

15 International Corporate Governance and Control

Chapter Objectives

- Describe the common forms of corporate governance by MNCs.
- Explain how MNC's use corporate control as a form of governance.
- Identify the factors that are considered when valuing a foreign target.
- Describe the process of valuing a foreign target.
- Explain why valuations of a target firm vary among MNCs that consider corporate control strategies.

15 International Corporate Governance and Control

Chapter Objectives (Contd.)

- Identify other types of international corporate control decisions.
- Explain how some corporate control decisions can be evaluated in a real time options framework.

International Corporate Governance (1 of 3)

Governance by Board Members — The Board of Directors is responsible for appointing high-level managers of the firm including the CEO.

The board is supposed to make sure that key management decisions are in the **best interest of shareholders**.

However, boards are not always effective at governance.

- Some allow the firm's CEO to serve as the chair of the board.
- Boards typically contain insiders (managers working for the firm) who might prefer policies that favor management.
- Board members who are employees of a foreign subsidiary may maximize the benefits to the subsidiary.

Governance by Institutional Investors

- Institutional investors
 - pension funds
 - mutual funds
 - hedge funds
 - and insurance companies
- The ability or willingness to enforce governance commonly varies among types of institutional investors.

Governance by Shareholder Activists

- Some institutional investors or individual shareholders of publicly traded MNCs are called blockholders because they hold a large proportion (Block – at least 5%) of the firm's stock.
- Blockholders commonly become shareholder activists, that is, they take actions to influence management.

International Corporate Control (1 of 7)

Market for Corporate Control

- If managers make decisions that destroy value, the MNC could be subject to takeover and managers could lose their jobs.
- Market for corporate control is a means for MNCs to achieve expansion goals

Motives for International Acquisitions

- Comparative advantage
- Better form of direct foreign investment

Trends in International Acquisitions

- Traditionally, MNCs in various countries tend to focus on specific geographic regions and use stocks or cash to make their purchases depending on shareholder power.
- International acquisitions have generally increased over time. However, the pace slowed during the credit crisis in 2008.

International Corporate Control (2 of 7)

Barriers to International Corporate Control

- **Anti-takeover amendments implemented by target:** an anti-takeover amendment that requires a large proportion of shareholders to approve the takeover.
- **Poison pills implemented by target:** Grants special rights to managers or shareholders under specified conditions.
- **Host government barriers:** Governments of some countries restrict foreign firms from taking control of local firms, or they may allow foreign ownership of local firms only if specific guidelines are satisfied.

Model for Valuing a Foreign Target

When an MNC engages in restructuring, it affects the structure of its assets, which will ultimately affect the present value of its cash flows.

$$NPV_a = -IO_a + \sum_{t=1}^n \frac{CF_{a,t}}{(1+k)^t} + \frac{SV_a}{(1+k)^n}$$

where

IO_a = initial outlay needed to acquire target

$CF_{a,t}$ = cash flow generated by target

k = required rate of return on acquisition

SV_a = salvage value of target

n = time when the target will be sold by acquirer

Model for Valuing a Foreign Target (cont.)

- **Estimating the initial outlay** – the price to be paid for the target
 - Firms commonly pay premiums (30%) above the prevailing stock price of a foreign target to gain ownership.
 - The initial dollar outlay ($IO_{U.S.}$) is determined by the **acquisition price** in foreign currency (IO_f) and the **spot price** of the foreign currency (S):

$$IO_{U.S.} = IO_f \times S$$

Model for Valuing a Foreign Target (cont.)

■ Estimating the Cash Flows

- The estimated foreign currency cash flows that are to be converted must account for any *taxes or blocked-funds restrictions imposed by the host government*.
- The dollar amount of cash flows to the U.S. firm is determined by the **foreign currency cash flows ($CF_{f,t}$)** per period and the **spot rate** at that time (S_t)

$$CF_{a,t} = CF_{f,t} \times S_t$$

- Also, consider Salvage values; **$Sva = (SV_f)S_n$**
 - The salvage value in foreign currency units times the spot rate at the time (when it will be converted to US\$)

Model for Valuing a Foreign Target (cont.)

■ Estimating the NPV

- The net present value of a foreign target can be derived by substituting the equalities just described in the capital budgeting equation

$$\begin{aligned} NPV_a &= -IO_a + \sum_{t=1}^n \frac{CF_{a,t}}{(1+k)^t} + \frac{SV}{(1+k)^n} \\ &= -(IO_f)S + \sum_{t=1}^n \frac{(CF_{f,t})S_t}{(1+k)^t} + \frac{(SV_f)S_n}{(1+k)^n} \end{aligned}$$

Impact of the SOX Act on the valuation of the target –

- Improved the process for reporting profits used by U.S. firms (including U.S.-based MNCs).
- It requires firms to document an orderly and transparent process for reporting so that they cannot distort their earnings.
- It also requires more accountability for oversight by executives and the board of directors.

Factors Affecting Target Valuation

Target-Specific Factors

- Target's previous cash flows – (Historical data)
- Managerial talent of the target – (changes?)

Country-Specific Factors

- Target's local economic conditions (adverse shocks)
- Target's local political conditions
- Target's industry conditions – may be considered desirable
- Target's currency conditions
- Target's local stock market conditions
- Taxes applicable to the target

Example of the Valuation Process (1 of 5)

International Screening Process

- Lincoln Co. considers these factors when it conducts an initial screening of prospective targets.
- It has identified prospective targets in
 - **Mexico, Brazil, Colombia, and Canada. (Exhibit 15.1)**
- The target's expected cash flows can be measured by determining the revenue and expense levels in recent years and then adjusting those levels to reflect the changes that would occur after the acquisition.

Exhibit 15.1 Example of Process Used to Screen Foreign Targets

TARGET BASED IN:	IS THE TARGET RECEPTIVE TO AN ACQUISITION?	LOCAL ECONOMIC AND INDUSTRY CONDITIONS	LOCAL POLITICAL CONDITIONS	LOCAL CURRENCY CONDITIONS	PREVAILING STOCK MARKET PRICES	TAX LAWS
Mexico	No	Favorable	OK	OK	OK	May change
Brazil	Maybe	OK	OK	OK	Too high	May change
Colombia	Yes	Favorable	Volatile	Favorable	OK	Reasonable
Canada	Yes	OK	Favorable	Slightly unfavorable	OK	Reasonable

Example of the Valuation Process (2 of 5)

Estimating the Target's Value (Exhibit 15.2)

- **Estimated Revenue of Target** — Forecasted revenues are C\$100 million next year, C\$93.3 million in the following year, and C\$121 million in the year after that.
- **Estimated Expenses of Target** — Cost of goods sold expected to fall to 40% of revenue because of improvements in efficiency.
- **Estimated Earnings of Target** — Earnings before taxes and earnings after taxes are estimated.

Exhibit 15.2 Valuation of Canadian Target Based on the Assumptions Provided (in Millions of Dollars)

		LAST YEAR	YEAR 1	YEAR 2	YEAR 3
1.	Revenue	C\$90	C\$100	C\$93.3	C\$121
2.	Cost of goods sold	<u>C\$45</u>	<u>C\$40</u>	<u>C\$37.3</u>	<u>C\$48.4</u>
3.	Gross profit = (1) – (2)	C\$45	C\$60	C\$56	C\$72.6
4.	Selling & administrative expenses	C\$20	C\$15	C\$15	C\$15
5.	Depreciation	C\$10	C\$10	C\$10	C\$10
6.	Earnings before taxes = (3) – (4) – (5)	C\$15	C\$35	C\$31	C\$47.6
7.	Tax (30%)	<u>C\$4.5</u>	<u>C\$10.5</u>	<u>C\$9.3</u>	<u>C\$14.28</u>
8.	Earnings after taxes = (6) – (7)	C\$10.5	C\$24.5	C\$21.7	C\$33.32
9.	+ Depreciation		C\$10	C\$10	C\$10
10.	– Funds to reinvest		C\$5	C\$5	C\$5
11.	Sale of firm after capital gains taxes				<u>C\$230</u>
12.	Cash flows in C\$ = (8) + (9) – (10) + (11)		C\$29.5	C\$26.7	C\$268.32
13.	Exchange rate of C\$		\$.80	\$.80	\$.80
14.	Cash flows in \$ = (12) × (13)		\$23.6	\$21.36	\$214.66
15.	PV (20% discount rate)		\$19.67	\$14.83	\$124.22
16.	Cumulative PV		\$19.67	\$34.50	\$158.72

Example of the Valuation Process (3 of 5)

Estimating the Target's Value (cont.)

- **Cash Flows to Parent** — Because Lincoln's parent wishes to assess the target from its own perspective, it focuses on the dollar cash flows that it expects to receive.
- **Valuing the Present Value of Estimated Cash Flows** — Assuming a required rate of return of 20%, the present value of the target is estimated to be \$158.72 million after 3 years.

Example of the Valuation Process (4 of 5)

Estimating the Target's Value (cont.)

■ Sources of Uncertainty

- Growth rate of revenue is subject to uncertainty.
- Cost of goods sold could exceed assumed level.
- Selling and administrative expenses could exceed assumptions.
- Corporate tax rate could increase.
- Exchange rate may be weaker than expected.
- Estimated selling price of target in future may be incorrect.

Example of the Valuation Process (5 of 5)

Changes in Valuation Over Time

- **Impact of stock market conditions** — A change in stock market conditions affects the price per share of each stock in that market.
- **Impact of credit availability** — Greatly impacts the ability of MNCs to make acquisitions.
- **Impact of exchange rates** — If the foreign currency appreciates by the time the acquirer makes payment, the acquisition will be more costly.
- **Impact of market anticipation regarding the target** — The stock price of the target may increase if investors anticipate that the target will be acquired because they are aware that stock prices of targets rise abruptly after a bid by the acquiring firm.

Disparity in Foreign Target Valuations

Expected cash flows of the foreign target — Each MNC may have a different plan as to how the target will fit within its structure and how the target will conduct future operations.

Exchange rate effects on remitted earnings — Valuation can vary among MNCs simply because of differences in the exchange rate effects.

Required return of the acquirer — The valuation of the target could also vary among MNCs because of differences in their required rate of return.

Other Corporate Control Decisions (1 of 4)

International partial acquisitions — A partial international acquisition requires less funds because only a portion of the foreign target's shares are purchased.

- **Valuation Process** — When an MNC considers a partial acquisition it must take the perspective of a passive investor rather than as a decision maker.

Other Corporate Control Decisions (2 of 4)

International acquisitions of privatized businesses

- **Valuation Process** (difficult for following reasons):
 - Future cash flows are uncertain due to introduction of competition.
 - Data regarding value and benchmarks are limited.
 - Economic conditions are uncertain in transitional economies.
 - Political conditions are volatile.
 - Potential conflict between government control and acquirers may exist.

Other Corporate Control Decisions (3 of 4)

International Divestitures — Common external forces that could reduce the present value of a foreign subsidiary's future cash flows.

- A **weakening economy** in the host country could reduce expected cash flows to be generated by the subsidiary,
- a **reduction in the local currency** of the host country could reduce the exchange rate at which the cash flows generated by the subsidiary would be converted to dollars,
- **higher taxes** imposed by the host government would reduce the expected cash flows of the subsidiary

Other Corporate Control Decisions (4 of 4)

International Divestitures (cont.)

- **An increase in the MNC parent's cost of capital** would increase the discount rate at which expected future cash flows are discounted when determining the present value of the subsidiary.
- **Valuation process**
 - The valuation of a proposed international divestiture requires **comparing the present value of the cash flows if the project is continued to the proceeds that would be received (after taxes) if the project is divested.** (Exhibit 15.3)

Exhibit 15.3 Divestiture Analysis: Spartan, Inc.

	END OF YEAR 2 (TODAY)	END OF YEAR 3 (1 YEAR FROM TODAY)	END OF YEAR 4 (2 YEARS FROM TODAY)
1. S\$ remitted after withholding taxes		S\$6,840,000	S\$19,560,000
2. Selling price in S\$	S\$13,000,000		
3. Exchange rate	\$.46	\$.44	\$.40
4. U.S. dollars received from divestiture = (2) × (3)	\$5,980,000		
5. U.S. dollar cash flows forgone because of divestiture = (1) × (3)		\$3,009,600	\$7,824,000
6. PV of forgone cash flows (15% discount rate)		\$2,617,044	\$5,916,068
$\begin{aligned} \text{NPV}_d &= \$5,980,000 - (\$2,617,044 + \$5,916,068) \\ &= \$5,980,000 - \$8,533,112 \\ &= -\$2,553,112 \end{aligned}$			

Control Decisions as Real Options

Real Options are implicit options on real assets such as buildings, machinery, and other assets.

Call option on real assets represents a proposed project that contains an option of pursuing an additional venture.

Put option on real assets represents a proposed project that contains an option of divesting part or all of the project.