

*Jerzy Różański\**

## SOURCES OF FINANCING MULTINATIONAL CORPORATIONS

**Abstract.** This paper describes various sources of financing transnational corporations and related opportunities for raising capital at a relatively low cost. Risks involved in location of subsidiary companies in countries lacking economic stability are discussed and other factors unfavourably affecting the efficiency of different sources of finance are analysed. In view of a growing number of multinational enterprises operating in the countries of Central and East Europe, issues addressed in this paper are becoming increasingly important and topical for these countries.

### 1. Introduction

Multinational companies have subsidiaries or branches operating in different countries varying widely in terms of the economic, social, political and cultural context. This requires adaptation of the various sub-units of a multinational company to operation in different conditions. Subsidiary companies have to learn to carry out operations in different market conditions. They also have to take into account the specificity of the economic legislation, including tax legislation, varying availability of the factors of production, and the availability and cost of capital.

The problems mentioned above are due to the fact that different countries differ widely as regards the ways of using shareholders' equity, costs of securing various kinds of financing, possibility of obtaining funds on local capital markets, convertibility of local currencies and principles of profit distribution (dividend level, taxation, creation of reserves).

In some countries regulations may turn out to be favourable to foreign enterprises, while in others they are not. For this reason the sphere of financing business activity is an important aspect taken into consideration

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\* Department of Enterprise Management, Faculty of Management, University of Łódź, Poland, katzprz@uni.lodz.pl

in making decisions on the location of a subsidiary. It should be pointed out, however, that a multinational company has a much wider range of possibilities in the financial sphere than a typical enterprise operating on a national scale, which will be discussed further in the text.

The strategies of financing the activity of an enterprise operating internationally are bound to be significantly different from those used by domestic companies. A company that carries out its business on an international scale operates in differing economic, social, political and cultural environments and thus has to face up to this diversity, which creates both opportunities and threats. A company can be said to take advantage of the opportunities offered by such a situation when it skilfully adjusts the operations of its branch establishments to specific conditions existing in particular countries and gets all the benefits that can be derived in consequence of choosing a particular location.

## **2. Specification of the sources of finance for multinational companies**

The financial sphere is of primary importance in this respect. There may be considerable differences between countries as regards costs of obtaining foreign capital, opportunities offered by the type of the capital market in a given country, foreign exchange constraints, shareholders' rights or rules for the preparation of financial statements. The regulatory context in certain countries may prove, in terms of the factors mentioned above, very unfavourable to companies operating on an international scale. On the other hand, a transnational corporation can take advantage of a number of opportunities to derive benefits, such as tax reliefs, exemptions from certain charges or direct investment facilities. There also are some other advantages arising from differences in foreign exchange rates, risk reduction as a result of its dispersion, lower interest rates on credits and greater ease to raise finance through issue of securities.

One advantage of a multinational company over that operating domestically is that it has more leeway in such areas as:

- raising funds at the lowest possible cost,
- reporting profits in the countries where it carries on its business operations,
- transfer costs determination,
- costs of securities issue,
- avoiding excessive taxation,
- reducing the risk of loss on transactions or investments by hedging.

All this makes it easier to achieve greater profitability and improved liquidity.

A multinational company can maintain the liquidity of its daughter companies through appropriate management of their current revenues and expenditures, taking care that liquidity is achieved in all currencies that enter into the financial settlement system of the multinational company. The application of this practice also ensures that overdependence of the subsidiaries on local capital markets is avoided.

The principal advantage of multinational corporations is the multiplicity of alternative sources of finance available to them.

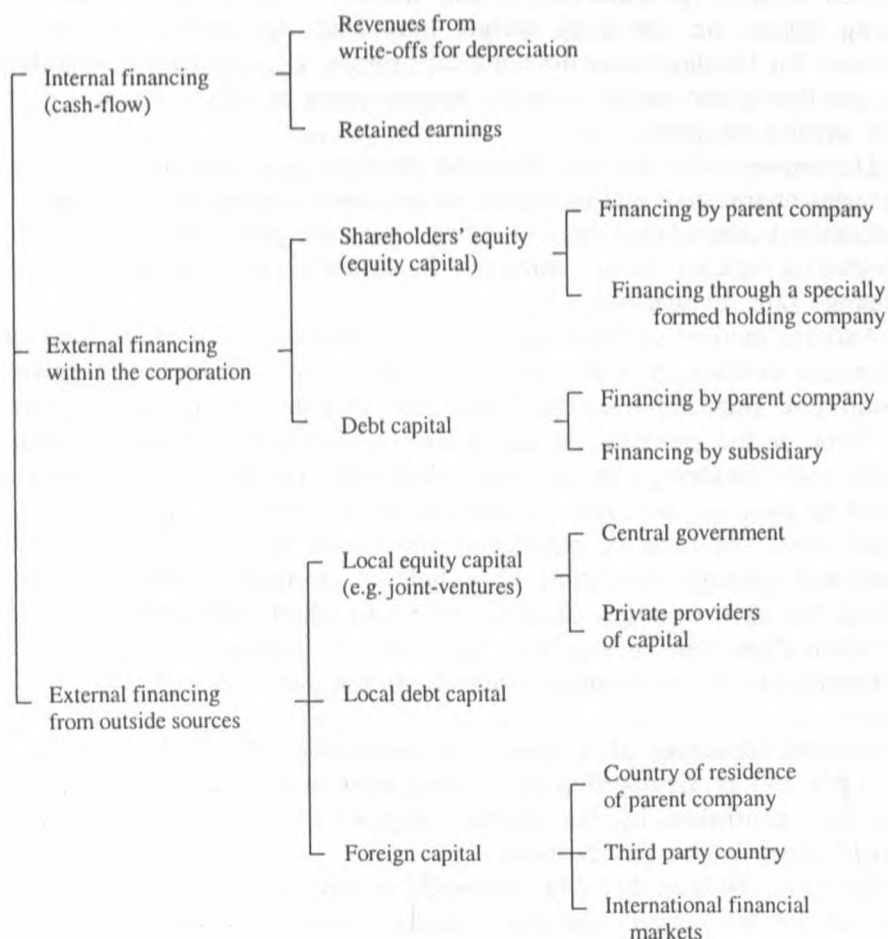


Fig. 1. Sources of financing a multinational company

Source: Perlitz, 2000, p. 509.

Internally generated cash includes provisions for depreciation, the amount of which in foreign subsidiaries is largely determined by rules governing depreciation in particular countries, that is the method of calculating depreciation (straight-line, declining-balance, progressive, accelerated) and estimated useful lives of fixed assets, which, too, affects the amount of annual provisions. Of considerable importance is also the method of determining the base value of the depreciable fixed assets.

The rules for the distribution of profits also differ widely across countries, like many other factors constituting business environment. Local regulations may require foreign investors to leave part of their profits in a given country (constraints on the transfer of profits). Difficulties in raising capital on the local market may lead the investor to use own resources for funding future development projects. Of considerable importance, too, are divergences in the rules for appropriating profits to reserves exempt from income taxation.

The reasons why internal financing plays an important role in financial strategies of transnational corporations are many and varied. The possibility to finance business development using internally generated funds protects subsidiaries against local variations in interest rates, unstable markets, exchange rate fluctuations, etc.

Another method of financing business operations is financing particular companies making up a multinational corporation by means of transfer of unemployed financial resources from one company to another – either in the form of the purchase of shares (equity financing) or in the form of a loan (debt financing). In this way subsidiaries are protected against being forced to raise capital from outside the group. Internal financing in such a case takes the form of purchasing the shares by a parent company or is effected through formation of a holding company. Debt financing is carried out by the parent company or its daughter companies.

“Cash flows can be regulated by means of leading or lagging internal payments or by appropriate transfer pricing policy” (Perlitz 2000, p. 511).

Internal financing of a group of companies affects the structure of dividends and profit distribution in companies making up the group. Cash flows are controlled by the parent company or the financing company, formed specially for this purpose.

Perlitz (2000, p. 511–512) distinguishes three specific types of financing used where, for various reasons, a foreign corporation can not carry out internal funds transfers between member companies of the group:

- a) parallel financing,
- b) deposit financing,
- c) credit financing.

Parallel financing designates a situation when two multinational corporations operating in different countries co-operate in such a way that the parent company of one corporation grants credit to a subsidiary of the other corporation. The credits are granted in the same amounts and for the same length of time. Since the parent company of the transnational corporation X operates in the same country as the daughter company of the corporation Y, such a transaction makes it possible to avoid problems relating to exchange rates as well as the need to transfer capital to another country. Obviously, the only problem in this case is finding a multinational corporation X whose parent company is resident in country A, where also the subsidiary of corporation Y is based, and, vice versa, country B in which the parent company of corporation Y would be able to finance the daughter company of corporation X.

With deposit financing the idea is that a parent company deposits money in a bank in the country in which its subsidiary operates. The bank allows the subsidiary credit, obviously in the currency of a given country. When the daughter company repays the loan, the parent company withdraws the deposit. As the deposit is made in the currency of the country in which the parent company is resident, and the credit is granted in the currency of the country where the subsidiary operates, the bank has to carry the burden of all the settlement operations as well as, in part, the risk associated with the transaction.

Credit financing differs from deposit financing in that the parent company deposits money not in a bank operating in the subsidiary's host country, but in the bank's branch operating in the parent company's country. This makes it easier for the parent company to exert influence on the bank dealing with the subsidiary in question.

External financing within a multinational corporation plays a major role. It provides an alternative to internal financing, and in many cases is treated as a supplementary method of financing, thus enabling subsidiaries to carry on operations without excessive reliance on local capital markets and local sources of funding. The profitability of this type of financing is accounted for in the multicriterial investment account maintained by transnational corporations (Schoppe 1998, p. 565–657).

External financing from sources outside the group can take different forms. One of the primary methods of external financing from outside sources is through formation of joint-ventures. In this way the equity capital of a subsidiary is supplemented with capital brought in by the local partner. Obviously, the partner from the host country gains influence on financial decisions of the new-established company. The state treasury or private capital can act as the local partner in a joint-venture. A multinational company should carry out international benchmarking in order to compare

the relative attractiveness of the various aspects of operating in foreign countries, financing methods available being one of major considerations (Solnik 1996, p. 575–599).

Subsidiaries can take advantage of local sources of external financing, their willingness to use these sources being largely dependent upon:

- terms on which credit would be granted by local banks (interest rates, commissions and charges, repayment terms),
- terms of raising finance through securities issue.

This type of external financing may sometimes prove very advantageous, because:

- it strengthens the company's position and facilitates its integration into the host country's economy,
- local providers of capital may be interested in contributing to good financial condition and thus to further operation of the subsidiary, which may result in favourable terms of obtaining capital on local capital markets,
- allows subsidiaries to avoid their financial decisions being influenced by local co-owners (as in the case of joint-ventures).

In order to protect subsidiaries from excessive influence of local capital providers, the parent company itself can derive funds from local markets and transfer them to its daughter company. If, however, local banks, stock-exchange and other financial institutions in the subsidiary's host country turn out to be too weak or not reliable enough, then it will have to seek finance in:

- the country where its parent company is based,
- some other country,
- international financial markets.

The attractiveness of international capital markets lies in their being able to offer a number of different kinds of financing, unavailable on local markets. However, in order to take advantage of this wide offer, the borrowers need to be able to make right choices. It is important to note that in financing their operations transnational corporations can choose the offer of the cheapest financial markets regardless of the location of their own resources (Caves 1999, p. 140). The operation of subsidiaries of large multinational enterprises in international financial markets is facilitated because they are backed by the power of the whole group, which may guarantee with all its assets the solvency of its member company. A major factor facilitating cross-border cooperation of enterprises, their internationalisation and supply of capital is progressing European integration (Faulhaber, Tamburini 1992, p. 138–140).

In choosing the method of financing, companies should take into account the risk connected with interest rate variations, which may significantly affect their financial position.



### 3. Cost of capital and capital structure in multinational companies

Multinational enterprises view the cost of capital in a different way than domestically-operating enterprises. The cost of capital in multinationals includes:

- cost of interest on capital,
- cost of commissions and charges connected with obtaining capital,
- costs related to raising capital abroad,
- costs related to exchange rate fluctuations.

A multinational enterprise will tend to seek financing in those countries where the cost of capital turns out to be the lowest.

Since multinational enterprises are particularly sensible to risk related to changes in interest rates and foreign exchange rates, they mostly choose those financing sources which do not involve such risks. Additionally, one of major elements of a company's financial strategy is determining the optimal capital structure. Hence the decisions on equity levels in subsidiary companies are taken in the group's headquarters. The proportion of equity capital in daughter companies is particularly important when such a company operates in countries where economic and political stability is low, and foreign exchange risk is high.

Where there is danger that the state may take over the company's equity capital or restrict the transfer of profits, a low proportion of equity is recommended. Low equity levels in such cases do not necessarily imply the risk of insolvency, but this will largely depend on the availability and terms of acquiring capital in a foreign country.

Financial and credit rating of the entire multinational corporation is largely dependent on the rating of its subsidiary companies. The reverse of this statement is also true, the dependence being even stronger: the creditworthiness of the multinational enterprise affects the rating of its daughter companies. As a result of existing interdependencies there is a tendency for capital structure to converge in companies comprising the group, which also enhances the comparability of the financial standing and creditworthiness between subsidiaries as well as makes their credibility closer to the level achieved by the parent company.

Management of the capital structure of a multinational company is undisputedly more complex than in a company operating on a national scale. There are many more possibilities of attaining a structure than on the one hand would minimise the cost of capital, and on the other hand would not lead to overdependence of a multinational company on particular sources of finance.

Major advantages in the financial sphere include:

- greater potential for raising capital, which is due to a wider variety of financing methods available to such a company,
- possibility of finding cheaper sources of finance,
- possibility of flexible internal financing (inter-company transfers of shareholdings and loans),
- greater competitiveness of subsidiary companies (financial and credit standing is guaranteed by the whole group).

There also are some risks and limitations concerning the financing process:

- sometimes it is necessary to acquire debt finance offered by local money and capital markets characterised by high volatility of loan interest, exchange rates, stock values and expected return on capital,
- additional costs may have to be incurred in raising capital (cost of transfer, currency translations, increased capital charges),
- certain risks are involved in co-operation with the local partner (as in a joint-venture).

#### 4. Conclusion

An important element in the evaluation of the conditions in which multinationals operate is economic, social and political stabilisation in the countries where these enterprises carry out their operations. Unstable business environments sometimes force companies to seek finance either in the parent company's country of residence, or on international capital markets, which involves increased costs of obtaining capital, the need for currency translations and heightened risk related to capital transfers. This is the main reason why transnational corporations sometimes give up locations with potentially more profitable markets if this would mean operation of their subsidiaries in unstable environments. A question arises, then, what levels of expected extraordinary profits would induce multinational corporations to venture business operations in countries with little stability in the economic, social and political spheres.

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*Jerzy Róžański*

## **ŹRÓDŁA FINANSOWANIA PRZEDSIĘBIORSTW MIĘDZYNARODOWYCH**

(Streszczenie)

Artykuł ukazuje różnorodność źródeł finansowania przedsiębiorstwa międzynarodowego oraz związane z tym możliwości pozyskiwania kapitału przy relatywnie niskich kosztach kapitałowych. Wymienia się również niebezpieczeństwa, które wiążą się z lokalizacją spółek-córek przedsiębiorstwa międzynarodowego w krajach o mniej stabilnej gospodarce oraz wpływem innych czynników niekorzystnie oddziałujących na efektywność określonych źródeł finansowania. Wzrastająca liczba przedsiębiorstw międzynarodowych w krajach Europy Środkowo-Wschodniej sprawia, że przedstawione problemy stają się w tych krajach coraz ważniejsze i bardziej aktualne.

*Jerzy Róžański*

## **TARPTAUTINIŲ VERSLO KORPORACIJŲ FINANSAVIMO ŠALTINIAI**

(Santrauka)

Pranešime pateikta tarptautinio verslo korporacijos finansavimo šaltinių įvairovė ir su tuo susijusios galimybės gauti kapitalą esant santykinai mažoms kapitalo lėšoms.

Taip pat išvardinti pavojai, kurie yra susiję su tarptautinio verslo dukterinių įmonių išsidėstymu šalyse, kuriose yra mažiau stabilus ūkis ir yra kiti faktoriai, nepalankiai veikiantys apibrėžtų finansavimo šaltinių efektyvumą. Dėl didėjančio tarptautinių įmonių skaičiaus vidurio ir rytų Europos šalyse pranešime aprašytos problemos tose šalyse tampa vis svarbesnės ir vis labiau aktualios.