

An Introduction to Multinational Finance

The more we learn of the possibilities of our world, and the possibilities of ourselves, the richer, we learn, is our inheritance.

—H.G. Wells

This book assumes the viewpoint of the financial manager of a *multinational corporation (MNC)* with investment or financial operations in more than one country. Managers encounter new opportunities as they extend their operations into international markets, as well as new costs and risks. The challenge facing the multinational financial manager is to successfully develop and execute business and financial strategies in more than one culture or national business environment.

1.1 THE GOALS OF THE MULTINATIONAL CORPORATION

Figure 1.1 presents the ownership and control structure that is typical of companies in market economies. In these countries, the primary goal of the firm is to maximize shareholder wealth. However, shareholder wealth maximization is far from the only objective of the MNC. Many other *stakeholders* have an interest in the firm, including suppliers, customers, debtholders, managers, business partners, employees, and society at large. The objectives of these other stakeholders often are in conflict with shareholder wealth maximization, especially during periods of financial distress.

Stakeholders include those with a stake in the firm.

Figure 1.2 represents the value of the various claimants on the corporation's future revenues. In this view of the firm, the value of revenues can be allocated to operating expenses (labor and materials), the government (taxes), suppliers of debt and equity capital, and other potential claimants (e.g., litigants through local or foreign legal systems). Stakeholders sometimes are narrowly defined as the owners of the firm's debt and equity. These claims are paid out of operating income and are

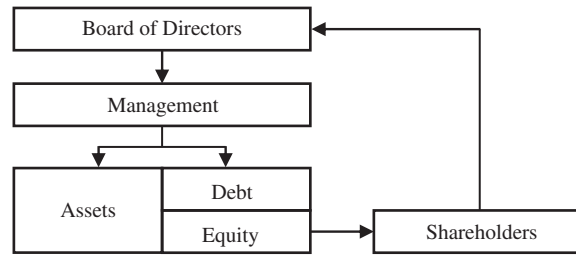


FIGURE 1.1 Corporate Governance

represented by V_{Debt} and V_{Equity} in Figure 1.2. The values of these claims depend on the laws and conventions of the nations within which the MNC operates.

A broader definition of stakeholder includes anyone with an interest in the company, such as the firm's customers, suppliers, employees, host government(s), and anyone else with an actual or potential claim on the firm. The firm's customers help determine the value of revenues, $V_{Revenues}$. Suppliers and employees determine the value of operating expenses, $V_{Expenses}$. Governmental claims, V_{Govt} , represent the claims of society at large and include taxes, tariffs, and the costs of compliance with local laws and regulations (e.g., environmental and corporate governance rules).

The objectives of these other stakeholders are seldom the same as those of debt or equity. Labor is more concerned with wages and job security than with shareholder wealth. Customers and suppliers likewise are concerned with their own well-being. The objective of "maximize shareholder wealth" also can be in conflict with host countries' cultural, economic, political, environmental, or religious goals.

Managers have their own objectives, which are not the same as those of equity shareholders or other stakeholders. *Agency costs* refer to any loss in value from conflicts of interest between managers and other stakeholders, particularly

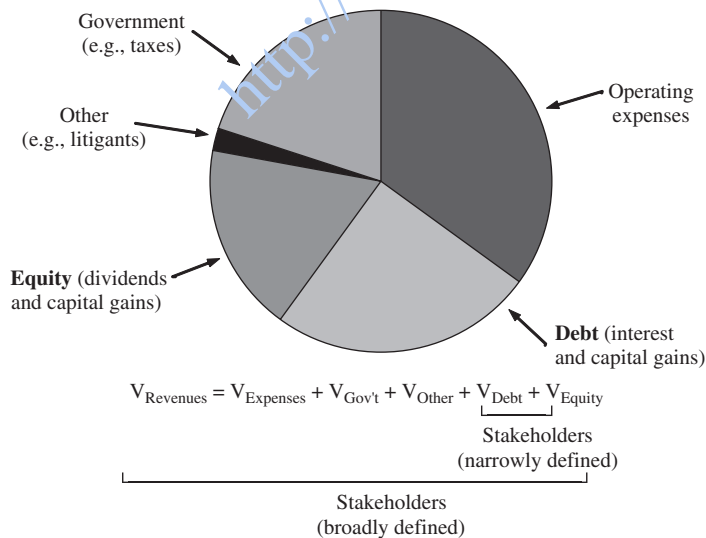


FIGURE 1.2 Stakeholders and Their Claims on the Revenues of the Firm

equity shareholders. These costs include the costs of contracting and monitoring between the various stakeholders to reduce potential conflicts of interest. A good example of an agency cost from everyday life is the physician who recommends a costly procedure that may or may not be good for the patient—but is certainly good for the physician's pocketbook. The presence of agency costs does not mean that management will not act in the best interests of shareholders, only that it is costly to encourage managers to do so. As the residual owners of the firm, it is the shareholders who ultimately bear these agency costs.

Agency costs arise from conflicts of interest.

Not all of the firm's activities appear in the financial statements. Some of these activities can and do affect other stakeholders. For example, if the firm violates the laws of a host country, it may be liable for civil or criminal penalties. Union Carbide's disaster at its plant in Bhopal, India (see box ahead), resulted in huge claims that adversely affected all stakeholders.

Countries differ in the extent to which they protect each of these stakeholders. Countries with strong socialist movements place an emphasis on employee welfare. Some countries emphasize environmental concerns, while others actively promote their local economy to the detriment of the local—and global—environment. Most countries protect or subsidize key industries deemed to be of vital importance to the nation's economy or national identity. Protected industries often include products related to agriculture, such as rice in Japan, beer in Germany, and wine in France. In the United States, as in other countries, various agricultural products that are vulnerable to foreign competition are protected through price supports and tariffs.

Sovereign nations determine the nature of the playing field on which MNCs operate. Company representatives must work within the rules and respect the sensitivities of the societies in which they operate.¹ Businesses ignoring the local rules of the game do so at their own peril.

MARKET UPDATE Union Carbide's Bhopal Disaster

Union Carbide (www.unioncarbide.com) is a diversified U.S. company with worldwide operations in a variety of industry segments. Union Carbide's 51%-owned subsidiary in India operated a chemical plant in Bhopal, India. In 1984, poisonous gases were inadvertently released from the plant, causing the death of more than 2,000 people and injuries to nearly a quarter of a million people. This disaster resulted in losses for nearly all of Union Carbide's stakeholders (broadly defined). Debt and equity lost value in anticipation of a class action suit that eventually was settled in India's courts. The careers and self-esteem of managers and employees involved in the Bhopal operation also suffered. The biggest losses were suffered by the Indian government (Union Carbide's equity partner) and the local population.

1.2 THE CHALLENGES OF MULTINATIONAL OPERATIONS

Recognizing and Overcoming Cultural Differences

An English aristocrat once said, “The only trouble with going abroad is that you have to leave home to do it.” True enough. People and their cultural norms vary widely. Managers and employees of the MNC must deal with unfamiliar business and popular cultures as they seek to extend the firm’s competitive advantages into new and unfamiliar markets. Being able to understand, adapt to, and manage cultural differences can make the difference between a successful and an unsuccessful international venture.

Cultural differences can be a source of risk.

Language is one of the more obvious differences between cultures. Literal translations of common words or phrases can create some amusing situations. If you’ve traveled, you’ll no doubt have your own favorite anecdote. (I once announced to a class in Germany that “Ich bin warm”—only to discover that “I am warm” is German slang for “I am gay.”) A little language can go a long way, but only if you are able to laugh about your lack of fluency with your hosts.

As if verbal language weren’t enough of a barrier to communication, body language differs across cultures as well. In many settings, what we do with our bodies is even more important than what we say. (Voltaire wrote, “Words were given to man to enable him to conceal his true feelings.”) Although some body language is universal, much of it is a reflection of our culture.

Eye contact is a good example. In the Western world, direct eye contact conveys confidence. Avoiding eye contact is taken as a sign of weakness and may even convey untrustworthiness. In Western countries, subordinates show respect by meeting the eyes of their superiors. In some Asian countries, subordinates show their respect by avoiding eye contact. In some Arab countries, excessive eye contact between a man and woman is thought to be disrespectful to the woman. The eyes are the windows to the soul, but be careful which windows you look through.

Another way to categorize differences in national business environments is along the functional areas of business. The following list characterizes some of the differences that MNCs encounter in their cross-border operations:

- *Differences in legal, accounting, and tax systems.* Successful multinational managers must learn unfamiliar tax laws, accounting and legal conventions, and business procedures. As an example, governments in developing countries sometimes offer tax benefits in the form of tax holidays as an investment incentive. Negotiating these benefits and ensuring that they are not revoked subsequent to investment can be a delicate and time-consuming task.
- *Differences in personnel management.* MNCs must adapt their human resource practices and organizational structures to accommodate the labor conditions

and conventions in foreign markets. Human resource policies developed at home often do not translate into other cultures.

- *Differences in marketing.* Cross-cultural differences in marketing extend well beyond differences in language. For example, Walt Disney owns and operates some of the world's most successful theme parks. At the heart of Disney's U.S. success is its family appeal. When it opened its EuroDisney theme park near Paris in the late 1980s, Disney tried to retain this family orientation and refused to sell alcoholic beverages. This unfortunately ensured that no self-respecting Frenchman would visit the park. EuroDisney was beset by other difficulties as well, including overly optimistic forecasts, labor strife, and popular opposition. Fortunately for Disney, its equity stake was kept to a minimum by bringing in other investors in a project finance arrangement. Disney's reputation did take a beating, along with several classes of foreign investors and the reputation of the French government of François Mitterrand.
- *Differences in distribution.* A prolonged stay in another country inevitably means shopping for groceries. Observant shoppers can detect many national differences in the ways in which foods are distributed. U.S. residents are accustomed to large grocery chains that offer wide selections of food and nonfood items. These large chains keep expenses low through efficient supply chain management. In many other parts of the world, groceries are sold in local mom-and-pop stores. Large discount stores are seen as impersonal and are not trusted by shoppers. The source of the local owners' advantage lies in their close relationships with their customers.
- *Differences in financial markets.* Financial market operations vary across countries. Although the most obvious differences are in the liquidity and volume of trade, other differences can be profound. For example, banking practices in many Islamic countries are conducted according to the teachings of the prophet Mohammed as found in the Koran and other Islamic holy scriptures. According to these Islamic banking customs, depositors do not receive a set rate of interest but instead share in the profits and losses of the bank. Western banks opening branch banks in Islamic countries must be cognizant of these local religious norms.
- *Differences in corporate governance.* Another difference between national business cultures lies in *corporate governance*—the mechanisms by which major stakeholders exert control over the firm (and discussed at length in Chapter 17). The corporation is defined by a legal framework of contracts between customers, suppliers, labor, debt, equity, and management. Because each of these contracts is executed within the laws of the societies in which the firm operates, society itself helps determine the forms of these contracts and the rights and responsibilities of the various parties.

A foreign venture that does not respect local cultural sensibilities is destined for trouble. Multinational managers must learn new business systems and social behaviors, including what types of corporate behaviors are punished, what types are merely tolerated, and what types can lead to fruitful partnerships with foreign residents and their governments.

APPLICATION ¿Que Hora Es?

Mexico City, September 12, 11:50 A.M.: You are a New Yorker working for AT&T on a satellite communications deal with the Mexican telecom giant Telmex. You have scheduled lunch with Aldo Martinez of Telmex at a fashionable restaurant in Mexico City. Conscious of the importance of the proposed deal, you arrive early and secure a private table in a secluded area of the restaurant.

12:20 P.M.: Thirty minutes have passed since your arrival and still no sign of Aldo. Could he have been caught in one of Mexico City's infamous traffic jams? Should you try to contact him on your cell phone? The waiter doesn't seem concerned that you haven't begun to order. Should you order food for the two of you? Oh, dear.

12:35 P.M.: It has been over half an hour! Now you are really concerned. Your imagination starts to run away with you. Perhaps the deal has fallen through? No, you're just panicky. Perhaps he was overcome by smog? The delay is beginning to irritate you. You resolve to contact Aldo by phone—and just at that moment Aldo strolls calmly into the restaurant. Greeting you as if nothing is out of the ordinary, he takes a seat and inquires how you have been. Doesn't he realize the anxiety and inconvenience that he has caused?

Attitudes toward time vary across cultures, particularly in the precision with which time is measured. You are merely experiencing the difference between a New York minute and la hora Mexicana (Mexican time).

Managing the Costs and Risks of Multinational Operations

Cross-border operations create additional costs. They also increase the MNC's risk exposures. *Risk* exists whenever actual outcomes can differ from expectations. The MNC has *exposure* to risk when its assets or liabilities can change in value with unexpected changes in business conditions. As individuals and businesses pursue cross-border opportunities, they expose themselves to a wide variety of new risks.

Risk exists when outcomes can differ from the expected.

An important new risk exposure arising from cross-border operations is *country risk*—the risk that the business environment in a host country or the host country's relationship with another country will unexpectedly change. Important sources of country risk to which the MNC is exposed include political risks and financial risks.

Political risk is the risk that the business environment in a host country will unexpectedly change due to political events. Political risk usually is determined

within a country as local political forces influence the business environment. Sources of political risk include unexpected changes in the business environment arising from repatriation restrictions, taxes, local content and employment regulations, restrictions on foreign ownership, business and bankruptcy laws, foreign exchange controls, and expropriation.

Country risks include political and financial risks.

Financial risk refers to the risk of unexpected change in the financial or economic environment of a host country. Financial risk is influenced by political factors, but also by a myriad of financial and economic factors that are outside the control of local political forces. A particularly important financial risk exposure for MNCs with operations in more than one country is currency risk. The MNC is exposed to *currency risk*—also called *foreign exchange risk* or *forex (FX) risk*—if unexpected changes in currency values affect the value of the firm. Volatility in the world's currency markets can cause the value of the MNC to fluctuate in unexpected ways. Profits can be wiped out quickly by changes in currency values. For this reason, financial risk management is essential for both large and small firms competing in today's global marketplace.

1.3 THE OPPORTUNITIES OF MULTINATIONAL OPERATIONS

According to the *discounted cash flow* approach to valuation, asset value is equal to the present value of expected future cash flows discounted at an appropriate risk-adjusted discount rate.

$$V = \sum_t [E[CF_t]/(1+i)^t] \quad (1.1)$$

This valuation equation has an important implication for the firm. If a corporate decision has no impact on the firm's expected future cash flows or discount rate, then the decision also has no impact on the value of the firm. Conversely, if a decision is to add value, then the decision must either increase expected cash flows or decrease the cost of capital.

Multinational Investment Opportunities

The set of investments available to the corporation is called its *investment opportunity set*. The corporation's investment objective is to identify, invest, and then manage the set of assets that maximizes the value of the firm to its key stakeholders. In terms of Equation 1.1, the objective is to choose the set of investments that maximizes the present value of expected future operating cash flows. This means accepting projects with expected returns that exceed investors' required return, and rejecting projects that do not meet this hurdle.

Multinational corporations have many opportunities that are not available to local firms for increasing operating cash flows.

Enhancing Revenues Multinational corporations enjoy higher revenues than local firms by providing goods or services that are not readily available in local markets. Here are a few examples of revenue-enhancing advantages that MNCs enjoy over domestic firms.

- *Global branding.* A global brand can provide an advantage over local competitors. For example, McDonald's and Coca-Cola have leveraged their internationally recognized brand names into marketing efficiencies that are unavailable to local competitors.
- *Marketing flexibility.* MNCs have more marketing flexibility than domestic firms, in that they can more easily shift sales efforts toward markets willing to pay higher prices for their products. For example, if Ford's Focus is in high demand in Europe, then Ford can shift its marketing efforts toward Europe and away from regions of lower demand or profitability.
- *Advantages of scale and scope.* Because of their size and the breadth of their operations, MNCs can exploit their competitive advantages on a larger scale and across a broader range of markets and products than domestic competitors. For example, Nike promotes its corporate brand—the Nike swoosh—in multiple international markets and across its product line.

Reducing Operating Costs Multinational operations can reduce operating expenses in a number of ways that are not available to domestic firms.

- *Low-cost raw materials.* MNCs seek low-cost raw materials to reduce costs and ensure supplies. The lure of low-cost resources can be powerful. In 1997, the French company Total secured a \$2 billion deal to develop Iran's South Pars gas field. Political opposition from Tehran—as well as from other governments—had prevented foreign investment in Iran since its 1979 revolution. When Iran sought outside investment to increase production and overcome a budget deficit, MNCs such as Total were quick to respond, and economic necessity overcame two decades of political opposition.
- *Low-cost labor.* Labor costs vary widely around the world, and manufacturers have an incentive to buy their goods and services from low-cost sources. Rapid industrialization in Japan and Korea during the 1960s and 1970s was driven by their low labor costs and educated workforces. These countries rose to the first rank of international economies as they acquired technological expertise. In more recent years, the ascendance of China and India similarly has been fueled by low labor costs. The threat of low-cost foreign labor is a major fear of organized labor in industrialized countries. Indeed, labor unions are vocal opponents of efforts to promote international trade through organizations such as the European Union (EU), the North American Free Trade Agreement (NAFTA), and the World Trade Organization (WTO).
- *Flexibility in global site selection.* MNCs have greater flexibility than domestic firms in the location and timing of their investments. Competition between local, regional, and national governments for capital investment allows MNCs to “shop around” for the most attractive deal. For example, automobile manufacturers such as Toyota and General Motors routinely shop for tax incentives

before investing in new plants or product lines. Because of their size and international presence, multinational corporations are in a better position than local firms to manage their international site location decisions.

- *Flexibility in sourcing and production.* By having a diversified manufacturing base, MNCs can shift production to low-cost locations in response to currency movements or other factors. If changes in currency values make components less expensive from some countries than from others, then MNCs can use their global manufacturing network to increase production in the low-cost countries and decrease production in the high-cost countries. Local competitors typically do not enjoy this flexibility.
- *Economies of scale and scope.* Companies possess *economies of scale* when size itself results in lower average or per-unit production costs. Economies of scale arise as fixed development or production costs are spread over a larger output. For example, manufacturing integrated circuits entails high development costs and large fixed investment costs. Once a manufacturing plant is set up, variable production costs can be quite low. High start-up costs serve to insulate large MNCs from local competition. *Economies of scope* are similar, but refer to efficiencies that arise across product lines, such as when joint production results in lower per-unit costs.
- *Economies of vertical integration.* Firms possess *economies of vertical integration* when they enjoy lower costs through their control of a vertically integrated supply chain. Firms vertically integrate when it is more efficient to arrange the steps of a production process through internal rather than external markets. Vertical integration is popular in industries that need to protect their production processes or technologies from competitors. Mature MNCs often integrate their supply chains from labor and raw material inputs right through the final marketing, distribution, and after-sale service of their products.

Multinational Business Strategy Here are a few classic strategies for preserving or enhancing operating cash flows through multinational operations. Note these strategies are often influenced by local (foreign or domestic) factors.

- *Following the customer.* Service firms, such as banks and accounting firms, often follow their customers into foreign markets. Parts suppliers in industries such as automobile manufacturing also follow this strategy. As the nuances of operating in a foreign country are mastered, these firms can begin to pursue foreign clients as well.
- *Leading the customer.* Many firms try to attract foreign companies into their domestic market. This lead-the-customer strategy is a way of solidifying relations with foreign companies before they establish relations with other local competitors.
- *Following the leader.* When competitors are actively acquiring foreign assets, a common response is to similarly acquire foreign assets to reduce the threat of falling behind in global market share or production costs. This bandwagon phenomenon is especially common in industries enjoying high profitability.
- *Going local.* MNCs often build capacity directly in foreign markets to avoid quotas or tariffs on imported goods. This reduces the risk of protectionism, as

the MNC is seen as less of an outsider if it employs local workers. It also may increase sales, as customers are more receptive to locally produced goods.

Multinational Financial Opportunities

The objective of financial policy is to maximize the value of the firm through its financing choices, given the firm's investment decisions. Financial policy includes decisions regarding the mix of debt and equity, the maturity structure of debt, the markets in which capital is raised and its currency of denomination, the method of financing domestic and foreign operations, and financial risk management.

Many financial opportunities arise from financial market imperfections, so it is sensible to first define a perfect financial market.

The Perfect Market Assumptions and Concepts of Market Efficiency The *perfect financial market assumptions* will prove useful at several points in the text.

In a perfect financial market, rational investors have equal access to market prices and information in a frictionless market.

This definition has several components, summarized in Figure 1.3.

- *Frictionless markets.* A frictionless market has no transaction costs, taxes, government intervention, agency costs, or costs of financial distress. Some market frictions such as transaction costs are a function of market volume and liquidity. Other frictions such as taxes are externally imposed and independent of volume and liquidity.
- *Equal access to market prices.* If all market participants have equal access to market prices, then no single party can influence prices. Although this is a convenient assumption, it does not always hold. Many domestic and international actors can influence prices. Governments influence asset and currency values through their fiscal and monetary policies, cartels such as the Organization of

Rational investors have equal access to market prices and information in a frictionless market.

1. Frictionless markets	No transactions costs No government intervention No taxes No agency costs No costs of financial distress
2. Equal access to market prices	Perfect competition No barriers to entry
3. Rational investors	More return is good, and more risk is bad
4. Equal access to costless information	Everyone has instantaneous and costless access to information

FIGURE 1.3 The Perfect Market Assumptions

Petroleum Exporting Countries (OPEC) influence commodity prices through their control of production, and hedge funds such as George Soros's Quantum Fund affect market prices through the sheer size of their trades.

- *Rational investors.* Rational investors price assets with a dispassionate eye toward expected returns and risks. Although this sounds great in theory, investors are not always rational, and there are significant cross-border differences in investors' behaviors. The study of the impact of psychological factors on behaviors and asset prices is referred to as behavioral finance, and is an active area of financial research.
- *Equal access to costless information.* Equal access to costless information puts market participants on an equal footing with one another. This assumption belies the fact that language serves as a very real barrier to the flow of information across (and sometimes within) national boundaries. Even with a common language, information is difficult to convey and can change in the telling. There are also wide differences in accounting measurement and disclosure requirements, and managers and other insiders benefit from their privileged access to information in both developed and developing markets.

The assumption of frictionless markets is an assumption of *operational efficiency* such that there are no drains on funds as they are transferred from one use to another. The last three assumptions are sufficient to ensure an *informationally efficient* market in which prices fully reflect all relevant information. Informational efficiency does not require frictionless markets, as prices can fully reflect information despite the existence of transaction costs. For example, a bid-ask spread on currency transaction would preclude costless *arbitrage*, although currencies could still be correctly priced within the bounds of transaction costs.² Similarly, stock and bond markets can be informationally efficient despite relatively high transaction costs.

Operational efficiency and informational efficiency together promote *allocational efficiency*; that is, an efficient allocation of capital toward its most productive uses. Allocational efficiency—the basic objective of any financial market—is greatest when there is high liquidity and transaction volume in freely traded assets. Less liquid financial markets do not allocate capital between savers and borrowers as efficiently as more liquid markets.

In a perfect financial market, there is no need for government regulators, bank auditors, or attorneys. With no taxes, there is no need for tax collectors or tax accountants. With equal access to market prices and no transaction costs, there is no need for financial intermediaries such as banks and brokers, nor any market for finance graduates. And, with costless information, there is no need for finance professors or this text. The net result is that the price of a particular asset is the same all over the world. Although this is strictly true only in a perfect world, it has important implications for real-world financial policies.

Implications of Perfect Financial Markets for Multinational Financial Policy The perfect market assumptions provide a convenient starting point for investigating many difficult issues in finance. In particular, the corporation's financial policy is irrelevant in a perfect financial market because—with equal access to market prices and information in a frictionless market—individual investors can replicate or reverse

any action that the firm can take.³ In such a world, financial policy cannot affect firm value.

The converse of this irrelevance proposition also must be true.

If financial policy is to increase firm value, then it must increase the firm's expected cash flows or decrease the discount rate in a way that cannot be replicated by individual investors.

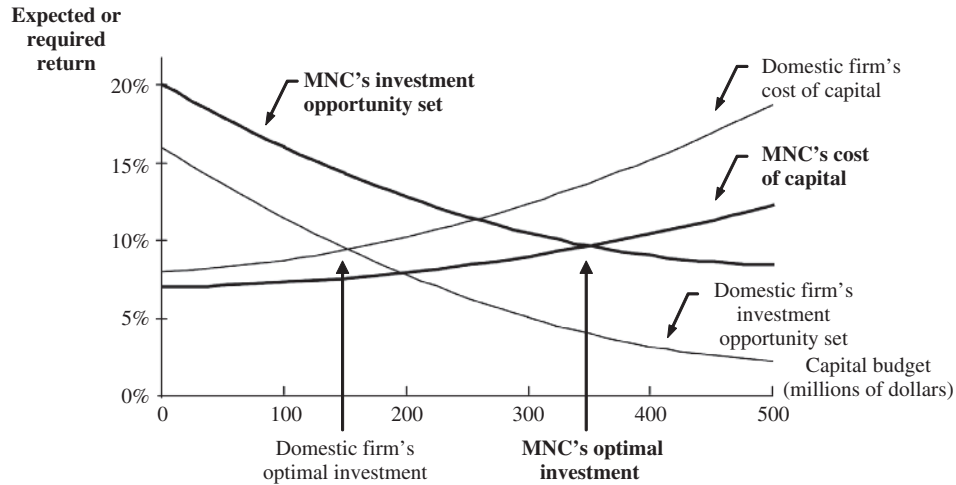
Financial market imperfections are more prominent in international than in domestic markets, so MNCs have more opportunities than comparable domestic firms to create value through their financial policies. Here are a few examples.

- *Financial market arbitrage.* Chapter 4 shows how market participants can take advantage of cross-border differences in asset prices, such as disequilibria in currencies and interest rates.
- *Hedging policy.* Chapter 8 shows how financial managers can create value by reducing drains on operating cash flows (e.g., by reducing expected bankruptcy costs) through the firm's hedging policy.
- *MNC cost of capital when there are capital flow barriers.* Chapter 14 discusses how MNCs can lower their cost of capital by selling debt or equity securities to foreign investors that are willing to pay higher prices than domestic investors.
- *Reducing taxes through multinational operations.* Chapter 15 shows how MNCs can reduce their tax burden through multinational tax planning. In particular, MNCs have an incentive to recognize income in low-tax countries and expenses in high-tax countries.
- *Barriers to the free flow of capital across international markets.* Chapter 18 surveys the world's debt and equity markets, and describes some of the barriers that impede the free flow of capital across national borders. Chapter 18 also discusses vehicles for diversifying across national boundaries in the presence of these capital flow barriers.
- *Currency risk and the cost of capital.* Chapter 20 discusses the multinational corporation's exposure to currency risk and the impact of this exposure on investors' required returns and the MNC's cost of capital.

Violations of any of the perfect financial market assumptions can lead to financial opportunities, particularly for multinational corporations with access to international financial markets.

Multinational Opportunities and Firm Value

Figure 1.4 illustrates the potential increase in firm value provided by multinational opportunities. The downward-sloping lines represent the investment opportunity set of a domestic corporation and of a comparable multinational corporation. Each firm accepts its most lucrative projects first, so expected returns fall as more capital is invested. The expected return on the domestic firm's first dollar of investment



Key: Investment opportunities reflect expected returns on an incremental dollar of investment.
Capital costs reflect investors' required returns on a given dollar used to fund that investment.

FIGURE 1.4 The Potential Benefits of Multinationality

is 16 percent along the y-axis. With more attractive investment alternatives, the MNC's initial investments are displayed with an expected return of 20 percent.

The upward-sloping lines represent the required return or cost of capital on investment. Firms draw upon their lowest cost sources of funds first, so cost of capital is an increasing function of the capital budget. The domestic firm in Figure 1.4 has a cost of capital of 8 percent on the first dollar that it invests. With access to lower cost funds from international sources, the MNC in Figure 1.4 faces a required return of only 7 percent on its initial investment.

The MNC in Figure 1.4 earns an expected return of 20 percent at a required return of only 7 percent along the y-axis, so its first dollar of investment increases shareholder wealth by 13 cents. The MNC in Figure 1.4 will continue to invest until its expected return falls below its required return at a capital budget of approximately \$350 million. With a larger and richer set of investments, this MNC will have a higher value than a comparable domestic firm.

The market value of a multinational corporation should reflect these expanded investment and financing opportunities. However, these opportunities come with additional costs and risks as well. Although an MNC's international experience places it in a better position than its domestic rivals to evaluate and manage these opportunities, costs, and risks, it is an open question whether multinational operations per se can increase the value of the firm.⁴

1.4 FINANCIAL MANAGEMENT OF THE MULTINATIONAL CORPORATION

At the heart of the opportunities, costs, and risks of multinational operations are the differences among the countries and peoples of the world. Local culture

influences the conduct of business in profound and subtle ways, creating important cross-border differences in financial, economic, political, regulatory, accounting, and tax environments. The multinational financial manager must be sensitive to these differences in the conduct of both professional and personal life. Failing to accommodate cultural patterns and expectations can obstruct negotiations and result in hostility and mistrust even if both counterparties have the best of intentions.

MNCs have operations in more than one country

Because of the far-reaching influence of local business environments on multinational operations, the multinational financial manager must be well versed in each of the traditional fields of business, including marketing, management of physical and human resources, law, regulation, taxation, accounting, and finance. Successful operation in each of these areas depends on knowing local cultures and their written and unwritten conventions. Business problems are rarely the province of a single discipline, and the challenges facing multinational corporations are especially prone to be multidisciplinary.

To be able to recognize and develop business opportunities in foreign markets, the multinational financial manager also must be an expert in several fields within finance. Multinational financial managers must understand the capabilities and limitations of traditional investment analysis, have a plan of attack for entry into and exit from foreign markets, and value the flexibilities and real options presented by investment opportunities in foreign markets. The financial opportunities of the MNC also are richer than those of the domestic corporation, because of cross-border differences in investors' expectations, risk tolerances, and required returns. Multinational financial management requires a thorough knowledge of the international financial markets for equity securities, interest rate contracts, currencies, commodities, and derivatives (futures, options, and swaps). Today's multinational financial manager must be a jack-of-all-trades, as well as a master of finance.

1.5 SUMMARY

An understanding of multinational financial management is crucial to success in today's, and inevitably in tomorrow's, marketplace. This is unquestionably true for firms competing directly with foreign firms, such as domestic automakers in competition with foreign automakers. It is also true for domestic firms whose suppliers, customers, and competitors are increasingly likely to be from foreign countries.

In today's business environment, the success of a multinational corporation depends on its manager's abilities to recognize and exploit imperfections in national markets for products and factors of production, and to work effectively within the political and economic constraints imposed by host governments.

This book develops a framework for evaluating the opportunities, costs, and risks presented by the world's marketplaces. Although we usually take the perspective

of the financial manager of a large multinational corporation, this framework works just as well for government entities, small businesses, and even individuals. Along the way, we provide a tour of business environments in many countries around the world. Bon voyage.

KEY TERMS

agency costs

allocational, informational, and operational efficiency

arbitrage

corporate governance

country risk

currency (foreign exchange) risk

discounted cash flow

economies of scale and scope

economies of vertical integration

financial risk

investment opportunity set

multinational corporation (MNC)

perfect financial market assumptions

political risk

risk versus risk exposure

stakeholders

CONCEPTUAL QUESTIONS

- 1.1 List the MNC's key stakeholders. How does each have a stake in the MNC?
- 1.2 In what ways do cultural differences affect the conduct of international business?
- 1.3 What is country risk? Describe several types of country risk one might face when conducting business in another country.
- 1.4 What is political risk?
- 1.5 What is foreign exchange risk?
- 1.6 What investment opportunities might MNCs enjoy that are not available to local firms?
- 1.7 How can MNCs reduce operating expenses relative to domestic firms?
- 1.8 What are the perfect financial market assumptions? What is their implication for multinational financial management?
- 1.9 Describe the ways in which multinational financial management is different from domestic financial management.

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