

BFF2341 International Financial Management

Individual Assignment: Trimester A 2020

Due Date: 25th May by 12 pm

Q.1 Case Study: FDI decision

(40 marks)

For the last year, Max Roller Pty Ltd has been exporting to Malaysia in order to supplement its declining Australian sales. Under the current arrangement, Max Roller sells 80,000 pairs of sunglasses annually to Sunglass Hut, a Malaysian retailer, for a fixed price denominated in Malaysian ringgit. The arrangement will last for another two years. Furthermore, to diversify internationally and to take advantage of an attractive offer by Fashion Glasses Ltd., a British retailer, Max Roller has recently begun exporting to the United Kingdom. Under the new arrangement, Fashion Glasses will annually purchase 100,000 pairs of Sunglasses annually at a fixed price of £90 per pair.

Max Roller's suppliers of the needed components for its sun glass production are located primarily in Australia, where Max Roller incurs the majority of its cost of goods sold. Although prices for inputs needed to manufacture sunglasses vary, recent costs have run approximately A\$50 per pair. Max Roller also imports components from Malaysia because of the relatively low price of glasses and plastic components and because of their high quality. These imports are denominated in Malaysian ringgit, and the exact price (in MYR) varies and depends on prevailing market prices for these components in Malaysia. Currently, inputs sufficient to manufacture a pair of sunglasses cost approximately 1200 Malaysian ringgit per pair of sunglasses.

Although Malaysia had been among the world's fastest growing economies, recent events in the country have increased the level of economic uncertainty. Specially, the Malaysian ringgit, which had been pegged to the dollar, is now a freely floating currency and has depreciated substantially in recent months. Furthermore, recent levels of inflation in Malaysia have been very high. Hence, future economic conditions in Malaysia are highly uncertain.

Keith Watson, Max Roller's CFO, is seriously considering DFI in Malaysia. He believes that this is a time to either establish a subsidiary or acquire an existing business in Malaysia because the uncertain economic conditions and the depreciation of the MYR have substantially lowered the initial costs required for FDI. Keith believes the growth potential in Asia will be extremely high once the Malaysian economy stabilizes.

Although Keith has also considered FDI in the United Kingdom, he would prefer that Max Roller invest in Malaysia as opposed to the United Kingdom. Forecasts indicate that the demand for sunglasses in the United Kingdom is similar to that in Australia; since Max Roller's Australian sales have recently declined because of the high prices it

charges, Keith expects the FDI in the United Kingdom will yield similar results, especially since the components required to manufacture sunglasses are more expensive in the United Kingdom than in Australia. Furthermore, both domestic and foreign sunglass manufacturers are relatively well established in the United Kingdom, so the growth potential there is limited. Keith believes that Malaysian sunglass market offers more growth potential.

Max Roller can sell its products at a lower price but generate higher profit margins in Malaysia than it can in Australia. This is because the Malaysian customer has committed itself to purchase a fixed number of Max Roller's products annually only if it can purchase sunglasses at a substantial discount from the Australian price. Nevertheless, since the cost of goods sold incurred in Malaysia is substantially below that incurred in Australia, Max Roller has managed to generate higher profit margins from the Malaysian exports and imports than in Australia.

As a financial analyst for Max Roller, Pty Ltd, you generally agree with Keith's assessment of the situation. However, you are concerned that Malaysian consumers have not yet been affected by the unfavorable economic conditions. You believe that they may reduce their spending on leisure products within the next year. Therefore, you think it would be beneficial to wait until next year, when the unfavorable economic conditions in Malaysia may subside, to make a decision regarding FDI in Malaysia. However, if economic conditions in Malaysia improve over the next year, FDI may become more expensive both because target companies will be more expensive and because the MYR may appreciate. You are also aware that several of Max Roller's Australian competitors are considering expanding into Malaysia in the next year.

If Max Roller acquires an existing business in Malaysia or establishes a subsidiary there by the end of next year, it would fulfil its agreement with Sunglass Hut for the subsequent year. The Malaysian retailer has expressed an interest in renewing the contractual agreement with Max Roller at that time if Max Roller establishes operations in Malaysia. However, Keith believes that Max Roller could charge a higher price for its products if it establishes its own distribution channels.

Keith has asked you to answer the following questions:

- i. Identify and discuss some of the benefits that Max Roller, Pty Ltd could obtain from FDI.
- ii. Do you think Max Roller should wait until next year to undertake FDI in Malaysia? What is the trade-off if Max Roller undertakes the FDI now?
- iii. Do you think Max Roller should renew its agreement with the Malaysian retailer for another three years? What is the trade-off if Max Roller renews the agreement?
- iv. Assume a high level of unemployment in Malaysia and that a unique production process employed by Max Roller in Malaysia is more labor-intensive. How do you think the Malaysian Government would view the establishment of a subsidiary in Malaysia by a company such as Max Roller? Do you think the Malaysian

government would be more or less supportive if firm such as Max Roller acquired existing businesses in Malaysia? Why?

- v. Given the weak economic conditions and high unemployment in Malaysia, how would the government respond to a request for subsidized purchase of land by Max Roller?
- vi. How would Max Roller respond if the Malaysia Government stipulated a local content requirement of at least 50 per cent for its subsidiary?
- vii. Assume that a Chinese manufacturer of sunglass is planning to set up a subsidiary in Malaysia and make a competing product? How would this situation potentially affect Max Roller?
- viii. For each of the three possible scenarios below for the Malaysian Ringgit and the British pound, use a spreadsheet to estimate cash flows for the next year. Briefly comment on the level of Max Roller's economic exposure. Ignore possible tax effects.

Scenario 1	Scenario 2	Scenario 3
MYR=\$0.380	MYR=\$0.361	MYR=\$0.342
BP=\$1.700	BP=\$1.649	BP=\$1.666

Q. 2 Acquisition decision:

(15 marks)

Now Consider that, Max Roller's sister company Atlas Inc consists of two businesses. Its local business is expected to generate cash flows of \$1,000,000 at the end of each of the next 3 years. It also owns a foreign subsidiary based in Mexico, whose business is selling technology in Mexico. This business is expected to generate \$2,000,000 in cash flows at the end of each of the next three years. The main competitor of the Mexican subsidiary is Perez Co., a privately-held firm that is based in Mexico. Atlas Company just contacted Perez Co., and wants to acquire it. If it acquires Perez, Atlas would merge the operations of Perez Co. with its Mexican subsidiary's business. It expects that these merged operations in Mexico would generate a total of \$3,000,000 in cash flows at the end of each of the next 3 years. Perez Co. is willing to be acquired for a price of 40 million pesos. The spot rate of the Mexican peso is \$.10. The required rate of return on this project is 24%.

Required:

Determine the net present value of this acquisition by Atlas Company. Should Atlas Company pursue this acquisition?

Q. 3 Hedging Decision:**(15 marks)**

Atlas Company expects to receive 5 million Australian dollars in one year from exports, and it wants to consider hedging its exchange rate risk. The spot rate of Australian dollar as of today is US\$0.79. Interest rate parity exists. Atlas Co. uses the forward rate as a predictor of the future spot rate. The annual interest rate in the United States is 8 per cent versus an annual interest rate of 5 per cent in Australia. Put options on Australian dollars are available with an exercise price of US\$0.80, an expiration date of one year from today, and a premium of US\$.06 per unit. Estimate the US dollar cash flows that Atlas Co. will receive as a result of using each of the following strategies.

It can use any one of the following strategies to deal with the exchange rate risk. Estimate the dollar cash flows received as a result of using the following strategies:

- a. unhedged strategy
- b. money market hedge
- c. option hedge

The spot rate of the euro as of today is \$1.10. Interest rate parity exists. Atlas Company uses the forward rate as a predictor of the future spot rate. The annual interest rate in the US is 8% versus an annual interest rate of 5% in the eurozone. Put options on euros are available with an exercise price of \$1.11, an expiration date of one year from today, and a premium of \$.06 per unit. Estimate the dollar cash flows it will receive as a result of using each strategy. Which hedge is optimal?

Q.4 Investment and Taxation**(20 marks)**

Fairfox, Inc. is considering a capital budgeting project in India. The project requires an initial outlay of 1 million Indian Rupee; the Rupee is currently valued at \$0.60. In the first and second years of operation, the project will generate 600,000 Rupee in each year. After two years, Fairfox will terminate the project, and the expected salvage value is 350,000 Rupee. Fairfox has assigned a discount rate of 12 percent to this project. There is currently no withholding tax on remittances to the U.S., but the Indian government will impose a withholding tax of 10 percent beginning next year. Compute the expected NPV of the project and make a recommendation to Fairfox regarding its feasibility. Show your calculation considering two scenarios: with and without withholding tax.