CHAPTER 17

Corporate Strategy and Foreign Direct Investment

Opening Case 17: How Can Companies Get the Most Out of Their Foreign Investment?

We can classify the benefits of foreign direct investment into two broad categories: tangible and intangible. Some benefits, such as reductions in labor, capital, and logistics costs, are tangible and easy to measure; others, such as new ideas from foreign research centers, customers, and suppliers, are intangible and difficult to measure. If foreign manufacturing operations play a negligible strategic role, the tangible benefits usually dominate the decision to manufacture abroad. As a company upgrades the strategic role of its foreign manufacturing operations, however, it stresses the intangible benefits more.

Many multinational companies (MNCs) establish and manage their foreign plants only for the benefits of tax concessions, cheap labor, and capital subsidies. However, Ferdows (1997) argues that higher market share and greater profits can only be achieved if both tangible and intangible benefits are realized. When an MNC employs a foreign plant to produce intangible benefits, the plant will have a better chance to be innovative, to be productive, to achieve low costs, and to provide exemplary service to customers throughout the world. To get more out of its foreign factories, therefore, the MNC should use them to get closer to their customers and suppliers, to attract skilled and talented employees, and to create centers of expertise for the entire company.

Some companies indeed invest abroad to seek technology, managerial expertise, and other intangible benefits. For example, German, Japanese, and Korean companies have purchased US-based electronics firms for their technology. Take a look at LG's acquisition of Zenith as an example. On July 17, 1995, LG Electronics of Korea acquired Zenith, the last remaining TV manufacturer in the United States, to obtain its HDTV and multimedia technologies. This is because changes in international competitiveness had compelled LG to engage in its own aggressive research and development.

Source: K. Ferdows, "Making the Most of Foreign Factories," *Harvard Business Review*, Mar./Apr. 1997, p. 82.

Direct investments are equity investments such as the purchase of common stock, the acquisition of entire firms, or the establishment of new subsidiaries. The US Department of Commerce defines **foreign direct investment (FDI)** as investment in either real capital assets or financial assets with a minimum of 10 percent equity ownership in a foreign firm. Most MNCs invest overseas directly for a variety of reasons. Chapter 2 discussed key economic motives for overseas direct investment. This chapter discusses several practical issues of FDI in three sections. The first section describes the overall concept of FDI. The second section covers inflows of FDI to developing countries. The third section considers cross-border mergers and acquisitions.

17.1 An Overview of Foreign Direct Investment

Decisions on capital expenditures involve the allocation and commitment of funds to investment projects whose returns are expected to extend beyond 1 year. Such investments usually require very large sums of money and are made in expectation of benefits over an extended period. Capital investment decisions are not readily reversible once they are made. Used plants and most used equipment in foreign countries have limited markets. In certain areas, production methods are rapidly outdated by increasingly higher levels of technology. Moreover, foreign investments are much riskier than domestic investments. Thus, the rational use of capital resources is critical for the future well-being of an MNC.

17.1.1 The benefits of foreign investment

Company Benefits MNCs invest their capital abroad to utilize their oligopoly-created advantages. These advantages include proprietary technology, management know-how, multinational distribution networks, access to scarce raw materials, production economies of scale, financial economies of scale, and possession of a strong brand or trade name. The use of such oligopolistic advantages could enable an MNC to reduce its cost of capital and to increase its profitability, thereby increasing the value of the firm.

Host-Country Benefits There are three basic forms of cross-border financial flows: portfolio investment, FDI, and bank lending. FDI forms one of the most important links between developing and industrial countries because it is stable. For example, FDI flows to Southeast Asia had proved to be much more stable than other forms of financial flows during the Asian financial crisis of 1997–8.

Host countries, particularly developing countries, can benefit from FDI in many ways:

1 Foreign investment induces the transfer of technology and skills that are frequently in short supply.
2 It increases both national employment and domestic wages.
3 It provides local workers with an opportunity to learn managerial skills.
4 It contributes to tax revenues and helps balance the international balance of payments.

17.1.2 *Arguments against foreign investment*

Although foreign investment tends to contribute much needed resources to host countries, developing countries in particular many view it with misgivings. There are many arguments against foreign investment. Most of these arguments have to do with conflicts between company goals and host-government aspirations:

1 Foreign investment brings about the loss of political and economic sovereignty.
2 It controls key industries and export markets.
3 It exploits local natural resources and unskilled workers.
4 It undermines indigenous cultures and societies by imposing Western values and lifestyles on developing countries.

It seems that, while FDI has the potential to contribute positively to development, there is no guarantee that it will have no harmful impact on host countries. The question of foreign investment, however, need not be a zero-sum game. A feasible framework for investment must be set up to define the rights and responsibilities of both parties. This framework should allow for a reasonable return to the investor and positively contribute to the development of a host country.

17.1.3 *How to invest abroad: modes of foreign investment*

When a company decides to invest its money abroad, it has seven distinct alternatives available: construction of new plants, mergers and acquisitions, joint ventures, equity alliances, licensing agreements, franchising agreements, and contract manufacturing.

CONSTRUCTION OF NEW PLANTS (INTERNAL GROWTH) Companies can penetrate foreign markets by establishing new operations in foreign countries to produce and sell new products. Some companies may prefer this internal growth because they can tailor their foreign operations to their exact needs. For example, General Motors had spent several years determining the market size for its cars in China before the company decided to build a $1 billion auto assembly plant in the country. Such a demand forecast or potential market size depends on many factors, such as competition, income, population, economic conditions, and the feasibility of serving nearby foreign markets. However, it would take some time for MNCs to reap any rewards from internal growth, because they have to build a plant and establish a customer base first. We discuss this type of foreign investment in detail in chapter 18.

Mergers and Acquisitions (External Growth) Although internal growth is usually natural and economical, the process of growth may be too slow. These days, many MNCs acquire other firms in foreign countries to penetrate foreign markets rather than building factories that may take years to complete. Some companies purchase parts of foreign firms to obtain a stake in foreign operations. In many cases, MNCs acquire foreign firms to obtain the instant access to the market that they serve and to reduce their competitors. For example, in December 1998, British Petroleum purchased Amoco of the United States to expand their US market share and to reduce one of its major US competitors. We discuss cross-border mergers and acquisitions in detail in the second half of this chapter.

The Joint Venture A joint venture is owned by two or more firms. Sometimes the owners of a joint venture are from several different countries. Many MNCs penetrate foreign markets by forming a joint venture with companies that reside in those markets. Most joint ventures permit two companies to use their respective comparative advantages in a given project. For example, General Mills of the USA and Nestlé of Switzerland formed a joint venture so that the cereals produced by General Mills could be sold through the huge global distribution network established by Nestlé.

The basic advantage of a joint venture is that it enables a company to generate incremental revenue or cost savings. A joint venture, however, normally faces many complex problems. Because representatives of both companies sit on the board of directors, it is difficult to forge a consensus, especially when an MNC and host-country firms form a joint venture. Nevertheless, these days international joint ventures crop up everywhere. The rush of new technology, the expense of staying on the leading edge, the demands of customers, and worldwide competition have required many MNCs to form a wide range of joint ventures and partnerships.

Equity Alliances An alliance whereby one company takes an equity position in another company is known as an **equity alliance**. In some cases, each party takes an ownership in the other. The purpose of the equity ownership is to solidify a collaborative contract so that it is difficult to break, particularly if the ownership is large enough to secure a board membership for the investing company. The airline industry epitomizes the use of equity alliances. IBM maintains more than 500 equity alliances around the world.

Licensing Agreements Under a **licensing agreement**, an MNC (the licensor) allows a foreign company (the licensee) to produce its products in a foreign country in exchange for royalties, fees, and other forms of compensation. MNCs can set up their own production facilities abroad or license a local firm to manufacture their products in return for royalties. AT&T has a licensing agreement to build and operate part of India's telephone system. Sprint Corp. has a licensing agreement to develop telecommunications services in England.

Advantages to a licensor include: (1) a relatively small amount of investment, (2) an opportunity to penetrate foreign markets, (3) lower political and financial risks, and (4) an easy way to circumvent foreign market entry restrictions. Benefits to a licensee include: (1) a cheap way to obtain new technology, (2) an easy way to diversify into other product lines, and (3) an opportunity to capitalize on its unique positions, such as the channels of distribution, the financial resources, and the marketing know-how.

Like all aspects of good business, successful licensing requires management and planning. Because there is no global clearinghouse for technology, the matching process stretches around the world, with a wide variety of intermediaries. The process is further complicated because of politics, international laws, different cultures, and global secrecy. Consequently, a continuous stream of profitable licensing agreements comes from hard thinking, good planning, and large outlays for research and development.

FRANCHISING AGREEMENTS Under a **franchising agreement**, an MNC (franchiser) allows a foreign company (franchisee) to sell products or services under a highly publicized brand name and a well-proven set of procedures. Under this arrangement, the franchiser allows the franchisee not only to sell products or services but also assists on a continuing basis in the operation of the business.

Franchising is most associated with the USA and accounts for about one third of US retail sales. Some 500 US franchisers have approximately 50,000 outlets worldwide. Fast-food operations, such as McDonald's, Kentucky Fried Chicken, and Dunkin Donuts, are the most numerous. For example, McDonald's alone has almost 10,000 restaurants in 100 countries. Other types of franchisers are hotels (Hilton), soft drinks (Coca Cola), clerical services (Kelly Services), and automotive products (Midas).

CONTRACT MANUFACTURING In **contract manufacturing**, an MNC contracts with a foreign manufacturer to produce products for them according to their specifications. The contract manufacturer does not market the products that it produces. Instead, the MNC markets the products under its own brand name, just as Wal-Mart sells a variety of products made by contract manufacturers under its own brand name. Thus, the buying public normally does not realize that the selling company has not actually produced the product. Sometimes, MNCs subcontract assembly work or the production of parts to independent companies overseas.

17.2 Foreign Direct Investment in Developing Countries

Table 17.1 shows that in 2003, for the first time, China attracted more foreign investment than the USA. A survey by consulting firm A. T. Kearney of more than 150 chief executives predicted that China would remain the world's hottest destination for foreign investment in the near future. Because of the rush to China, Asia is for the first time likely to overtake Europe as an investment destination, said Kearney. Worldwide, foreign direct investment fell 21 percent in 2003 from 2002 as economies around the world, with the exception of China and a few others, grew slowly or not at all.

FDI into the USA fell from $70 billion in 2002 to $40 billion in 2003, down 87 percent from the peak in 2000. Reduced capital flows into the USA can cut the value of the dollar and lead to higher interest rates. It also can slow expenditures on technology and improvements that help boost productivity and corporate profits. China's huge investment inflows come at a sensitive time for relations with the biggest trading partners. The USA, Japan, and Europe have criticized China recently for its fixed exchange rate, which some economists believe takes jobs from other countries and artificially cuts the costs of its exports by significantly undervaluing its currency.

The flow of equity-related finance to developing countries takes two forms: portfolio investment and direct investment. Figure 17.1 shows that combined inflows of both forms totaled a

Table 17.1 Foreign direct investment (billions of US dollars)

	2000	*2001*	*2002*	*2003*
World	$1,393.0	$823.8	$651.2	$512.0
USA	314.0	144.0	72.0	40.0
China	40.8	46.8	53.7	53.0

Source: *USA Today*, Sept. 5, 2003, p. 3B; and *The Wall Street Journal*, June 28, 2004, p. A2.

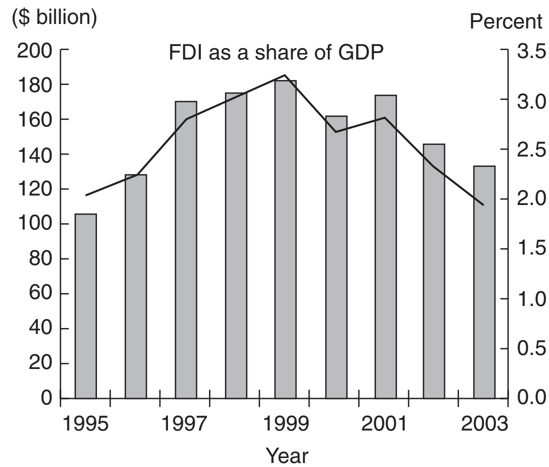


Figure 17.1 Net inward FDI flows to developing countries, 1995–2003
Source: The World Bank, *Global Development Finance*, 2004, p. 78.

net of about $135 billion in 2003, down from $178 billion in 2001 and from their peak of $196 billion in 1997.

Figure 17.2 shows that net FDI flows to developing countries have fallen sharply since 2001. The decline in FDI flows to developing countries was associated with a slowdown in privatization and mergers-and-acquisitions transactions (figure 17.3). Despite the overall decline in FDI flows to developing countries and another rise in the share of FDI accounted for by China, there was a decline in the overall concentration. The dip in FDI flows in 2003 was almost entirely due to the decline in flows to Latin America and the Caribbean. Three factors accounted for that decline. First, the regional recession undermined incentives to invest in the region. Second, no large mergers and acquisitions of the kind that inflated the inflows numbers in recent years occurred in 2003. Finally, the process of privatization has moved toward completion. It also appears that the Iraq conflict and severe acute respiratory syndrome (SARS) had a limited impact on FDI in 2003.

The downturn in FDI flows to developing countries occurred against even sharper decline in global FDI flows in 2003. As a result, developing countries' share in global FDI flows actually rose. However, when viewed against the plunge in debt outstanding to private-sector creditors,

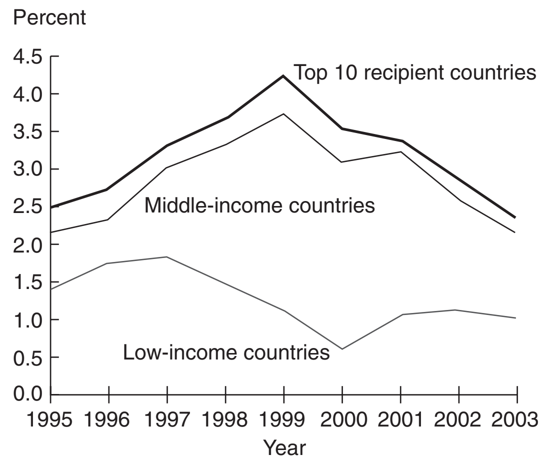


Figure 17.2 FDI as the share of GDP in developing countries, 1995–2003
Source: The World Bank, *Global Development Finance*, 2004, p. 79.

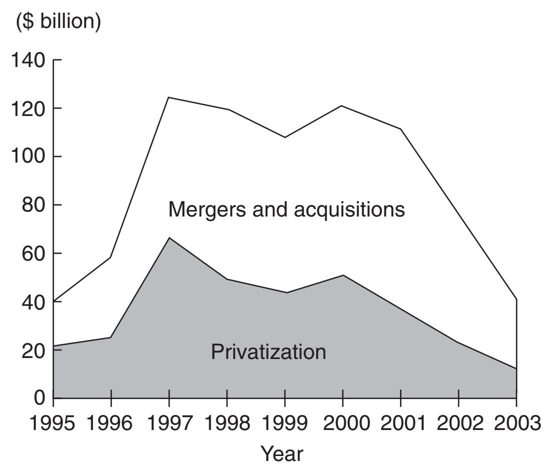
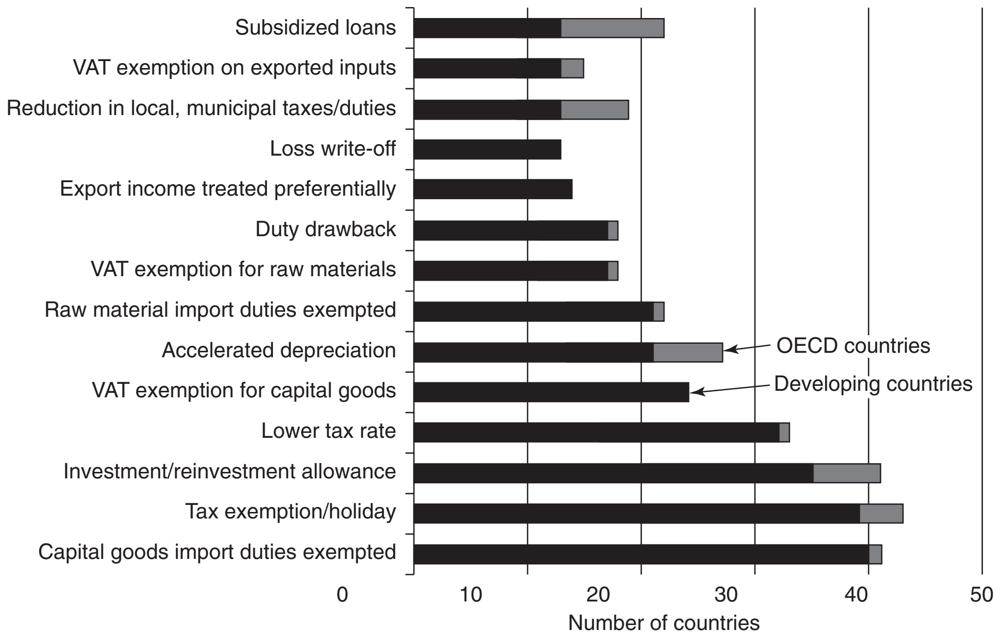


Figure 17.3 Privatization and M&A in developing countries, 1995–2003
Source: The World Bank, *Global Development Finance*, 2004, p. 79.

discussed in chapter 12, the flow of private-sector equity-related capital appears remarkably robust.

17.2.1 An improved investment climate

Perhaps the best way of improving a country's investment climate is to remove obstacles that impede foreign investment, although many are unavoidable, inadvertent, or unintended. Bad



Note: VAT is value added tax. Data on fiscal and financial incentives were compiled for 71 developing and 20 OECD countries. The most common incentives (used in at least 18% of developing countries) are shown in the chart.

Figure 17.4 Incentives for foreign direct investment

Source: The World Bank, *Global Economic Prospects*, 2003, p. 80.

roads, primitive port facilities, and the lack of local capital or qualified local technicians constitute unavoidable obstacles to investment. In some cases, the government of a country permits some obstacles to exist, but for reasons other than their effect on private foreign investment. As examples, the existence of a communist dictatorship in Cuba and the social orientation of Syria deter foreign investment. Finally, there are unintended obstacles that the government of the host country is anxious to avoid. These obstacles include a broad range of conditions, from excessive red tape to corruption in the courts.

There are two broad groups of reasons why MNCs will invest heavily in developing countries: various incentive programs and emerging market-based capitalism. The shortage of capital in many parts of the world and an almost universal desire for economic growth have recently compelled many countries to institute incentive programs for private foreign investment. Several surveys have found that developing countries have various incentive programs for foreign investors. As shown in figure 17.4, these incentives include tariff exemptions, tax incentives, financial assistance, and others. These and other incentive programs undoubtedly motivate MNCs to invest in those countries that offer them.

Many developing countries are embracing market-based capitalism. Privatization, liberalization of trade, a positive attitude toward foreign investment, a relaxation of the tight state control, stock market development, and sounder macroeconomic policies – these are all enthusiastically embraced by foreign investors. More concretely, these are the measures that make investment possible by putting companies on the block and allowing foreigners into the market. One critical factor of the domestic policy environment in attracting foreign investment is whether the government operates with transparency, credibility, and stability. Corporate governance – an independent board of directors, mechanisms for citizens to monitor public behavior, and rules that constrain corruption – is essential to sustained FDI inflows.

17.3 Cross-Border Mergers and Acquisitions

These days, companies look for and need to explore growth opportunities on a global basis. In principle, the growth of the foreign presence in any national economy could take place in either of two ways. Companies could grow primarily through the construction of new production facilities in a foreign country, financed either through the establishment of new subsidiaries or through investment by their existing facilities in the foreign country. Alternatively, companies could grow through the acquisition of existing foreign firms.

Obviously, both kinds of growth have recently taken place in the USA and other countries. For example, ventures such as the establishment of Japanese automobile plants in the USA have occurred simultaneously with events such as Daimler's acquisition of Chrysler. In quantitative terms, however, acquisitions (external growth) are much larger than the construction of new production facilities abroad (internal growth). Although internal growth is usually natural and economical, the process of growth may be very slow. In recent years, a company's growth through a merger with the existing business activities of a foreign firm has received substantial attention as an alternative to internal growth.

In chapter 18, we consider the purchase of an individual asset as a capital budgeting decision. When a company is buying another company, it is making an investment. Thus, the basic principles of capital investment decisions apply. But mergers are often more difficult to evaluate. First, the financial manager must be careful to define benefits. Second, the financial manager needs to understand why mergers occur and who gains or loses as a result of them. Third, the acquisition of a company is more complicated than the purchase of a new machine, because special tax, legal, and accounting issues must often be addressed. Finally, the integration of an entire company is much more complex than the installation of a single new machine.

17.3.1 Terminology

A **merger** is a transaction that combines two companies into one new company. An **acquisition** is the purchase of one firm by another firm. Although we have drawn the formal distinction between a merger and an acquisition, the two terms are often used interchangeably. The parties in a merger can be classified as an acquiring company and an acquired company. The acquiring company, also known as a bidder, initiates the offer, while the acquired company, often called a target company, receives the offer.

Acquisitions are also categorized as being either friendly or hostile. A friendly takeover is an offer made directly to the firm's management or its board of directors. In a hostile takeover, the acquiring company often bypasses the target company's management and approaches its shareholders directly with a tender offer for the purchase of their assets. A **tender offer** is an offer to buy a certain number of shares at a specific price and on a specific date for cash, stock, or a combination of both. A tender offer is usually associated with a hostile takeover, but it is also used in friendly takeovers when the target company's management approves the offer before it is presented to shareholders.

17.3.2 *Mergers and corporate governance*

The market-based system of corporate governance used in the United States and the United Kingdom is characterized by a highly diversified equity ownership, a large portion of public debt and equity capital, and a relatively independent management team. The bank-based system of corporate governance used in Japan, France, and Germany depends on a concentrated ownership in the hands of a main bank and the firm's business partners for both debt and equity capital. Figure 17.5 shows that corporate ownership is more widely dispersed in the USA and the UK than in France, Germany, and Japan. The structure of these corporate governance systems influences top executive turnover and the market for corporate control.

In the USA, management is much more likely to be disciplined through either friendly takeovers or hostile takeovers. Corporate control contests in the USA tend to be large-scale, aggressive, financially motivated, and arm's-length deals that often involve private investors and other corporations. Hostile acquisitions frequently provoke equally forceful defensive maneuvers by the management of target firms.

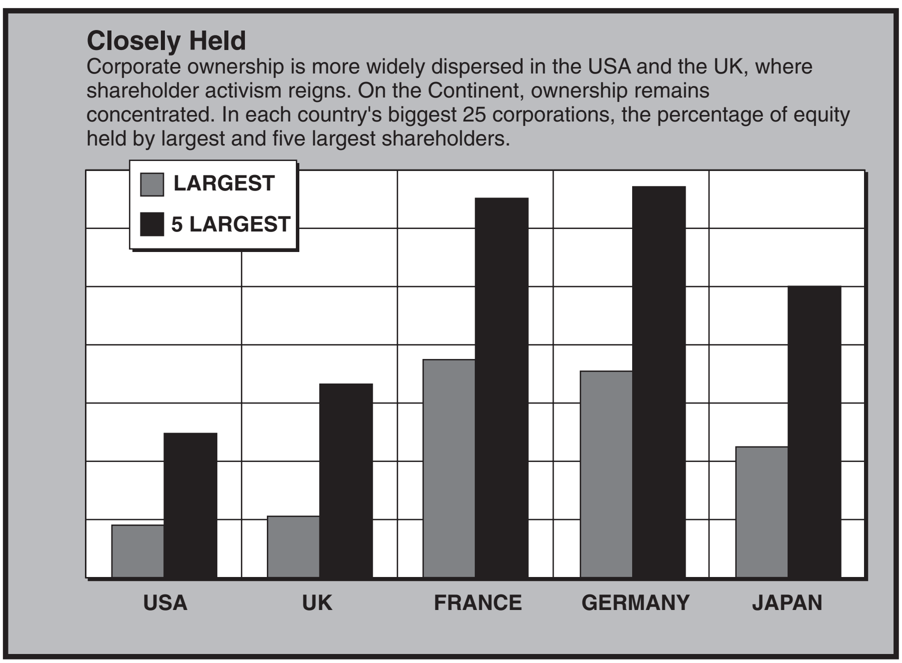


Figure 17.5 Corporate ownership in five major countries

Source: *The Wall Street Journal*, Apr. 26, 1999, p. R15; reprinted by kind permission.

In Japan, corporate takeovers are typically managed from inside rather than in the public markets by the company's main bank, by its business partners, or by both. Hostile acquisitions are almost nonexistent in Japan, due to the concentration of equity ownership in the hands of the main bank and other keiretsu members.

Corporations in most countries around the world have a supervisory board charged with monitoring and supervising the management team on behalf of the stakeholders. The composition of the board, its powers, and its responsibilities vary widely across countries. In the USA this board, called the board of directors, represents a dispersed set of shareholders and usually includes outsider directors who have no other business contact with the corporation.

In Japan, it is rare for a board member to come from a group other than the corporation's management or from a close affiliate of the corporation, such as another keiretsu member or the main bank. The Japanese word **keiretsu** refers to the large, financially linked groups of companies that play a significant role in the country's economy. The governance of most large Japanese corporations is thus dominated by an inner circle of inside managers, their bankers, and their business partners. These board differences between the USA and Japan explain why there are many hostile acquisitions in the USA and why, on the other hand, there are hardly any hostile acquisitions in Japan.

Weakening Cross-Holdings in Japan In Japan, banks and borrowers or manufacturers and suppliers held an intricate network of shares in each other for decades. Those ties have been weakening as these networks of mutual shareholdings have slowly turned from benefit to burden. Cross-holdings have depressed corporate returns on equity, locking in outdated business alliances and hampering the formation of more forward-looking ones. Consequently, companies and banks unloaded approximately $50 billion in cross-held shares between January 1999 and February 2000. Gary Evans, a corporate strategist in Tokyo, figured that the percentage of all Japanese outstanding shares cross-held by corporations would fall to 25 percent in 2000, as compared to 42 percent in 1990 (Spindle 2000).

The industries in which cross-holdings are falling fastest – airlines, railways, steel, and banking – are considered to be among the most outdated in Japan. In addition, industry executives and analysts say that the selling of shares is a sign that restructuring efforts are bearing some fruit. For example, after handing control over to a management team from Renault SA of France, Nissan Motor Co. announced a restructuring plan in 1999; it called on Nissan to cut the number of companies in its core group from more than a thousand to four. Industrial Bank of Japan, in the midst of a three-way merger, stated that it planned to sell about a quarter of its three trillion yen of stakes in borrowers and allied companies over a 4-year period, beginning in 1999.

Analysts say that the selling of cross-held shares could eventually reach a point at which sufficient numbers of shares are available to spark a boom in mergers and acquisitions, perhaps even in hostile takeovers. That could spur a still more dramatic restructuring of old-line corporate Japan.

17.3.3 Some accounting aspects of mergers

A merger can be treated on the books of the acquiring company as either a pooling of interests or a purchase of assets. If a merger is financed with an exchange of stock, it may qualify for the pooling of interests. Under the **pooling-of-interest** method, the items on the balance sheets of the two companies are added together, so that the merger would not create goodwill. The firms that like pooling most are those with a lot of intangible assets – intellectual property, brand names, copyrights, patents, customer lists, and research and development. The obvious advantage of this method is that there are no charges against future earnings and thus it would produce higher reported earnings. As a result, this form of business merger has been popular in practice and has caused the recent surge in mergers and acquisitions.

It is, then, no wonder that the use of pooling in mergers and acquisitions by dollar volume increased from only 5 percent in the early 1990s to 55 percent in the late 1990s (King 2000). However, the Financial Accounting Standards Board (FASB), the US accounting rulemaker, eliminated the pooling-of-interest method effective July 1, 2001. Most financial officers expect the ban on pooling to slow, but not stop, merger activity.

If a merger is made with cash, the merger must be treated as a purchase of assets. The purchase method views a merger as an investment for the acquiring company. Under the **purchase-of-assets** method, the acquired assets or companies are usually recorded in the accounts of the acquiring company at the market value of assets given in exchange. If the acquiring company pays more than the book value of the acquired company, the excess is treated as goodwill. Goodwill write-offs are not deductible for income tax purposes. This accounting treatment results in lower reported earnings for several years; thus, this form of business merger is not popular in practice.

17.3.4 A new merger movement

It was not exactly merger mania like the merger boom in the 1990s, but companies started to make acquisitions again in 2003. After a 3-year deal-making downturn, the pace of mergers and acquisitions finally accelerated in the second half of 2003 (figure 17.6). The worldwide volume of announced transactions edged up 10 percent to $1.33 trillion in 2003 from $1.21 trillion in 2002, but this volume is still only 40 percent of the record $3.4 trillion of transactions racked up in the merger craze of 2000. The renewed interest in pursuing mergers and acquisitions came amid the signs of an improving economy and a rising stock market. For 2005 and beyond, worldwide merger advisors believe that the cautious enthusiasm for mergers will continue, particularly in sectors such as financial institutions, health care, and consumer products.

17.3.5 Motives for cross-border mergers and acquisitions

A company's acquisition of another firm is economically justified only if it increases the total value of a firm. The traditional approach to the valuation of the firm consists of four basic steps:

1 Determine the earnings after taxes that the company expects to produce over the years, or earnings before taxes multiplied by (1 − tax rate).
2 Determine the capitalization rate (discount rate) for these earnings.
3 Determine the extent to which the company may be leveraged or the adequate amount of debt.
4 Compute the total value of the firm from the following formula:

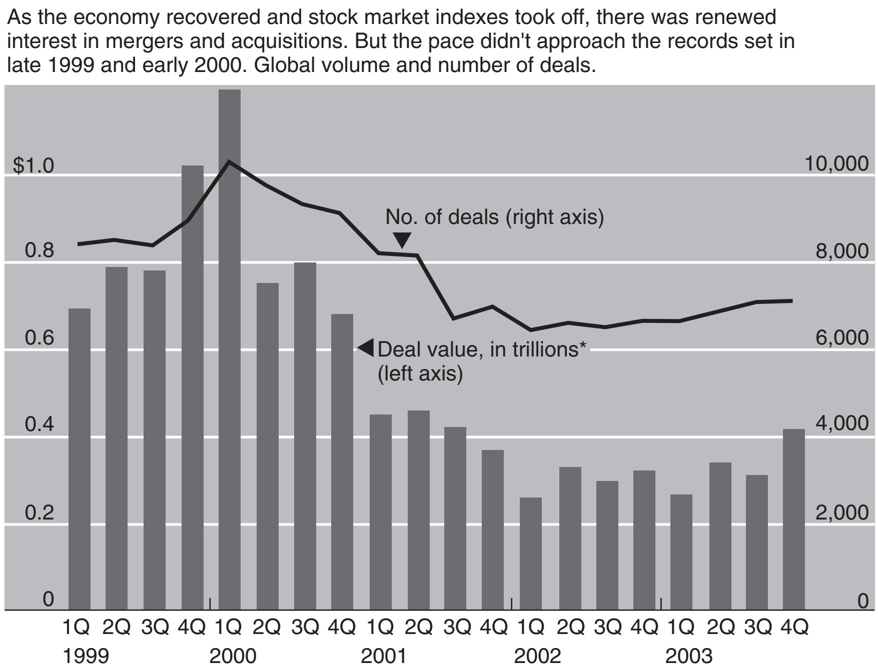


Figure 17.6 A pickup in merger activity

Source: *The Wall Street Journal*, Jan. 2, 2004, p. R15.

$$\text{value of firm} = \frac{\text{earnings before taxes}\,(1 - \text{tax rate})}{\text{capitalization rate}}$$

One can examine the effect of a merger on each of the factors that affect the total value of the firm.

EARNINGS BEFORE TAXES A merger itself creates a larger physical size and opportunities for a synergistic effect. The **synergistic effects** of business mergers are certain economies of scale due to the firm's lower overhead. The merger allows the firm to acquire necessary management skills and to spread existing management skills over a larger operation. There are also opportunities to eliminate duplicate facilities and to consolidate the functions of production, marketing, and purchasing. Finally, the merger enables the firm to enjoy greater access to financial markets and thus to raise debt and equity at a lower cost of capital. These types of better management, operating economies, and financial economies can increase the profit margin and also reduce risks.

Example 17.1

Assume that Buyco Corporation, with a 10 percent cost of capital, is analyzing the acquisition of the Sellco Corporation for $1 million. Sellco has expected net cash flows (earnings after taxes plus depreciation) of $100,000 per year indefinitely. Furthermore, the synergistic effect of the merger (in this case, combining production facilities) will add $20,000 per year to net cash flow indefinitely.

The present value of net cash flows from this merger is $1.2 million [($100,000 + $20,000)/0.10]. As a result, the acquisition appears to represent a desirable alternative for the expenditure of cash with a positive value of $200,000 ($1,200,000 – $1,000,000).

A company is often able to improve its risk–return performance through international acquisition rather than through domestic acquisition. The key element here is the correlation coefficient between acquired firms and an acquiring firm. When firms with low degrees of correlation are combined with each other, the acquiring firm is able to reduce its risk of expected return. Companies from different countries tend to be less correlated with each other than are domestic companies. For example, the economic cycles of different countries do not tend to be totally synchronized. On the other hand, most domestic companies tend to be highly correlated with each other, because they depend on the same state of economy.

Tax Considerations The tax benefit for mergers comes from the fact that the tax loss carryforward expires at the end of a certain number of years unless the firm makes sufficient profits to offset it completely. There are two situations in which mergers could actually avoid corporate income taxes. First, when a profitable company acquires companies with a large tax loss carryforward, it can reduce its effective tax rate and consequently increase its net operating income after taxes. Second, a company with a tax loss carryforward may acquire profitable companies in order to use its carryforward.

Example 17.2

In this example, we assume that all losses can be carried forward. Company A acquires company B, which has a $220,000 tax loss carryforward. Company A, with a tax rate of 40 percent, expects to earn $100,000 a year for the next 3 years.

As shown in table 17.2, the tax shield value of a carryforward is equal to the loss involved times the tax rate ($220,000 × 0.40 = $88,000). On the basis of the carryforward, company A can reduce its total taxes from $120,000 to $32,000, and thus it could pay $88,000 for the carryforward alone (this is on a nondiscount basis). Earnings after taxes also have gone up by $88,000 ($268,000 – $180,000). Obviously, company B's anticipated operating gains and losses for future years must also be considered in analyzing the deal.

Table 17.2 The effects of a tax loss carryforward

	Year 1	*Year 2*	*Year 3*	*Total values*
Company A without merger				
Earnings before taxes	$100,000	$100,000	$100,000	$300,000
Taxes (40%)	40,000	40,000	40,000	120,000
Earnings after taxes	$ 60,000	$ 60,000	$ 60,000	$180,000
Company A with merger				
Earnings before taxes	$100,000	$100,000	$100,000	$300,000
Tax loss carryforward	100,000	100,000	20,000	220,000
Earnings before tax	$ 0	$ 0	$ 80,000	$ 80,000
Taxes (40%)	0	0	32,000	32,000
Earnings after taxes	$100,000	$100,000	$ 68,000	$268,000

Accounting and tax laws may create even more competitive advantages for acquiring firms in some countries. If the acquiring company pays more than the net worth of the acquired company, the excess is treated as goodwill. Goodwill write-offs are not deductible for federal income taxes in some countries. This accounting treatment results in lower reported earnings for several years. However, in most industrialized countries, goodwill does not affect the acquiring company's earnings. Thus, foreign companies with more favorable accounting and tax laws may be able to bid higher prices for target companies.

Example 17.3

Suppose that company C and firm D try to acquire Echo Corporation with a $4 million book value (net worth) for $6 million. Company C is located in a country in which goodwill write-offs are not deductible for income taxes, but firm D is located in a country in which companies are allowed to deduct goodwill amortization for tax purposes. The tax rate of 40 percent is the same for company C and firm D.

Because a company can acquire a firm with $4 million book value for $6 million, $2 million of goodwill is created on the books of the acquiring company. If it must be written off over a maximum period of 10 years, this would cause a $200,000-per-year reduction in reported earnings ($2 million/10 years). Because the write-offs of goodwill are not tax-deductible expenses for company C, the company suffers the full amount of the deduction without any tax relief. On the other hand, firm D would realize $800,000 in real cash savings ($2,000,000 × 0.40) over 10 years, because firm D is allowed to deduct goodwill amortization for tax purposes. Hence, the firm could pay $800,000 more due to this goodwill tax advantage alone.

The Capitalization Rate An important advantage of mergers is the fact that earnings of larger companies are capitalized at lower rates. The securities of larger companies have better marketability than those of smaller companies. Larger companies are also better known among investors. An acquiring company can develop these factors, which lead to lower required rates of return and higher price–earnings ratios. Consequently, the value of the acquiring firm exceeds the values of the companies operating separately.

A potential benefit of international acquisition is the lower required rate of return for the acquiring company. The required rate of return varies among countries because the cost of capital is different from country to country. As a result, companies in some countries may find acquisitions more attractive than companies in other countries.

Debt Capacity The appropriate mix of debt and equity reduces the overall cost of capital and thus raises the market value of the firm. There are two situations in which a merger can raise the debt capacity for the acquiring company above the sum of the debt capacities for the individual firms prior to the merger. First, there are companies that fail to make optimum use of debt. Second, it is frequently possible for the acquiring company to borrow more than the companies were able to borrow individually.

Companies normally finance a portion of international acquisitions with borrowed funds. Companies in some countries have more flexibility to borrow, because investors and creditors in these countries are more receptive to higher debt ratios. The debt ratio for most companies in Denmark, Finland, Norway, and Sweden, for example, is higher than the comparable debt ratio for American companies. In other words, companies in Scandinavian countries have more flexibility to borrow than US companies. Thus, US companies may be more successful in international acquisitions because they can borrow in countries where higher degrees of financial leverage are tolerated than in the USA.

Example 17.4

Suppose that the cost of debt (6 percent), the cost of equity (10 percent), the tax rate (50 percent), and annual earnings after taxes ($10,000) are the same for company X and firm Y. Company X's optimal capital structure is 20 percent debt and 80 percent equity. Firm Y is a multinational company and thus enjoys a higher debt ratio of 60 percent without additional risk. Compare the cost of capital for these two companies and their market value.

The weighted average costs of capital are 8.6 percent [$(0.20 \times 0.06)(1 - 0.50) + (0.80 \times 0.10)$] for company X and 5.8 percent [$(0.60 \times 0.06)(1 - 0.50) + (0.40 \times 0.10)$] for firm Y. Market values are $116,279 for company X ($10,000/0.086) and $172,414 for firm Y ($10,000/0.058). The multinational firm enjoys a lower cost of capital, a higher market value, and a higher share price because it has greater borrowing capacity. As cheaper debt is added to the capital structure, the cost of capital falls. This increases the value of the firm. Because this increase in the firm's value accrues to the owners of the firm, the price of the firm's stock rises.

OTHER CONSIDERATIONS A variety of other factors affect international acquisitions: exchange rate movements, country barriers, and strategic choices, among others.

The ideal time for Japanese investors to buy a US company is when the spot rate of the US dollar is perceived to be very low and is expected to appreciate over time. Several studies have confirmed that international acquisitions are, in fact, influenced by exchange rate movements. A study by Rohatyn (1989), for example, found that the combination of a relatively weak dollar and a strong Japanese stock market in the late 1980s encouraged Japanese acquisitions of US firms.

Many national governments impose explicit and implicit barriers to foreign acquisitions of their domestic companies. These barriers prevent or discourage international acquisitions rather than offering advantages to specific acquiring companies. All countries have one or more agencies that monitor mergers and acquisitions, but they vary among countries. International acquisitions are tolerated more in the USA than in Japan. Consequently, it is much easier for Japanese investors to purchase a US firm than for US investors to purchase a Japanese firm.

To achieve corporate growth, companies these days view the world as a total business community. They consider international acquisitions as a viable alternative for achieving a corporate growth strategy. Newman (1990) suggested that a growth-oriented company can globally close four types of growth gaps between its sales potential and its current actual performance. A product-line gap can be closed by introducing improved or new products. A distribution gap may be reduced by expanding an existing distribution network. A usage gap is reduced by inducing current nonusers. A competitive gap can be closed by making inroads into the market position of direct competitors. These strategic choices encourage companies to engage in international acquisitions.

SUMMARY

Once companies decide to enter new foreign markets, their next concern is how to enter the foreign market. Theory views the construction of new plants, mergers and acquisitions, joint ventures, equity alliances, licensing agreements, franchising agreements, and contract manufacturing as foreign-entry alternatives through investment. This chapter has covered a number of practical issues in foreign direct investment, such as the benefits and drawbacks of foreign investment, inflows of foreign investment to developing countries; and international mergers and acquisitions.

Questions

1 What are foreign market-entry alternatives?
2 Are US government restrictions on imports likely to increase or decrease foreign direct investment in the USA?

3 It is fair to assume that Toyota and Ford are automobile manufacturers that desire to benefit from economies of scale. Suppose that Toyota decides to establish distribution dealerships in foreign countries, while Ford decides to establish manufacturing subsidiaries in foreign countries. Which company is more likely to benefit from economies of scale? Which company has less to lose if the venture fails?
4 What are the distinct alternatives available to companies for their foreign investment?
5 What is the major difference in mergers and corporate governance between the USA and Japan?
6 Discuss some reasons for the recent decline of foreign direct investment in developing markets.
7 Explain why mergers are often more difficult to evaluate than the establishment of new production facilities.
8 What are the factors affecting international acquisitions?

Problems

1 GM is analyzing the acquisition of a British company for $1 million. The British company has expected cash flows of $90,000 per year. The synergistic benefits of the merger will add $10,000 per year to cash flow. Finally, the British company has a $50,000 tax loss carryforward that can be used immediately by GM. GM is subject to a 40 percent tax rate and has a 10 percent cost of capital. Should GM acquire this British company?
2 The cost of debt (10 percent), the cost of equity (15 percent), the tax rate (50 percent), and annual earnings after taxes ($10,000) are the same for a domestic firm and a multinational company. The firm's target debt ratio (optimum capital structure) is 20 percent, while the company's target debt ratio is 50 percent.
   (a) Determine the weighted average costs of capital for these two enterprises.
   (b) Determine the market values of the two enterprises.
3 Assume that the worldwide profit breakdown for Ford is 85 percent in the USA, 5 percent in Japan, and 10 percent in the rest of the world. On the other hand, the worldwide profit breakdown for Toyota is 40 percent in Japan, 35 percent in the USA, and 25 percent in the rest of the world. Earnings per share are $5 in the USA, $8 in Japan, and $10 in the rest of the world for both companies.
   (a) What are the weighted average earnings per share of Ford and Toyota?
   (b) Which company is likely to have the international competitive advantage?
4 We will assume that IBM is analyzing the acquisition of a privately held French company. The French company is more similar to Low Tech (LT) than any other company whose stock is traded in the public market. To establish a fair market price for the French company, IBM has compiled the statistics presented in the following table. Estimate the market value of

the French company (FM) in the following three ways: (a) the price–earnings ratio, (b) market value/book value, and (c) the dividend growth model.

Variables	*French company*	*Low Tech*
Earnings per share	$ 2.00	$ 4.00
Dividend per share in year 1	$ 1.50	$ 2.00
Annual dividend growth rate	0.04	0.04
Price per share	?	$40.00
Book value per share	$16.00	$20.00
Cost of equity	?	0.14
Number of shares outstanding	1 million	1.2 million

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Case Problem 17: BP's Acquisition of Amoco

On December 31, 1998, British Petroleum PLC (BP) bought Amoco Corp., the fourth-largest US oil company, for $52.41 billion in stock, then the largest industrial merger in history. This deal surpassed the $40.5 billion dollar purchase of Chrysler Corp. by Germany's Daimler-Benz AG, completed in November 1998. The combined company, named BP Amoco, would remain the world's third-largest oil company, but the deal would make it a bigger rival to the number one, Royal Dutch/Shell, and the number two, Exxon Corp., in size and scope (see figure 17.7): $108 billion in annual revenue, 14.8 billion barrels in oil and gas reserves, 1.9 million barrels of daily oil production, $6.4 billion in annual profit, $132 billion in market value, and 100,000

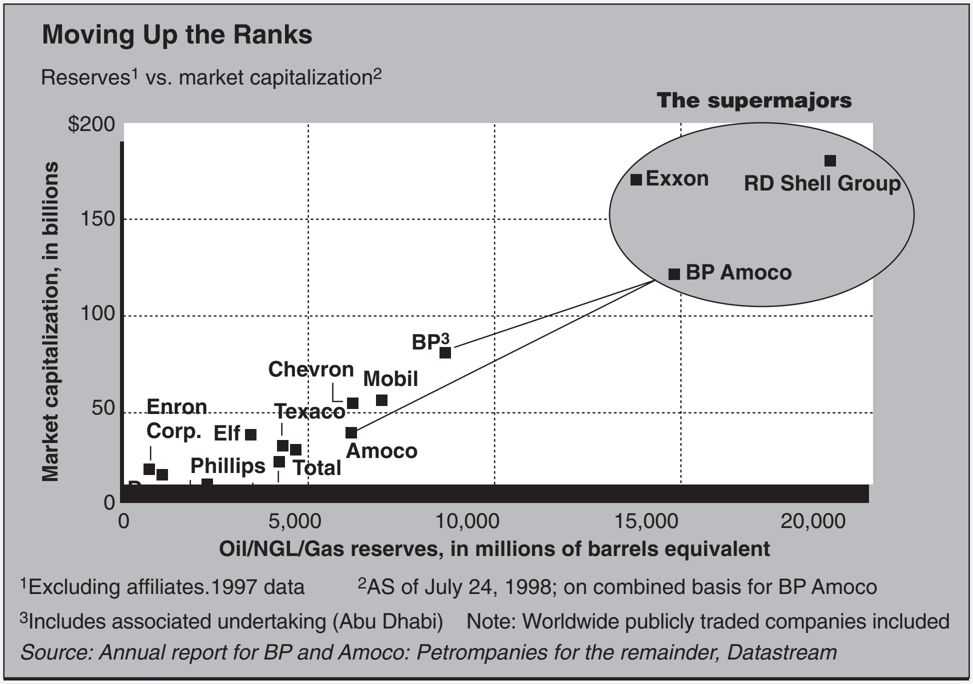

Figure 17.7 Major oil companies: their reserves and market capitalization
Source: BP Amoco.

employees. Amoco shareholders received a 0.66 BP American depository receipt for each share of Amoco. This price represents a premium of about 15 percent to the value of Amoco before the merger. BP used the pooling-of-interest accounting treatment in acquiring Amoco instead of the purchase-of-asset accounting treatment.

"The potential for cost-cutting and improving efficiencies is enormous," said analyst Fadel Gheit at Fahne-Stock & Co. "There will be no weakness in the new company, which will have the two top international players looking over their shoulders."

By combining operations, BP Amoco contended that it would cut $2 billion in annual costs from its operations by the end of the year 2000, boost its annual pretax profits by a few hundred million dollars in the next 2 years, and reduce the cost of capital substantially. This combined company failed to increase its earnings in 1999, but the merger boosted shareholder value substantially through December 1999.

BP had already demonstrated that it knows how to hold down costs, most notably during a big reorganization that took place in the early 1990s, when it slashed its payroll deeply. Now, led by Chief Executive John Brown, BP was expected to apply some of the same discipline to Amoco, whose performance on the cost-cutting front had lagged. But, just as important, there was also the potential for substantial growth. The combined company's revenues would enable it to finance more development itself, keep costs down, and help win more victories at auctions of oil reserves.

Analysts stated that the assets of these two companies complimented each other. BP brought a huge worldwide exploration and production operation to the company, plus a strong European retail network. As for Amoco, it was the largest natural gas producer in North America and had a large US gasoline marketing network. Both companies had petrochemicals operations that would become among the largest in some areas. Both also operated in the niche area of solar energy and would pose a challenge to that market's leader, Germany's Siemens AG.

More specifically, BP Amoco Chairman John Brown said that beyond the projected $2 billion in savings, he expected additional savings and growth opportunities. He pointed to such areas as Azerbaijan, the oil-rich Central Asian nation where both companies are major players. Other synergies would include deeper-water exploration and production, where BP would bring its expertise to Amoco's fields in the Gulf of Mexico. Similarly, the deal could combine Amoco's lower development costs with BP's cheaper exploration costs.

Since BP announced its proposed acquisition of Amoco in August 1998, a wave of merger activity has hit the oil industry. These more recent acquisitions include Exxon's agreement to buy Mobile for $75 billion, BP Amoco's proposed merger with Arco for $25 billion, the agreement by France's Total SA to buy Belgium's Petrofina SA for $15 billion, and proposed alliances among national oil companies of Brazil, Mexico, Saudi Arabia, and Venezuela. Why have all these oil mergers and alliances happened in recent years? First, the most successful companies, such as BP and Exxon, had already slashed costs. When costs have been cut to the bone, merger remains a route to higher profits. Second, advances in drilling and other oil technologies have enabled oil companies to discover previously untapped oil fields. In addition, these new technologies have allowed hundreds of players to produce ever larger amounts of petroleum at ever lower costs.

Case Questions

1 Explain how BP Amoco could cut $2 billion in costs and boost annual pretax profits by a few hundred million dollars for the first 2 years.
2 Explain how this merger could reduce its cost of capital substantially.
3 Why did BP treat its merger with Amoco as a pooling transaction rather than a purchase transaction?
4 Explain how the BP–Amoco merger could boost its shareholder wealth as reflected by its stock price. According to the case, the combined company did not earn more money after the merger, but its stock price increased. How do you explain this apparent conflict between earnings and stock price?
5 Briefly explain American depository receipts. The last closing price per share for Amoco stock was about $52. What was the closing price of BP American depository receipts (ADRs) on its last trading day?

6 Some websites, such as www.dbc.com and www.quicken.com, provide many pieces of information about publicly held companies for investors. Use several websites of your choice to compare some key financial statistics of BP Amoco with those of its major competitors.

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