

17.4: Fundamentals of Finance

Learning Objectives

1. Know the various financing options available to international firms.
2. Explain the value of capital budgeting.
3. Understand the role of governments in affecting investment decisions.

Financial Structure and Sources of Financing

As demonstrated in the opening case study, governments, banks, and individuals all play a role in international financing. Businesses get external capital from these sources—capital that lets them build, expand, and grow.

Financial structure refers to the ways in which a multinational firm's assets are financed—from short-term borrowing to long-term debt and equity. Managing a multinational firm's financial structure involves asking: *What is the ideal mix of debt versus equity to finance international operations? Where should these funds be invested?* Multinational firms engage in both **transnational financing** (i.e., seeking capital from a foreign sources) and **transnational investment** (i.e., investing capital in foreign markets).

Sources of financing available to firms include foreign stock exchanges, foreign bond markets, foreign banks, venture-capital firms, and funding from the parent company. Although global equity and debt markets offer firms a new way to get funding—often at lower cost than US markets—they are also complicated by foreign currency and exchange rates.

Equity financing refers to raising capital by selling shares of stock. The **stock market** refers to the organized trading of securities through exchanges. An individual or entity can purchase partial ownership in a corporation, buying shares of stock in the company. The **global equity market** refers to all stock exchanges worldwide where firms can buy and sell stock for financing an investment.

The largest exchanges in the world include the New York Stock Exchange (NYSE) Euronext, the Tokyo Stock Exchange, NASDAQ (National Association of Securities Dealers Automated Quotations) stock exchange, and the London Stock Exchange. The advantage of raising capital in equity markets is that the firm doesn't have to repay the money at a specific time or at a specific interest rate, as it does with bank loans. The disadvantage is that each time a firm offers stock, the firm's management loses some control of the company because shareholders can now vote to approve or disallow management actions.

Debt financing refers to raising capital by borrowing the money and agreeing to repay the entire amount plus agreed-on interest at a specific date in the future. Firms can borrow money from banks or by selling bonds. The advantage of raising money through debt financing is that company management doesn't give up any ownership of the firm.

Firms can also obtain funding via intrafirm loans or trade credits. A **trade credit** lets the customer (in this case, the subsidiary buying the goods or services) defer payment on the good or service for a specified period of time, typically thirty or ninety days. By borrowing capital from a parent, both the subsidiary and the parent eliminate paying transaction costs to an outside entity such as a bank, which would charge fees to make the transaction.

Financing Options Available to Subsidiaries

Subsidiaries can choose between two major ways to finance their operations through external sources: overseas equity markets and overseas debt markets. Let's look at each in turn.

Raising Money in Overseas Equity Markets

Multinational firms choose to raise money in foreign markets for a number of reasons. For example, French luxury beauty products company L'Occitane conducted its initial public offering (IPO) on Hong Kong's stock exchange, rather than on the stock exchange in its home country—the NYSE Euronext in Paris. Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, "The Great Rebalancing," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/The_great_rebalancing_2627. L'Occitane made this decision because emerging-market consumers are its fastest-growing segment. Listing on Hong Kong's exchange makes the company more visible in these growing markets and lets locals participate in the growth of the firm by buying shares.

Some multinational firms raise money in both their home-country and overseas stock exchanges. One of the reasons for listing on multiple exchanges is a lower cost of capital as shares become available to global investors who might not otherwise be able to

purchase shares due to international investment barriers.

Emerging markets are also opening stock exchanges. For example, the Shanghai and Shenzhen Stock Exchanges in China opened in 1990. In July 2010, the Shanghai Stock Exchange became the sixth-largest stock exchange in the world based on market capitalization.

Figure 15.1 Shanghai Stock Exchange



Courtesy of Jindao Floors Inc.

Public share ownership in China remains complex with three classes of shares: A, B, and H. A-shares are local shares denominated in China's local currency for domestic investors. B-shares are denominated in Hong Kong dollars or US dollars and are generally owned by foreigners. H-shares are for China-incorporated companies traded in Hong Kong. Chinese authorities (the China Securities Regulatory Commission, the People's Bank of China, and the State Administration of Foreign Exchange) closely regulate the Shanghai and Shenzhen Stock Exchanges. Indeed, the Chinese government actively intervenes in its capital markets. For example, it didn't allow any new equity funds to be established in 2007. The government also owns a relatively high number of shares in many listed companies. China's low transparency, poor implementation of securities regulations, and restrictions on hedging and risk-management tools are warning signs to foreign investment-fund executives. At the same time, the government lacks many regulations related to educating or protecting investors. A brokerage firm can allow an investor to buy and sell any amount of any security after the investor answers three questions in the following areas: name, health, and risk tolerance. Matt Anderson, Daniel Curtis, Derek Lin, and Ian Van Reepinghe, "Coming of Age: A Look at China's New Generation of Investors," in The Lauder Institute, *Lauder Global Business Insight Report 2010: First-Hand Perspectives on the Global Economy* (Philadelphia: Wharton, University of Pennsylvania, 2010), 69–73, accessed October 28, 2010, knowledge.wharton.upenn.edu/papers/download/021710_GlobalBiz_2010.pdf.

Raising Money in Overseas Debt Markets

Multinational firms can issue bonds in overseas markets as well as in their home countries. Even China now has an active bond market. Before April 2008, Chinese state-owned enterprises were about the only ones issuing corporate debt in China because corporate bonds were so costly and time-consuming to issue there. Corporate bonds had to be listed on the stock exchange and approved by exchange regulators, making the process subject to political whims. State-owned enterprises raised money in the bond market to finance big infrastructure projects, and the bonds had state guarantees. In 2008, new rules simplified the issuing process, and the Chinese government began letting foreign companies issue yuan-denominated bonds through Hong Kong in 2010. The attraction of the Chinese bond market, according to Chris Zhou, director of debt capital markets at UBS Securities in Beijing, is that "the bond market is a relatively easy and cost-effective way to get money." Frederik Balfour, "In China, A Burst of Corporate Bonds," *BusinessWeek*, July 6, 2009, 25.

McDonald's was the first foreign company to issue yuan-denominated bonds, selling 200 million yuan (or \$29 million) of 3 percent notes due in September 2013. As Donald Straszheim, senior managing director and head of China research at the International

Strategy & Investment Group observed, “There are hundreds of global companies wanting to do more business in China, and they will want to be involved in the country’s evolving credit market.” Patricia Kuo and Shelley Smith, “McDonald’s Sets Benchmark for China With Yuan Bond Sale,” *Bloomberg*, August 20, 2010, accessed August 23, 2010, <http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html>.

According to McDonald’s spokesperson Lisa Howard, issuing bonds in China “gives us access to new funding to support growth in China. We are very confident in the Chinese market and have a strong plan to grow our business in China.” Patricia Kuo and Shelley Smith, “McDonald’s Sets Benchmark for China with Yuan Bond Sale,” *Bloomberg*, August 20, 2010, accessed August 23, 2010, <http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html>. McDonald’s will use the money it has raised in the bond market to provide working capital for expansion in China, including opening as many as 175 restaurants in 2010, adding to the 1,000 restaurants it already has there.

Innovation and Entrepreneurship

WaterHealth: Financing for Entrepreneurs in Developing Countries

WaterHealth is a company that sells and leases water purification systems for use in developing countries. The company also sells and leases special sanitary water containers that reduce the spread of waterborne diseases from contaminated ladles. WaterHealth developed ultraviolet technology to sanitize water. The technology doesn’t require large-scale operations or equipment, which enables local entrepreneurs in developing countries to use the technology to open their own water shops to sell water to local customers. The result? Consumers gain access to cheaper, cleaner water, while the local economy gains new businesses. WaterHealth’s innovative financing doesn’t require high up-front payments for its technology. Instead, the company collects user fees, allowing the repayment of financing costs over time. WaterHealth International, “Frequently Asked Questions,” accessed August 14, 2010, www.waterhealth.com/.

Investment Decisions

Capital Budgeting

Capital budgeting refers to the process of financing long-term outlays for major projects such as plant expansion, entry into new markets, or research and development. The process of capital budgeting helps a firm decide which major investment projects will be most economically advantageous for the firm by assessing each project’s benefits, costs, and risks. When making capital-investment decisions, firms examine the initial investment that will be required, the cost of capital, and the amount of cash flow or other gains which the project will provide. The **cost of capital** is the rate of return that a company could earn if it chose a different investment of equivalent risk. The cost of capital comes into play because firms have choices in how to put their capital to use; using the capital for one purpose precludes using it for a different purpose.

Some governments court foreign borrowers by offering low-interest loans or by offering lower corporate income tax to attract investment in their countries. For example, Poland created special tax breaks for companies. These tax breaks make the country attractive for firms such as Hewlett-Packard and IBM to locate operations there. Similarly, Singapore’s government has invested heavily in education and training in an effort to attract investment by leading multinational firms. Singapore also offers subsidies to companies locating there. As corporations think about where to invest, build factories, locate offices, and source talent, they explore such opportunities actively. Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, “The Market State,” *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/The_market_state_2628.

How Government Actions Affect Investment Decisions

Government policy affects foreign investment and innovation. According to Jeffrey Sachs, a leading international economic advisor and Columbia University professor, the near-term prospects for Brazil are bright, and it’s poised to do the best among Latin American countries.

Brazil

For the last fifteen years, Brazil has been investing heavily in education. In particular, Brazil made high school available to all citizens and invested in higher education, science, and technology. The result of these government investments is that not only does Brazil have a more educated workforce, but it has also narrowed off the gap between rich and poor and between ethnically divided segments of Brazilian society. In contrast, countries with deep ethnic and racial inequities aren’t unified societies, which leads to mediocre economic performance. Brazil plans to invest another \$22 billion in science and technology innovation in 2010 and seeks

corporations to join in additional investments in the country. Jeffrey Sachs, “Economics for a Crowded Planet” (webinar, HSM Global, 2009), accessed October 28, 2010, us.hsmglobal.com/contenidos/hsm-webinars-sachs.html; Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin, 2005).

IBM is one of the companies investing in Brazil. CEO Sam Palmisano met with Brazilian President Luiz Inacio Lula Da Silva to discuss the creation of a “collaboratory” in Brazil. IBM’s collaboratories match IBM researchers with local experts from governments, universities and companies. IBM’s Palmisano praised Brazil’s strategy: “Investments in innovation are critical, especially in a downturn. They can help Brazil and other countries, including the US, realize an economic expansion.” Among the BRIC countries (Brazil, Russia, India, and China), Brazil is seeing the highest growth in business partners that IBM works with, averaging 150 percent year over year, according to Claudia Fan Munce, managing director of IBM Venture Capital Group. Steve Hamm, “Big Blue’s Global Lab,” *BusinessWeek*, August 27, 2009, accessed October 28, 2010, http://www.businessweek.com/magazine/content/09_36/b4145040683083.htm; Spencer E. Ante, “IBM Bets on Brazilian Innovation,” *BusinessWeek*, August 17, 2009, accessed October 28, 2010, http://www.businessweek.com/technology/content/aug2009/tc20090817_998497.htm.

As the above example illustrates, Brazil is attracting foreign business. Companies making foreign investments, however, must be aware of the total financial picture, including the tax environment. Brazil has a very complex tax system. “If it’s not the most complicated tax system in the world, it’s certainly right up there,” said Mark Buthman, finance chief at Kimberly-Clark, the consumer packaged goods giant, which has approximately 3,000 people in its Brazilian operation. “It’s not uncommon to have disagreements with the taxing authorities that you have to work through over time.” Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833. What makes doing business in Brazil challenging is that the tax laws have not kept pace with the progress of modern products or services; that is, the categories of taxes do not correspond to modern-day categories of products and services. The lack of parallelism leads to confusion and misinterpretation. To deal with the difficulties, Kimberly-Clark, for example, employs seventy people—most of them native Brazilians—in its finance group in Brazil.

In addition to federal taxes, Brazilian states assess their own taxes as well. Thack Brown, CFO of SAP Latin America, says that any misstep regarding a labor or tax regulation can prove costly. “If you do have an issue, not only can the penalties be large, but you can spend three or four or even 10 years working through the judicial system.” Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833. Despite the difficulties, Brown says that compared to China, the Brazilian system is still more structured and capable of dealing with issues. Kate O’Sullivan, “Brazil Is Booming (and Maddening),” *CFO*, July 15, 2010, accessed October 28, 2010, www.cfo.com/printable/article.cfm/14508833.

Indonesia

Indonesia is the third-largest democracy in the world and the largest economy in Southeast Asia. The country recently created an investment coordinating board to attract foreign direct investment into Indonesia. How is Indonesia making itself attractive to foreign investors?

1. It’s touting its young population—half of the population is under thirty years of age, which bodes well for a skilled workforce and growing consumer base.
2. It’s touting its political stability of twelve years after democratization, and monetary stability for the last five to six years.
3. It’s investing in infrastructure. “We are committing \$50 billion from a budgetary standpoint for the development of infrastructure as part of a \$150 billion five-year program,” said Gita Wirjawan, Indonesia’s chairman of Badan Koordinasi Penanaman Modal (BKPM), the country’s newly created investment coordinating board. “That will produce 20,000 kilometers of new roads and an additional 15,000 megawatts of power generation. That is going to create a much higher degree of connectivity than what we have today.” “Why Gita Wirjawan Wants to Open Indonesia to International Investors,” *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553>.

Despite these advances, Indonesia still restricts which industries foreign investors can invest in. For example, investors can’t invest in telecommunications towers. Nonetheless, Indonesia has attracted some major investors, such as a large Middle Eastern investor who will build an integrated infrastructure project including a port, a rail track, and new power-generation capability. The total investment will be about \$5.2 billion. Indonesia has also convinced the Swiss firm Holcim to expand its cement capabilities in

Indonesia. “Why Gita Wirjawan Wants to Open Indonesia to International Investors,” *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, <http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553>.

The Role of Government

The role of government in terms of international business and finance includes

- passing laws and setting policies (e.g., regulating stock and bond markets and setting tax codes),
- enforcing laws (laws laxly enforced have little value),
- providing infrastructure (e.g., fast communications infrastructure and reliable electricity are important to the smooth functioning of capital markets), and
- providing capital (e.g., providing or guaranteeing loans, as the US government does through the Export-Import Bank of the United States). Scott Leibs, “A Force to Be Reckoned With,” *CFO*, February 1, 2010, accessed August 7, 2010, www.cfo.com/printable/article.cfm/14470883.

KEY TAKEAWAYS

- Multinational firms have a choice in how they finance international operations. Some choose to raise capital through equity markets, issuing stock on domestic or overseas stock exchanges. Others opt for debt financing through banks or bond markets in order to not give up ownership in the firm.
- Capital budgeting is the process by which firms assess the relative merits of different investment choices, weighing the cost of capital and the expected returns of different investment options.
- Governments can play an active role in attracting firms to invest in their countries or enticing foreign borrowers by offering low-interest loans or lower corporate income taxes. When evaluating countries for investment potential, companies consider a government’s economic policies (e.g., business environment, trade policy, investment policy, and infrastructure) as well as any cultural issues (e.g., ethnic, religious, and gender inequalities) that may be a barrier.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What sources of financing are available to a company’s subsidiaries?
2. What is the advantage of equity financing over debt financing?
3. When might a company choose debt financing?
4. Name two advantages of raising money on a foreign stock exchange.
5. Why is capital budgeting important to a multinational company?

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