UNIT 12 COST OF CAPITAL FOR MNCs

Objectives

After going through this unit you should be able to:

- Identify the peculiar features of an MNC from the point of view of cost of capital
- Analyse the forces contributing to differences in cost of capital across countries
- Describe the process of determining the cut off rate for foreign projects appraisal.

Structure

12.1 Introduction

12.2 Cost of Capital for MNCs vis-a-vis Domestic Firms

12.3 Cost of Capital across Countries

12.4 Determining cut-off rate for Foreign Projects Appraisal

12.5 Summary

12.6 Self Assessment Questions

12.7 Further Readings

12.1 INTRODUCTION

The term cost of capital refers to the minimum rate of return that a firm must earn on its investments so as to keep the value of the enterprise in tact. It represents the rate of return which the firm must pay to the suppliers of capital for using their funds. The cost of capital of a firm is mainly used to evaluate investment projects. It represents minimum acceptable rate of return on new investments. The basic factors underlying the cost of capital for a firm are the degree of risk associated with the firm, the taxes it must pay, and the supply of and demand of various types of financing.

The determination of the firm's cost of capital is important because it:

(i) Provides the very basis for financial appraisal of new capital expenditure proposals and thus serves as acceptance criterion for capital expenditure projects,

(ii) Helps the managers in determining the optimal capital structure of the firm,

(iii) Serves as the basis for evaluating the financial performance of top management,

(iv) Helps in formulating dividend policy and working capital policy, and

(v) Can serve as capitalization rate which can be used to determine capitalization of a new firm.

12.2 COST OF CAPITAL FOR MNCS VIS-A-VIS DOMESTIC FIRMS

Although concept of cost of capital and methodology applied to compute it are invariably the same both in case of domestic firms and MNCs, yet they differ in practice because of several peculiar features of an MNC, as outlined below:

Scale of Operations:

MNCs generally being larger in size as compared to the domestic firms may be in a privileged position to garner funds both through stocks and bonds at lower cost because they are accorded preferential treatment due to their size.

Access to International Capital Markets:

In view of easier access to international capital markets, MNCs are in a position to obtain funds at lower cost than that paid by the domestic firms. Further, international availability permits MNCs to maintain the desired ratio, even if substantially large funds are required. This is not true in the case of domestic firms. They have either to rely on internally generated funds or borrow for short and medium-term from commercial banks. Furthermore, subsidiaries may be in a position to procure money locally at a lower cost than that available to the parent company if the prevailing interest rates in the host country are relatively low. For example, the Coca-Cola company, because of its global presence and strong capital position and therefore, having an easy access to key financial markets, could raise funds with a lower effective cost.

International Diversification:

MNCs, by virtue of their diversified operations, are in a better position to reduce their cost of capital in comparison to domestic firms for at least two reasons:

a) A firm with cash inflows pouring in from different sources across the world enjoys relatively greater stability, for the fact that total sales will not be greatly influenced by a single economy. Less cash flow volatility causes the firm to support a higher debt ratio leading to lower cost of capital;

b) International diversification (by country and by product) should lower the systematic risk of the firms, thus lowering its beta coefficient and consequently the cost of equity.

Exposure to Exchange Rate Risk:

Operations of MNCs and their cash flows are exposed to higher exchange rate fluctuations than domestic firms leading to greater possibility of bankruptcy. As a result, creditors and stockholders demand a higher return, which enhances the MNC's cost of capital.

Exposure to Country Risk:

The total country risk of foreign investment, as noted earlier, is greater in the case of foreign investment than in similar domestic investment because of the additional cultural, political and financial risks of foreign investments. Thus, risks increase the volatility of returns on foreign investment, often to the detriment of the MNC. To what extent international diversification minimizes the impact of country-specific and currency-specific risks would depend on the magnitude of capital market segmentation and how widely the firm's investments are locally or globally diversified. Where a firm's investment is concentrated in a local economy and markets are partially segmented from other capital markets, country-specific and currency-specific risks cannot be diversified and hence the firm's exposure to these risks cannot be eliminated. In contrast, a firm with globally diversified investors especially in integrated financial markets can eliminate these risks and the cost of capital of such firm will obviously be low. According to a large body of literature, MNCs have lower systematic risks in relatively integrated financial markets, such as the UK and the USA than comparable domestic companies, presumably, due to benefits of international diversification.

The above factors that distinguish between cost of capital of an MNC and that of a domestic firm are exhibited in Figure 12.1. In general, the first three factors

listed below, viz; (scale, access to international capital markets, and international diversification) are favourable factors for an MNC resulting in reduced cost of capital, while the last two factors (exchange rate risk and country risk) are unfavourable, and are likely to result in increase in cost of capital.

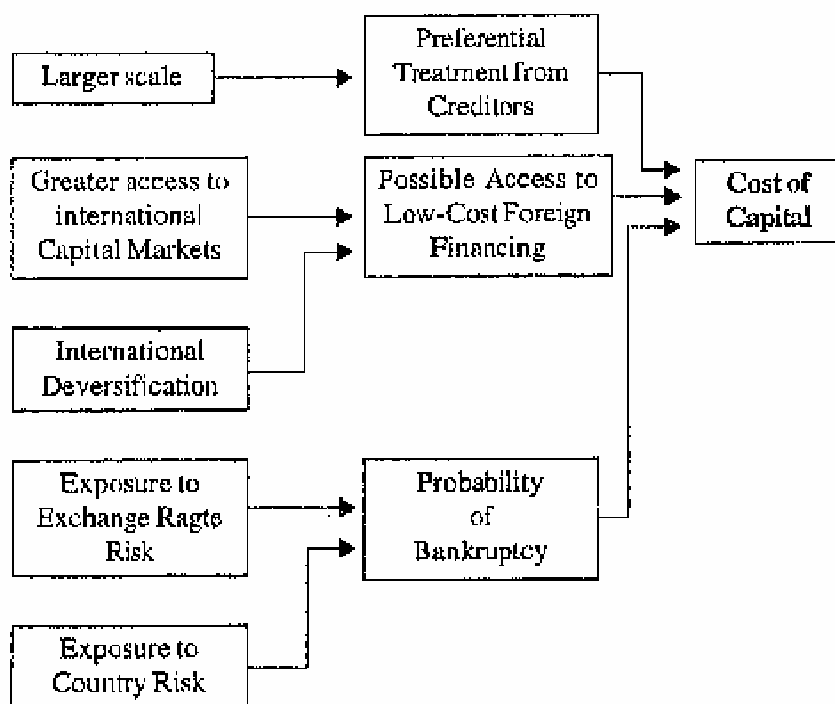

Figure 12.1: Summary of factors contributing to difference between cost of capital of MNC and that of a domestic firm

In sum, it is difficult to generalize that MNCs have always cost of capital lower than their domestic counterparts. Each MNC should evaluate the implications of each of these factors on the cost of capital and determine the net impact on overall cost of capital.

12.3 COSTS OF CAPITAL ACROSS COUNTRIES

An understanding of why cost of capital varies across different countries provides an insight into the reasons for competitive superiority of some MNCs in some countries. Knowledge of differences in cost of capital in different countries may enable an MNC to formulate suitable strategy regarding procurement of funds from those countries where they are available at lower cost. An appreciation of cost of capital across the globe can throw light on the differences existing in the pattern of capitalization of different MNCs.

As such, the following paragraphs are devoted to discussion of country differences in the cost of debt and cost of equity.

Country Differences in the Cost of Debt:

Cost of debt to an MNC is the function of two variables, viz; risk-free rate of interest in the currency borrowed and the premium for additional risk required by creditors. Since risk-free interest rate and risk premium differ from country to country, cost of capital will not be the same in different countries. There are various reasons for country differences in the risk-free rate and in the risk premium.

Country Differences in the Risk free Rate: Differences in the risk-free interest rate in different countries depend on supply of and demand for funds. A

host of factors such as tax laws, demographics, monetary policies and state of economy influence supply of and demand for funds.

Tax laws in different countries differ in terms of tax rate, exemption and incentives, thus influencing differently the supply of funds to the corporate sector and hence the interest rate. Corporate demand for funds may also vary because of provisions of depreciation and investment tax credits and consequently interest rate differs.

Demographic condition of a country impacts demand and supply of funds and thereby the interest rate. A country with a majority of population being younger will have higher interest rate, for the fact that youngsters are relatively less thrifty and demand more money to satisfy their varied needs.

Monetary policy of Central bank of a country directly influences interest rate at which funds can be borrowed by MNCs. The Central bank following tight monetary policy to curb inflationary tendencies in the country will raise bank rate and hence the interest rate.

Because of varying levels of economic development, interest rates differ across countries. Thus, in relatively advanced countries and so also highly developed and integrated financial markets interest rate on debt is always lower than the less developed nations.

Country Differences in the Risk Premium: *Amount* of premium to compensate for the risk arising out of borrowers' inability to repay the loan differs from country to country, depending on economic conditions, relationships between corporations and creditors, government intervention, and degree of financial leverage.

In case of economic stability, possibility of the country experiencing recession is relatively low and so also the borrowers defaulting in repayment. Under such a situation, risk premium is likely to be low.

Risk premium will be relatively lower in countries where the relationships between corporations and creditors are very cordial, as in Japan, the latter having greater concern for the former's financial health and always ready to help their client to get over the illiquidity crisis. In such a situation amount of risk premium will be less.

Governments in some countries like the UK and India intervene actively to rescue failing firms, particularly those partly owned by them and provide all kinds of financial support to them. However, in the USA, the probability of Government intervention to rescue firms from incipient sickness is low. Hence, risk premium in the case of the former will be lower than the latter.

Risk premium also differs across countries because of varying degree of financial leverage of firms in those countries. For instance, firms in Japan and Germany have a higher degree of financial leverage than firms in the USA. Obviously, the high leverage firms would have to pay a higher risk premium, with other factors being equal. In fact, the reason for higher leverage of the firm is their unique relationship with creditors and governments.

Country Differences in the Cost of Equity:

Cost of equity representing opportunity cost is a risk-free interest rate that the shareholders could have earned on the investment, plus a premium to reflect the risk of the firm. As risk-free interest rates, noted above, vary among countries, the costs of equity obviously differ among countries.

In countries with tremendous investment opportunities offering higher interest rates, cost of equity will be higher in comparison to those countries with limited business opportunities. According to Mc Cauley and Zimmer, country's cost of

equity can be estimated by first applying the price/earnings multiple to a given stream of earnings.

The cost of capital is related to the price-earnings multiple. A high price-earnings multiple signifies that the firm receives a high price when selling new stock for a given level of earnings and hence the cost of equity financing is low. There is however, need to adjust to the price-earnings multiples for the effects of a country's inflation, earnings growth and other factors.

Combining the Costs of Debt and Equity:

The costs of debt and equity can be combined to obtain an overall cost of capital after providing weightage to debt and equity in terms of their respective proportions. The weighted cost of capital so computed will tend to be comparatively lower for firms situated in countries like Japan which is known for relatively low risk-free interest rate. Further, the price-earnings multiples of Japanese firms are generally high which allow them to garner equity share capital at a relatively low cost.

12.4 DETERMINING CUT OFF RATE FOR FOREIGN PROJECT APPRAISAL

Cut-off rate is the minimum rate of return that must be earned on a foreign project if the firm's value has to be maintained. Determining the cut-off rate is therefore, imperative for assessing viability of a foreign project.

Although overall cost of capital forms the basis for setting cut-off rate, certain adjustments have to be made in the cost of capital to find the project-specific cut-off rate. These adjustments are made for the exchange risk, political risk, segmentation of capital markets and international diversification effect.

Adjusting for ***the Exchange Risk:*** The cost of capital of a foreign project may be adjusted by the average rate of appreciation (depreciation) of the host country's currency during the life of the project. In case of appreciation of home country currency against the host country currency, cost of capital will be adjusted downward.

Adjusting for the Political Risk: Risk premium to be incorporated in the cost of capital for a project in a country with high political risk will have to be higher than in the case of country with lower political risk.

Adjusting for Segmentation *of* ***Capital Markets:*** Segmentation of capital markets, caused by government control on the flow of capital across boundaries and the existence of varying degrees of depth and development of capital markets in different countries and dearth of accurate information on investment and lending opportunities in different markets, influences the cost of capital of an MNC upward or downward.

Cost of capital for a project in a segmented host country capital market has to be adjusted downward because restrictions are clamped on capital outflow resulting in availability of funds in the host country at lower interest rate than the one in the MNC's home country.

At times, segmentation of capital markets may lead to higher cost of capital than if such markets were fully integrated. A unique form of segmentation in many countries takes the form of non-availability or limited availability of equity financing. Many US MNCs find it difficult to procure substantial amounts of equity fund even from industrialized countries, except the UK. Investors of these countries are reluctant to invest in equity shares of foreign companies. Many of them are not fully aware of MNCs' shares in their country's market, Other

hurdles that render raising equity capital from some countries difficult and costly are government controls on purchase of foreign shares, problem of listing on foreign shares, problem of listing on foreign stock exchanges and stiff and lengthy registration and disclosure requirements.

In view of the above, an MNC finance manager has to decide carefully as to what would be suitable cut-off rate for the purpose of evaluation.

Adjusting For ***the International Diversification*** *Effect:* The beneficial impact of international diversification is reflected in reduced exchange rate and country risks. As such risk premium for a project in case of an MNC having portfolio of subsidiaries across different countries tends to be relatively lower. Ostensibly,

cost of capital in such a case will be adjusted upward with lower amount of risk premium.

Recent empirical studies have proved that despite the favourable effect of international diversification of cash flows, bankruptcy risk was only about the same for MNCs as for domestic firms. However, MNCs faced higher agency costs, political risk, foreign exchange risk, and asymmetric information. These have been identified as the factors leading to lower debt ratios and even a higher cost of long-term debt for MNCs.

Activity I

a) Select three MNCs operating in India and three domestic companies, find out their overall Cost of Capital and make your comment thereon.

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b) Why is cost of capital in economically stable country lower than the on experiencing oscillations?

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12.5 SUMMARY

The term `cost of capital' refers to the minimum rate of return that a firm must earn on its investments so as to keep the value of the enterprise in tact. It represents the rate of return which the *firm* must pay to the suppliers of capital for using their funds. Though concept of cost of capital and methodology applied to compute it are invariably the same both in case of domestic firms and MNCs, yet they differ in practice because of several peculiar features of an MNCs, Knowledge of differences in cost of capital in different countries may enable an MNC to formulate suitable strategy regarding procurement of funds from those countries where they are available at lower cost. Cut-off rate is the minimum rate *of* return that must be earned on a foreign project if the firm's value has to be maintained. Determining the cut-off rate is therefore, imperative for assessing viability of ,a foreign project. Although overall cost of capital forms the basis for setting cut-off rate, certain adjustments have to be made in the cost of capital to find the project-specific cut-off rate. These adjustment are made for the exchange risk, political risk, segmentation of capital markets and international diversification effect.

12.6 SELF ASSESSMENT QUESTIONS

1). Why does cost of capital for MNCs differ from that for domestic firms?

2). How does internationally diversified operations of an MNC affect its cost of capital?

3). Why is cost of capital different across countries?

4). List out the factors contributing to differences in the risk-free rate and risk premium.

5). How would you set cut-off rate of an MNC for evaluating a foreign project? What specific adjustments are required to be made?

12.7 FURTHER READINGS

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