

Chapter 1

Multinational Financial Management: An Overview

Lecture Outline

Managing the MNC

- How Business Disciplines Are Used to Manage the MNC
- Agency Problems
- Management Structure of an MNC

Why Firms Pursue International Business

- Theory of Comparative Advantage
- Imperfect Markets Theory
- Product Cycle Theory

Methods to Conduct International Business

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

Valuation Model for an MNC

- Domestic Valuation Model
- Multinational Valuation Model
- Uncertainty Surrounding an MNC's Cash Flows
- How Uncertainty Affects the MNC's Cost of Capital

Organization of the Text

Chapter Theme

This chapter introduces the multinational corporation as having similar goals to the purely domestic corporation, but a wider variety of opportunities. With additional opportunities come potential increased returns and other forms of risk to consider. The potential benefits and risks are introduced.

Topics to Stimulate Class Discussion

1. What is the appropriate definition of an MNC?
2. Why does an MNC expand internationally?
3. What are the risks of an MNC which expands internationally?
4. Why must purely domestic firms be concerned about the international environment?

POINT/COUNTER-POINT: Should an MNC Reduce Its Ethical Standards to Compete Internationally?

POINT: Yes. When a U.S.-based MNC competes in some countries, it may encounter some business norms there that are not allowed in the U.S. For example, when competing for a government contract, firms might provide payoffs to the government officials who will make the decision. Yet, in the United States, a firm will sometimes take a client on an expensive golf outing or provide skybox tickets to events. This is no different than a payoff. If the payoffs are bigger in some foreign countries, the MNC can compete only by matching the payoffs provided by its competitors.

COUNTER-POINT: No. A U.S.-based MNC should maintain a standard code of ethics that applies to any country, even if it is at a disadvantage in a foreign country that allows activities that might be viewed as unethical. In this way, the MNC establishes more credibility worldwide.

WHO IS CORRECT? Use the Internet to learn more about this issue. Which argument do you support? Offer your own opinion on this issue.

ANSWER: The issue is frequently discussed. It is easy to suggest that the MNC should maintain a standard code of ethics, but in reality, that means that it will not be able to compete in some cases. For example, even if it submits the lowest bid on a specific foreign government project, it will not receive the bid without a payoff to the foreign government officials. The issue is especially a concern for large projects that may generate substantial cash flows for the firm that is chosen to do the project. Ideally, the MNC can clearly demonstrate to whoever oversees the decision process that it deserves to be selected. If there is just one decision-maker with no oversight, an MNC can not ensure that the decision will be ethical. But if the decision-maker must be accountable to a department who oversees the decision, the MNC may be able to prompt the department to ensure that the process is ethical.

Answers to End of Chapter Questions

1. Agency Problems of MNCs.

- a. Explain the agency problem of MNCs.

ANSWER: The agency problem reflects a conflict of interests between decision-making managers and the owners of the MNC. Agency costs occur in an effort to assure that managers act in the best interest of the owners.

- b. Why might agency costs be larger for an MNC than for a purely domestic firm?

ANSWER: The agency costs are normally larger for MNCs than purely domestic firms for the following reasons. First, MNCs incur larger agency costs in monitoring managers of distant foreign subsidiaries. Second, foreign subsidiary managers raised in different cultures may not follow uniform goals, and some managers may focus on satisfying respective employees. Third, the sheer size of the larger MNCs would also create large agency problems.

2. Comparative Advantage.

- a. Explain how the theory of comparative advantage relates to the need for international business.

ANSWER: The theory of comparative advantage implies that countries should specialize in production, thereby relying on other countries for some products. Consequently, there is a need for international business.

- b. Explain how the product cycle theory relates to the growth of an MNC.

ANSWER: The product cycle theory suggests that at some point in time, the firm will attempt to capitalize on its perceived advantages in markets other than where it was initially established.

3. Imperfect Markets.

- a. Explain how the existence of imperfect markets has led to the establishment of subsidiaries in foreign markets.

ANSWER: Because of imperfect markets, resources cannot be easily and freely retrieved by the MNC. Consequently, the MNC must sometimes go to the resources rather than retrieve resources (such as land, labor, etc.).

- b. If perfect markets existed, would wages, prices, and interest rates among countries be more similar or less similar than under conditions of imperfect markets? Why?

ANSWER: If perfect markets existed, resources would be more mobile and could therefore be transferred to those countries more willing to pay a high price for them. As this occurred, shortages of resources in any particular country would be alleviated and the costs of such resources would be similar across countries.

4. International Opportunities.

- a. Do you think that either the acquisition of a foreign firm or licensing will result in greater growth for an MNC? Which alternative is likely to have more risk?

ANSWER: An acquisition will typically result in greater growth, but it is riskier because it normally requires a larger investment and the decision can not be easily reversed once the acquisition is made.

- b. Describe a scenario in which the size of a corporation is not affected by access to international opportunities.

ANSWER: Some firms may avoid opportunities because they lack knowledge about foreign markets or expect that the risks are excessive. Thus, the size of these firms is not affected by the opportunities.

- c. Explain why MNCs such as Coca Cola and PepsiCo still have numerous opportunities for international expansion.

ANSWER: Coca Cola and PepsiCo still have new international opportunities because countries are at various stages of development. Some countries have just recently opened their borders to MNCs. Many of these countries do not offer sufficient food or drink products to their consumers.

5. International Opportunities Due to the Internet.

- a. What factors cause some firms to become more internationalized than others?

ANSWER: The operating characteristics of the firm (what it produces or sells) and the risk perception of international business will influence the degree to which a firm becomes internationalized. Several other factors such as access to capital could also be relevant here. Firms that are labor-intensive could more easily capitalize on low-wage countries while firms that rely on technological advances could not.

- b. Why might the Internet have resulted in more international business.

ANSWER: The Internet allows for easy and low-cost communication between countries, so that firms could now develop contacts with potential customers overseas by having a website. Many firms use their website to identify the products that they sell, along with the prices for each product. This allows them to easily advertise their products to potential importers anywhere in the world without mailing brochures to various countries. In addition, they can add to their product line and change prices by simply revising their website, so importers are kept abreast of the exporter's product information by monitoring the exporter's website periodically. Firms can also use their websites to accept orders online. Some firms with an international reputation use their brand name to advertise products over the internet. They may use manufacturers in some foreign countries to produce some of their products subject to their specification

6. Impact of Exchange Rate Movements. Plak Co. of Chicago has several European subsidiaries that remit earnings to it each year. Explain how appreciation of the euro (the currency used in many European countries) would affect Plak's valuation.

ANSWER: Plak's valuation should increase because the appreciation of the euro will increase the dollar value of the cash flows remitted by the European subsidiaries.

- 7. Benefits and Risks of International Business.** As an overall review of this chapter, identify possible reasons for growth in international business. Then, list the various disadvantages that may discourage international business.

ANSWER: Growth in international business can be stimulated by (1) access to foreign resources which can reduce costs, or (2) access to foreign markets which boost revenues. Yet, international business is subject to risks of exchange rate fluctuations, and political risk (such as a possible host government takeover, tax regulations, etc.).

- 8. Valuation of an MNC.** Hudson Co., a U.S. firm, has a subsidiary in Mexico, where political risk has recently increased. Hudson's best guess of its future peso cash flows to be received has not changed. However, its valuation has declined as a result of the increase in political risk. Explain.

ANSWER: The valuation of the MNC is the present value of expected cash flows. The increase in risk results in a higher expected return, which reduces the present value of the expected future cash flows.

- 9. Centralization and Agency Costs.** Would the agency problem be more pronounced for Berkley Corp., whose parent company makes most major decisions for its foreign subsidiaries, or Oakland Corp., which uses a decentralized approach?

ANSWER: The agency problem would be more pronounced for Oakland because of a higher probability that subsidiary decisions would conflict with the parent. Assuming that the parent attempts to maximize shareholder wealth, decisions by the parent should be compatible with shareholder objectives. If the subsidiaries made their own decisions, the agency costs would be higher since the parent would need to monitor the subsidiaries to assure that their decisions were intended to maximize shareholder wealth.

- 10. Global Competition.** Explain why more standardized product specifications across countries can increase global competition.

ANSWER: Standardized product specifications allow firms to more easily expand their business across other countries, which increases global competition.

- 11. Exposure to Exchange Rates.** McCanna Corp., a U.S. firm, has a French subsidiary that produces wine. All of the European countries where it sells its wine use the euro as their currency, which is the same as the currency used in France. Is McCanna Corp. exposed to exchange rate risk?

ANSWER: The subsidiary and its customers based in countries that now use the euro as their currency would no longer be exposed to exchange rate risk. However, McCanna Corp is exposed to exchange rate risk, because the subsidiary will ultimately remit its earnings to the parent, and the euro earnings will be converted to dollars when they are remitted.

- 12. Macro versus Micro Topics.** Review this book's table of contents and indicate whether each of the chapters from Chapter 2 through Chapter 21 has a macro or micro perspective.

ANSWER: Chapters 2 through 8 are macro, while Chapters 9 through 21 are micro.