CAPITAL STRUCTURE DECISION FOR MULTINATIONAL ENTERPRISES

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Abstract: *companies doing business across international borders face different challenges concerning their international expansion, establishing new foreign subsidiaries and using foreign investments. Many scientists and researchers tried to explain why firms choose international business instead of domestic and foreign direct investment over exporting, licensing or franchising. Capital structure choice is an important strategic decision for most companies. Even in a domestic enterprise, it is a very complex decision influenced by many factors that are reflected in the stability of a company's cash flows, business risk, default and bankruptcy risks, industry debt ratio norms, and other factors that may include factors unique to the firm and its business environment.*
Keywords: *multinational Corporate Financing, multinational enterprises (MNEs), foreign direct investment (FDI), debt financing, equity financing, sinking fund provision, capital structure.*

РЕШЕНИЕ О СТРУКТУРЕ КАПИТАЛА ДЛЯ МЕЖДУНАРОДНЫХ КОМПАНИЙ

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Аннотация: *международные компании часто сталкиваются с различными проблемами, связанными с их международной экспансией, созданием новых иностранных дочерних компаний и использованием иностранных инвестиций. Многие ученые и исследователи пытались объяснить, почему фирмы выбирают международный бизнес вместо прямых иностранных инвестиций в экспорт, лицензирование или франчайзинг. Выбор структуры капитала является важным стратегическим решением для большинства компаний, на которое влияют многие факторы, которые отражаются на стабильности денежных потоков компании, бизнес-рисках, рисках дефолта и банкротства.*
Ключевые слова: *международное корпоративное финансирование, многонациональные предприятия (MNE), прямые иностранные инвестиции (ПИИ), долговое финансирование, долевое финансирование, амортизационные фонды, структура капитала.*

The principle of comparative advantage is basic concept in international trade theory and was introduced by David Ricardo. He produced an opinion that both countries can gain from trade even if one of them is more efficient in production than the other. A country should specialize in producing and exporting those products in which it has a comparative advantage and should import those goods in which it has a comparative disadvantage.

According to imperfect market theory, the decision of a firm to invest in foreign markets is based on certain advantages the firm has over the local firms such as managerial and marketing skills, product differentiation, economies of scale or firm specific technology. But this theory doesn't answer the question why a firm chooses FDI instead of licensing, franchising or joint ventures.

The international product life cycle theory was developed by Raymond Vernon (1966). The model describes how products go through the phases of introduction of product at domestic market, exporting it to foreign markets, establishing presence in foreign country and, finally, either differentiating or declining the production. But this theory cannot be applied to some types of goods and, as previous one, doesn't explain the choice of FDI.

The eclectic theory formulated by John Dunning (1988) says that foreign investment by MNCs results from three comparative advantages: firm specific advantages, internalization and location advantages. But the model doesn't focus on long run, only on initial stage of production.

Although, all the theories have different explanations of investment in international markets and FDI flows, it is evident that FDI has a positive influence on country's export performance. Firstly, FDI is undertaken for the purpose of cost reducing (production costs, labor costs, cost of materials, etc.). Nike, for example, produces a large amount of its training shoes in Asian countries, where the labour is very cheap. Secondly, a firm will set up a production facility close to the source of raw materials in the foreign countries to avoid transportation costs. Countries which very often serve as hosts for this kind of FDI are Canada, Australia, Chile, Malaysia. Thirdly, MNE's can take advantage of FDI as some international markets are growing much faster than others. Also, MNE's are entering an international market in order to attack potential competitors and prevent them from expanding their operations overseas. A company may undertake FDI to protect a brand name or product quality.

For example, McDonalds expanded overseas to protect its reputation of producing burgers. So, FDI is a driver of international business and many companies use FDI to establish in the world market by setting up operations in foreign markets or by acquiring businesses there.

Multinational enterprises always have many foreign subsidiaries and therefore it is very important which type of financing to choose for them: debt or equity. Many factors, such as profitability, risk, competitiveness of the business depend on this choice. Both debt and equity financing are important ways for businesses to obtain capital to fund their operations.

Debt financing is usually in the form of loan which needs periodical interest payments. Debt financing can be short-term (one year or less for repayment) or long-term (repayment over more than one year). MNEs can choose this type of financing if they want total control over the business as the person or entity who lends money does not have any liberties or ownership over the enterprise. Moreover, the interest on the loan is tax deductible and reduces amount of income tax to pay. But at the same time, the enterprise has to make loan payments and the inability to do it may cause loosing of assets, decreasing credit rating and bankruptcy.

These problems can be avoided using equity financing, which takes the form of money obtained from investors in exchange for an ownership share in the business. It doesn't involve any payments or interest, but investors own a piece of business and expect profits from it. So, there is loss of ownership and control over the company or, in this case, subsidiary.

Each MNE should analyze the subsidiary, its environment, market of the foreign country and decide which method of financing to use, or which proportion of both of them will lead to success. To make decision about use of debt in financing the subsidiary, the company should take into consideration interest rates and exchange rates of the country as this will influence the amounts of loan payments. Government policies, country risk and tax laws also can influence the capital structure decision. If there is a danger of government to confiscate the assets of the company, the subsidiary may use local debt financing and the creditors themselves will be interested in success of the company. Local debt financing can also be appropriate as it can reduce the tax paid. Multinational corporations take advantage of higher local tax rates by holding high debt levels in such subsidiaries. They borrow more from external non-parent sources, in countries where such financing is available, for example, countries with low political risks, and in countries where the real cost of debt may be low, such as countries with high inflation rates and high levels of corruption. It is important to mention MNE's profits and growth potential. If the enterprise is profitable, it can provide itself with sufficient funds and doesn't need loans, but if the company is expecting future expansion, it should rely on debt financing more. In addition, according to Hand, Holthausen, and Leftwich (1992) downgrade announcements of bond rating agency also affect the equity price of the firm, and the negative average effects on the debt and equity are similar, though the effects on equity are somewhat more negative than the effect on the debt [6, p. 2].

Since multinational corporations usually invest in long-term projects, they need sufficient long-term financing.

Due to Ho and Singer (1984) most of corporate debt issues contain a sinking fund provision which provides for periodic retirement of a proportion of the issue prior to maturity. Retirement may be achieved either through a call at a specified price or through market purchases.

Sinking fund adds safety to a corporate fund issue: the issuer is less likely to default on the repayment of the remaining principal since the amount of the final repayment will be less. Also, a sinking fund provides price protection because as price falls below face value, the company will become a natural buyer of its bonds in order to meet its sinking fund obligations. So, it provides security for the MNE against future business conditions, but at the same time it may cause cash shortages and in the case of inability to fulfill the requirements, the company may default or become bankrupt. In some cases, sinking fund provision can reduce the cost of debt for the MNE. Of course, the enterprise will have additional issuing costs, but the interest savings on such bonds are expected to be greater than additional variable costs.

From the point of view of investor, sinking funds reduce default risk but increase reinvestment risk. The bondholder can even loose his money if the sinking fund purchases some bonds back at a lower price. But nevertheless, sinking fund provision is advantageous for the bondholder as it provides higher interest rate compared to similar straight bond.

Sinking funds not only reduce investor risk but also have a lower yield. Since some of the bonds in the issue are retired prior to maturity, the average maturity of the bond issue decreases. This tends to reduce the risk premium of the bond much as a shorter maturity would reduce yield.

Debt may be extinguished before maturity using a call provision allowing the issuer of the bond to retire it at a specific price. When interest rate declines, the issuer can call the bond and replace it with a low coupon one. Investors, whose bonds are called, face a danger of earning less money than they expected to, because they may have to reinvest the money at lower interest rate securities. To compensate investors for the risk of bonds to be called, issuers offer higher interest rates on bonds with a call provision. They also set the call price higher than par value. That means that callable bonds have higher yield which protects investors. At the same time, the price of bonds with call and sinking fund provision is always lower than the price of identical straight bond, because if interest rates are relatively high, the issuer is able to buy back bonds at a relatively low market price, but if rates are low and prices are high, then the issuer will be able to buy back the bonds on the call option at the call price.

So, capital structure choice is an important strategic decision for most companies. Even in a domestic enterprise, it is a very complex decision influenced by many factors that are reflected in the stability of a company's cash flows, business risk, default and bankruptcy risks, industry debt ratio norms, and other factors that may include factors unique to the firm and its business environment. This complexity increases for companies that operate in more than one country. In such a company, capital structure decisions must reflect the business and financial environments in many countries where it operates. Further, such a company must make multiple capital structure decisions - capital structure decisions for each foreign affiliate and for the parent company. Due to international differences in business and financial institutional structures, choosing the best or optimal capital structure for a multinational company and its subsidiaries is a challenging task.

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