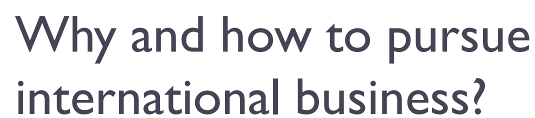
QUICK CHECKLIST

International Corporate Finance

Anna Chmielewska



Why and how to pursue international business?

Why?

- Comperative advantage
- Imperfect markets
- International product life cycle

How?

- International trade
- Licencing to Franchising
- Joint ventures
- Acquistion or establishment of new sub

© Anna Chmielewska, SGH 2017

© Anna Chmielewska, SGH 2017

Agency problem

- Discrepancy between management and shareholders interest
- Reasons
  - personal motivations
  - wrongly set KPIs
  - corporate governance
  - misleading information
- How can MCN manage agency problems?
- Centralised or de-centralised management?

© Anna Chmielewska, SGH 2017

Why and how to pursue international business?

Why?

- Comperative advantage
- Imperfect markets
- International product life cycle

How?

- International trade
- Licencing to Franchising
- Joint ventures
- Acquistion or establishment of new sub

© Anna Chmielewska, SGH 2017

CURRENCY EXPOSURE

- Long position
  - Assets in foreign currency → gives profits if FX rate of foreign currency goes up
- Short position
  - Liabilities in foreign currency → gives profits if FX rate goes down
- Balance position
  - Assets or liabilities on the current value date
- Off-balance / cash flow position
  - Settlement of FX cash flows will be done in the future
- Indirect FX exposure
  - FX changes affects competitiveness or volumes

© Anna Chmielewska, SGH 2017

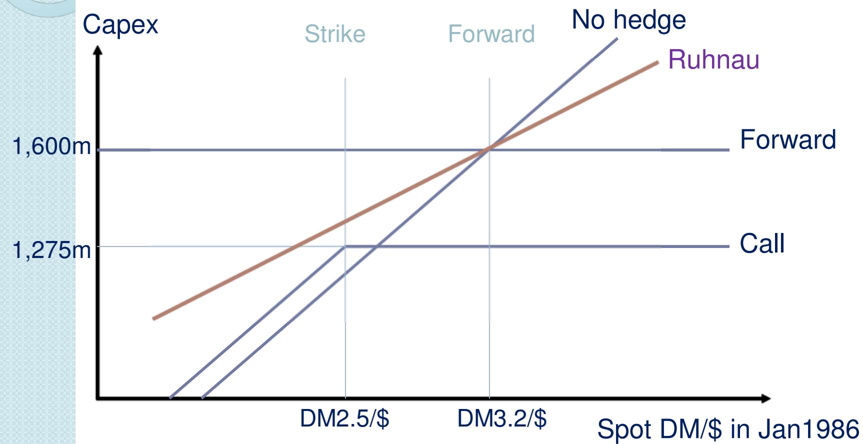
How to hedge FX Exposure

- Natural hedge
- FX Forward
- Options

© Anna Chmielewska, SGH 2017

© Anna Chmielewska, SGH 2017

Hedging strategies



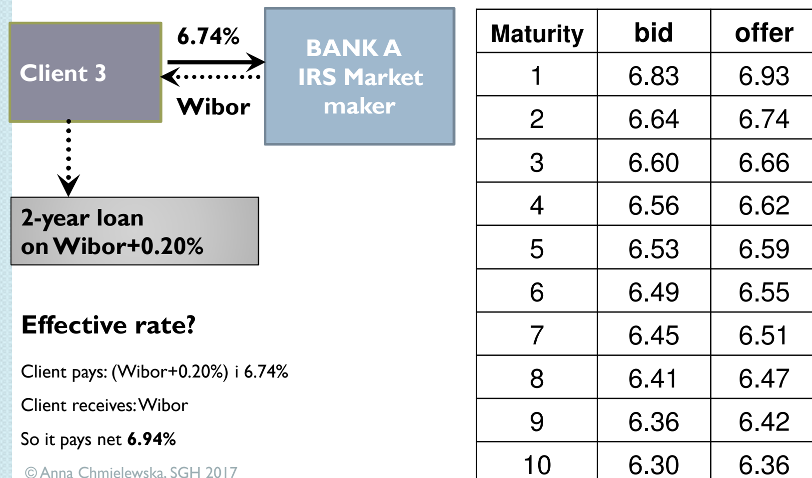
© Anna Chmielewska, SGH 2017

Interest rate exposure

- Situation where company faces profits or losses on the interest rate fluctuations
- Long position in interest rate is when Company benefits from interest rate increases
  - Company has significant liquid interest bearing assets
- Short position in interest rate is when Company benefits from interest rate decreases
  - Company has loans with interest calculated based on variable interest benchmark (e.g. LIBOR)

© Anna Chmielewska, SGH 2017

Application of interest rate swap



Maturity	bid	offer
1	6.83	6.93
2	6.64	6.74
3	6.60	6.66
4	6.56	6.62
5	6.53	6.59
6	6.49	6.55
7	6.45	6.51
8	6.41	6.47
9	6.36	6.42
10	6.30	6.36

Effective rate?

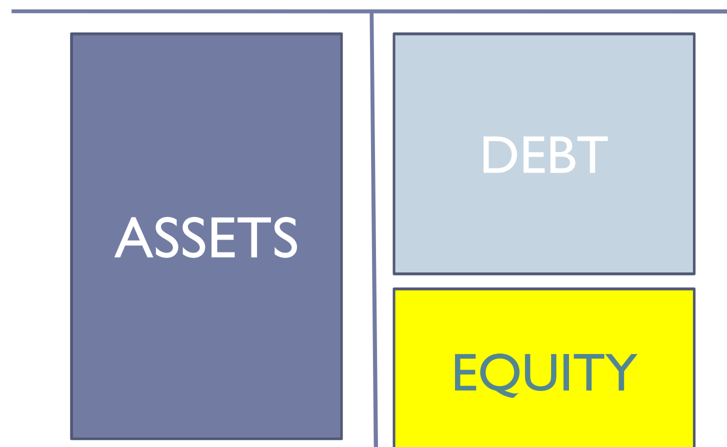
Client pays: (Wibor+0.20%) i 6.74%

Client receives: Wibor

So it pays net **6.94%**

©Anna Chmielewska, SGH 2017

Company's Balance Sheet



©Anna Chmielewska, SGH 2017

WACC

The **weighted average cost of capital (WACC)** is the marginal cost of raising additional capital and is affected by the costs of capital and the proportion of each source of capital

© Anna Chmielewska, SGH 2017

Capital Structure Irrelevance

- Franco Modigliani and Merton Miller (MM) theory that helps us understand how taxes and financial distress affect a company's capital structure decision.

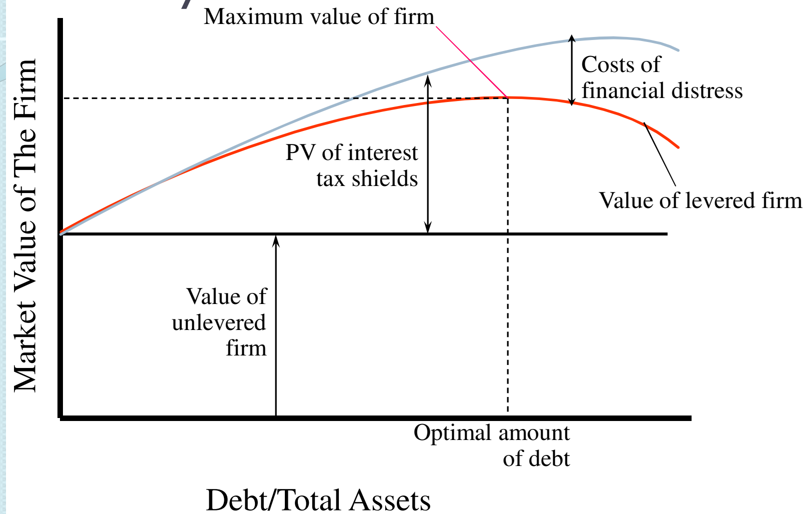
- Unrealistic assumptions, but helpful conclusions:

1. Homogeneous expectations
2. Bonds and stocks are perfectly traded
3. Borrowing rate = lending rate
4. No agency costs.
5. Investment and financing decisions are independent

© Anna Chmielewska, SGH 2017

© Anna Chmielewska, SGH 2017

Modified corporate structure theory



© Anna Chmielewska, SGH 2017

No Optimal Capital Structure

Taxes	Costs to Financial Distress	Optimal Capital Structure?
No	No	No (classic MM)
Yes	No	Yes, 99.99% debt
Yes	Yes	Yes, benefits of interest deductibility are offset by the expected costs of financial distress

Optimal capital structure for a given company depends:

- business risk
- tax situation
- tangibility of company's assets
- corporate governance.
- transparency

© Anna Chmielewska, SGH 2017

© Anna Chmielewska, SGH 2017

Leverage impact on IRR

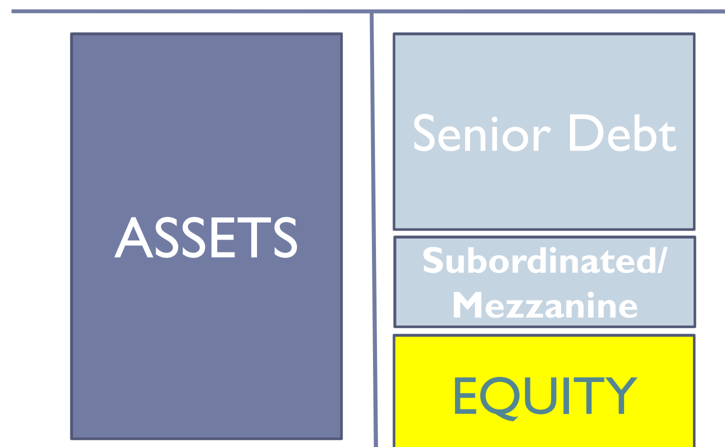
- Unlevered investment of $1mio yields 4.8% p.a.
- 70% levered investment yields 12.2% p.a.
- Exit after 2 years, selling price $ 1 100 000, Prepayment fee 1%

- Unlevered example
  - 2 years profits add to $96k
  - Sales revenues were $1100k, therefore tax is 20k
  - Total inflows for equity is 96k + 1100k - 20k = 1176k
  - Therefore return on equity investment is 76 000 /1 000 000 = 17.6%

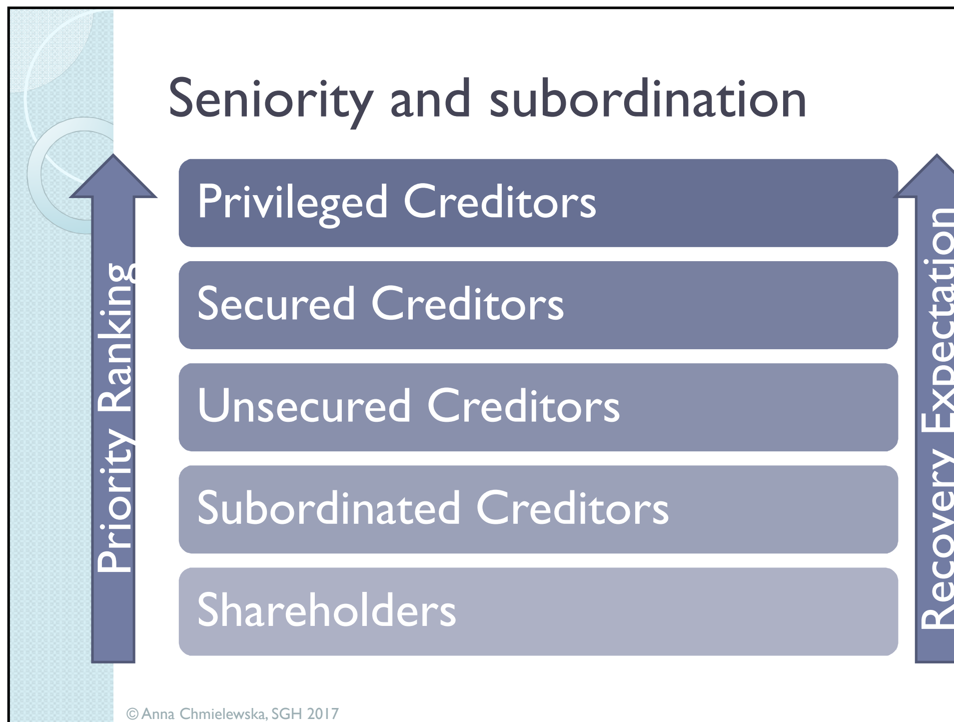
- Levered example
  - 2 years profits add to $3.6k
  - Sales revenues were $1.1mio, therefore capital gain tax is $20k
  - Loan remaining to be repaid $630k , prepayment fee $6.3 mio
  - Therefore all inflows for equity is (3.6k + 1100k -20k- 636.3) = 447.3
  - in return is $ 147 300 / 300 000 = 49.1%

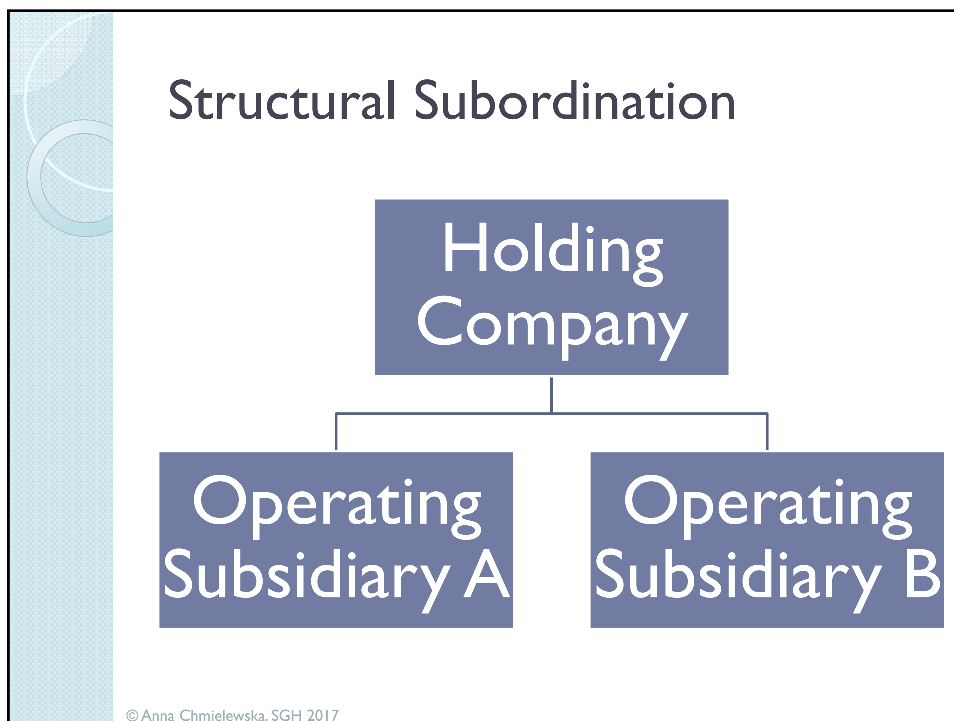
© Anna Chmielewska, SGH 2017

Structure of Indebtness



© Anna Chmielewska, SGH 2017


Seniority and subordination
Priority Ranking
Privileged Creditors
Secured Creditors
Unsecured Creditors
Subordinated Creditors
Shareholders
Recovery Expectation
© Anna Chmielewska, SGH 2017


Structural Subordination
Holding Company
Operating Subsidiary A
Operating Subsidiary B
© Anna Chmielewska, SGH 2017

Covenants - examples

- Negative pledge
- Pari-passu
- Cross default
- Change of control
- Material Adverse Clause

Other requirements

- Debt Service Reserve Account
- Cash Sweep Mechanism

© Anna Chmielewska, SGH 2017

Financial Covenants

- Debt service coverage ratio
- Interest coverage ratio
- Debt to EBITDA
- Current ratio
- Leverage ratio
- Tangible net worth

© Anna Chmielewska, SGH 2017

Private equity or public equity?

- Know the co-investor
- Choose the co-investors
- Pre-agreed shareholders agreement
- Better protection of sensitive information
- Lower costs
- Typically lower price

- Access to broad investor base
- Publicity/ Prestige
- Stock exchange rules apply
- Access to capital in the future
- Limited influence on the choice of investors
- High costs but higher proceeds
- Motivation for employees
- Market Valuation

© Anna Chmielewska, SGH 2017

Shareholders Agreement – main areas of decisions

- Core business / Strategy of the Company and majority needed to change it
- Management and its appointment
- Supervisory Board composition
- Scope of decisions made at Shareholders and Supervisory Board Meetings (and majority needed)
- Anti dilution – decisions on capital increases
- EXIT (especially for the minority investors)

© Anna Chmielewska, SGH 2017

Exit
– special provisions

- Put option
- Call option
- Right of First Refusal
- Drag-along rights
- Tag-along rights

© Anna Chmielewska, SGH 2017

Contrasting a buyout with an acquisition

	PE acquirer	Corporate acquirer
Use of a Newco	Newco must be created to hold the shares	Target can be taken as a subsidiary of the acquirer
Impact of debt	Acquisition debt is held in the Newco and does not gear up the PE fund	Debt relating to the acquisition is not ring-fenced and affects the acquirer's capital structure
Conditional payments	Ratchets can be used change shareholdings, dependent on performance	Earn-outs can be used to give the sellers further proceeds, dependent on performance
Changes to target business operations	Part of the acquisition plan agreed with management	Generally plans for synergies to be created
Management incentives	Linked completely to the eventual exit from the investment	Will depend on the corporate objectives
Purpose and timescale of acquisition	The acquisition is made with an ultimate profitable disposal in mind	Probably made for strategic reasons with no expectation of selling on
Funding the acquisition	A relatively high level of debt	To meet the corporate financial structure

© Anna Chmielewska, SGH 2017

Pre- and Post- Money Valuation

- Pre-money valuation
  - Takes into account situation before the new proceeds
  - Assumes new proceeds will generate similar IRR
- Post-money valuation
  - Takes into account new proceeds for the valuation of the Company
  - % holding is determined based on share in valuation (discounted)

© Anna Chmielewska, SGH 2017

Pre- vs. Post-Money Does it matter?

If the Company is worth 100m and needs 100m investment, which is expected to boost it to 300m (as new project is more promising than existing business).

Than PE approach would be to get 50% stake,

…. Perhaps VC could accept 33%

© Anna Chmielewska, SGH 2017

Term Sheet : typical areas

- Offer
- Use of proceeds
- Return/Dividends
- Other options: conversion, drag along, tag along, right of first refusal
- Voting rights
- Exit
- Other undertakings

© Anna Chmielewska, SGH 2017

Country Risk

POLITICAL ASPECTS

- Attitude of consumers in the host country
- Actions of host government
- Blockage of fund transfers
- Currency inconvertibility
- War
- Inefficient bureaucracy
- Corruption

FINANCIAL ASPECTS

- Economic growth
- Interest rates
- Exchange rate
- Public debt
- Inflation

© Anna Chmielewska, SGH 2017

Country risk ratings
Rating Agencies

Issuer Ratings Scales

S&P	Moody's	Fitch
Investment grade		
AAA	Aaa	AAA
AA+	Aa1	AA+
AA	Aa2	AA
AA-	Aa3	AA-
A+	A1	A+
A	A2	A
A-	A3	A-
BBB+	Baa1	BBB+
BBB	Baa2	BBB
BBB-	Baa3	BBB-
Speculative grade		
BB+	Ba1	BB+
BB	Ba2	BB
BB-	Ba3	BB-
B+	B1	B+
B	B2	B
B-	B3	B-
CCC+	Caa1	CCC+
CCC	Caa2	CCC
CCC-	Caa3	CCC-
CC	--	CC
C	--	C

© Anna Chmielewska, SGH 2017

Sample questions

Which strategy allows the exporter from Poland to US to limit FX risk:

a) bill the clients in USD
b) buy USD in the forward transaction
c) buy a put option for USD
d) ensure all costs are in domestic currency
e) all the above

© Anna Chmielewska, SGH 2017

Sample questions

Depreciation of local currency is typically favourable in short term

a) For importers to that country
b) For exporters from that country
c) For both importers and exportes
d) One cannot say if for exporters or importers
e) It depends on the sector

© Anna Chmielewska, SGH 2017

Sample questions

Which of the following is true about FX risk:

a) It relates only to floating currency regime
b) It affects only companies which are active abroad
c) It cannot be lowered with natural hedging methods
d) It can only be lowered using derivatives
e) None of the above

© Anna Chmielewska, SGH 2017

Sample questions

Tax shield effect means

a) Setting company in tax-friendly country
b) Tax benefit granting for businesses in special economic zones
c) Lowering of tax, related to higher use of financial debt
d) Main assumption of the classic Miller Modigliani theorem
e) None of the above

© Anna Chmielewska, SGH 2017

Sample questions

To protect against interest rate increase related to a floating rate loan, you need to:

a) pay fix rate under the IRS
b) receive fix rate under the IRS
c) conclude an FX Swap contract
d) invest the loan proceeds to buy FX options
e) sell a forward rate agreement

© Anna Chmielewska, SGH 2017

Sample questions

Which of the following is true:

a) Modigliani-Miller theorem says company's value is independent from how it is financed
b) Equity owners always want company managers to minimize the costs in the company
c) Equity owners always want company managers to maximize dividends
d) Managers who know Modigliani-Miller theorem pay much attention to how (debt vs. equity) the company is financed
e) All answers are correct

© Anna Chmielewska, SGH 2017

Sample questions

Pre-money valuation is 100 million and you want to invest 25 million in equity of this company as new capital for the expansion of the company to finance project which is expected to boost Company's valuation to 250 million. Based on pre-money valuation approach when making such capital increase you will receive:

a) 25% of shares in the company
b) 20% of shares in the company
c) 25% of shares but only 20% of votes in the company
d) 10% of shares in the company
e) There is not enough information to calculate

© Anna Chmielewska, SGH 2017

Sample questions

Which currency would you use (as currency of a 10 year loan you take) if your company is Switzerland based and need to pay for machinery in USD (in 3 payments over the next two years), but your revenues are denominated in EUR

a) USD
b) EUR
c) CHF, as there are lowest interest rates in the Switzerland
d) USD or EUR depending on which currency benefits from lower interest rates
e) It does not make a difference to the company – any currency can be used, as it can be easily converted using FX spot market

© Anna Chmielewska, SGH 2017

Sample questions

Private equity transaction means investing in

a) Equity in form of shareholders loans
b) Shares by private investors other than via stock exchange
c) Shares by high net worth individuals rather than by institutional investors
d) Equity that is not listed at the stock exchange
e) Early stage businesses

© Anna Chmielewska, SGH 2017

Sample questions

Classic Miller and Modigliani theory suggests that

a) Company value should be unaffected by how it is financed
b) Company should do international to benefit from diversification
c) The optimal leverage is around 70%
d) The lower the share of debt the more the company is worth
e) Company's value depends in 50% on financing structure and in 50% on business risk

© Anna Chmielewska, SGH 2017

Sample questions

Which of the below represents the highest (safest) country rating

a) AAA
b) BB
c) ABC
d) D
e) A

© Anna Chmielewska, SGH 2017

Sample questions

Which is the cheapest (from the company perspective) way to finance the new project:

a) Bank loan
b) Shareholders' loan
c) Equity from the IPO
d) Venture capital
e) Subordinated bond

© Anna Chmielewska, SGH 2017

© Anna Chmielewska, SGH 2017