What is International Strategic Financial Planning (ISFP)?

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Why do we need ISFP?

What do we do in Finance?

- We evaluate and manage the timing and predictability of cash in- and outflows related to a corporation's activities.

- In managing these cash flows, we balance goals related to firm profitability, the implementation of our strategy and the risk of financial distress. Our goals are:
  - maximize stakeholder utility,
  - optimally invest excess funds and raise funds (short-term or long-term) for new or ongoing projects, and
  - understand how to manage financial risks.

➢ The choices we make depend on the firm's objectives as well as business and financial constraints.

What are we going to do in ISFP?

- Extend the relationships discussed in other courses between financial choices and firm objectives recognizing the breadth of domestic and international alternatives.

- Understand the pros and cons of access to various financial markets around the world:
  - Financial Markets: Stocks, Bonds, Derivatives, etc.
  - Pros/Cons: How risky are the assets? Liabilities? When are they risky? What cash flows will they produce/require?
    - Is it a worthwhile use/source of corporate funds?

➢ ***Develop a logical framework linking firm strategic decisions and financial markets.***

Administrative Issues

- Materials
  - Assigned readings: the case packet, and a class web page (www.ivey.uwo.ca/faculty/ssapp/Teaching/EMBA_ISFP_TO.htm)

- Grades
  1) Case brief on Melco (to be done in class last weekend together)
  2) Final project due two weeks after our last class and
  3) Contribution.

  - Contribution based on:
    - My evaluation of each participant's class-by-class contribution and peer evaluation of contribution.
    - Please email if you have to miss a class.

Case Analysis: Review

Steps we will follow:

- Who is the decision maker?
- What is the decision? What are the criteria?
  - Maximizing shareholders' wealth? Corporate wealth? Management's wealth? NGO's?
  - Limiting risk? What type of risk(s)? How significant are each of these risks?
  - Implementing a new strategy …
- Key alternatives to consider? (Not just those in the case!)
- Analysis and discussion of the alternatives.
- Decision and action plan.

Major Topics in the Course

1. ***Risk Management*** - Identifying and characterizing the risks faced by firms in trying to accomplish their goals. What financial tools exist to manage these risks and how they may impact the achievement of organizational goals.

2. ***Raising Capital*** - Understanding the costs and benefits of raising funds for operations in various markets.

3. ***International Investments*** - Evaluating the costs and benefits to purchasing and/or operating assets in different markets (e.g., domestic/foreign or emerging/developed).

Risk Management

Risk Management

- The sources of risk must be identified. This is more difficult than frequently acknowledged. Just ask JP Morgan, UBS, Citibank, S&P, Moodys, DBRS, …

"A culture of irresponsibility took root from Wall Street to Washington to Main Street. A regulatory regime basically crafted in the wake of a 20th century economic crisis, the Great Depression, was overwhelmed by the speed, scope and sophistication of a 21st century global economy" Barack Obama, June 2009

"… As Enron should have taught us seven years ago, the most deceitful words in the English language are not "the cheque is in the post" … but rather "off balance sheet". … As a result no one, including banks themselves, knew where the risks lay nor how large they were." FT September 1, 2009

Risk Management

When identifying risks we start with the major types of risk:

1. *Business or Operational Risk*
   - Risks associated with manufacturing, marketing and selling the firm's products.

2. *Financial Risk*
   - The risk associated with ensuring the firm has adequate cashflows to meet its committed cash in and outflows.

- How do these risks depend on our actions? Others' actions? Financial markets?
- How large are the risks? Are they something we should try to manage? If yes, what tools should we consider?

Where Do The Risks Originate?

- Increased global trade of goods and services has increased both risks and opportunities.
  - Global supply and demand have increased dramatically over the past 30 years. This has provided both increased risks and opportunities.
- The most obvious sources of risk:
  - Importing/exporting requires buying/selling different currencies
  - What happens to:
    - Chinese exporters as the value of the Yuan increases?
    - Canadian importers with the value of the Mexican Peso?
    - Mexican exporters with the value of the Peso?
    - American importers with the value of the US dollar?
  - What about borrowing/lending in different countries?
- How do these impact your competitive position domestically? Internationally? Are they risks or opportunities?

Examples of Risks and Opportunities

- Need to identify sources of risk, magnitude of the risk, ability to manage the risk and desirability of managing the risk:

- Financial Risk
  - Capital Market risk – equity values (market segmentation), interest rates
  - Currency risk – domestic value of inputs and outputs
  - Liquidity risk – the ability to easily buy or sell financial securities
  - Commodity risk – the value of inputs and outputs

- Political and Regulatory Risk
  - Difficulty enforcing contracts or “rule of law” (including expropriation).
  - Changes in regulation or differences in regulation.
  - Legal restrictions on market access.

- Strategic and Operational Risk
  - Move production overseas. Economies of scale
  - Diversification of market risk.
  - Global investment opportunities.

Example: Identification of Risks

- McDonalds (MCD – NYSE). Extracted from their 2012 A/R.

  Examples of some tools to identify and quantify risks:

- Constant currency financials (EPS, Operating Income etc.),
- Comparable sales, and comparable guest counts.
  - These all allow explicit analysis of the changes in the actual business versus changes resulting from currency fluctuations.

- 64% of Operating Income (and decreasing) and 36% of Debt is in foreign currencies (and decreasing).
  - In their forecasts they present a *sensitivity analysis* for the impact of a 10% change in value of the US dollar and a 1% change in interest rates.
    - What is Value-at-Risk?
    - What are stress tests?

Example: Identification of Risks

- Annual Report Discussion of Foreign Exchange Translation Risk:
  - In 2012, foreign currency translation had a *negative* impact on consolidated operating results driven by the strengthening US dollar.
  - In 2011, foreign currency translation had a *positive* impact on consolidated operating results driven by the stronger Euro and Australian Dollar as well as most other currencies versus the US dollar.
  - In 2010, foreign currency translation had a *positive* impact on consolidated operating results driven by stronger global currencies, primarily the Australian Dollar and Canadian Dollar, partly offset by the weaker Euro.

Example: Management of Risks

- "In managing the impact of interest rate changes and foreign currency fluctuations, the Company uses interest rate swaps and finances in the currencies in which assets are denominated."

- "The Company uses ***foreign currency debt*** and ***derivatives*** to hedge the foreign currency risk associated with ***certain royalties, intercompany financings and long-term investments in foreign subsidiaries and affiliates***. This reduces the impact of fluctuating foreign currencies on cash flows and shareholders' equity. Total foreign currency-denominated debt was $4.9 and $5.0 billion for the years ended December 31, 2012 and 2011. In addition, where practical, the Company's restaurants purchase goods and services in local currencies resulting in ***natural hedges***."

Raising Capital: Financing Strategies

- There are many costs and benefits to using global financial markets to meet capital needs.
  - Decreased cost of capital, diversification of capital sources, hedging currency and interest rate risks, managing political risk ...
- Alternatives:
  - The standard choices you should always *consider*:
    - Internal versus External? Debt versus Equity (or Preferred)? Private versus public?
    - Also, International or Domestic? What currency? …

➢ ***How can we minimize the after-tax costs within an acceptable level of risk?***

International Investments

- Is this an investment worth taking?
  - Standard valuation methodologies from previous courses …
- Are there differences in the risks and thus how we value foreign and domestic projects?
  - Business risks? Political risks? Economic risks? Financial risks?
- How do we account for these in making our decision?
  - What is the required return for this type of investment? Comparables? Growth rates?

➢ ***Should we do it and, if so, how to finance it and manage the associated risks?***

Optimizing Global Financial Decisions

In this course we will:

- Identify and characterize the financial (and business) risks and opportunities faced by a firm. We will consider their impact on its cashflows and balance sheet.

- Determine the significance of the risks/opportunities associated with the financial instruments available to improve the firm's competitive position.

- Evaluate the value created by different alternatives around the world.

→ ***Want to choose the best alternative(s) to increase value for the firm's stakeholders***!