CHAPTER 11: F I I, F D I & I F M

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F I I & F D I

FDI is the investment that is made in a country (host country) which is different from the country (home country) of the investor. FDI / FII have the following effects:

Host country:

a. Improves the BOP position as it involves capital inflow. Similarly BOP is adversely affected because of outflows in the nature of Royalties, dividends, technical fees etc.
b. Use of imported material could lead to dependence on foreign country.
c. Damages the environment and natural resources.
d. MNCs' are reluctant to hire and train local people.
e. Improves forward and backward linkages.
f. Usage of updated technology along with continuous upgradation.
g. Prices of products will be high.
h. Foreign culture is imposed.
i. Domestic industries may face premature death due to the invasion of foreign firms.
j. Improves bilateral relations.
k. I T collections will go up for government.

Home country:

a. Involves flight of capital and manpower.
b. Affects BOP due to capital outflow and inflow of dividends, royalty, technical fee etc.
c. More employment generation as the parent company enters new countries.
d. Improves bilateral relations.

INTERNATIONAL FINANCIAL MANAGEMENT

The essence of financial management is to source funds in the cheapest possible manner and use them effectively for optimum returns. This holds well in international financial management also. There are various ways and sources through which international finances can be raised.

External Commercial Borrowings (ECB): This is one of the most common ways of raising foreign funds. It can be in any of the following forms:

a. Commercial bank loans;
b. Buyer's credit;
c. Supplier's credit;
d. Floating rate notes (Interests are adjusted to reflect the prevailing exchange rate. These are not popular.) / fixed rate bonds etc.;
e. Euro Commercial Papers: Designated in US Dollar, they are short-term instruments.
f. Credit from official export credit agencies;
g. Borrowings from multilateral financial institutions like IFC, ADB, FIIs, PEs, Export Credit agencies, etc.
h. International capital markets; etc.

ECB is to be used towards foreign exchange payments of capital goods and services. However, in case of infra projects that are crucial for the development and growth of country, like power, telecom, railways etc. The fund can be used for rupee payments also by bringing the ECB funds into India immediately. The fund is to be utilised at the earliest and RBI guidelines are to be complied. The crucial principle is the funds should be long term funds and costs low. The government of India, from time to time changes the guidelines and limits for which the ECB alternative as a source of finance is pursued by the corporate sector. During past decade the government has streamlined the ECB policy and procedure to enable the Indian companies to have their better access to the international financial markets. ECB funds are not to be used for:

a. Investment in stock market;
b. Speculation in real estate; etc.

The government permits the ECB route for variety of purposes namely expansion of existing capacity as well as for fresh investment. But ECB can be raised through internationally recognised sources. There are caps and ceilings on ECBs so that macro economy goals are better achieved. Units in SEZ are permitted to use ECBs under a special window.

Security to be provided to lenders is left to borrowers. ECBs are exempt from withholding tax. In case of short term (upto 3 years) loans, RBI permission is needed and for long term loans, approval from ECB division of Department of Economic affairs of Ministry of Finance is required.

Instruments of International Finance:

1. **Foreign Currency Convertible Bonds (FCCB):** FCCB is an instrument issued by an Indian Company in foreign currency. This is a mix of a debt and equity instrument. The bond is optionally convertible into equity as per the desire of the holder. The bonds carry small coupon rate during their identity as bonds. Salient features of the bond are:
   a. These bonds can be converted into shares of the Indian Company in rupee terms.
   b. Prior permission of the Department of Economic Affairs, Government of India, Ministry of Finance is required for their issue.
   c. There will be a domestic and a foreign custodian bank involved in the issue.
   d. FCCB shall be issued in accordance with applicable Laws relating to issue of capital by a company.
   e. Tax on FCCB shall be as per provisions of Indian Taxation Laws and Tax will be deducted at source.
   f. Conversion of bond to FCCB will not give rise to any capital gains tax in India.

   Advantages:

   a. Bonds give an opportunity to the investor to have the coupon rate or to have them converted into equity and take benefit of capital appreciation.
   b. Bonds benefit the companies to have delayed dilution.
   c. These are easily convertible and investor is assured of minimum coupon payment.
   d. Bonds have generally low coupon rates.

   Disadvantages:

   a. Forex risk in payment of interest and principal to the Company.
   b. Hedging of interest and principal payment risk is difficult as it is uncertain about their duration and amount.

2. **Global Depository Receipt (GDR):** A depository receipt is basically a negotiable certificate, denominated in a currency not native to the issuer, that represents the company's publicly - traded local currency equity shares. Most GDRs are denominated in USD, while a few are denominated in Euro and Pound Sterling. Theoretically, GDR can mean debt as well, but rarely it is used with this sense. GDRs are issued by a foreign bank upon deposit of shares in Indian currency by the Indian Company with the foreign bank’s depository. GDRs may be issued in the

ratio of one GDR for each Indian share or any other suitable ratio. Upon issue of GDRs' they are freely tradeable in foreign exchanges upon their listing or in OTC market. Alternatively, they may be issued to only QIBs (These are institutions in USA which, in the aggregate, own and invest on a discretionary basis at least US $ 100 million in eligible securities.) By virtue of GDRs Indian corporates are able to tap global markets and at times at premiums eventhough their shares were trading at discount in local markets.

The impact of GDRs is significant:

a. Indian capital market has shifted to certain extent from Bombay to Luxembourg.
b. There is arbitrage possibility in GDR issues.
c. Indian stock market is no longer independent from the rest of the world. This puts additional strain on the investors as they now need to keep updated with worldwide economic events.
d. Indian retail investors are completely sidelined. GDR's / Foreign Institutional Investors' placements + free pricing implies that retail investors can no longer expect to make easy money on heavily discounted rights / public issues.
e. A considerable amount of foreign investment has found its way in the Indian market which has improved liquidity in the capital market.
f. Indian capital market has started to reverberate by world economic changes, good or bad.
g. Indian capital market has been widened and deepened as well.
h. It has now become necessary for Indian capital market to adopt international practices in its working including financial innovations.

As a result of introduction of GDR's a considerable foreign investment has flown into India. This has also helped in the creation of specific markets like:

a. GDR's are sold primarily to institutional investors.
b. Demand is likely to be dominated by emerging market funds.
c. Switching by foreign institutional investors from ordinary shares into GDR's is likely.
d. Major demand is also in UK, USA (Qualified Institutional Buyers), South East Asia (Hong Kong, Singapore), and to some extent continental Europe (principally France and Switzerland).

The following profile of GDR investors has been observed.

a. Dedicated convertible investors.
b. Equity investors who wish to add holdings on reduced risk or who

require income enhancement.

c. Fixed income investors who wish to enhance returns.
d. Retail investment money, normally managed by continental European banks which on an aggregate basis provide a significant base for Euro-convertible issues.

Characteristics:

a. Holders of GDRs participate in the economic benefits of being ordinary shareholders, though they do not have voting rights.
b. GDRs are settled through CEDEL & Euro-clear (Depositories) international book entry systems.
c. GDRs are listed on the Luxembourg stock exchange.
d. Trading takes place between professional market makers on an OTC (over the counter) basis.
e. The instruments are freely traded.
f. They are marketed globally without being confined to borders of any market or country as it can be traded in more than one currency.
g. Investors earn fixed income by way of dividends which are paid in issuer currency converted into dollars by depository and paid to investors and hence exchange risk is with investor.
h. An investor may get the GDR cancelled any time after a cooling off period of 45 days. A non-resident holder of GDRs may ask the overseas bank (depository) to redeem (cancel) the GDRs In that case overseas depository bank shall request the domestic custodians bank to cancel the GDR and to get the corresponding underlying shares released in favour of non-resident investor. The price of the ordinary shares of the issuing company prevailing in the Bombay Stock Exchange or the National Stock Exchange on the date of advice of redemption shall be taken as the cost of acquisition of the underlying ordinary share.

3. **Euro Convertible Bonds:** A convertible bond is a debt instrument which gives the holders of the bond an option to convert the bond into a predetermined number of equity shares of the company. Usually, the price of the equity shares at the time of conversion will have a premium element. There bonds may have two options:
   a. **Call option:** Under this the issuer can call the bonds for redemption before the date of maturity. Where the issuer's share price has appreciated substantially, i.e., far in excess of the redemption value of bonds, the issuer company can exercise the option. This call option forces the investors to convert the bonds into equity. Usually, such a case arises when the share prices reach a stage near 130% to 150% of the conversion price.
   b. **Put option:** It enables the buyer of the bond a right to sell his bonds

to the issuer company at a pre-determined price and date. The payment of interest and the redemption of the bonds will be made by the issuer-company in US dollars.

4. **American depository Receipts (ADR):** ADR is basically a negotiable certificate denominated in US dollars that represent a non-US Company's publicly traded local currency (INR) equity shares / securities. When such receipts are issued outside the US, but issued for trading in the US they are called ADRs.

   An ADR is generally created by depositing the securities of an Indian company with a custodian bank. In arrangement with the custodian bank, a depository in the US issues the ADRs. The ADR subscriber / holder in the US is entitled to trade the ADR and generally enjoy rights as owner of the underlying Indian security. ADRs with special / unique features have been developed over a period of time and the practice of issuing ADRs by Indian Companies is catching up.

   Only companies intending to have international recognition avail the opportunity to issue ADRs. As these are US depository receipts, they are governed by the provisions of Securities and Exchange Commission (SEC) of USA. The listing requirements in US and the US GAAP requirements are fairly severe to adhere. So, Indian companies tap the American market through private debt placement of GDRS listed in London and Luxemburg stock exchanges. Further, apart from legal impediments, ADRS are costlier than Global Depository Receipts (GDRS). Legal fees are considerably high for US listing. Registration fee in USA is also substantial. Hence, ADRs are less popular than GDRs.

   However, if such conditions are met ADR becomes an excellent source of capital bringing in foreign exchange.

   ADRs are of 3 types:

   Unsponsored ADRs are issued without any formal agreement between the issuing company and depository. Certain costs like dividend distribution costs etc. are born by the investor. These are relatively inexpensive for the issuing company. Most of the provisions of SEC are also exempt for this category.

   Restricted Sponsored ADRs: These are issued to select investors through private placement and are exempt from the provisions of SEC.

   Unrestricted Sponsored ADRs: These are issued to the general investing public in US. These are further classified into 3 levels each requiring increased compliance of the reporting requirements of SEC.

Level 1 ADRs are exempted from compliance with US GAAP and reporting requirements of SEC and hence less costlier.

Level 2 ADRs are issued by companies intending to get listed in US stock exchange. The company should comply with US GAAP and also the reporting requirements of SEC. These sorts of ADRs are costlier.

Level 3 ADRs are issued by companies that intend to make a public issue in US. The company should comply with US GAAP and also the reporting requirements of SEC. This provides high visibility to the company in US.

5. **Indian Depository Receipts (IDRs):** Foreign companies intending to raise capital in India can do so by issuing IDRs and Indian investors can invest in foreign companies through this route. IDRs are listed on Indian exchanges and provide liquidity. The companies would however be required to fulfil a number of guidelines for listing in India through an IDR issue. Standard Chartered Bank plc has got listed in India through this route.
6. **Other Sources:**
   a. **Euro Bonds:** A Eurobond is an international bond that is denominated in a currency not native to the country where it is issued. Also called external bond e.g. A Yen floated in Germany; a GBP bond issued in India.
   b. **Euro Convertible Bonds:** These bonds are structured as a convertible bond. No interest is payable on the bonds. But conversion of bonds takes place on maturity at a pre-determined price. Usually there is a 5 years maturity period and they are treated as a deferred equity issue.
   c. **Euro-bonds with Equity Warrants:** These bonds carry a coupon rate determined by the market rates. The warrants are detachable. Pure bonds are traded at a discount. Fixed income funds' managements may like to invest for the purposes of regular income.
   d. **Foreign Bonds:** These are debt instruments denominated in a currency which is foreign to the borrower and is denominated in a currency that is native to the country where it is issued. A British firm placing $ denominated bonds in USA is said to be selling foreign bonds.
   e. **Fully Hedged Bonds:** In foreign bonds, the risk of currency fluctuations exists. Fully hedged bonds eliminate that risk by selling in forward markets the entire stream of interest and principal payments.
   f. **Floating Rate Notes:** These are debt instruments issued upto 7 years maturity. Interest rates are adjusted to reflect the prevailing exchange rates. They provide cheaper money than fixed rate debt instruments;

however, they suffer from inherent interest rate volatility risk.

g. **Euro Commercial Papers:** Euro Commercial Papers (ECPs) are short-term money market instruments usually designated in US dollars. They are for maturities for less than a year.
h. **Syndicated bank loans:** Companies with good credit rating and track record can raise funds in short time and with few formalities from foreign banks. The maturity of the loan can be 5 to 10 years. The interest rate is generally set with reference to an index, say, LIBOR plus a spread which depends upon the credit rating of the borrower. Some covenants are laid down by the lending institution like maintenance of key financial ratios etc.

Euro Issues

A Euro-issue does not mean the shares (directly or indirectly) get listed on a European Stock Exchange. For example, ADR is a Euro-Issue, as much as a GDR is. And ADRs are listed in the USA. However, **subscription can come from any part of the world except India**. Finance can be raised by Global Depository Receipts (GDRs), Foreign Currency Convertible Bonds (FCCB) and pure debt bonds. However, GDRs, and FCCBs are more popular instruments.

Advantages to Company:

a. Euro-issues are priced around the market price of share.
b. Foreign exchange fluctuations are to the account of investor and not to the company.
c. Enhances the image of the company's products, services or financial instruments in a market place outside their home country. This also provides a mechanism for raising capital or as a vehicle for an acquisition.

Advantages to Investor:

a. GDRs are usually quoted in dollars, and interest and dividend payments are also in dollars.
b. GDRs overcome obstacles that mutual funds, pension funds and other institutions may have in purchasing and holding securities outside their domestic markets.
c. Global custodians / safe-keeping charges are eliminated, saving GDR investors 30 to 60 basis points annually.
d. GDRs are as liquid as the underlying securities because the two are interchangeable.
e. GDRs are negotiable.
f. GDRs overcome foreign investment restrictions.

Disadvantages of Euro Issues:

a. GDR issue would be immediately earnings dilutive.
b. Pricing of GDRs are expected to be at a discount to the local price
c. It is sometimes necessary to use warrants with GDRs to disguise discount, which can increase dilution.
d. GDR issues of Indian Companies have an uneven track record for international investors.

Cross Border leasing

In this type of leasing, the lessor and the lessee are situated in two different countries. The lease may be routed through a third nation known as "convenient country" for tax or equipment registration purposes. Fourth nation may be involved for debt in a particular currency required to give effect to the equipment purchase and lease transaction. This type of arrangement means more complications in terms of different legal, fiscal, credit and currency requirements and risk involved. Cross border lease benefits are more or less the same as are available in domestic lease viz. 100% funding off- balance sheets.

International Capital budgeting

Multinational Capital Budgeting has to take into consideration the different factors and variables which affect a foreign project and are complex in nature than domestic projects. An important aspect in multinational capital budgeting is to adjust cash flows or the discount rate for additional risk arising from location of the project. **Adjusted Present Value (APV)** is used in evaluating foreign projects. The APV model is a value additive approach under which each cash flow is considered individually and discounted at a rate consistent with risk involved in the cash flow. Critical factors involved in the process are:

a. Cash flows from foreign projects have to be converted into the currency of the parent organization.
b. Parent cash flows are quite different from project cash flows.
c. Profits remitted to the parent firm are subject to tax in the home country as well as the host country.
d. Effect of foreign exchange risk on the parent firm's cash flow.
e. Changes in rates of inflation causing a shift in the competitive environment and thereby affecting cash flows over a specific time period.
f. Restrictions imposed on cash flow distribution generated from foreign

projects by the host country.

g. Initial investment in the host country to benefit from the release of blocked funds.
h. Political risks in the form of changed political events reduce the possibility of expected cash flows.
i. Concessions/benefits provided by the host country ensures the upsurge in the profitability position of the foreign project.
j. Estimation of the terminal value in multinational capital budgeting is difficult since the buyers in the parent company have divergent views on acquisition of the project.

International Working Capital Management

This is a complex issue and the reasons for complication are:

a. A multinational firm has a wider option for financing its current assets.
b. Interest and tax rates vary from one country to the other.
c. A multinational firm is confronted with foreign exchange risk due to inflow / outflow of funds.
d. In countries which operate on full capital convertibility, a MNC can move its funds from one location to another and thus mobilize and 'position' the funds in the most efficient way possible. Such freedom may not be available for MNCs operating in countries that have not subscribed to full capital convertibility (like India).

International cash management has 2 basic objectives:

- Optimising Cash Flow movements.
- Investing excess cash.

To achieve the above objectives, cash management should endeavour to:

a. Minimise currency exposure risk.
b. Minimise overall cash requirements of the company as a whole without disturbing smooth operations of the subsidiary or its affiliate.
c. Minimise transaction costs.
d. Minimise country's political risk.
e. Take advantage of economies of scale as well as reap benefits of superior knowledge.

Centralised cash system helps MNCs as follows:

a. To maintain minimum cash balance.
b. To manage judiciously liquidity requirements.
c. To optimally use various hedging strategies so that MNC's foreign exchange exposure is minimised.

d. To aid the centre to generate maximum returns by investing all cash resources optimally.
e. To take advantage of multinational netting so that transaction costs and currency exposure are minimised.
f. To make maximum utilization of transfer pricing mechanism so that the firm enhances its profitability and growth.
g. To exploit currency movement correlations.

Cash flows can be optimised by the following methods:

a. **Accelerating**: Faster recovery of funds for better utilisation
b. **Managing blocked funds**: The host country may block funds of the subsidiary to be sent to the parent or make sure that earnings generated by the subsidiary be reinvested locally before being remitted to the parent so that jobs are created and unemployment reduced. The subsidiary may be instructed to obtain bank finance locally from the parent firm so that blocked funds may be utilised to pay off bank loans. Parent company should assess the future potential of blockage of funds and take appropriate measures.
c. **Leading and Lagging strategy**: This technique is used by subsidiaries for optimizing cash flow movements and reduce foreign exchange exposure or to increase available working capital. Firms **accelerate payments of hard currency payables and delay payments of soft currency payables and vice versa** to reduce foreign exchange exposure. The advantages associated with Leading and Lagging are:
d. Using **netting** to reduce overall transaction costs by eliminating number of unnecessary conversions and transfer of currencies. Netting helps in minimising the total volume of inter-company fund flow. Bilateral netting involves netting of transactions between parent and subsidiary or between two subsidiaries. Multilateral netting involves each affiliate nets all its inter affiliate receipts against all its disbursements and receivables and receives or pays the net difference to the parent.
e. Minimising tax on cash flow through international **transfer pricing**.
f. **Investing Excess Cash:** MNCs pool together excess funds from subsidiaries enabling them to earn higher returns due to the larger deposits lying with them. Sometimes a separate investment account is maintained for all subsidiaries so that short term financing needs of one can be met by the other subsidiary without incurring transaction costs charged by banks for exchanging currencies. Such an approach leads to an excessive transaction costs.

International Inventory Management: An international firm normally has stock piling. The different units of a firm get a large part of their inventory from sister units in different countries. If the currency of the importing country depreciates, imports will be costlier thereby giving rise to stock piling. The firm has to weigh the cumulative carrying cost vis-à-vis expected increase in the price of input due to changes in exchange rate. If the probability of interruption in supply is very high, the firm may opt for stock piling even if it is not justified on account of higher cost.

International Receivables Management: There are two types of receivables: viz. Inter firm receivables and Intrafirm receivables.

The exporter may be willing to invoice the transaction in the weak currency even for a long period if it has debt in that currency. This is due to sale proceeds being used to retire debts without loss on account of exchange rate changes. With regard to terms of payment, the exporter does not provide a longer period of credit and gets the export proceeds quickly in order to invoice the transaction in a weak currency. Also credit terms may be liberal in cases where competition in the market is keen. Such an action from the exporter helps to expand sales in a big way.

In case of Intra firm sales, the focus is on global allocation of firm's resources. Different parts of the same product are produced in different units established in different countries and exported to the assembly units leading to a large size of receivables at the assembling country.

Questions:

a. Write a short note on Euro Convertible Bonds.
b. Write short note on American Depository Receipts (ADRs).
c. Write a short note on Global Depository Receipts (GDRs).
d. What is the impact of GDRs on Indian Capital Market?
e. Write a brief note on External Commercial Borrowings (ECBs).
f. Explain briefly the salient features of Foreign Currency Convertible Bonds.
g. Write a short note on Debt route for foreign exchange funds.
h. Discuss the major sources available to an Indian corporate for raising foreign currency finances.
i. Explain the term 'Exposure netting', with an example.
j. Write a short note on the application of Double taxation agreements on Global depository receipts.

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