Multinational business Finance

Introduction

BreadTalk is a publicly listed company in Singapore which operates around the world, in countries including Indonesia, China, Malaysia, the Philippines, Kuwait, Oman, India, Hong Kong, Thailand, Korea, Vietnam, Bahrain and Saudi Arabia. Recently, the company is considering a project regarding installation of fully automated baking equipment in Beijing, China which would contribute towards reducing labour and improving efficiency of bread production. The paper revolves around evaluating the project and preparing a project analysis report on their intended investment. This report would assist the company in understanding the risks and the ways of hedging it to ensure minimization of risk of loss.

Economic and political risks in China

Economic risk refers to the risk that the output of a project would not generate adequate revenues to cover its operating costs and repay its debt obligation in financing a project. On the other hand, political risk is referred to as the government interference in the business affairs of foreign companies operating in a specific country (CRM, 2012). The difference forms of interference can range from outright nationalisation of industries through asset confiscation to contract repudiation with regards to contracts with government entities or government owned firms. Both risks in China are deemed to be high (Orlik, 2012).

China is particularly hazardous in terms of political risks encompassing confiscation risks, expropriation, currency inconvertibility and contract repudiation. Currency devaluation and rampant inflation is one of the significant potential problems inflicting havoc on the adequacy of insurance limits (Reuters, 2012). Another unique form of political risk that is observed in China is the constant battle between the central government of the country with the provincial and local governments regarding the applicable law and observance and non-observance of it

(CRM, 2012). These results in a difficulty for companies operating in China to understand exactly which rules are to be followed.

On the other hand, the International Monetary Fund (IMF) has claimed that the worsening debt crisis in the eurozone possess a potential risk to China’s growth and development in terms of economy. The growth in the Chinese economy has been observed at a three-year low in the second quarter of this year (BBC, 2012). The eurozone is a key market for the Chinese exports and if the debt crisis in this market grows it would certainly dent the consumer sentiments and demand leading to a slowing exports in the region.

However, the domestic issues of the country are also recognised as a threat to its economic growth including the property section in China. China’s banks have lent out considerable sums of money in a bid to sustain growth in the past few years amid the global financial crisis. That led to a boom in the country’s property market (BBC, 2012). Nevertheless, there have been estimations of asset bubbles being formed and of the impact of a crash in property prices on the overall economy of China. A survey undertaken by the Chinese Academy of Social Sciences determined that 70% of the public recognises inflation for the lower living standards as reported by China daily (Lelyveld, 2011).

Key issues in financing the project

The company is encountering certain issues in financing the project and the key issues among them can be summarised as below:

- The growing economic risks and political risks in the market where the investment is to be made. Favourable investment culture in a country comprises of its growing economic and stable political environment.
- Whether to invest in the project using home country currency or the host country currency that is, in SGD or CR. Selecting a proper currency to invest would provide

BreadTalk an edge over the market through high returns. The effectiveness of an investment is a specific market would be determined by its annually compounding risk-free return and the market risk premium.

- Whether the cost of capital of the project or the expected return from the project exceeds the WACC of the overall company. WACC adjusted rate of return determines the profitability of the project.
- The risks which are inherent in the proposed investment and the financial instruments that can be used to hedge against such risks.
- The measures which can minimize the financing cost of the project

Cost of capital for the project

The cost of capital for the project is different to that of the cost of capital for an overall company. The cost of capital for this project has been calculated with the help of a capital budgeting technique of Internal Rate of Return (IRR) analysis (Chapman, Hopwood, & Shields, 2007). The Internal Rate of Return determines the discounting rate to be applicable in the computation of the present value of the project with its cash inflows.

Particulars	Cash Inflows	Discount rate	Present value	Discount rate	Present value
Year 1	1000000	10%	909090.9091	11%	900900.9009
Year 2	1000000	10%	826446.281	11%	811622.4332
Year 3	1500000	10%	1126972.201	11%	1096787.072
Year 4	1500000	10%	1024520.183	11%	988096.4612
Year 5	1800000	10%	1117658.382	11%	1068212.391
Salvage value	100000	10%	62092.13231	11%	59345.13281
Total Cash Inflows			5066780.088		4924964.391
Initial Outlay			5000000		5000000
Net Present Value			66780.0883		-75035.60937

In order to determine the IRR value for the project by calculation, a trial and error method has been deployed to determine the Net Present value (NPV) of the investment to be Zero. The above table shows the NPV calculated with the discount rates 10 percent and 11 percent which provides with a positive and negative value denoting that the IRR to be somewhere in between (Mittal, 2006). Therefore, an interpolation technique has been used to determine the IRR and the project demonstrated an IRR value of 10.47 percent which is well beyond the WACC of the overall company. Hence, the project would be profitable for the company.

Risks

Types of inherent risks

There are various types of risk that are inherent in a project including systematic risk, unsystematic risk, political risk, exchange rate risk, market risk, credit or default risk, country risk and interest rate risks. The inherent risks for this specific project of BreadTalk include the political and economic risk, country risk, exchange rate risk and market rate risk. As the project is being installed in another country of operations, China, its political risks and economic risks are deemed to impact the project as well as there would be country risk that denotes defaults regarding the financial commitments. Moreover, market risk has a bearing on the effectiveness of the project.

Financial Instruments to hedge risk

As per the calculations of market risk (β) from the obtained expected return from the project and the risk-free return prevailing in the respective currencies, the market risk is higher in CR. Therefore, the fluctuations in the market is higher which can impact a project adversely and render BreadTalk's operation in China ineffective to repay the funds borrowed for funding the project from the parent company in Singapore. Therefore, in order to minimize the risk of loss in case the CR market fluctuates is to be adopted calling for the need for a hedging strategy.

Hedging is making an investment in order to reduce the risk of adverse price movement in security or asset. Generally, a hedge comprises of undertaking an offsetting position in a related security or asset. The different hedging strategies those are applicable in these cases are forward contracts, future contracts and other derivative instruments like call and put options and currency or interest rate swaps (Bychuk & Haughey, 2011).

The hedging strategy which is deemed suitable in case of this project is buying future in China's currency CR for an agreed time period between the parent company and the operating company in China with respect to the repayment of the funds. Buying future would enable the company to hedge against the amount to be repaid to the parent company (Cusatis & Thomas, 2005). During the time of payment, the company operating in China can buy SGD at spot price as well as sell the futures to make up for the loss, if any incurred.

Recommendation and conclusion

Financing cost of a project includes not only the initial outlay which is S$ 5.0 million in this case but also the interest payments which are required to be paid to the parent company for the borrowed amount and the cost of administering the project amid the high economic risks. Financing cost of the project can be minimised if the company is able to cope up with the volatility of the market leading to fluctuating currency values and inflation.

Therefore, in order to minimise not only the risk of loss but also the financing cost of the project the company should hedge the amount to be paid to the parent company in such a way that during repayment it does not have to encounter losses. The company should also insist on repaying their debt soon so as to avoid the excess payment of cost of capital.

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