Multinational Finance – by Kirt C. Butler

Learning objectives

✓ Foreign exchange & Eurocurrency markets
✓ Financial risk management
  – Derivative instruments (futures, options, & swaps)
  – Management of exposures to financial price risk
✓ International corporate finance
  – Country risk, capital budgeting, cost of capital, taxation, real options, corporate governance, & cross-border M&A
✓ International portfolio investment
  – Capital markets, portfolio investment, and asset pricing
Everything should be made as simple as possible, but not simpler.

Albert Einstein
Chapter 1
An Introduction to Multinational Finance

Learning objectives

✓ Corporate governance and the goals of the multinational corporation
✓ The challenges of multinational operations
  – Cultural differences and country risks
✓ The opportunities of multinational operations
  – Investment opportunities
  – Financial opportunities
✓ Financial management of the MNC
A starting point...

- **Multinational financial management** is financial management conducted in more than one cultural, social, economic, or political environment

- We’ll develop a framework for evaluating the **opportunities, costs and risks** of operating in the world’s markets for goods, services, and financial assets and liabilities
Governance of the MNC

Supervisory board

Management

Assets

Debt

Equity

Shareholders

✓ Goals of the MNC
✓ Challenges of the MNC
A definition of the MNC
✓ Opportunities of the MNC
Financial management of the MNC
Claims on corporate revenues
Claims on corporate revenues

\[ V_{\text{REVENUES}} = V_{\text{EXPENSES}} + V_{\text{GOVT}} + V_{\text{OTHER}} + V_{\text{DEBT}} + V_{\text{EQUITY}} \]
The gentle reader will never, never know what a consummate ass he can become, until he goes abroad.

Mark Twain
The MNC’s additional risks

- **Country risk** - the risk that the business environment in a host country will unexpectedly change
  
  - **Political risk** - the risk that the business environment in a host country will change unexpectedly due to political events
  
  - **Financial risk** - the risk of unexpected change in the financial or economic environment of a host country
Risk versus risk exposure

- **Risk** exists whenever actual outcomes can differ from expectations.

- A company has an **exposure to risk** when its value can change with unexpected changes in business conditions.
The MNC’s opportunities

\[ \text{Value} = \sum_{t} \left[ \frac{\text{E}[\text{CF}_t]}{(1+i_t)^t} \right] \]

- **Multinational investment policy**
  - Higher returns from existing investments
  - New investment opportunities

- **Multinational financial policy**
  - Reduced capital costs through access to international capital markets
The optimal capital budget

Domestic firm’s cost of capital

Domestic firm’s investment opportunity set

Capital budget ($ millions)

Return
The value of multinationality

- MNC’s investment opportunity set
- MNC’s cost of capital
- Domestic firm’s cost of capital
- Domestic firm’s investment opportunity set

Goals of the MNC
- Challenges of the MNC
- Opportunities of the MNC
- Financial management of the MNC

The MNC’s opportunities
- Imperfect financial markets
- Market inefficiencies
Perfect financial market assumptions

- **Frictionless markets**
  - No government intervention or taxes
  - No transactions, agency, or bankruptcy costs

- **Rational investors**

- **Equal access to costless information**

- **Equal access to market prices**

Financial opportunities often involve a violation of one of these assumptions.
Characteristics of financial markets

➤ Types of market efficiency

- **Operational efficiency** refers to the influence of transactions costs

- **Informational efficiency** refers to whether prices reflect information

- **Allocational efficiency** refers to whether capital moves to productive uses

Each of these is promoted by market **liquidity** (that is, the ease with which you can capture an asset’s value)
Vivé la difference

Cross-border differences can affect all areas of business, particularly through differences in

- Language & culture
- Accounting
- Distribution
- Financial markets
- Other business conventions (legal, accounting, taxation, regulation, etc.)
- Human resource management
- Marketing
- Logistics
- Corporate governance
Multinational financial management

- Multinational finance is *interdisciplinary* within the field of finance

Multinational financial managers must know...

- Foreign exchange and Eurocurrency markets
- Derivatives (futures, options, & swaps)
- International financial markets (debt & equity)
- International markets for real assets (e.g., land or labor)
- International portfolio investment
The notes I handle no better than many pianists, but the pauses between the notes — ah, that is where the art resides.

Arthur Schnabel