Reasons for overseas Investments:

MOTIVES – 5Cs
- Company – eg economies of scale
- Country – eg cheap labour/grants
- Customer – eg shorter lead times
- Competition – eg weaker rivals
- Currency – eg matching effect
**Overseas investments**

**Strategic reasons for FDI**

- **Horizontal integration** – replication of existing operations on a global scale
- **Vertical integration backwards** – acquisition of raw material and component sources
- **Vertical integration forwards** – establishment of final production and distribution in other countries
- **Diversification**

**Overseas investments**

**Ways to establish an interest abroad**

Foreign Direct Investments (FDIs)

- Joint ventures
- Licensing agreements
- Management contracts
- Subsidiary – by merger or setting one up
- Branches
**Overseas investments**

**Joint ventures**
- **Contractual** – for a fixed period. Duties and responsibilities of parties are defined in contract
- **Joint-equality** – involves investment, no fixed duration, continually evolves

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**Overseas investments**

**Advantages of joint ventures**
- Relatively **low cost access** to new markets
- **Easier access to local capital markets**, possibly with accompanying tax incentives or grants
- **Use of joint venture partner's existing management expertise**, local knowledge, distribution network, technology, brands, patents and marketing or other skills
- **Sharing of risks**
- **Sharing of costs**, providing economies of scale
Overseas investments

Disadvantages of joint ventures

- Managerial freedom may be restricted by the need to take account of the views of all the joint venture partners
- There may be problems in agreeing on partners' percentage ownership, transfer prices, reinvestment decisions, nationality of key personnel, remuneration and sourcing of raw materials and components
- Finding a reliable joint venture partner may take a long time
- Joint ventures are difficult to value, particularly where one or more partners have made intangible contributions

Overseas investment

Licensing

- Licensing is when overseas producers are given rights to use the licensor's production process in return for royalty payments
- Licensing may be the best method of investment because of tariffs, quotas or other import restrictions in overseas markets
- Local production may be the only feasible option in the case of bulky products, such as cement and flat glass
**Overseas Investment**

**Advantages of licensing**
- Allows fairly rapid **penetration of** overseas markets
- Does not require **substantial financial resources**
- Political risks are **reduced** since the licensee is likely to be a local company
- May be a **possibility** where direct investment is restricted or prevented by a country
- For a multinational company, licensing agreements provide a way for **funds to be remitted** to the parent company in the form of licence fees

**Overseas Investment**

**Disadvantages of licensing**
- The arrangement may give to the licensee **know-how** and **technology** which it can use in competing with the licensor after the licence agreement has expired
- It may be more **difficult to maintain quality standards**, and lower quality might affect the standing of a brand
- It might be possible for the licensee to **compete** with the licensor by exporting the product to markets outside the licensee’s area
- Although relatively insubstantial financial resources are required, on the other hand **relatively small cash inflows** will be **generated**
Management contracts

- A firm agrees to sell management skills – sometimes used in combination with licensing
- Can serve as a means of obtaining funds from subsidiaries, where other remittance restrictions apply
- Many multinationals use a combination of methods for servicing international markets

Overseas Investment

Branches

- Firms that want to establish a presence in an overseas country may choose to establish a branch rather than a subsidiary
- In many instances a company will establish a branch and utilise its initial losses against other profits, and then turn the branch into a subsidiary when it starts making profits
Overseas Investment

Advantages of branches

- Establishment of a branch is likely to be simpler than a subsidiary.
- In many countries, remitted profits of a subsidiary will be taxed at a higher rate than those of a branch, as profits paid in the form of dividends are likely to be subject to a withholding tax.

Overseas Investment

Disadvantages of branches

- Parent company is fully liable for the liabilities of the branch.
- Parent company may have to appoint an individual/company to represent it in dealing with the tax authorities and the individual/company may be liable as well.
- Obligations of branch will be the same as those of parent.
- Banks and clients may prefer dealing with local company rather than branch of foreign company.
**Overseas Investment**

**Disadvantages of branches**

- Board of parent company **may need to ratify acts of branch**
- A branch may **not be ideal for substantial projects** because parent company runs the entire risk

**Overseas Investment**

**Overseas takeovers and mergers**

- If the company wishes to establish a presence overseas quickly, then it may prefer acquisition to starting from scratch
- The main problem is that the better acquisitions may only be available at a premium
**Overseas Investment**

**Advantages of overseas takeovers and mergers**

- Merging with *established firms abroad* can be a means of *purchasing market information, market share, distribution channels and reputation*
- *Other synergies* include *acquisition of management skills and knowledge, intangibles* such as brands and trademarks, or *additional cash and debt capacity*
- Acquiring a subsidiary may be a means of *removing trade barriers*
- Acquisition can be a means of *removing a competitor*
- *Start-up costs* will not be incurred

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**Overseas Investment**

**Disadvantages of overseas takeovers and mergers**

- *Cultural issues* may make it difficult to integrate the subsidiary into the group
- Growing organically may be cheaper. In the long-run it is more likely to *be financed* by *retained cashflows* than new sources with issue costs, and it will not involve paying a premium for a desirable subsidiary
- There may be *duplication of resources/operations* with the acquiring company
Foreign direct investment

Establishing a subsidiary

- The basic structure of many multinational companies consists of a parent (holding) company with subsidiaries in several countries
- The subsidiaries may be wholly or partly-owned, and some may be owned through other subsidiaries

Advantages of overseas subsidiaries

- Local subsidiary may have a significant profile for sales and marketing purposes
- As a separate legal entity, a subsidiary should be able to claim legal privileges, reliefs and grants
Foreign direct investment

Disadvantages of overseas subsidiaries

- As a separate entity, a subsidiary may be subject to significant legal and accounting formalities, including minimum capital requirements.
- In some regimes, the activities of the subsidiary may be limited to the objects set out in its constitution and it may not be able to draft these objects too widely.
- Dissolution of a subsidiary may be fairly complex.

Appraising Overseas Investment

The appraisal of projects involving international investments uses the same NPV model we have used in earlier sessions. It includes basics such as:

- identifying relevant cash flows
- dealing with inflation and distinguishing money and real flows
- calculating a project’s corporation tax liability and tax savings

However, international investment appraisal includes additional challenges:

- Forecasting future exchange rates.
- Double taxation.
- Exchange controls
- Intercompany transactions
Forecasting exchange rates

The future exchange rates, which may be needed to convert estimated future cashflows into home currency, can be estimated using:

- **Interest Rate Parity (IRP)**
- **Purchasing Power Parity (PPP)**

**Interest rate parity**

Difference between two countries’ interest rates should offset difference between spot rate and forward rate.

\[
F_0 = S_0 \times \frac{(1 + i_c)}{(1 + i_b)}
\]

- \(F_0\) = forward rate
- \(S_0\) = spot rate
- \(i_c\) = interest rate in overseas country
- \(i_b\) = interest rate in home country

The currency of the country with the higher nominal interest rate trades at a discount on the forward rate compared to its spot (i.e., it depreciates).
Forecasting exchange rates

Purchasing power parity

- Purchasing power parity (PPP) predicts that the exchange rates between two currencies depend on the relative differences in the rates of inflation in each country. The PPP is based on the "law of one price" (Prices of products in different countries will be the same when expressed in the same currency).

- However, according to PPP the "law of one price" holds because any weakness in one currency will be compensated by the rate of inflation in the currency's country.

- If PPP holds, then companies may not be affected by exchange rate fluctuations, as lower currency value can be compensated by the ability to raise prices due to higher inflation levels. This depends on markets being efficient.

\[
S_1 = S_0 \times \frac{1 + h_c}{1 + h_b}
\]

Where

- \( S_1 \) = forward rate
- \( S_0 \) = spot rate
- \( h_c \) = inflation rate in overseas country
- \( h_b \) = inflation rate in base country

Therefore, if one country has a higher rate of inflation compared to another, then its currency is expected to depreciate over time.
Forecasting exchange rates

International Fisher effect

\[
\frac{1 + i_e}{1 + i_b} = \frac{1 + h_c}{1 + h_b}
\]

With no trade or capital flows restrictions, real interest rates in different countries will be expected to be the same.

Differences in interest rates reflect differences in inflation rates.

Forecasting exchange rates

The base currency is that which is quoted to 1 unit

The spot exchange rate is £0.6667 = $1 between the UK sterling and the US Dollar. Inflation is expected to be 2% and 5% in the UK and in the US per annum respectively for the next 3 years.

Required:
Using the PPP calculate the expected spot rates for the next three years.

\[
\begin{align*}
X_1 &= 0.6667 \times \frac{1.02}{1.05} = 0.6472 \\
X_2 &= 0.6472 \times \frac{1.02}{1.05} = 0.6291 \\
X_3 &= 0.6291 \times \frac{1.02}{1.05} = 0.6112
\end{align*}
\]

Forecasting exchange rates

The base currency is that which is quoted to 1 unit

The spot exchange rate is £1.5325 to £1.

Expected inflation rates are:

<table>
<thead>
<tr>
<th>Year</th>
<th>Europe</th>
<th>UK</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3%</td>
<td>1%</td>
</tr>
<tr>
<td>2</td>
<td>1%</td>
<td>4%</td>
</tr>
<tr>
<td>3</td>
<td>2%</td>
<td>3%</td>
</tr>
</tbody>
</table>

Required:
Required:
Using the PPP calculate the expected spot rates for the next three years.

Double Taxation

- To prevent double taxation, most governments give tax credit for foreign tax paid on overseas profits often known as double tax relief.
- So always assume that a double tax relief is available or a bilateral tax treaty exists between the overseas country and the home country if not stated.
- The home country will only charge the company tax as the differential between that suffered overseas and that due in the home country.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Home country tax</th>
<th>Overseas tax</th>
<th>Additional home country tax payable</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>30%</td>
<td>&gt; 25%</td>
<td>5%</td>
</tr>
<tr>
<td>2</td>
<td>30%</td>
<td>= 30%</td>
<td>nil</td>
</tr>
<tr>
<td>3</td>
<td>30%</td>
<td>&lt; 40%</td>
<td>nil</td>
</tr>
</tbody>
</table>

Exchange Controls

Exchange controls
- Another potential problem is that some countries impose delays on the payment of a dividend from an overseas investment.

- These exchange controls create liquidity problems and add to exchange rate risk because the exchange rate may have worsened by the time that dividends are permitted.
Exchange controls

Strategies to overcome exchange controls

Transfer pricing
- Where the parent company sells goods or services to the subsidiary and obtains payment

Royalty payments adjustments
- When a parent company grants a subsidiary the right to make goods protected by patents

Loans by the parent company to the subsidiary
- Setting interest rate at appropriate level

Management charges
- Levied by the parent company for costs incurred in the management of international operations

Intercompany transactions

Inter-company transactions, such as transfer prices, royalties and management charges, can also affect the tax computations.

For exams purposes:

- Assume inter-company transactions are allowable for tax (and state it) unless the question says otherwise

- If an inter-company transaction is allowable for tax relief overseas, there will be a corresponding tax liability on the income in the home country
**Evaluating Foreign Investments – 2 methods**

Investments can be assessed either:
- Discounting the nominal cash flows in home currency at home country cost of capital.
- Discounting the nominal cash flows in foreign currency at foreign cost of capital and converting into home currency at the spot rate.

1. Convert to home currency
2. Add any home currency cash flows
3. Discount using the firm's cost of capital

**Evaluating foreign investments**

**Effect of exchange rates on NPV**
- When there is a devaluation of home currency relative to a foreign currency, the home currency value of cash flows and NPV increase.
- The opposite happens when the home currency appreciates.

**Effect on exports**
- A multinational company sets up a subsidiary in another country in which it already exports.
- The relevant cash flows for evaluation of the project should account for loss of export earnings in the particular country. This is effectively an opportunity cost.

**Foreign direct investment**

A project carried out by a US subsidiary of a UK company is due to earn revenues of $150m in the US in Year 2 with associated costs of $40m. A tax allowable depreciation of $10m on capital investment is also available in year 2. Royalty payments of $10m will be made by the US subsidiary to the UK. Assume tax is paid at 20% in the US and 30% in the UK; and assume a forecast $/£ spot rate of $1.491/£ for Year 2.

**Required:**
Forecast the project's cash flows in Year 2.
Foreign direct investment

A UK company is considering an overseas project in a major US city. The pre-tax cash flows are estimated as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>$millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td>1</td>
<td>40</td>
</tr>
<tr>
<td>2</td>
<td>80</td>
</tr>
</tbody>
</table>

Net cash flow from operations excluding royalties:
- Year 0: $20 million
- Year 1: $40 million
- Year 2: $80 million

Royalties:
- Year 0: $5 million
- Year 1: $10 million
- Year 2: $20 million

Capital Investment: $(30 million)

The exchange rate is currently $1.50 = £1. Annual inflation is expected to be 5% and 2% in the US and UK respectively. US tax is 25% with straight line tax-allowable depreciation of 33 1/3% per year. UK tax is 30% with a double tax agreement in force between the two countries. Assume that in both countries, tax payments and refunds are made in the year in which they relate without delay.

The UK cost of capital is 10% per year.

Required: Calculate the NPV of the project.
Financing Foreign direct investment

Finance for overseas investment depends on:

- **Local finance costs**, and any available subsidies
- **Tax systems** of the countries (best group structure may be affected by tax systems)
- Any restrictions on dividend remittances
- Possible flexibility in repayments arising from the parent/subsidiary relationship

Financing overseas subsidiaries

- Amount of **equity capital** parent puts into subsidiary
- **Proportion of profits** retained by subsidiary
- Whether parent should hold **100% of the equity** of the subsidiary, or should it try to create a minority shareholding
- **Borrowing of long-term debt** by subsidiary and in what currency
- **Listing of subsidiary** on local Stock Exchange
- Levels of **working capital** of subsidiary
International debt finance

Borrowing markets are becoming increasingly internationalised, particularly for larger companies

- Companies are able to borrow long-term funds on the **Eurocurrency (money) markets** and on the markets for **Eurobonds**

- **Eurocurrency** is currency held by individuals or institutions outside its country of issue

- **Eurobonds** are bonds sold outside the jurisdiction of the country in whose currency the bond is denominated

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International debt finance

**Advantages of Eurobonds**

- Eurobonds are **bearer instruments**, meaning that owners do not have to declare their identity

- Interest is **paid gross** – this means that Eurobonds have been used by investors to avoid tax

- Eurobonds create liability in a foreign currency to **match** against foreign currency asset

- Eurobonds are often **cheaper** than a foreign currency bank loan as they can be sold on by investors, who will thus accept lower yield in return for greater liquidity
International debt finance

Advantages of Eurobonds

- **Flexible** – most Eurobonds are fixed rate but they can be floating rate or linked to the financial success of the company

- Eurobonds are typically issued by companies with excellent credit ratings and are normally **unsecured**, which making it easier for companies to raise debt finance

- Eurobond issues are **placed** with institutional investors, reducing issue costs

International debt finance

Disadvantages of Eurobonds

- **Issue costs** to consider (approximately 2% of funds raised in the case of Eurobonds)

- Problems if **gearing levels** are too high

- **Foreign exchange risk** of a long-term foreign currency loan
International trade

- World output of goods/services increased if countries specialise in production of goods/services in which they have a **comparative advantage**
- Countries **lacking in raw materials** can take advantage of other countries’ surpluses
- International trade **increases competition amongst suppliers**
- International trade creates **larger markets for outputs**
- International trade **provides a foundation for closer political links**

Comparative advantage

- Countries specialising in what they produce, even if they are less efficient (in absolute terms) in production of all types of good
- This is the comparative advantage justification of free trade, without protectionism or trade barriers
International trade

Barriers to international trade

- Free trade is encouraged within regions of the world by organisations such as the EU and NAFTA. However, for multinationals, it is common to encounter barriers to trade outside these free trade zones.

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Barriers to market entry

- Product differentiation barriers
- Absolute cost barriers
- Economy of scale barriers
- The level of fixed costs
- Legal/patent barriers
Protection

Why protect trade?
- To combat imports of cheap goods
- To counter ‘dumping’
- Infant industries might need special treatment
- Declining industries might need special treatment
- Protection might reduce a trade deficit

Protection

- Tariffs or customs duties
- Import quotas
- Embargoes
- Hidden subsidies
- Import restrictions
- Restrictive bureaucratic procedures
- Currency devaluations
World Trade Organisation – aims

- Reduce existing barriers to free trade
- Eliminate discrimination in international trade (e.g., tariffs and subsidies)
- Prevent growth of protection by getting member countries to consult with others first
- Act as a forum for assisting free trade, and offering a disputes settlement process
- Establish rules and guidelines to make world trade more predictable

Although the WTO has helped to reduce the level of trade protection, there are still some problems remaining.

- Member countries may be reluctant to offer a tariff reduction to another country as they would be required to offer the same reduction to all other members.
- Developed countries complain about the export of low-cost goods from developing nations as they are not subject to the same health, safety and environmental standards.
- Some member countries have difficulty in accepting new agreements.
International Monetary Fund – aims

- Promote international monetary co-operation, and establish code of conduct for international payments
- Provide financial support to countries with temporary balance of payments deficits
- Provide for orderly growth of international liquidity

International Monetary Fund – loan conditions

- IMF wants countries which borrow from the IMF to get into a position to start repaying the loans fairly quickly
- Countries must thus take effective action to improve their balance of payments position by reducing demand for goods and services in the economy (e.g., by increasing taxes and cutting government spending)
- This will reduce imports and help to put a brake on any price rises. The country's industries should then also be able to divert more resources into export markets
- With 'deflationary' measures along these lines, standards of living will fall and unemployment may rise
The World Bank and IDA

World Bank and IDA

- The World Bank provides loans, often direct to governments, on a commercial basis, for capital projects. Loans are generally for a long-term period.
- However, the terms of the loan may be onerous, not just the finance costs but the other conditions imposed on the scope of the projects.

IDA

- International Development Association, which is part of the World Bank. This provides loans on more generous terms to the poorest countries.
- However, it is designed for countries with very high credit risk which would struggle to obtain funding by other means.

Political risks

Factors in assessing political risks

- Government stability
- Political and business ethics
- Economic stability/inflation
- Degree of international indebtedness
- Financial infrastructure
- Level of import restrictions
Political risks

Factors in assessing political risks
- Remittance restrictions
- Assets seized
- Special taxes and regulations on overseas investors, or investment incentives

Dealing with political risks
- Negotiations with host government
- Insurance
- Production strategies
- Contacts with customers
- Financial management – eg borrowing funds locally
- Management structure – eg joint ventures
Litigation risks

Legal impacts
- Export and import controls for political, environmental, or health and safety reasons
- Favourable trade status for particular countries, e.g., EU membership, former Commonwealth countries
- Monopolies and mergers legislation, which may be interpreted not only within a country but also across nations
- Law of ownership – for example, there may be legislation requiring local majority ownership of a firm or its subsidiary in a country

Litigation risks

Legal impacts
- Acceptance of international trademark, copyright and patent conventions – not all countries recognise such international conventions
- Minimum technical standards that the goods must meet, e.g., noise levels, contents, and so on
- Standardisation measures such as packaging sizes
- Pricing regulations, including credit (e.g., some countries require importers to deposit payment in advance and the price to be no lower than those of domestic competitors)
- Restrictions on promotional messages, methods, and media
Litigation risks

Legal impacts

• **Product liability** – different countries have different rules regarding product liability (manufacturer's/retailer's responsibility for defects in product and/or injury caused)

Litigation risks

Legal problems

• Legal penalties
• Costs of legal action
• Bad publicity
• Compliance costs
Litigation risks

Managing litigation risks
- Keeping abreast of legislation
- Compliance with best practice
- Responsiveness to ethical concerns
- Human resource policies to ensure compliance

Cultural risks

Influences on cultural risks
- Cultures and practices of customers and consumers in individual markets
- Media and distribution systems in overseas markets
- Different ways of doing business in overseas markets
- Degree to which national cultural differences matter for the product concerned
- Degree to which a firm can use its own ‘national culture’ as a selling point
Cultural risks

Dealing with cultural risks
Deciding which markets to enter
- Market attractiveness
- Competitive advantage
- Risk, particularly political risks

Use of control systems
- Diffusion of central functions
- Role of subsidiary managers
- Co-ordination (corporate culture and shared values)

Cultural risks

Dealing with cultural risks
Balancing local and expatriate staff
- Availability of technical skills such as financial management
- Need for control
- Importance of product and company experience
- Need to provide promotion opportunities
- Costs associated with expatriates such as travel and higher salaries
- Cultural factors – ease of adoption to local culture
Products

Examples of products that might have to be adapted to suit individual markets and why.

Clothes – certain countries and religions are very strict about how women should dress

Chocolate – there are restrictions on the types of fat that are permitted in chocolate items in some countries

Electrical and electronic products – have to be adapted to suit the voltage and sockets of different countries

Cars – left hand drive or right hand drive depending on the country

Decentralisation

Arguments for decentralisation

• Local management team is likely to have a better understanding of the local economy, such as tastes, cultural and legislation, and be able to make decisions to suit these characteristics.

• Local staff will have greater motivation as they feel they are making contribution towards subsidiary’s performance.

• Decisions will probably be made more quickly as the management team will already be ‘on the ground’, rather than having to defer to Head Office staff.
Decentralisation

Arguments against decentralisation

• Easier to coordinate decisions if they are all made at Head Office. It is also easier to ensure that decisions made for all overseas subsidiaries are consistent.

• Head Office staff have knowledge of whole group, therefore will be able to take wider view when making decisions.

• Fewer agency issues of local management making decisions that are in their own best interests rather than those of the group.

• Cheaper to have decisions made centrally rather than having to employ a local management team.