - *the agency problem*.
- ▶ Agency costs are normally larger for MNCs than for purely domestic firms.
  - ▶ The sheer size of the MNC.
  - ▶ The scattering of distant subsidiaries.

CONFLICTS AGAINST THE MNC

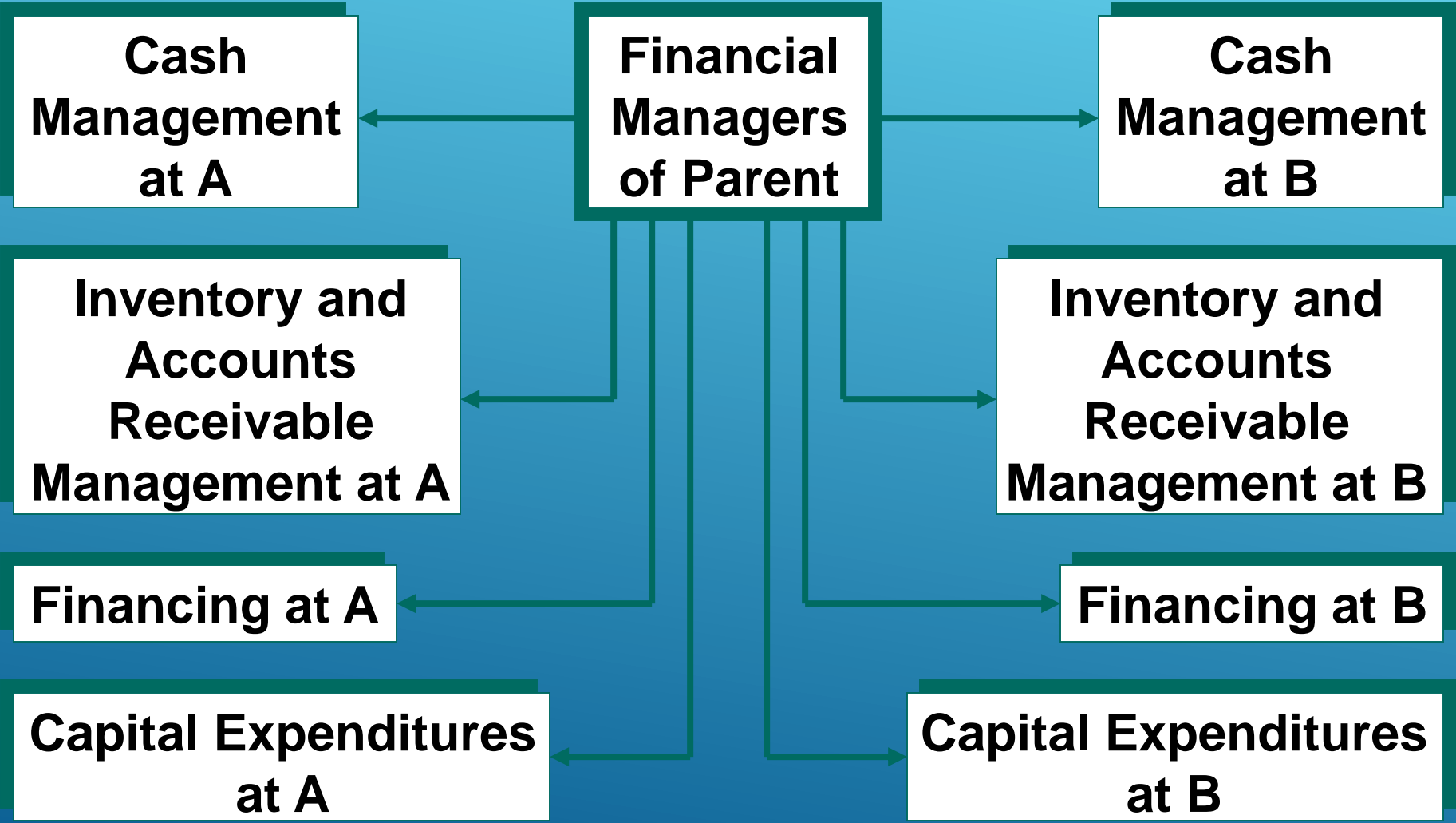
GOAL

- ▶ The culture of foreign managers.
- ▶ Subsidiary value versus overall MNC value.

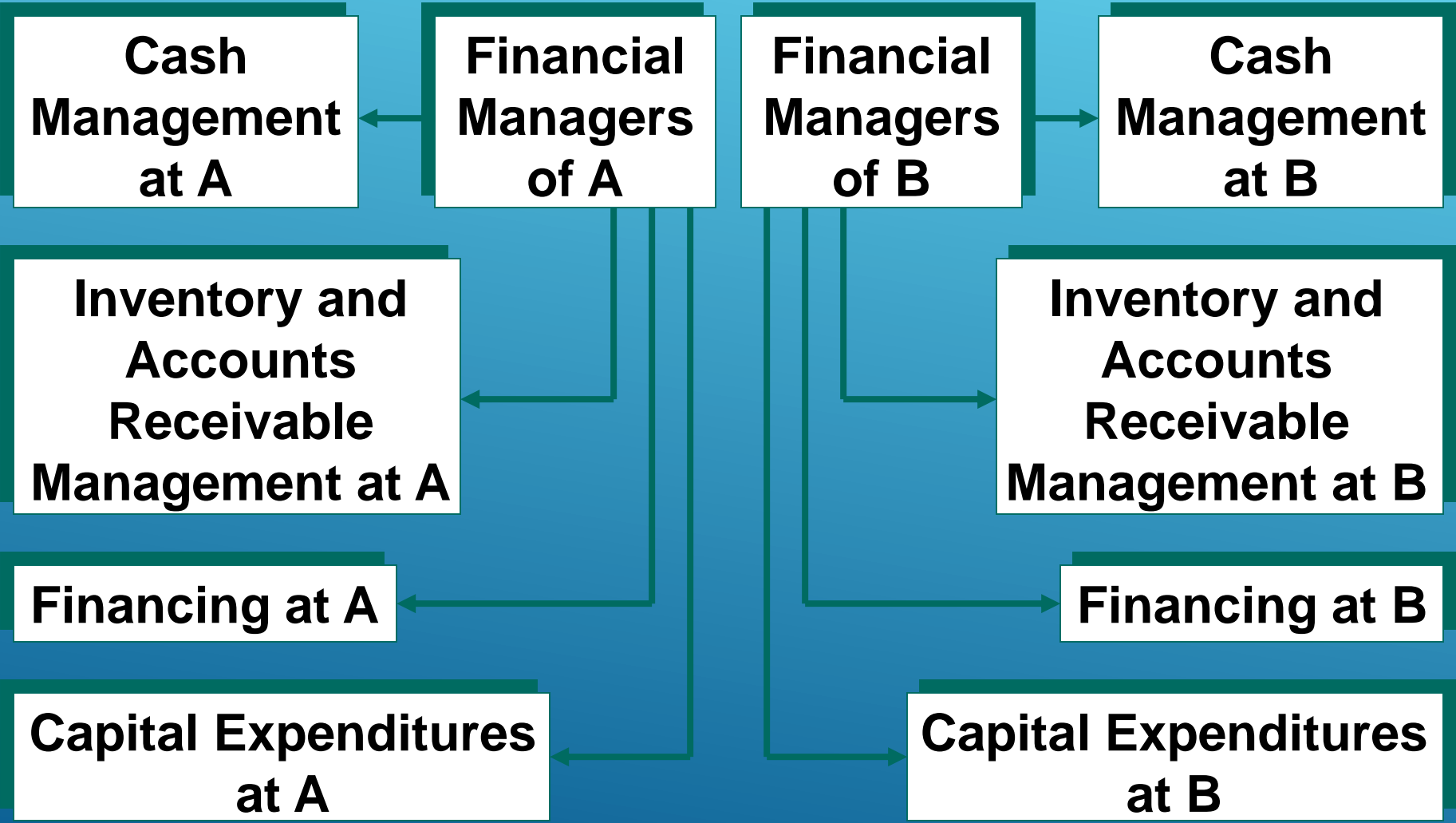
- ▶ The magnitude of agency costs can vary with the management style of the MNC.
- ▶ A *centralized* management style reduces agency costs. However, a *decentralized* style gives more control to those managers who are closer to the subsidiary's operations and environment.

## IMPACT OF MANAGEMENT CONTROL

# CENTRALIZED MULTINATIONAL FINANCIAL MANAGEMENT for an MNC with two subsidiaries, A and B



# DECENTRALIZED MULTINATIONAL FINANCIAL MANAGEMENT for an MNC with two subsidiaries, A and B



- ▶ Some MNCs attempt to strike a balance - they allow subsidiary managers to make the key decisions for their respective operations, but the decisions are monitored by the parent's management.

## IMPACT OF MANAGEMENT CONTROL

- ▶ Electronic networks make it easier for the parent to monitor the actions and performance of foreign subsidiaries.
- ▶ For example, corporate intranet or internet email facilitates communication. Financial reports and other documents can be sent electronically too.

## IMPACT OF MANAGEMENT CONTROL

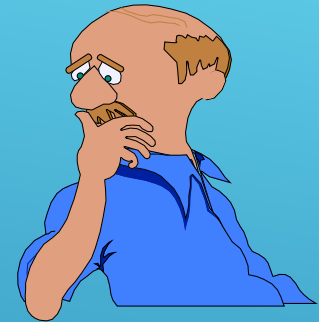
- ▶ Various forms of corporate control can reduce agency costs.
  - ▶ Stock compensation for board members and executives.
  - ▶ The threat of a hostile takeover.
  - ▶ Monitoring and intervention by large shareholders.

## IMPACT OF CORPORATE CONTROL

- ▶ As MNC managers attempt to maximize their firm's value, they may be confronted with various constraints.
  - ▶ Environmental constraints.
  - ▶ Regulatory constraints.
  - ▶ Ethical constraints.

## CONSTRAINTS INTERFERING WITH THE MNC'S GOAL

# 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.”

# THEORIES OF INTERNATIONAL BUSINESS

# Why are firms motivated to expand their business internationally?



## ③ Product Cycle Theory

- ▶ As a firm matures, it may recognize additional opportunities outside its home country.

# THEORIES OF INTERNATIONAL BUSINESS

# THE INTERNATIONAL PRODUCT LIFE CYCLE

**① Firm creates product to accommodate local demand.**

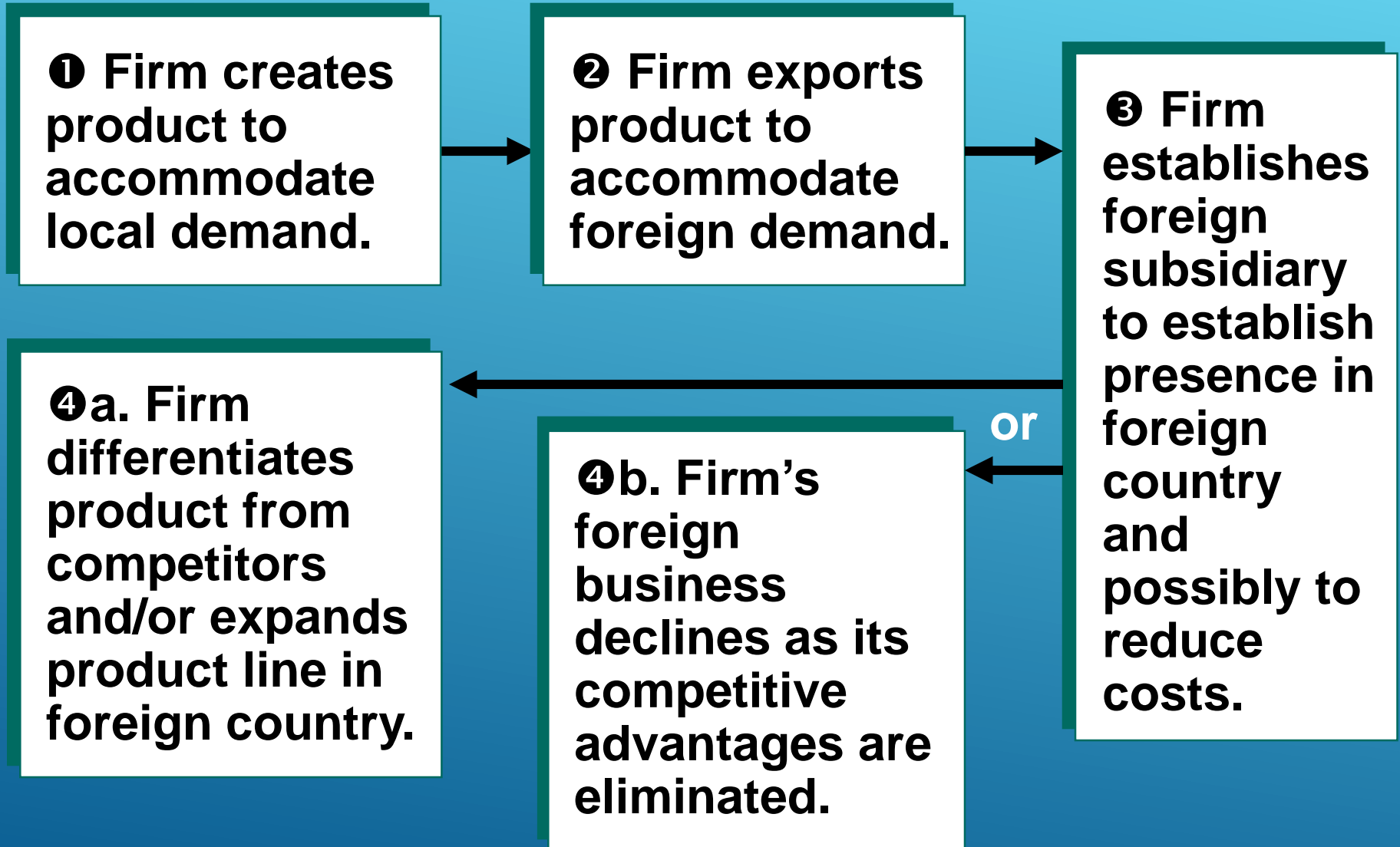
**② Firm exports product to accommodate foreign demand.**

**③ Firm establishes foreign subsidiary to establish presence in foreign country and possibly to reduce costs.**

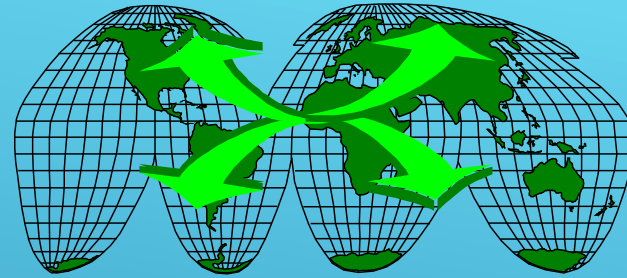
**④a. Firm differentiates product from competitors and/or expands product line in foreign country.**

**④b. Firm's foreign business declines as its competitive advantages are eliminated.**

or



# INTERNATIONAL BUSINESS METHODS

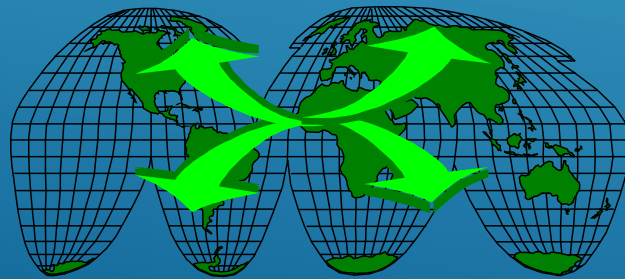


**There are several methods by which firms can conduct international business.**

- ▶ **International trade** is a relatively conservative approach involving exporting and/or importing.
  - ▶ The internet facilitates international trade by enabling firms to advertise and manage orders through their websites.

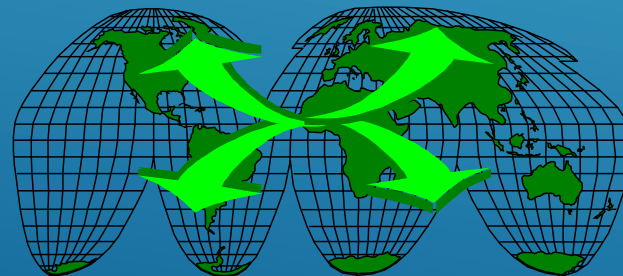
# INTERNATIONAL BUSINESS METHODS

- ▶ **Licensing** allows a firm to provide its technology in exchange for fees or some other benefits.
- ▶ **Franchising** obligates a firm to provide a specialized sales or service strategy, support assistance, and possibly an initial investment in the franchise in exchange for periodic fees.



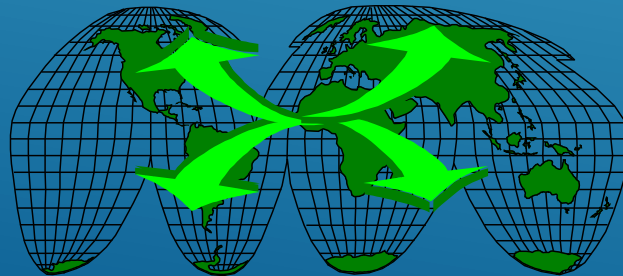
# INTERNATIONAL BUSINESS METHODS

- ▶ 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.

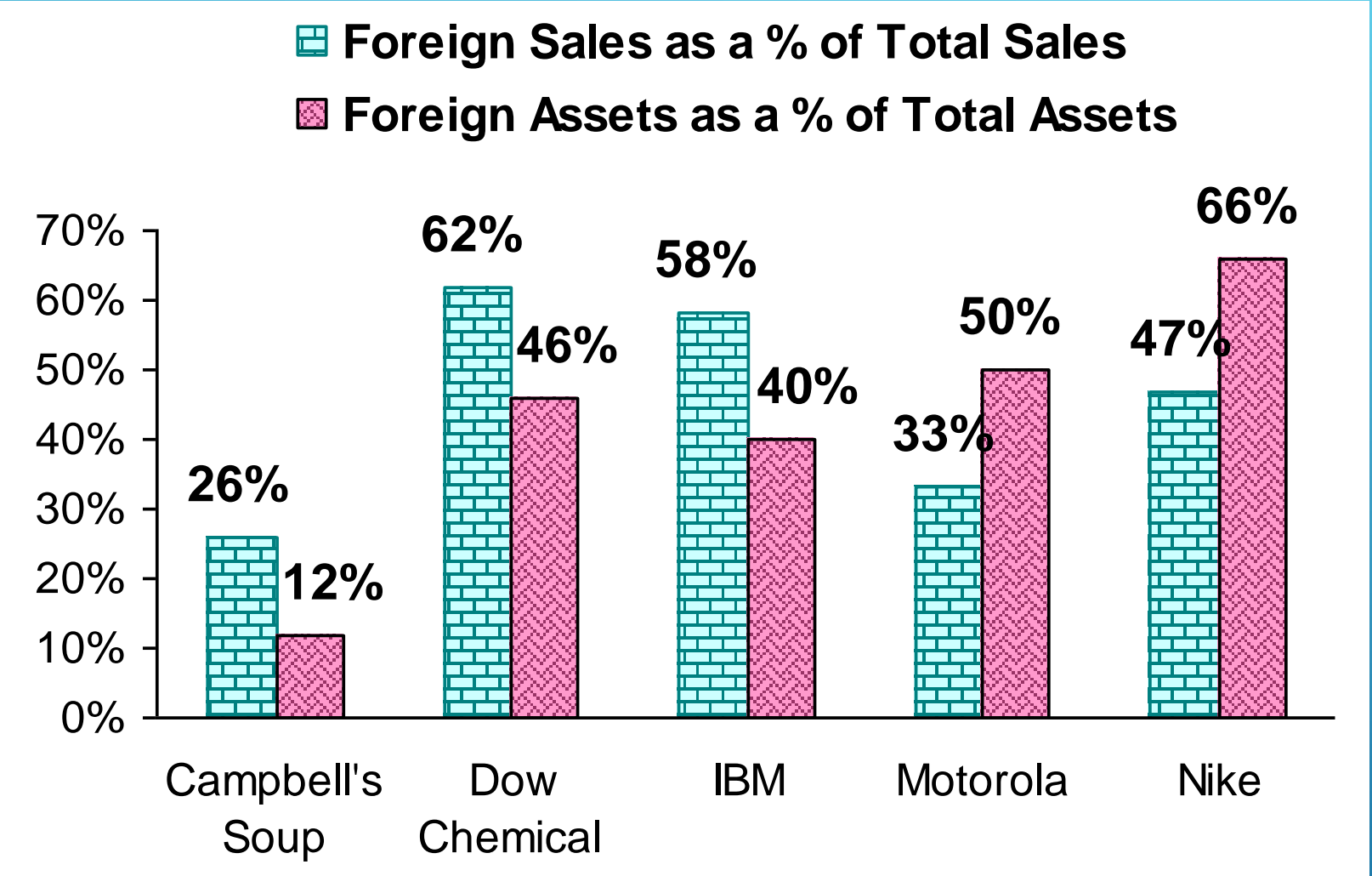


# INTERNATIONAL BUSINESS METHODS

- ▶ Firms can also penetrate foreign markets by **establishing new foreign subsidiaries**.
- ▶ In general, any method of conducting business that requires a direct investment in foreign operations is referred to as a **direct foreign investment (DFI)**.
- ▶ The optimal international business method may depend on the characteristics of the MNC.



# DEGREE OF INTERNATIONAL BUSINESS BY MNCS



# ONLINE APPLICATION



- ▶ Check out the following international trade promotion sites.

TradeNet's Export Advisor

[HTTP://WWW.TRADENET.GOV](http://www.tradenet.gov)



[Export Contacts](#)

[Getting Started](#)

[Export Finance](#)

[Export Library](#)

[Tutorials](#)

[Web Search](#)

[Trade Leads](#)

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# International Trade Administration

United States Department of Commerce 1-800-USA-TRADE

[Hot News](#)

[DOC](#)

[Site Map](#)

[Press Room](#)

[Contact Us](#)

[Get New Customized State Export Data](#)

## Get International Trade Assistance

Explore Exporting

Make Export Sales Happen

Expand Your International Business

Solve Trade Problems: Foreign Markets  
U.S. Markets

Find a Partner in the U.S.

[Advocacy](#) •

[Trade Events](#) •

[Trade Statistics](#) •

[Tariffs and Taxes](#) •

[Market Research](#) •

[NAFTA Rules of Origin](#) •

[Key Policy Initiatives](#) •

[Export Documentation](#) •

[Financing Your Export Transactions](#) •

[HTTP://WWW.TRADE.GOV](http://www.trade.gov)

<http://www.export.gov>



## INTERNATIONAL TRADE

### International Trade

- [Country Research](#)
- [On-Line Directories](#)
- [Company Background](#)
- [Education & Training](#)
- [Product Market Research](#)
- [Trade Leads](#)
- [FAQ's](#)
- [Trade Finance](#)
- [Trade Laws/Regulations](#)
- [Trade Associations](#)
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- [Trade Events/Conferences](#)

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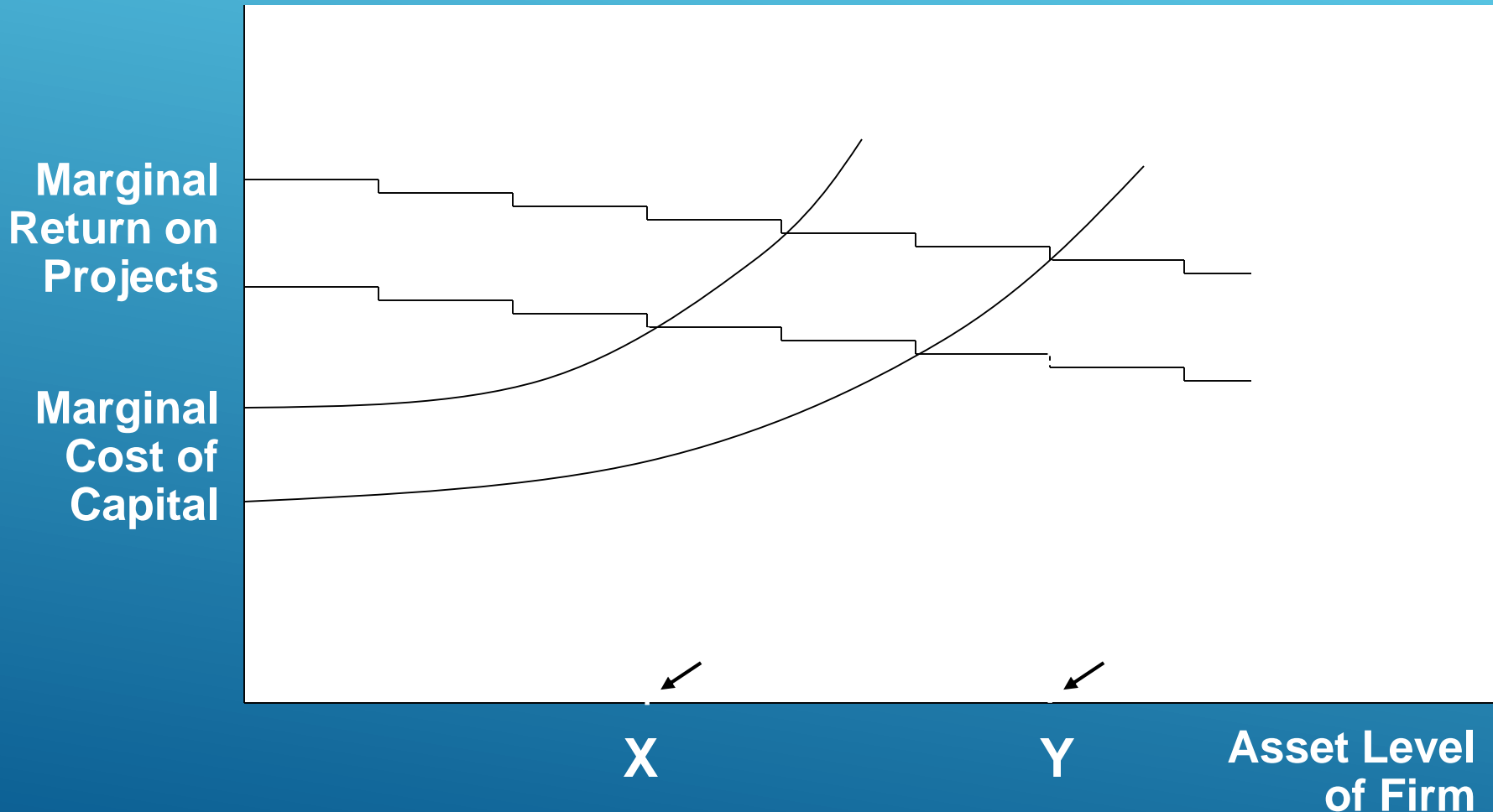
# INTERNATIONAL OPPORTUNITIES



- ▶ Investment opportunities - The marginal return on projects for an MNC is above that of a purely domestic firm because of the expanded opportunity set of possible projects from which to select.
- ▶ Financing opportunities - An MNC is also able to obtain capital funding at a lower cost due to its larger opportunity set of funding sources around the world.

# INTERNATIONAL OPPORTUNITIES

## Cost-benefit Evaluation for Purely Domestic Firms versus MNCs



# INTERNATIONAL OPPORTUNITIES

- ▶ Opportunities in Europe
  - ▶ The Single European Act of 1987.
  - ▶ The removal of the Berlin Wall in 1989.
  - ▶ The inception of the euro in 1999.
- ▶ Opportunities in Latin America
  - ▶ The North American Free Trade Agreement (NAFTA) of 1993.
  - ▶ The General Agreement on Tariffs and Trade (GATT) accord.



# INTERNATIONAL OPPORTUNITIES

- ▶ Opportunities in Asia
  - ▶ The reduction of investment restrictions by many Asian countries during the 1990s.
  - ▶ China's potential for growth.
  - ▶ The Asian economic crisis in 1997-1998.



# ONLINE APPLICATION

- ▶ For more information on the Asian crisis, check out the following sites:
  - ▶ <http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html>
  - ▶ <http://www.asienhaus.org/navigat/english/asienhaus.htm>



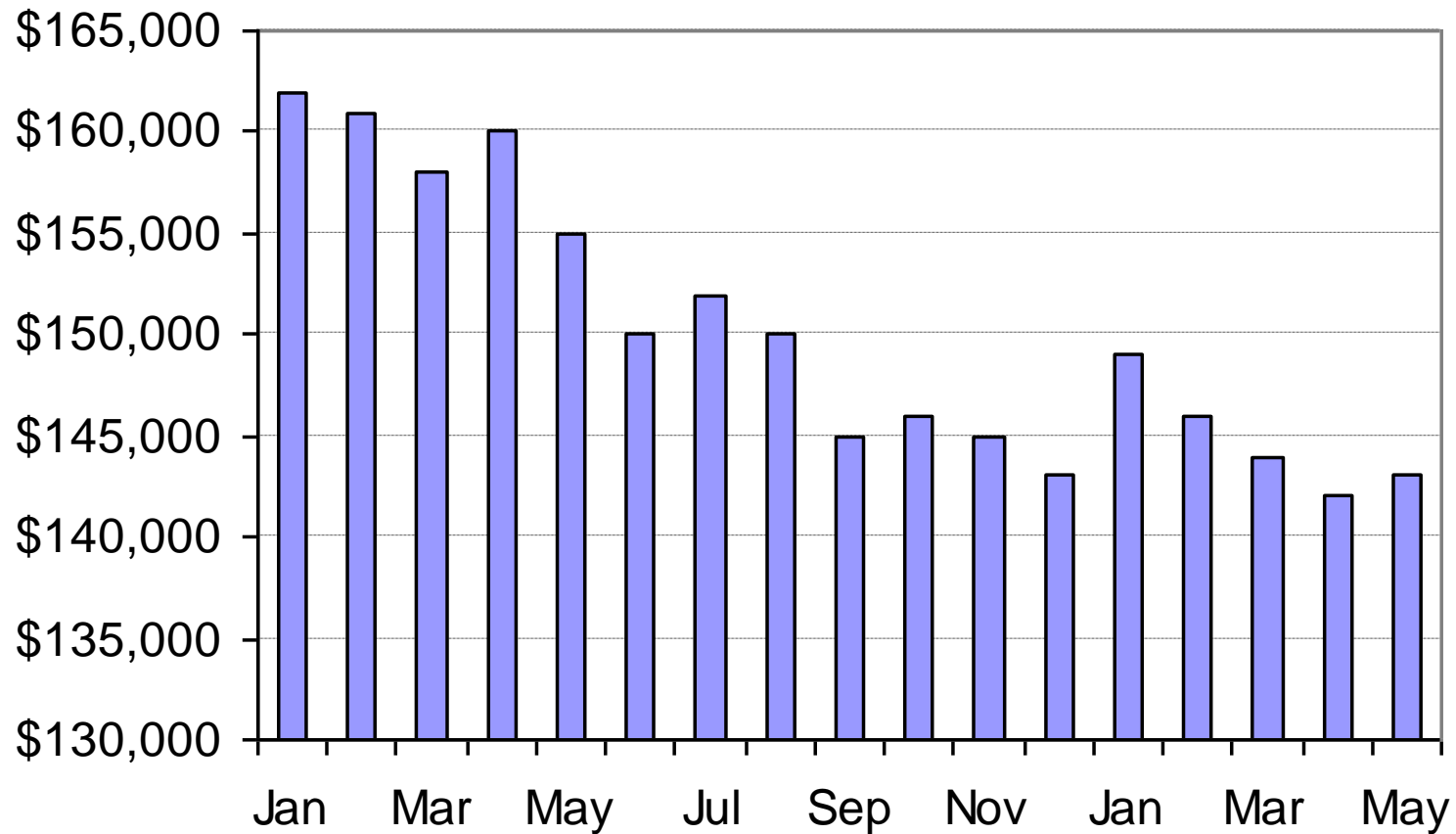
# International business usually increases an MNC's exposure to:

- ① exchange rate movements
  - ▶ Exchange rate fluctuations affect cash flows and foreign demand.
- ② foreign economies
  - ▶ Economic conditions affect demand.
- ③ political risk
  - ▶ Political actions affect cash flows.

## EXPOSURE TO INTERNATIONAL RISK

# EXPOSURE TO INTERNATIONAL RISK

## U.S. Firm's Cost of Obtaining £100,000



# ONLINE APPLICATION

- ▶ Visit FRED<sup>®</sup>, Fed's economic time-series database, at <http://www.stls.frb.org/fred> for numerous economic and financial time series, e.g., balance of payment statistics, interest rates, foreign exchange rates.
- ▶ Visit <http://www.ita.doc.gov/td/industry/otea> (Office of Trade and Economic Analysis) for an outlook of international trade conditions for each of several industries.

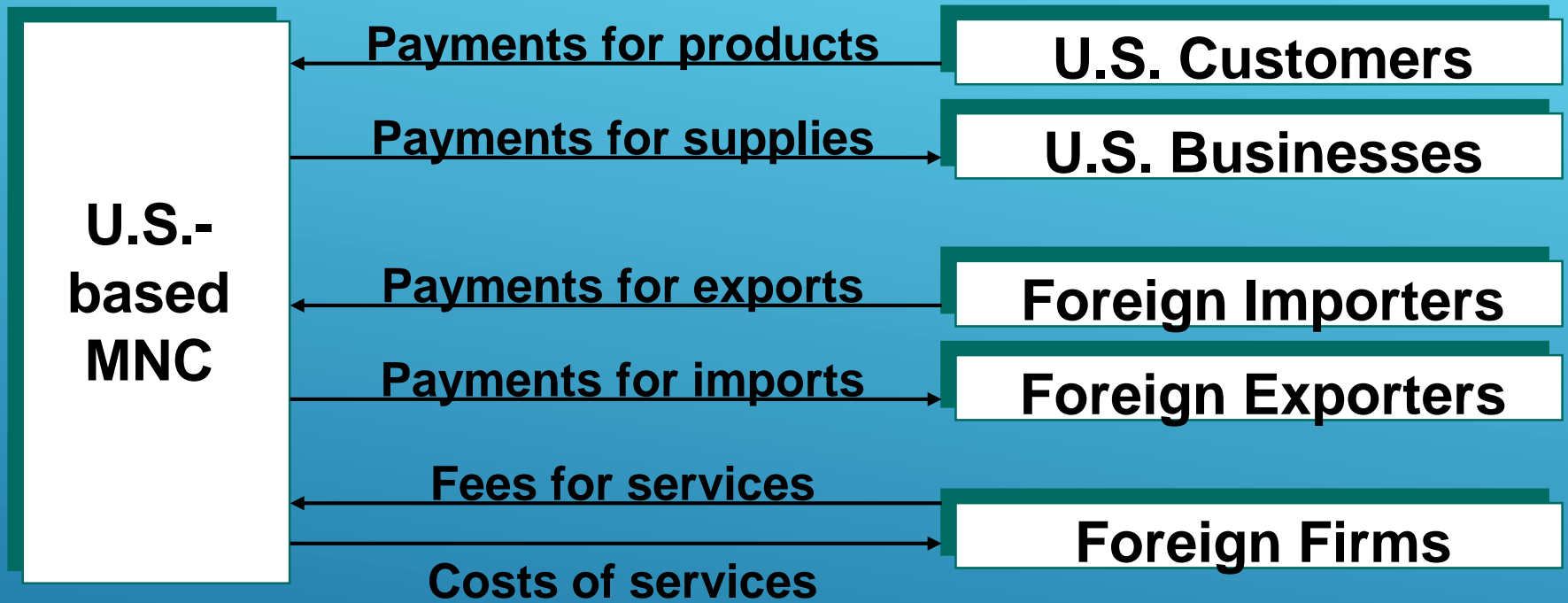


## Profile A: MNCs focused on International Trade



OVERVIEW OF AN MNC'S CASH FLOWS

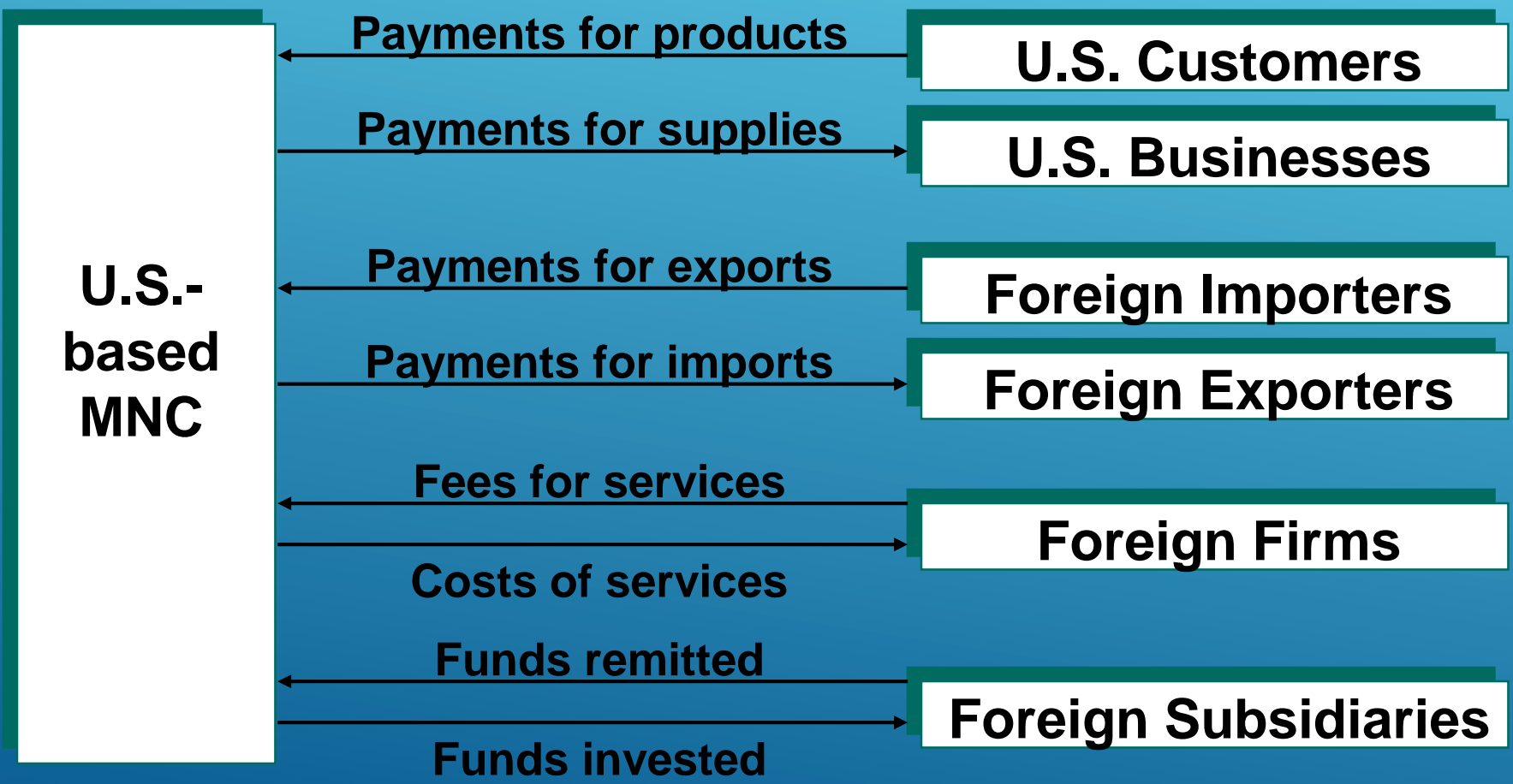
# Profile B: MNCs focused on International Trade and International Arrangements



OVERVIEW OF AN MNC'S CASH FLOWS

# OVERVIEW OF AN MNC'S CASH FLOWS

## Profile C: MNCs focused on International Trade, International Arrangements, and Direct Foreign Investment



- ▶ Like domestic projects, foreign projects involve an investment decision and a financing decision.
- ▶ When managers make multinational finance decisions that maximize the overall present value of future cash flows, they maximize the firm's value, and hence shareholder wealth.

# MANAGING FOR VALUE

► Domestic Model

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

**E (CF<sub>\$,t</sub>)** = 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

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

$E(\text{CF}_{j,t})$  = expected cash flows denominated in currency  $j$  to be received by the U.S. parent at the end of period  $t$

$E(\text{ER}_{j,t})$  = expected exchange rate at which currency  $j$  can be converted to dollars at the end of period  $t$

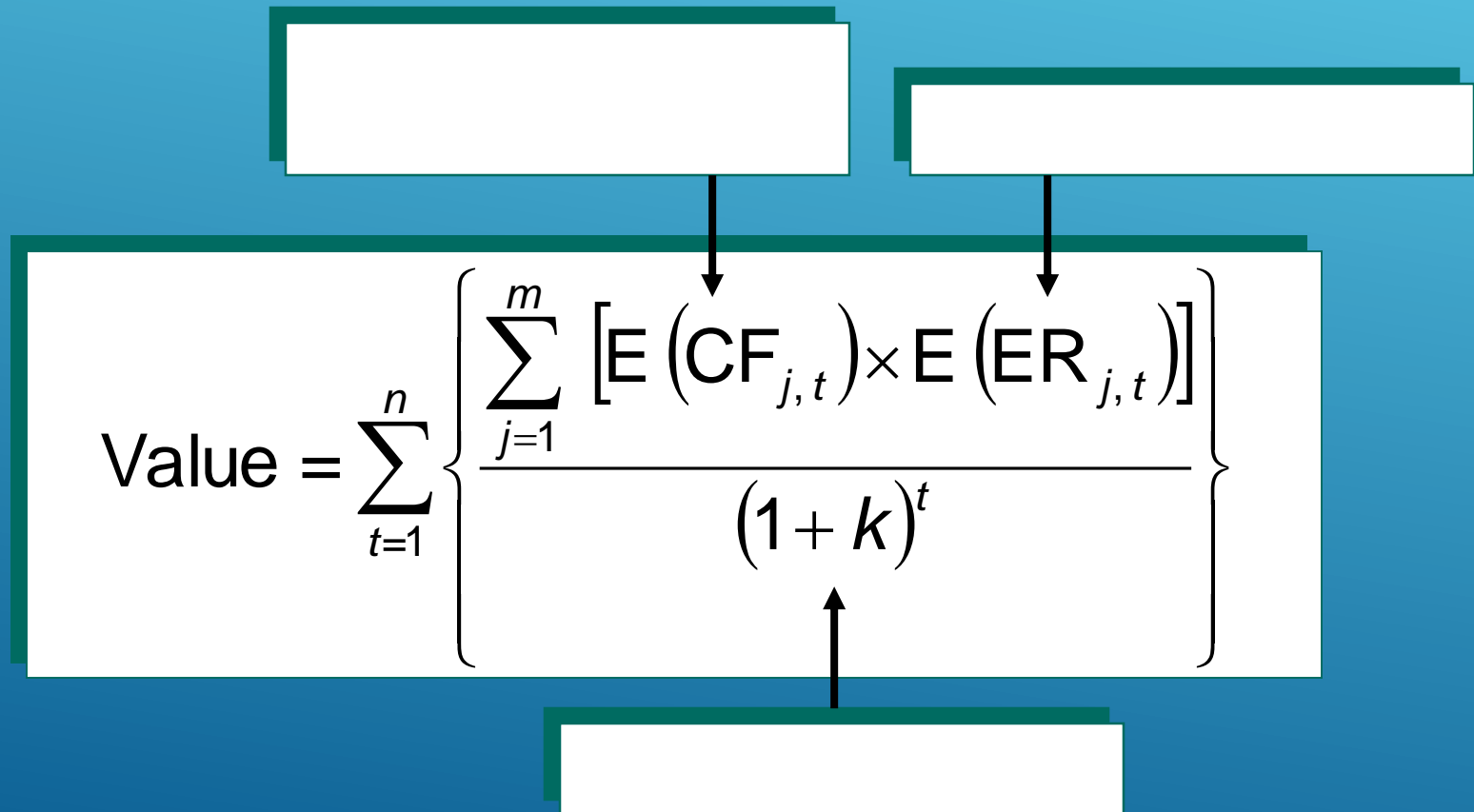
$k$  = the weighted average cost of capital of the U.S. parent company

- ▶ An MNC's financial decisions include how much business to conduct in each country and how much financing to obtain in each currency.
- ▶ Its financial decisions determine its exposure to the international environment.

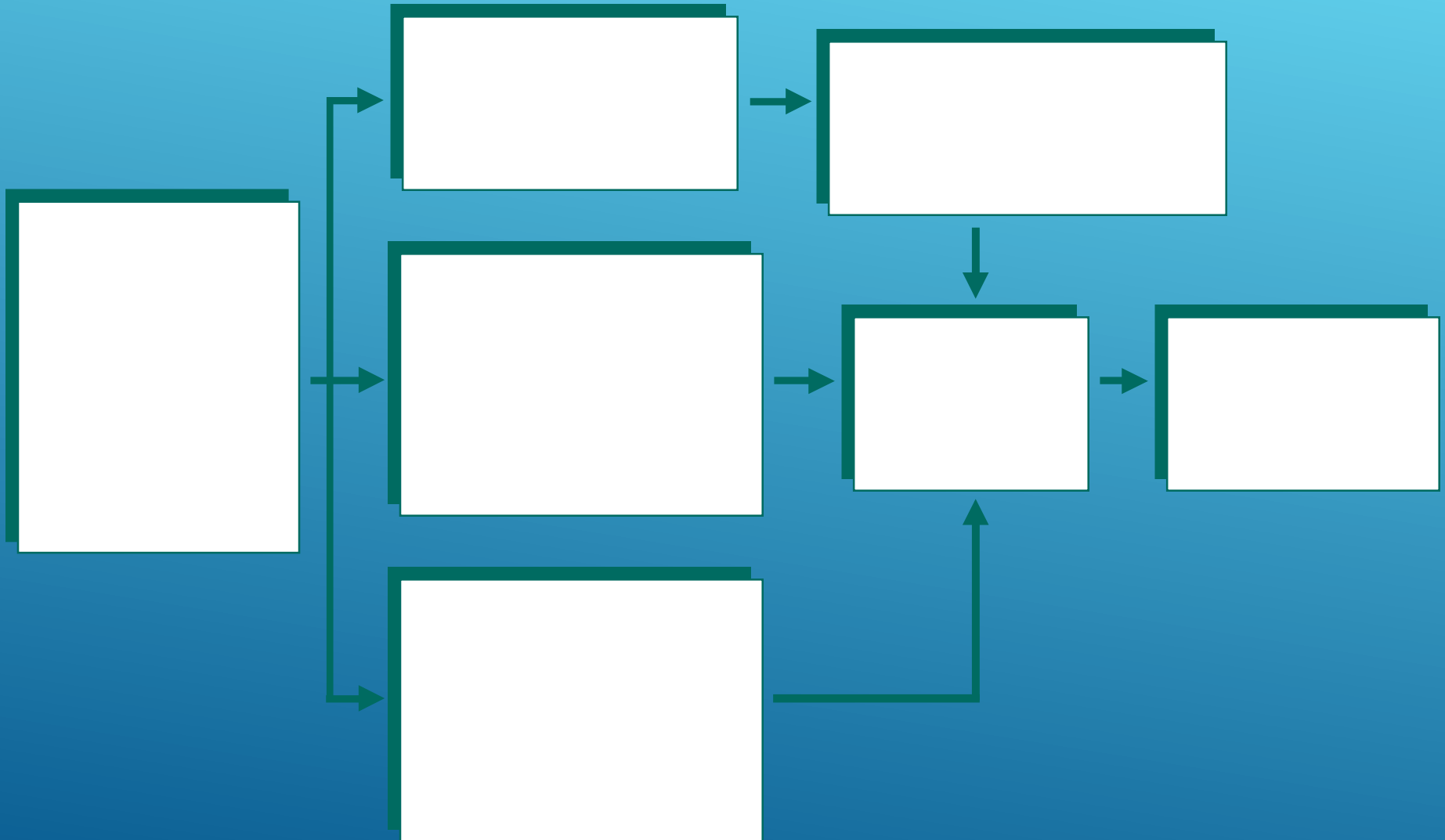
## VALUATION MODEL FOR AN MNC

# VALUATION MODEL FOR AN MNC

## Impact of New International Opportunities on an MNC's Value



# HOW CHAPTERS RELATE TO VALUATION



# CHAPTER REVIEW

- ▶ Goal of the MNC
  - ▶ Conflicts Against the MNC Goal
  - ▶ Impact of Management Control
  - ▶ Impact of Corporate Control
  - ▶ Constraints Interfering with the MNC's Goal
- ▶ Theories of International Business
  - ▶ Theory of Comparative Advantage
  - ▶ Imperfect Markets Theory
  - ▶ Product Cycle Theory



- ▶ International Business Methods
  - ▶ International Trade
  - ▶ Licensing
  - ▶ Franchising
  - ▶ Joint Ventures
  - ▶ Acquisitions of Existing Operations
  - ▶ Establishing New Foreign Subsidiaries

## CHAPTER REVIEW

- ▶ International Opportunities
  - ▶ Investment Opportunities
  - ▶ Financing Opportunities
  - ▶ Opportunities in Europe
  - ▶ Opportunities in Latin America
  - ▶ Opportunities in Asia

## CHAPTER REVIEW

- ▶ Valuation Model for an MNC
  - ▶ Domestic Model
  - ▶ Valuing International Cash Flows
  - ▶ Impact of Financial Management and International Conditions on Value
  - ▶ How Chapters Relate to Valuation

## CHAPTER REVIEW

- ▶ Exposure to International Risk
  - ▶ Exposure to Exchange Rate Movements
  - ▶ Exposure to Foreign Economies
  - ▶ Exposure to Political Risk
- ▶ Overview of an MNC's Cash Flows
- ▶ Managing for Value

## CHAPTER REVIEW