

International Financial Management

Assignment 1

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International financial management: A look at Amazon Inc.

Introduction

The internationalisation of business practices is subject to many externalities considering that diverse economic and financial variables influence business operations both locally and globally. The performance of business enterprises in the global markets is subject to financial structures that vary from one country to another (Madura, 2022). Precisely, the fiscal and monetary policies instituted by individual countries impact how global franchises or subsidiaries operate (Caprio, 2012). It is imperative for the global parent company to understand such structures before making a decision to set up shop. This paper explores the global operations of Amazon Inc. with the main focus on its global financial management structure and how international finance management supports the business. The last section looks at the challenges that the company faces in the context of global financial markets.

Overview of the company operations

An e-commerce giant that pegs its success on highly efficient operational management, Amazon Inc. was established about three decades ago from a small start-up. Built by a hedge fund executive in 1994, the start-up was committed to selling books online after thorough research. Despite the presence of other online merchants like Computer Literacy doing the same business, Amazon.com model of doing business was unique, delivering any book to the readers anywhere (Hall, 2022). Though the company began as a bookseller, the founder contended from the beginning that the online company was a technology venture meant to simply online buying and selling. There was some scepticism from some financial analysts and journalists given the rivalry from renowned bookselling chains, for example, Borders and Barnes. This was supported by the company's lack of profit(s) for about seven years (to the

end of 2001). However, the firm went through an aggressive expansion strategy providing a platform for other associates (websites) to offer their merchandise, which includes other consumer goods other than books (Ferguson, 2017). To ensure sustainable growth in its operations, the company needed to digress from private investors; therefore, it became a public entity and raised more than \$50 million on the NASDAQ market. Apart from that, the company leveraged its impressive stock to fund its aggressive expansion and acquisition growth strategy (Hall, 2022). Amazon Inc. remains one of the largest commercial enterprises in the world, with a market capitalisation of \$1.485T and a share price index of \$2,921 (CompaniesMarket.com, 2022).

Evaluation of international finance management theories

There are a number of variables that direct businesses at the international level, including the foreign exchange market, money market(s), international equity markets, foreign direct investment (FDI) (Clickand Coval,2002), purchasing power parity, the interest rate parity (IRP), the Fisher and international Fisher Effect, and the expectation theory. The foreign exchange market (index) variable is a core element of any international business venture. Going global means undertaking projects that fall under the foreign investment portfolio, and this encompasses international financing and capital budgeting. There is also a risk of foreign exchange exposure, especially with the dynamics of supply and demand of the main global currencies. The interest rate parity (IRP) is well understood by the relationship between the interest rate and the foreign exchange risk (Kurihara, 2015; Thapa, n. d.).

According to Levich (2013), the IRP is one of the fundamental pointers of financial globalisation, and when its relationship holds, there is an identity on the yields covered in respect to the assets that share the important features save for their denomination currency. Another way to put it is, the difference between the interest rate of the two countries ought to be the same as the percentage variation between the spot and forward exchange rates.

Notably, this particular theory holds as long as the movement of money from one economy or country to another is restricted. Fundamentally, an equilibrium between the currency and money market ensures an equality between the interest rate(s) differentials and percentage variation in the exchange rates (both forward and spot). The theory utilises risk-free rates of two countries to relate the spot and forward exchange prices. Also, it takes into account a condition of equal returns in relation to money market tools that are comparable. Consider a hypothetical situation where Amazon Inc. plans to invest £1,000,000 in India in the first quarter of the year, and the investment period is one year. Assuming the deposit interest rate for the GBP is 2 percent annually while that of the Indian Rupees is 10 percent with a spot exchange rate of 50 rupees (Rs) per sterling pound (£); the company is to decide on which market to invest in. This context can be solved using two case scenarios as explained below;

Case I

If the company decides to invest in the U.S., the yield at the end of the year will be £1,020,000, that is £1,000,000 multiplied by 102 percent. This implies an interest amount of £20,000.

Case II

If Amazon Inc. decides to invest in India, the principal amount of £1,000,000 has to be converted to rupees, therefore, total amount invested is Rs.50,000,000 (£1,000,000 multiplied by 50). Considering a 10 percent interest rate on the invested rupees, the yield at the end of the year is Rs.55,000,000, which includes an interest of Rs.5,000,000. The said amount ought to be converted to the USD currency, however, the exchange rate at the end of the year needs to be set. The formula utilised below can be used to determine the forward exchange rate (FR) for final conversion;

$$(1 + R_{\$}) = \frac{S_R * (1 + R_{Rs.})}{F_R} \dots\dots\dots (1)$$

Where,

$R_{\$}$ - Interest rate of the GBP = 2%

R_{Rs} - Interest rate of the rupee = 10%

S_R - Spot exchange rate = Rs.50 per£

F_R - Forward exchange rate

Using equation (1) above and replacing with the given values, the calculated F_R is 53.922, and this is used as the exchange to convert the investment return realised at the end of the year. Following that, the expected end of year earning is £1,019,991.84, and this is similar to the results of case 1. It is apparent that an MNC like Amazon has to analyse the impact of the foreign exchange market (see fig.1), the interest rates, and supply of the base currency (USD in this context) before investing.

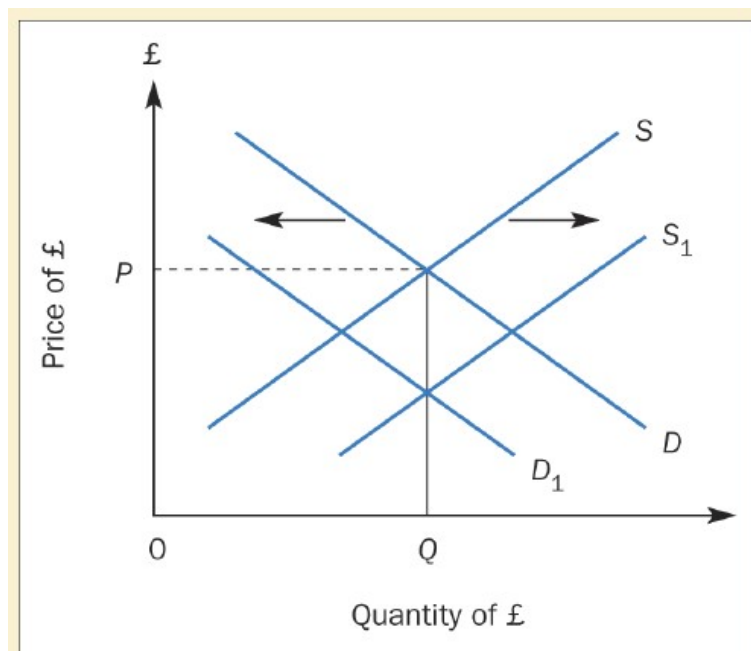


Fig. 1: Foreign exchange market showing demand and supply curves of the GBP

As per the figure above, the equilibrium exchange rate occurs when the demand and supply of the sterling is equal at a particular price point. An exchange rate is likely to fall when the supply (S) of the currency increases with a decrease in demand (D). Conversely, in the event that the demand for the currency surpasses the supply level, the exchange rate is bound to appreciate. Thus, the IRP theory is supposed to cushion investors from the arbitrage.

Another theory that guides international financial management is the purchasing power parity (PPP) theory, which helps in determining the spot exchange rate. The two types of PPP are the absolute form of PPP and the relative form. Notably, the absolute type of PPP does not hold true because of assumptions that are impractical, for instance, zero transaction costs, no taxes, tariffs, or political barriers, and identical products all over the globe. However, the relative PPP form is more realistic, and it underlines the determinants of the exchange rate fluctuation over a particular period. What this theory implies is that the variation in the rate of inflation (i) is typically similar to the changes in the spot exchange rate (S). Therefore, the difference in the exchange rate is strongly linked to the inflation rates of the two nations. Assuming a price increase of one percent in the U.S. and six percent in Brazil, then quantity of real that can purchase items for \$1 ought to increase by about 5 percent. Thus, the PPP theory postulates that, for the spot exchange rate to be estimated, the inflation rate(s) variation needs to be approximated. Essentially Amazon Inc. can utilise the PPP theory to gauge the fluctuation of inflation rates of different countries so that they adjust items prices accordingly.

Amazon's financial portfolio between 2016 and 2020

A quick look at some particular financial data shows the company's net sales increasing more than twice, from \$136 billion to \$386 billion. A key thing to note is the company's decision to acquire Whole Foods Market in 2017, which contributed to the said growth. One of the important elements highlighted in the company's financial report for 2020 is the foreign exchange element that significantly impacts its results as well as the consolidated trends. The report notes that a weakened U.S. dollar year-over-year in comparison to currencies in other countries where the firm is located results in higher operating expenses and net sales compared to situations when the currencies pricing is constant. Similarly, a year-over-year strengthening of the USD against the currencies in the global outlets indicates lower operating expenses and net sales than if the currency prices remained the same.

The shifts in foreign currency exchange rates have a profound effect on the gains or losses realised by the company hence currency volatilities are a major risk that Amazon has to contend with given its positive or negative impact on the financial results. For example, the Form 10-K report states that variations in the foreign exchange rates of the currency affected the net sales by \$2.6B in 2020 and \$1.4B in 2019, hence, a 38 percent increase in sales in 2020 (USSEC, 2022). The effect of the exchange rate for Amazon's operations between 2019 and 2020 is shown below.

	Year Ended December 31, 2019			Year Ended December 31, 2020		
	As Reported	Exchange Rate Effect (1)	At Prior Year Rates (2)	As Reported	Exchange Rate Effect (1)	At Prior Year Rates (2)
Net sales	\$ 280,522	\$ 2,560	\$ 283,082	\$ 386,064	\$ (1,438)	\$ 384,626
Operating expenses	265,981	2,740	268,721	363,165	(989)	362,176
Operating income	14,541	(180)	14,361	22,899	(449)	22,450

Fig. 2: The exchange rate effect on Amazon Inc.'s net sales and operating income and expenses (10-K report, 2020)

Conclusion

Multinational corporations (MNCs) such as Amazon are guided by international financial management theories, which elaborate on fundamental elements that affect the financial performance of companies engaged in international business. Theories such as interest rate parity (IRP), purchasing power parity (PPP), Fisher's theory among others highlight the inter-relationship between the interest rates, foreign exchange market, and inflation rates fluctuation in respect to financial operations and yields over time. Apparently, the form 10K-report from the US Securities and Exchange Commission proves the impact of global currencies volatilities on its operating income, expenses, and net sales.

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APPENDICES

Appendix 1: A schematic presentation showing an operational and financial structure of an MNC

