SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 406(A)

SUBJECT NAME: INTERNATIONAL FINANCIAL MANAGEMENT

UNIT-V

TOPIC NAME: CAPITAL BUDGETING FOR THE MULTINATIONAL CORPORATIONS

CAPITAL BUDGETING:

Capital budgeting is a process of evaluating investments and huge expenses in order to obtain the best returns on investment.

An organization is often faced with the challenges of selecting between two projects/investments or the buy vs. replace decision. Ideally, an organization would like to invest in all profitable projects but due to the limitation on the availability of capital an organization has to choose between different projects/investments.

Capital budgeting as a concept affects our daily lives. Let's look at an example-

Your mobile phone has stopped working! Now, you have two choices: Either buy a new one or get the same mobile repaired. Here, you may conclude that the cost of repairing the mobile increases the life of the phone. However, there could be a possibility that the cost to buy a new cell phone would be lesser than its repair costs. So, you decide to replace your cell phone and you proceed to look at different phones that fit your budget.

FEATURES OF CAPITAL BUDGETING:

1) It involves high risk
2) Large profits are estimated
3) Long time period between the initial investments and estimated returns

OBJECTIVES OF CAPITAL BUDGETING:

Capital expenditures are huge and have a long-term effect. Therefore, while performing a capital budgeting analysis an organization must keep the following objectives in mind:

1. Selecting profitable projects:

An organization comes across various profitable projects frequently. But due to capital restrictions, an organization needs to select the right mix of profitable projects that will increase its shareholders' wealth.

2. Capital expenditure control:

Selecting the most profitable investment is the main objective of capital budgeting. However, controlling capital costs is also an important objective. Forecasting capital expenditure requirements and budgeting for it, and ensuring no investment opportunities are lost is the crux of budgeting.

3. Finding the right sources for funds:

Determining the quantum of funds and the sources for procuring them is another important objective of capital budgeting. Finding the balance between the cost of borrowing and returns on investment is an important goal of Capital Budgeting.

FACTORS AFFECTING CAPITAL BUDGETING:

Availability of Funds	Working Capital
Structure of Capital	Capital Return
Management decisions	Need of the project
Accounting methods	Government policy
Taxation policy	Earnings
Lending terms of financial institutions	Economic value of the project

CAPITAL BUDGETING PROCESS:

The process of capital budgeting is as follows:

1. Identifying investment opportunities:

An organization needs to first identify an investment opportunity. An investment opportunity can be anything from a new business line to product expansion to purchasing a new asset. For example, a company finds two new products that they can add to their product line.

2. Evaluating investment proposals:

Once an investment opportunity has been recognized an organization needs to evaluate its options for investment. That is to say, once it is decided that new product/products should be added to the product line, the next step would be deciding on how to acquire these products. There might be multiple ways of acquiring them. Some of these products could be:

- Manufactured In-house
- Manufactured by Outsourcing manufacturing the process, or
- Purchased from the market

3. Choosing a profitable investment:

Once the investment opportunities are identified and all proposals are evaluated an organization needs to decide the most profitable investment and select it. While selecting a particular project an organization may have to use the technique of capital rationing to rank the projects as per returns and select the best option available.

In our example, the company here has to decide what is more profitable for them. Manufacturing or purchasing one or both of the products or scrapping the idea of acquiring both.

4. Capital Budgeting and Apportionment:

After the project is selected an organization needs to fund this project. To fund the project it needs to identify the sources of funds and allocate it accordingly.

The sources of these funds could be reserves, investments, loans or any other available channel.

5. Performance Review:

The last step in the process of capital budgeting is reviewing the investment. Initially, the organization had selected a particular investment for a predicted return. So now, they will compare the investments expected performance to the actual performance.

In our example, when the screening for the most profitable investment happened, an expected return would have been worked out. Once the investment is made, the products are released in the market; the profits earned from its sales should be compared to the set expected returns. This will help in the performance review.

CAPITAL BUDGETING TECHNIQUES:

To assist the organization in selecting the best investment there are various techniques available based on the comparison of cash inflows and outflows.

These techniques are:

1. Payback period method:

In this technique, the entity calculates the time period required to earn the initial investment of the project or investment. The project or investment with the shortest duration is opted for.

2. Net Present value:

The net present value is calculated by taking the difference between the present value of cash inflows and the present value of cash outflows over a period of time. The investment with a positive NPV will be considered. In case there are multiple projects, the project with a higher NPV is more likely to be selected.

3. Accounting Rate of Return:

In this technique, the total net income of the investment is divided by the initial or average investment to derive at the most profitable investment.

4. Internal Rate of Return (IRR):

For NPV computation a discount rate is used. IRR is the rate at which the NPV becomes zero. The project with higher IRR is usually selected.

5. Profitability Index:

Profitability Index is the ratio of the present value of future cash flows of the project to the initial investment required for the project.

Each technique comes with inherent advantages and disadvantages. An organization needs to use the best-suited technique to assist it in budgeting. It can also select different techniques and compare the results to derive at the best profitable projects.

CAPITAL BUDGETING DECISIONS:

The crux of capital budgeting is profit maximization. There are two ways to it; either increase the revenues or reduce the costs. The increase in revenues can be achieved by expansion of operations by adding a new product line. Reducing costs means representing obsolete return on assets.

1. Accept / Reject decision:

If a proposal is accepted, the firm invests in it and if rejected the firm does not invest. Generally, proposals that yield a rate of return greater than a certain required rate of return or cost of capital are accepted and the others are rejected. All independent projects are accepted. Independent projects are projects that do not compete with one another in such a way that acceptance gives a fair possibility of acceptance of another.

2. Mutually exclusive project decision:

Mutually exclusive projects compete with other projects in such a way that the acceptance of one will exclude the acceptance of the other projects. Only one may be chosen. Mutually exclusive investment decisions gain importance when more than one proposal is acceptable under the accept / reject decision. The acceptance of the best alternative eliminates the other alternatives.

3. Capital rationing decision:

In a situation where the firm has unlimited funds, capital budgeting becomes a very simple process. In that, independent investment proposals yielding a return greater than some predetermined level are accepted. But actual business has a different picture. They have fixed capital budget with large number of investment proposals competing for it. Capital rationing refers to the situation where the firm has more acceptable investments requiring a greater amount of finance than that is available with the firm. Ranking of the investment project is employed on the basis of some predetermined criterion such as the rate of return. The project with highest return is ranked first and the acceptable projects are ranked thereafter.

MULTINATIONAL CORPORATIONS:

A multinational corporation is a company that operates in its home country, as well as in other countries around the world. It maintains a central office located in one country, which coordinates the management of all other offices such as administrative branches or factories. It isn't enough to call a company that exports its products to more than one country a multinational company. They need to maintain an operation in other countries and must make a foreign direct investment there.

CHARACTERISTICS OF A MULTINATIONAL CORPORATION:

Not all businesses can be called a multinational corporation. There are certain features that must be met for them to be named as such. The following are the characteristics of multinational corporations:

1. Very high assets and turnover:
To become a multinational corporation, the business must be large and must own a huge amount of assets, both physical and financial. The company's targets are so high that they are also able to make substantial profits.

2. Network of branches:
Multinational companies keep production and marketing operations in different countries. In each country, the business oversees more than one office that functions through several branches and subsidiaries.

3. Control:
In relation to the previous point, the management of the offices in other countries is controlled by one head office located in the home country. Therefore, the source of command is found in the home country.

4. Continued growth:
Multinational corporations keep growing. Even as they operate in other countries, they strive to grow their economic size by constantly upgrading and even doing mergers and acquisitions.

5. Sophisticated technology:
When a company goes global, they need to make sure that their investment will grow substantially. In order to achieve substantial growth, they need to make use of capital-intensive technology, especially in their production and marketing.

6. Right skills:
Multinational companies employ only the best managers who are capable of handling huge funds, using advanced technology, managing workers, and running a huge business entity.

7. Forceful marketing and advertising:
One of the most effective survival strategies of multinational corporations is spending a huge amount of money on marketing and advertising. It is how they are able to sell every product or brand they make.

8. Good quality products:
Because they use capital-intensive technology, they are able to produce top-of-the-line products.

REASONS FOR BEING A MULTINATIONAL CORPORATION:

There is a reason why many companies want to become multinational corporations. Here are some of them:

1. Access to lower production costs:
It is a very common reason for companies to go global because if they set up production in other countries, especially in developing economies, they spend less on production costs. Though outsourcing is a way of doing this, setting up manufacturing plants in other countries may be even cheaper.

2. Proximity to target international markets:
It is beneficial to set up business in countries where the target market of a company is. It helps reduce transport costs, and it gives multinational corporations easier access to consumer feedback and information, as well as to consumer intelligence.

3. Avoidance of tariffs:
When a company produces or manufactures its products in another country where they sell them, they are exempt from import quotas and tariffs.

MODELS OF MULTINATIONAL CORPORATIONS:

The following are the different models of multinational corporations:

1. Centralized:
In the centralized model, companies put up an executive headquarters in their home country and then build various manufacturing plants and production facilities in other countries. Its most important advantage is being able to avoid tariffs and import quotas and take advantage of lower production costs.

2. Regional:
The regionalized model states that a company keeps its headquarters in one country that supervises a collection of offices that are located in various countries. Unlike the centralized model, the regionalized model includes subsidiaries and affiliates that all report to the headquarters.

3. Multinational:
In the multinational model, a parent company operates in the home country and puts up subsidiaries in different countries. The difference is that the subsidiaries and affiliates are more independent in their operations.

ADVANTAGES OF BEING A MULTINATIONAL CORPORATION:

There are many benefits of being a multinational corporation including:

1. Efficiency:
In terms of efficiency, multinational companies are able to reach their target markets more easily because they manufacture in the countries where the target markets are. Also, they can easily access raw materials and cheaper labor costs.

2. Development:
In terms of development, multinational corporations pay better than domestic companies, making them more attractive to the local labor force. They are favored in some way by the government because they also pay local taxes, which help boost the country's economy.

3. Employment:
In terms of employment, multinational corporations hire local workers who know the culture of their place and are thus able to give helpful insider feedback on what the locals want.

4. Innovation:
As multinational corporations employ both locals and foreign workers, they are able to come up with products that are more creative as a result of their convergence.

CAPITAL BUDGETING FOR MULTINATIONAL CORPORATIONS:

The original decisions to undertake an investment in a particular foreign country may be determine by a mix of strategic, behavioral and economic decisions.

The specific project as well as reinvestment decisions, it should be justified by traditional financial analysis.

Multinational capital budgeting like traditional domestic capital budgeting focuses on the cash inflows and outflows associated with prospective long term investment project.

INPUT FOR MULTINATIONAL CAPITAL BUDGETING:

The following forecasts are usually required:

1. Initial capital investment
2. Consumer demand over time
3. Product price over time
4. Fixed cost over time
5. Project lifetime

6. Salvage (liquidation) value
7. Restrictions on fund transfers
8. Tax payments and credits
9. Exchange rate forecasts
10. Required rate of return

FACTORS TO CONSIDER IN MULTINATIONAL CAPITAL BUDGETING:

1. **Uncertain salvage value:** The salvage value typically has a significant impact on the project's NPV and the MNC may want to compute the break even salvage value.
2. **Impact of project on prevailing cash flow:** The new investment may compete with the existing business for the same customers.
3. **Host government incentives:** These should also be considered in the analysis.
4. **Financing arrangement:** Financing costs are usually captured by the discount rate. However, many foreign projects are partially financed by foreign subsidiaries.
5. **Blocked funds:** Some countries may require that the earnings be reinvested locally for a certain period of the before they can be remitted to the parent.
6. **Exchange rate fluctuations:** Since it is difficult to accurately forecast exchange rates, different scenarios can be considered together with their probability of occurrence.
7. **Inflation:** Although price/cost forecasting implicitly considers inflation, inflation can be quite volatile from year to year for some countries.
8. **Financing arrangement:** Financing costs are usually captured by the discount rate. However, when foreign projects are partially financed by foreign subsidiaries a more accurate approach is to separate the subsidiary investment and explicitly consider foreign loan payments as cash outflows.
9. **Real options:** Some projects contain real options for additional business opportunities. The value of such a real option depends on the probability of exercising the option and the resulting NPV.