

- ▶ No funds are transferred across national boundaries which can have tax advantages.
- ▶ The loans will be shown as assets and liabilities in the respective consolidated balance sheets; a loan made by a holding company to its subsidiary does not appear in the consolidated balance sheet.
- ▶ If there had been a restriction on the remittance of funds out of France the parallel loan would have enabled the US company Virginia Inc to release funds from France.

A fronting loan (or link financing)

A fronting loan is an arrangement whereby a holding company makes a loan to a foreign subsidiary via a bank which acts as an intermediary. The holding company deposits funds with a bank which in turn lends the same amount to the foreign subsidiary. The effect of the arrangement is that the foreign subsidiary is borrowing money directly from a bank instead of its holding company. The repayments on this loan by the subsidiary are less likely to be restricted by the foreign government than if the loan had been made directly by the holding company.

Factors that influence the type of finance used

In the international context there are additional factors that are relevant to the financing decision.

The overriding aim is still to minimise the company's after tax cost of funds at an acceptable level of risk (a reduction in the cost of capital increases the value of the firm). A multinational company, with its access to the world's capital markets, has greater opportunity to achieve this than a company located in one country.

In deciding how to finance any business several factors need to be considered:

- ▶ how much debt and how much equity (dare I mention Modigliani and Miller)?
- ▶ How much short-term finance and how much long-term finance?
- ▶ What is the availability of alternative sources of funds?
- ▶ Impact on risk. Increases in debt may increase the risk to the ordinary shareholders.
- ▶ Cost of each type of funds. This may be direct, the return required on that type of finance or indirect, the effect an increase in one type of finance can have on the return required on other finance.
- ▶ Tax relief. Interest on debt attracts tax relief. A switch from debt to equity can increase the firm's tax liability.

Volatile earnings

An important message conveyed by the CAPM is that there is no benefit to shareholders in taking action within the company to reduce risks that shareholders can deal with themselves by holding the shares as part of a well diversified portfolio.

If a firm's earnings and net cashflows are subject to a high level of volatility this may have a detrimental effect on the firm.

High volatility of earnings can:

- ▶ reduce a firm's credit rating; this will cause a firm's interest costs to go up and may lead to restrictions on the level of gearing a firm is permitted to adopt. This will restrict the amount of tax relief a firm is able to obtain on interest payments.
- ▶ cause suppliers, customers and employees to be less willing to deal with the company. This could make purchases more expensive, reduce the amount of trade credit available, reduce the level of sales or result in lower-quality staff.

been made. This approach may be adopted because of agency costs: it is more difficult to monitor the activities of a foreign subsidiary, therefore, by not guaranteeing a subsidiary's loans the holding company is forcing the subsidiary to have closer monitoring by its local bankers.

Taxation

Because of inequality of tax rules in different countries the financing decision can reduce the company's total global tax liability. The items that can be subject to different treatment are:

- ▶ withholding taxes on dividends and interest.
- ▶ treatment of exchange gains and losses.
- ▶ different treatment of dividends and interest; this can make it beneficial to finance subsidiaries with loans and is an incentive to have high debt levels in countries with high corporate tax rates. This may well cause the individual subsidiary to ignore the group gearing level (another subsidiary which is faced with less favourable tax rules can have correspondingly low gearing). Tax authorities may limit the level of debt a firm can adopt.

Political risk

The method of finance can be used to manage a firm's exposure to political risk. The impact of political risk in a particular country can be reduced by:

- ▶ using as much local finance as possible, and
- ▶ the holding company avoiding giving loan guarantees to the subsidiary.

The idea being that if the government expropriates the assets it also has the pleasure of taking over the liabilities. If the holding company guarantees the debts of the subsidiary this effectively cancels the benefit, in terms of political risk, of using locally provided finance.

It is also possible to reduce political risk by involving international banks and governments in the financing arrangements making it more difficult for the host government to expropriate the assets. Political risk can also be reduced by using parallel loans and back-to-back loans as discussed in an earlier section.

Currency risk

A firm can use the financing mix as part of its strategy to manage currency risk. This was dealt with in Chapter 21 (internal asset and liability management). If a company is due to receive a stream of cashflows in a particular currency it can hedge the risk by taking out a loan in that currency and using the currency receipts to service the loan.

Hence the risk inherent in the currency receipts is matched with the risk associated with changes in the value of the loan payments. A risk averse policy is to try to match assets and liabilities in the same currency. If debt cannot be obtained by a subsidiary locally the holding company can borrow on behalf of the subsidiary.

It is worth mentioning again the relationship between interest rates and exchange rates. When a treasurer is choosing which currency in which to obtain a loan low interest rates are likely to be associated with a strengthening currency (remember the International Fisher effect). The benefit from reduced interest costs may be more than countered by an appreciation in the capital value of the outstanding loan.

In some countries a currency loss arising because of a strengthening of the currency of the loan is not allowable for tax purposes. If this is the case the company may be better off paying the higher interest rates.

Interest rates may be artificially low in a particular country because of government intervention; a firm should obviously take advantage of such low rates (but beware the International Fisher effect!).

Partly owned subsidiaries

A holding company may permit outside share ownership because:

- ▶ it is required by law.
- ▶ it may be necessary in order to reduce political risk.
- ▶ local shareholders may provide important contacts with customers and/or the government.

If a foreign subsidiary has outside shareholders this has several implications:

- ▶ it is more difficult for transactions (for example transfer prices) to be on anything other than an 'arm's length' basis.
- ▶ it may be more difficult for the subsidiary to follow the objective of the holding company.
- ▶ conflicts are likely to arise over dividend policy; the dividend may be the only tangible reward to the local shareholders.
- ▶ local shareholders will have a different attitude to currency risk. This may be a problem if hedging is organised centrally.
- ▶ local shareholders could make it necessary to maintain a lower gearing level particularly if the subsidiary is quoted on the local stock exchange. The holding company may prefer higher gearing to hedge currency risk.
- ▶ more difficult for the holding company to give loan guarantees.
- ▶ may be more difficult to obtain additional equity finance for the subsidiary.

The role of the company's lenders

As gearing increases the risk and expected cost of bankruptcy increase. In some countries banks are represented on the board of directors. This gives the bank better access to information. The banks are then involved in taking remedial action at an early stage (which could involve replacing the board of directors which is quite possible in Japan, but less likely in the UK or the USA). This reduces the likelihood of bankruptcy making it possible to adopt higher gearing. Gearing tends to be higher in Japan and Germany where banks are inevitably represented on the board of directors and hold significant amounts of equity.

Also the governments of some countries are more likely to rescue companies in difficulty.

Capital structure of a multinational may therefore depend on which country the company bases its headquarters.

Summary

In this chapter we have covered topics which relate to how a company should go about investing overseas.

Strategic reasons for foreign direct investment

- ▶ Financial: increase the wealth of the holding company shareholders.
- ▶ Political risk. A firm may be able to reduce its exposure to political risk by careful choice of location of foreign investment.

- ▶ Currency risk. A firm involved in investments in different countries is exposed to currency risk. By financing in an appropriate combination of currencies the firm can reduce its exposure to currency risk.
- ▶ Market segmentation. Whether the market is segmented influences the return required by the providers of finance.
- ▶ Market imperfections. It may be possible to raise debt more cheaply in some countries but beware of the effect of a movement in exchange rates (low interest may well be associated with a strengthening currency).
- ▶ Partly owned subsidiaries. The existence of outside shareholders introduces additional constraints on the financing mix.

In the final chapter we will discuss how a firm should make its international investment decision.

Suggested reading

Additional reading references include:

Buckley *Multinational Finance*.
Prentice Hall, London, 1992.

Buckley deals with financial structure in Chapter 28, exchange controls in Chapter 32 and political risk in Chapter 24.

Shapiro *Multinational Financial Management*. Allyn and Bacon, 1992.

Shapiro explains financial structure in Chapter 24, political risk in Chapter 20 and forms of entity in Chapter 17.

Eiteman, Stonehill and Moffett
Multinational Business Finance.
Addison-Wesley, 1992.

Eiteman explains financial structure in Chapter 14, forms of entity in Chapter 15 and political risk in Chapter 16.

Articles:

Goddard, S. 'Political Risk in International Capital Budgeting.' *Managerial Finance*, 16 (2), 1990.

Knudsen, H. 'Explaining the National Prosperity to Expropriate: An Ecological Approach.' *Journal of International Business Studies*, Spring 1974, pp. 57-71.

Self test questions

- 1 What are the relative advantages of setting up a foreign investment as a branch as opposed to a subsidiary?
- 2 What methods are available to a company to reduce the effect of restrictions on remittances from a foreign investment centre?