

MULTINATIONAL CAPITAL BUDGETING

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Abstract

Capital budgeting is one of the areas that have attracted a lot of academic attention during the last decades and a lot of descriptive literature has emerged. Capital budgeting decision of the firm is of strategic importance not only for the growth of the firm but for the overall growth of the economy because such decisions involve the firm committing its limited productive resources to its production system as they strengthen or renew their resources. Therefore capital budgeting involves how resources should be allocated in the firm in order to maximise the shareholder's wealth capital budgeting decisions involves commitment of large amounts of money on a given project, and such decisions are hard to reverse without disturbing the organisation economically and financially. This paper report results of a survey on the capital budgeting practices in Spartan. This paper presents impact of capital budgeting in multinational corporations.

Introduction

Multinational corporations evaluate international projects by using multinational capital budgeting, which compares the benefits and costs of these projects. Given that many MNCs spend more than \$100 million per year on international projects, multinational capital budgeting is a critical function. Many international projects are irreversible and cannot be easily sold to other corporations at a reasonable price. Proper use of multinational capital budgeting can identify the international projects worthy of implementation.

The most popular method of capital budgeting involves determining the project's net present value by estimating the present value of the project's future cash flows and subtracting the initial outlay required for the project. Multinational capital budgeting typically uses a similar process. However, special circumstances of international projects that affect the future cash flows or the discount rate used to discount cash flows make multinational capital budgeting more complex. Financial managers must understand how to apply capital budgeting to international projects, so that they can maximise the value of the MNC. (Madura, Jeff, "International Financial Management").

Objectives

- To identify the international projects worthy for implementation.
- To expand the business beyond the boundaries of the home country.
- Avail of competitive advantage internationally.
- Establish an international corporate image (www.toppers4u.com).

Research Methodology

The given the research paper is based on secondary data. The secondary data collected from various references books such as international financial management, fundamentals of financial management etc. Under this research study, the secondary data is also collected from the different National and international journals that are related to multinational capital budgeting. The present study relating to various objectives as explained below by the review of literature on the subject concerned. The literature was collected by visiting libraries and concerned websites.

Review of literature

Capital budgeting is one of the most important decisions faced by the financial management of any organisation (Batra & Verma, 2014). Capital budgeting is the process of valuing and choosing investments projects to allocate firm's capital. It has been widely discussed in the conventional finance literature, where it documented that the underlying methodology of investment decisions making has shifted from relying mainly on business experience and intuition (Pollard, 1965) into incorporating the use of sophisticated financial management techniques (Haka, 2007). Capital budgeting is a tool that can be used for very simple operational decisions such as equipment replacement or more complex strategies such as the construction of a new plant (Leon et al., 2008). In any case when considering the importance of capital investments decisions, it is imperative that managers use the appropriate practice to ensure a sound decision. (Toit & Pienaar, 2005).

Input for MNC Capital Budgeting

Regardless of the long-term project to be considered, an MNC will normally require forecasts of the economic and financial characteristics related to the project. Each of these characteristics is briefly described here:

1. Initial Investment.

The parent's initial investment in a project may constitute the major source of funds to support a particular project. Funds initially invested in a project may include not only whatever is necessary to start the project but also additional funds, such as working capital, to support the project over time.

Such funds are needed to finance inventory, wages, and other expenses until the project begins to generate revenue. Because cash inflows will not always be sufficient to cover upcoming cash outflows, working capital is needed throughout a project's lifetime.

2. Price and consumer demand.

The price at which the product could be sold can be forecasted using competitive products in the markets as a comparison. A long-term capital budgeting analysis requires projections for not only the upcoming period but the expected lifetime of the project as well.

When projecting a cash flow schedule, an accurate forecast of consumer demand for a project is quite valuable, but future demand is often difficult to forecast. For example, if the project is a plant in Germany that produces automobiles, the MNC must forecast what percentage of the auto market in Germany it can pull from prevailing auto producers. Once a market share percentage is forecasted, projected demand can be computed. In addition, many projects reflect a first attempt, so there are no predecessors to review as an indicator of the future.

3. Costs.

Like the price estimate, variable-cost forecasts can be developed from assessing prevailing comparative costs of the components. Such costs should normally move in tandem with the future inflation rate of the host country. Even if the variable cost per unit can be accurately predicted, the projected total variable cost may be wrong if the demand is inaccurately forecasted.

4. Tax laws.

The tax laws on earnings generated by a foreign subsidiary or remitted to the MNC's parent vary among countries. Under some circumstances, the MNC receives tax deductions or credits for tax payments by a subsidiary to the host country. Withholding taxes must also be considered if they are imposed on remitted funds by the host government.

5. Remitted funds.

In some cases, a host government will prevent a subsidiary from sending its earnings to the parent. These restrictions may reflect an attempt to encourage additional local spending or to avoid excessive sales of the local currency in exchange for some other currency. Sometimes, however, the host government adjusts its restrictions over time, in that case, the MNC can only forecast the future restrictions and incorporate these forecasts into the analysis.

6. Exchange rates.

Any international project will be affected by exchange rate fluctuations during the life of the project, but these movements are often very difficult to forecast. While it is possible to hedge over longer periods, the MNC has no way of knowing the amount of funds that it should hedge. This is because it is only guessing at its future costs and revenue due to the project. Thus, the MNC may decide not to hedge the projected foreign currency net cash flows.

7. Salvage value.

The after-tax salvage value of most projects is difficult to forecast. It will depend on several factors, including the success of the project and the attitude of the host government toward the project. As an extreme possibility, the host government could take over the project without adequately compensating the MNC.

8. Required rate of return

Once the relevant cash flows of a proposed project are estimated, they can be discounted at the project's required rate of return, which may differ from the MNC's cost of capital because of that particular project's risk.

(<http://faculty.tamucc.edu>)

Multinational Capital Budgeting Example

Capital budgeting for the MNC is necessary for all long-term projects that deserve consideration. The projects may range from a small expansion of a subsidiary division to the creation of a new subsidiary. It explains with the example involving the possible development of new subsidiary. It begins with assumptions that simplify the capital budgeting analysis.

This example illustrates one of many possible methods available that would achieve the same result. Also, keep in mind that a real-world problem may involve more extenuating circumstances than those shown here.

BACKGROUND:

Spartan, inc. is considering the development of a subsidiary in Singapore that would manufacture and sell tennis rackets locally. Spartan's management has asked various departments to supply relevant information for a capital budgeting analysis. In addition, some Spartan executives have met with government officials in Singapore to discuss the proposed subsidiary. The project would end in 4 years. All relevant information follows.

1. **Initial Investment.** Estimated 20million Singapore dollars, which includes funds to support working capital, would be needed for the project. Given the existing spot rate of \$.50per Singapore dollar, the U.S dollar amount of the parent's initial investment is \$10 million.

2. **Price and demand.** The estimated price and demand schedules during each of the next 4 years are shown here:

	Year 1	Year 2	Year 3	Year 4
Price per Racket	S\$350	S\$350	S\$360	S\$380
Demand in Singapore	60,000units	60,000units	100,000units	100,000units

3. **Costs.** The variable costs (for materials, labour, etc.) per unit have been estimated and consolidated as shown here:

	Year 1	Year 2	Year 3	Year 4
Variable Cost per Racket	S\$200	S\$200	S\$250	S\$260

The expenses of leasing extra office space are S\$1 million per year. Other annual overhead expenses are expected to be S\$1 million per year.

4. **Depreciation.** The Singapore government will allow Spartan's subsidiary to depreciate the cost of the plant and equipment at a maximum rate of S\$2 million per year, which is the rate the subsidiary will use.
5. **Taxes.** The Singapore government will impose a 20% tax rate on income. In addition, it will impose a 10% withholding tax on any funds remitted by the subsidiary to the parent.
The U.S government will allow a tax credit on taxes paid in Singapore; therefore, earnings remitted to the U.S parent will not be taxed by the U.S government.
6. **Remitted funds.** The Spartan subsidiary plans to send all net cash flows received back to the parent firm at the end of each year. The Singapore government promises no restrictions on the cash flows to be sent back to the parent firm but does impose a 10% withholding tax on any funds sent to the parent, as mentioned earlier.
7. **Salvage value.** Most MNC's across the globe allocate resources in a way that reflects the business environment of the host countries. This implies that multinational companies invest in unpredictable markets such as telecommunications and manufacturing industries, they budget their capital with a view to cover the uncertain salvage value (Nguyen, 2019). The Singapore government will pay the parent S\$12 million to assume ownership of the subsidiary at the end of 4 years. Assume that there is no capital gain tax on the sale of the subsidiary.
8. **Exchange rate.** The spot exchange rate of the Singapore dollar is \$.50. Spartan uses the spot rate as its best forecast of the exchange rate will exist in future periods. Thus, the forecast exchange rate for all future periods is \$.50.
9. **Required rate of return.** Spartan, Inc. requires a 15% return on this project.
(<http://www.studyandjobs2.net>)

ANALYSIS

The capital budgeting analysis will be conducted from the parent's perspective, based on the assumption that the subsidiary is intended to generate cash flows that will ultimately be passed on to the parent. Thus, the net present value (NPV) from the parent's perspective is based on a comparison of the present value of the cash flows received by the parent to the initial outlay by the parent. An international project's NPV is dependent on whether a parent or subsidiary perspective is used. Since the U.S parent's perspective is used, the cash flows concerns are the dollars ultimately received by the parent as a result of the project. The required rate of return is based on the cost of capital used by the parent to make its investment, with an adjustment for the risk of the project. For the establishment of the subsidiary to benefit Spartan's parent, the present value of future cash flows (including the salvage value) ultimately received by the parent should exceed the parent's initial outlay.

Factors to consider in Multinational Capital Budgeting

The example of Spartan, Inc. ignored a variety of factors that may affect the capital budgeting analysis, such as:

1. **Exchange Rate Fluctuations**
Spartan, Inc., uses the Singapore dollar's current spot rate (\$.50) as a forecast for all future periods of concern. The company realizes that the exchange rate will typically change over time, but it does not know whether the Singapore dollar will strengthen or weaken in the future. Though the difficulty in accurately forecasting exchange rates is well known, a multinational capital budgeting analysis could at least incorporate other scenarios for exchange rates movements, such as pessimistic scenario and an optimistic scenario. From the parent's point of view, appreciation of the Singapore dollar would be favourable since the Singapore dollar inflows would someday be converted to more U.S dollars. Conversely, depreciation would be unfavourable since the weakened Singapore dollars would convert to fewer U.S dollars over time.
2. **Inflation**
Capital budgeting analysis implicitly considers inflation, since variable cost per unit and product prices generally have been rising over time. In some countries, inflation can be quite volatile from year to year and can therefore strongly influence a project's net cash flows. In countries where the inflation rate is high and volatile, it will be virtually impossible for a subsidiary to accurately forecast inflation each year. Inaccurate inflation forecasts can lead to inaccurate net cash forecasts.
3. **Blocked funds**
In some cases, the host country may block funds that the subsidiary attempts to send to the parent. Some countries require that earnings generated by the subsidiary be reinvested locally for at least 3 years before they can be remitted. Such restrictions can affect the accept/reject decisions on a project.
4. **Host Government Incentives**
Foreign projects proposed by MNCs may have a favourable impact on economic conditions in the host country and are therefore encouraged by the host government. Any incentives offered by the host government must be incorporated into the capital budgeting analysis. For example, a low-rate host government loan or a reduced tax rate offered to the subsidiary will enhance periodic cash flows. If the government subsidizes the initial establishment of the subsidiary, the MNC's initial investment will be reduced.
5. **Real Options**
A real option is an option on specified real assets such as machinery or a facility. Some capital budgeting projects contain real options in that they may allow opportunities to obtain or eliminate real assets. Since these opportunities can generate cash flows, they can enhance the value of a project.

Conclusion

Projects will usually be evaluated using NPV or IRR, but multinational corporations are also likely to use other techniques, such as the payback method. There is no dominant method for estimating the growth rate when computing future values, but NPV or IRR are quite popular choices. Capital budgeting is the part of the budget process that focuses on resource plans for building new facilities, renovating existing facilities, buying major pieces of equipment, or improving the multinational infrastructure.

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