Introduction to International Capital Budgeting

Capital budgeting is a process of investigation and analysis that leads to a key financial decision for both purely domestic firms and MNCs. More broadly, capital budgeting is defined as the process of analyzing capital investment opportunities and deciding. It refers to the allocation of scarce resources or making investment in fixed assets e.g., real estates, development expenditures etc. Capital budgeting is a process of evaluating investments and huge expenses in order to obtain the best returns on investment.

An organization is often faced with the challenges of selecting between two projects/investments or the buy vs replace decision. Ideally, an organization would like to invest in all profitable projects but due to the limitation on the availability of capital an organization has to choose between different projects/investments. Capital budgeting for a foreign project uses the same theoretical framework as domestic capital budgeting i.e., using the various capital budgeting techniques like NPV, IRR, PI, Paybackperiod etc.

Meaning of International Capital Budgeting

International Capital Budgeting is the process of making investment decisions in real productive assets in foreign countries. International Capital budgeting is used by companies to evaluate on the inflows and outflows associated with prospective long-term investment projects.

Importance of International Capital Budgeting

1) **Long-term Strategic Goals:** A capital budgeting decision has its effect over a long-time span and inevitably affects the company's future cost structure and growth. A wrong decision can prove disastrous for the long-term survival of firm. On the other hand, lack of investment in asset would influence the competitive position of the firm. So, the capital budgeting decisions determine the future destiny of the company.
2) **Involvement of large amount of funds:** Capital budgeting decisions need substantial amount of capital outlay. In case of international investment projects, the investments are usually larger than domestic investments. This underlines the need for thoughtful, wise and correct decisions as an incorrect decision would not only result in losses but also prevent the firm from earning profit from other investments which could not be undertaken.
3) **Future Uncertainty:** Capital budgeting decision is surrounded by great number of uncertainties. Investment is present and investment is future. The future is uncertain and full of risks. Longer the periodof project, greater may be the risk and uncertainty. The estimates about cost, revenues and profits may be affected not only by domestic economic environment but international environment.
4) **Difficult to decide:** Capital budgeting decision making is a difficult and complicated exercise forthe management. International capital budgeting is more complicated than domestic capital budgeting because usually which invest in overseas projects are typically large and the projects are highly capital intensive and the process involves a larger number of parameters and decision variables.
5) **High Risk:** Foreign projects differ from purely domestic projects concerning and several factors like the foreign currency dimension, different economic indicators in different countries, and different risk characteristics with which the companies entering foreign market

are not familiar as those of domesticprojects. All these differences lead to a higher level of risk in evaluating international projects than evaluating domestic capital budgeting projects.

Factors Affecting International Budgeting

Some of these issues in foreign investment analysis are as follows:

1) **Foreign Exchange Risk:** Firms investing abroad are exposed to foreign exchange risk the risk that the currency will appreciate or depreciate over a period of time. Understanding of foreign exchange risk is important in the evaluation of cash flows generated by the project over its life cycle. To incorporate the foreign exchange risk in the cash flow estimates of the project, first an estimateis made of the inflation rate in the host country during the life span of the project. The cash flows, in terms of local currency, are then adjusted upwards for the inflation factor. The cash flows are converted into the parent's currency at the spot exchange rate multiplied by an expected depreciation or appreciation rate.
2) **Changes in Exchange Rate:** The cash flow of the parent firm going to be affected on account of change in the exchange rate between parent firms` currency and foreign subsidiary unit's currency. Such changes in the exchange rate also affect the competitive position of the parent firm and in turn impact the long-term cash flow of the project.
3) **Tax Issue:** In capital budgeting, only after-tax cash flows are relevant. This is true both for domestic and overseas projects. The tax issue for multinational capital budgeting purposes is complicated by the existence of host country and home country taxes as well as a number of factors. Thus, earnings on foreign projects, first of all, fall in host country tax net. Then on distribution, it is subjected to withholding tax and finally, in the home country the earnings are further taxed.
4) **Effect of Inflation:** The rate of inflation in host country and parent country must also be anticipated to decide the real return and exchange rate forecasts. The impact of inflation on the parent's and subsidiary's cash flows can be volatile from year to year for some countries. It may cause the, currency to weaken and hence influence a project's cash flows. Also, inaccurate inflation forecast by a country, can lead to inaccurate cash flow forecasts. Thus, MNC’s cannot afford to ignore the impact of inflation on the cash flows.
5) **Segmented Markets:** Segmented Markets refers to market that is isolated from other markets. Since the project is being implemented in a different country, the capital markets are segmented by space. Markets usually become segmented through government intervention. For example, a government can erect investment barriers. Use of segmented capital markets may provide an opportunity for growth or may involve higher costs. The financing aspect has to be carefully examined, by considering the regulating framework in respective countries.
6) **Changes in Disclosure and Accounting Rules:** Investors looking to invest in foreign markets must be aware that foreign governments may not have the same level of regulations that are followed in home country. Each country will have different disclosure and accounting rules. This makes it harder and time-consuming for investors to assess the capital budgeting projects.

7) **Remittance Restrictions:** Where there are restrictions on the repatriation of income, substantial differences exist between project cash flows and cash flows received by the parent firm. Only those flows that are remittable to the parent are relevant from the parent firm perspective. Many countries impose a variety of restrictions on transfer of profits, depreciation and other fees accruing to the parent company.
8) **Blocked Funds:** Blocked Funds are cash flows generate by a foreign project that cannot be immediately transferred to the parent, usually because of exchange controls imposed by the government of the country in which the funds are held. Some countries require that the earnings generated by the subsidiary be reinvested locally for at least a certain period of time before they can be remitted to the parent. Blocked funds cause a discrepancy between the project value from the parent's and local perspective. Also, this can possibly affect the accept/reject decision for a project
9) **Complexities of Regulatory Environment:** The differences exist between the parent company cash flow and the project's cash flow because of tax laws and other regulatory environment. For parent company, the cash flows to the parent are relevant because the shareholders expect higher rate of return. Therefore, it is necessary to make a distinction between parent firm cash flow and that of the project.
10) **Salvage Value:** The salvage value of a project has an important impact on the NPV of the project. When the salvage value is uncertain, the cash flows will not be accurate and the MNC may need to calculate various possible outcomes for the salvage value and estimate the NPV based on each possible outcome. The feasibility of the project may then depend upon the present value of the salvage value.
11) **Political Risk**: In order to attract foreign investments in key sectors, the governments of developing economies generally provide support in the form of subsidy. Likewise, international agencies entrusted ' with the responsibility of promoting cross-border trade sometimes offer financing at below - market rates. The value of the subsidized loan should be added to the project while making the investment decision if the subsidized financing is inseparable from the project. But when the government changes the officers given by previous government may change. The additional value from the subsidized financing should not be allocated to the project.

Influence of Inflation on Capital Budgeting Decisions

Inflation affects profitability in four ways. It changes the cost of funds used to finance an enterprise; it increases costs of labour, materials and the price of the product; it affects the tax to be paid; it causes shiftsin demand patterns.

1) **Cost of borrowing:** When the interest rate rises, the cost of borrowing rises. This makes borrowingexpensive. Hence borrowing will decline and as such the money supply (i.e., the amount of money in circulation) will fall. A fall in the money supply will lead to people having lesser money to spend on goods and services. Hence, they will buy a lesser amount of goods and services. This, in turn, will lead to a fall in the demand for goods and services. With the supply remaining constant and the demand for goods and services declining; the price of goods and services will fall.

2) **Cost of input:** Cost push inflation is inflation caused by an increase in prices of inputs like labour, raw material, etc. The increased price of the factors of production leads to a decreased supply of these goods. While the demand remains constant, the prices of commodities increase causing a rise in the overall price level. The overall price level increases due to higher costs of production which reflects in terms of increased prices of goods and commodities which majorly use these inputs. This is inflation triggered from supply side i.e., because of less supply. The opposite effect of this is called demand pull inflation were higher demand triggers inflation.
3) **Impact on accounting practice:** Inflation has an impact on how a business is valued by investors and prospective purchasers who do not value inflation profits highly. A business that fails to take this factor into account in its financial planning may see the value of the business decline, despite steady or modestly rising profits. Companies that fall under this category may be required to update their statements periodically in order to make them relevant to current economic and financial conditions, supplementing cost-based financial statements with regular price-level adjusted statements. Although accountants apply different accounting standards like IFRS and GAAP, consistency is required within a particular business. However, different policies in different businesses can affect their reported results and distort the picture of where your business stands in relation to other businesses.
4) **Increases costs of labour:** Inflation affects labour market efficiency by influencing firms' wage- setting practices and compensation schemes. In economies with competitive labour, capital and product markets, comparable workers at equivalent jobs will tend to be compensated similarly. If an employer sets wages too low, it will lose employees; the resulting turnover will lead to lower profits. If an employer pays too much, it will either suffer a profit loss or be forced to lay off workers because it will be unable to price products competitively. Thus, any factor that interferes with firms' accurate wage setting can raise unemployment, worker turnover, or company failures. Since labour is typically a large component of companies' costs, such widespread interference in this market can impair the efficiency of the economy.
5) **Effects on discount rate:** A discount rate is the rate at which any given entity can expect to earn ontheir money invested. The discount rate has become one of the central concepts of finance. Setting a high discount rate tends to have the effect of raising other interest rates in the economy since it represents the cost of borrowing money for most major commercial banks and other depository institutions. This could be considered a contractionary monetary policy. Exactly how much a high discount rate affects the economy as a whole depends on the relationship between the discount rate andthe normal market rate of interest for loans to banks.
6) **Effects on corporate finance and tax on capital return:** Inflation refers to price increases and currency depreciation. It mainly means that if inflation occurs within ascertain period of time, not only will the purchasing power of the currency continue to decline, but also the overall price level will rise. Therefore, under the influence of inflation, the company will not only lack funds, but also cause poor purchasing power of

funds. Therefore, in order to do a good job in the company's financial management, especially to better cope with inflation, it should ensure that the company's reasonable cash holdings. For quantity, scientifically and reasonably determine the quantity of inventories and the status of collecting and responding to accounts as soon as possible, a longer-term investment strategic plan should also be formulated. Only by adopting effective methods to control the tax burden can the economic losses caused by inflation be truly reduced and can the sustainable development of enterprises be realized.

7) **Declines purchasing power of corporate funds:** During the period of inflation, the amount of monetary assets tends to be less than that of the same period, and the amount of goods or labour obtained is less, so the purchasing power of currency continues to decline. If the degree of monetary liabilities will cause business difficulties. As prices continue to rise and change, the value of non-monetary assets and liabilities of enterprises will continue to increase, and even limit the normal operation of enterprises.
8) **Affects production capacity:** During the period of inflation, due to the underestimation of capital and the overestimation of profits, there production capacity of enterprises was severely damaged. For example, insufficient capital compensation and compensation funds cannot make the enterprise function normally, which leads to the continuous shrinking of the production scale of the enterprise. Because the enterprise bears excess tax burden, resulting in a false increase in profits, in the end, if the company's profits increase, shareholders will demand the right to allocate more work, but the profit is less, this causes the company's effects companies financial strength.

Evaluation of Foreign Projects

International project appraisal also known by a variety of names such as internal company analysis, profiling the organization, capability or resource audit position and strategic advantage analysis is the process of evaluating a company's position, relative to its business competition within and outside the country, overall performance and its capability in terms of strengths and weaknesses.

Significance of International Project Appraisal

- The organization's deficiency should also be compared with those of its successful competitors. Such perceptive self-appraisal when matched with environmental analysis facilities management to grasp the opportunities and combat the threats inherent in the environment.
- International project appraisal has such a vital significance in international corporate planning. Without such an-exercise it will not be possible to formulate economic strategy for an organization on the objective basis.
- It helps the management in choosing the most suitable niche for the organization.
- Economic opportunities may bound in different parts of the globe.
- Position audit of the organization highlights its distinctive capabilities on which empire of foreign business can be gainfully built. It also enables management to formulate suitable competitive strategy.
- It focuses sharply on the areas where it is strong and can operate most effectively. With this

kind analysisthe management can decide on the type of business, company should engage in a country and what business abandon.

- It provides an insight into the weakness of the organization, through this way the management can take steps to remove the weaknesses of the organization in the long run.

Steps in International Project Appraisal

With the intention of developing the strategic advantage profile of an organization the management should first collect information from external or internal sources both from formal as well as informal channels and then interpret them incisively to determine its strengths and weaknesses. The following steps involvedin international project appraisal.

1) **Identifying strategic factors**: The first step in the process of corporate analysis is the identification of all those factors which are crucial to the success of an international organization. These factors may relate to different aspects of the organization. These factors could conveniently be found in different functional areas such as marketing and finance personal, research and development.
2) **Determining the importance of factors**: After identifying crucial factors for corporate appraisal the management will have to determine the importance of each of these factors. Since all the factors may not be of equal value to the organization for accomplishing its purpose it will be very necessary to attach dueimportance to them.
3) **Determining strengths and weaknesses:** Once the relative significance of different factors has been assessed the management should then attempt to determine the position of the organization in each of these factors. Normally the strengths and weakness of a firm can be assessed by with the firm's own pastresults, comparing with accomplishment of competitors and also by comparing with what they ought to be.
4) **Constructing strategic advantage profile of a firm**: After weighing the significance of each factor for the company in its environment, the management compiles a strategic advantage profile for the firm and compares it with profiles successful competitors of the potential of host countries to develop a pattern ofthe firms strengths and weaknesses relative to its present and proposed product market strategy.

Home Currency Approach & Foreign Currency Approach

Any company operating globally must deal in foreign currencies. It has to pay suppliers in other countrieswith a currency different from its home country's currency. The home country is where a company is headquartered. The firm is likely to be paid or have profits in a different currency and will want to exchange it for its home currency. Even if a company expects to be paid in its own currency, it must assessthe risk that the buyer may not be able to pay the full amount due to currency fluctuations.

Evaluating a foreign project is more complex than evaluating a local project due to multiple factors. First,foreign projects are subject to foreign exchange risk. It is because foreign project cash flows are in foreigncurrencies which must be converted to local currency. Even though there are different approaches such asrelative purchasing power parity and relative interest rate parity, it is hard to accurately forecast exchangerates.

Second, multiple tax jurisdictions are involved potentially subjecting the cash flows to double-taxation. Further, foreign governments may place restrictions on repatriation of earnings back to the home country.

Home Currency Approach	**Foreign Currency Approach**
The Home currency approach involves converting the foreign project cash flows to local currency based on expected forward exchange rates and discounting them based on home country cost of capital (**discounting is a valuation method used to estimate the value of an investment based on its expected future cash flows. DCF analysis attempts to figure out the value of an investment today, based on projections of how much money it will generate in the future.) (Cost of capital is a company's calculation of the minimum return that would be necessary in order to justify undertaking a capital budgeting project, such as building a new factory. The term cost of capital is used by analysts and investors, but it is always an evaluation of whether a projected decision can be justified by its cost. Investors may also use the term to refer to an evaluation of an investment's potential return in relation to its cost and its risks.)**	The foreign currency approach requires calculating NPV based on foreign country cost of capital and then converting the foreign-currency NPV to local currency at the spot exchange rate. **(Money in the present is worth more than the same amount in the future due to inflation and possible earnings from alternative investments that could be made during the intervening time. In other words, a dollar earned in the future won't be worth as much as one earned in the present)**
In the home currency approach, the net present value of a foreign project is determined by (a) converting the foreign-currency cash flows of the project to the domestic currency based on the expected forward exchange rates & (b) discounting the cash flows based on the domestic currency cost of capital.	In the foreign-currency approach, the foreign-currency cash flows are discounted based on implied cost of capital that would apply to the foreign currency to arrive at the foreign-currency NPV. The NPV denominated in foreign currencyis then converted to domestic currency using the spot exchange rate.
In the home-currency approach to international capital budgeting, one translates a project's expected foreign-currency cash flows to the home-currency perspective and then applies ahome currency discount rate.	In the foreign-currency approach, one discounts the expected foreign currency cash flows using a discount rate that reflects the project's required rate of return from the foreign-currency perspective, and then translates the resulting foreign-currency

	intrinsic value to the home- currency perspective using the spot foreign exchange (FX) rate.
The home currency approach to capital budgetinganalysis: • generally, produces more reliable results thanthose found using the foreign currency approach. • requires an applicable exchange rate for everytime period for which there is a cash flow. • uses the current risk-free nominal rate to discount all of the cash flows related to a project. • stresses the use of the real rate of return to compute the net present value (NPV) of a project. • converts a foreign denominated NPV into a dollar denominated NPV	The foreign currency approach to capital budgeting analysis: • is computationally easier to use than the homecurrency approach. • produces the same results as the home currency approach. • Utilizes theuncovered interest parity relationship. • computes the net present value of a project inboth the foreign and in the domestic currency

International Financing Decisions

1) **Investment decisions:** When a company innovate a specific technology and its product is mature in the markets abroad or when the company wants to reap the location advantage in a foreign country it sets upan affiliate there. Whatever the motivation behind foreign investment or foreign manufacturing, the company evaluates the cash inflow and outflow during the life of the project and makes investment only when the net present value of cash flows is positive. International finance thus studies the different theories of oversees production, the various strategies of investment capital budgeting decision and evaluation of foreign exchange and political risks pertaining to overseas investment.
2) **International working capital decisions:** When foreign operations begin, the parent company evaluates different sources of working capital so that the cost of financing is the cheapest. In this context an international company maintains an edge over a domestic company, as it can easily reach the internationalfinancial market or can tap resources from one subsidiary to another. International finance helps in takingcorrect decisions regarding the size of working capital **(the capital of a business which is used in its day- to-day trading operations, calculated as the current assets minus the current liabilities)** and suggests a mechanism for its management. It also deals with how foreign trade is finished.
3) **Financial decisions:** Any investment needs rising of funds. The MNCs take advantage of the many innovations which have taken place in the international financial market and international finance function guides them on how to take advantage of these. It deals with how different instruments are issued to raisefunds and how swaps are used for minimizing the cost of funds. The nature and management of interest rate exposure to form a part of IFM.
4) **International accounting and taxation decisions:** International accounting forms an integral part of IFM. It analyses the techniques for consolidation of financial statements of the various affiliates international audit international financial reporting and international taxation.

Transfer pricing is an important area of international accounting as it is used lowering the overall burden of taxes and tariff as well as for working capital management. Similarly international tax system should be so designed that itfosters economic efficiency and does not come in the way of the cross-border movement of goods and factors of production

5) **Debt crisis effect on banks:** International Banks were the victims of debt default of many governments in the 80s. When loans are given to international finance corporates, they can be forced into liquidation but not so in the case of the Governments. The Banks have therefore spent time and money to rescheduleand recover the money in installments and some debts are written off. The debt crisis weakened the banks but the banking system didn't collapse. The banks have become more cautious and started lending only to countries with market-oriented economies and undergoing structural reforms. The development in International Debt market gave rise to the new instruments and secondary market in many instruments such as scrutinized debt. Debt repaying capacity and foreign exchange earnings and production use of capital are all taken into account it is also one of the important functions of international finance.
6) **Corporate decision:** Another important function of international finance is foremost decision is the amount of debt for a given level of equity. The leverage and tax deductibility of Interest Payment and Debt would make the company prefer as much debt as possible. But debt increases the risk and hence there is a trade-off between leverage and risk because of the debt risk. The questions that any Corporation Management asks itself are the proper mix of equity and debt, composition of debt, show medium- and long-term debt, nature of debt secured and unsecured. Fixed Vs Floating Debt and maturity and terms of debt, what currency or currencies in which debt should be taken etc. The firm should keep its debt shouldbe taken etc. The firm should keep its debt at the optimum level. The debt should be self-liquidating through the returns that it generated. It should be in currencies in which it earns it exporting earnings. One should borrow in currencies, which are likely to be weakened and depreciated. The value of the company's shareholders will increase with the leverage enjoyed by debt but the risk associated with the debt is to behedged to improve the value of the firm.
7) **Capital Structure decisions:** The composition of capital structure influences the cost of Capital and returns and thus the shareholders' value. The composition of debt, its currency, interest rate, maturity and other terms of debts, its currency, interest rate maturity and other terms of debt are relevant valuables to be considered. Hedging of the debt risk reduces the risk of financial stress and even crisis. The firms have to match the composition debt to the payment and characteristics of the assets created so as to minimize the probability of financial distress. It pays a company to deviate from the maximum risk debt compositionof only the firm can beat the market.

Source of Finance/ International Financing/ Choice of Sources of Funds

Globalization has opened doors and opportunities that were never explored before. Activities of companies arenot limited to one region or a single country. And wherever there are activities of companies, there is money involved in them. Let's understand the world of international financing.

International Financing is also known as International Macroeconomics as it deals with finance on a global level. There are various sources for organizations to raise funds. To raise funds internationally is one of them. With economies and the operations of the business organizations going global, Indian companies have an access to funds in the global capital market.

International finance helps organizations engage in cross-border transactions with foreign business partners, such as customers, investors, suppliers and lenders. Various international sources from where funds may begenerated include the following.

- **Commercial Banks:** Global commercial banks all over provide loans in foreign currency to companies. They are crucial in financing non-trade international operations. The different types of loans and services provided by banks vary from country to country. One example of this is Standard Chartered emerged as a major source of foreigncurrency loans to the Indian industry. It is the most used source of international financing.
- **International Agencies and Development Banks:** Many development banks and international agencies have come forth over the years for the purpose of international financing. These bodies are set up by the Governments of developed countries of the world at national, regional and international levels for funding various projects. The more industrious among them include International Finance Corporation (IFC), EXIM Bank and Asian Development Bank.
- **International Capital Markets:** Emerging organizations including multinational companies depend upon fairly large loans in rupees as wellas in foreign currency. The financial instruments used for this purpose are:
  - **American Depository Receipts (ADR's):** This a tool often used for international financing. As the name suggests, depository receipts issued by a company in the USA are known as American Depository Receipts. ADRs can be bought and sold in American markets like regular stocks. It is similar to a GDR except that it can be issued only to American citizens and can be listed and traded on a stock exchange of the United States of America.
  - **Global Depository Receipts (GDR's):** In the Indian context, a GDR is an instrument issued abroad by an Indian company to raise funds in someforeign currency and is listed and traded on a foreign stock exchange. A holder of GDR can at any time convert it into the number of shares it represents. The holders of GDRs do not carry any voting rights but only dividends and capital appreciation. Many renowned Indian companies such as Infosys, Reliance, Wipro, and ICICI have raised money through issue of GDRs.
  - **Foreign Currency Convertible Bonds (FCCB's):** Foreign currency convertible bonds are equity-linked debt securities that are to be converted into equity ordepository receipts after a specific period. A holder of FCCB has the option of either converting them intoequity shares at a predetermined price or exchange rate or retaining the bonds. The FCCB's are issued in a foreign currency and carry a fixed interest rate which is lower than the rate of any other similar nonconvertibledebt instrument.

FCCB's resemble convertible debentures issued in India. It is true that businesses need funds but the funds required in business are of different types - long term, short term, fixed and fluctuating. That is the reasonwhy business firms resort to different types of sources for raising funds.

ADRs - AMERICAN DEPOSITORY RECEIPTS

What is ADR?

ADR stands for American Depository Receipts, which are a type of negotiable instrument that are basically stocks of foreign companies which are traded in US stock markets. American

Depository Receipts (ADR) are issued by a US Depository bank and offer investors in the US to invest in foreign companies. ADRs are traded on the US Stock exchange and are a great option for foreign companies to attract investors from the US.
ADRs are traded in New York Stock Exchange (NYSE) or NASDAQ, but can also be sold over the counter. ADRs are priced in US Dollars.
The following are the features of ADR:

- ADR can be listed on American Stock Exchange.
- A single ADR can represent more than one share. One ADR can be two shares or any friction also.
- The holder of the ADRS can get them converted into shares.
- The holders of ADR have no right to vote in the company.

Types of ADRs

ADRs that are sold in the US market are categorized into two types, which are:

1) **Sponsored ADR:** In sponsored ADR, the foreign company that is looking to issue shares to the public gets into an agreement with a US Depository bank for the purpose of selling shares in the US capital market. The US depository bank carries the responsibility of sale, distribution of shares to the public and also maintains record-keeping, dividend distribution. ADRs that are sponsored are listed in US stock exchanges. US stock exchanges are regulated by the SEC (Securities and Exchange Commission) which acts as a watchdog for all the necessary compliances that should be maintained while trading in US stockexchanges and instruments.
   This facility is established jointly by an issuer and a depository. Sponsored ADR facilities are created in the same manner as unsponsored facility expect that the issuer of the deposited securities enters into a deposit agreement with the depository and signs responsibilities of the issuer, the depository and the ADR holder. Like unsponsored ADR facilities, sponsored ADR facilities usually involve the use of a foreign custodian to hold the deposited securities
2) **Non-sponsored ADR:** Non-sponsored ADR is created by brokers and dealers without the involvement of the foreign company. These types of ADRs are sold over the counter and do not require any registration with the SEC (Securities and Exchange Commission). This facility is created in response to a combination of investor, broker-dealer and depository interest. It is initiated by a third party. Depository is the principal initiator of a facility because it perceives US investor interest in a particular foreign security and recognizes the potential income that may be derived from a facility.

Termination of ADR

ADR can be terminated by the foreign company or the depository bank which created the instrument. Thetermination of ADR results in delisting and cancellation of the ADRs that were issued from US stock markets.
Benefits of ADR's - There are different benefits to the issuers and investors.
Benefits to the issuing company

1) An ADR program can make the investors interested in them. It also increases the companies'

visibility,broaden its shareholders base and increase liquidity.

2) It enables a company to tap US equity markets. The ADR offers a new avenue for raising capital butat highly competitive costs.
3) ADRs can provide increased communications with shareholders in the US.
4) They provide an essay way for US employees of non-US companies to invest in their companies'employee stock purchase plan.

Benefits to the investors

Investors aim to diversify their portfolio internationally. Obstacles, however, such as undependable settlements, costly currency conversions, custodian services, poor information flow, unfamiliar market practice confusing tax conventions may discourage institutions private investors from venturing outside their local market. As negotiable securities, ADRs are quoted in US dollars and pay dividend or interest. They overcome the obstacles that mutual funds, pension funds, and other enumerated beloware the principal advantages to the investors:

1) **Depository receipts are US securities: Depository** receipts are registered with the US Securities and Exchange Commission and trade like any other US security in the over-the-counter market or on a nationalexchange. They enjoy rights which are comparable to those of holders of the underlying securities, plus they have the benefits, convenience and efficiency of trading in the US securities markets.
2) **Depository receipts are easy to buy and sell:** Investors purchase and sell depository receipts through their US brokers in exactly the same way as they purchase or sell securities of US companies. Many regional brokers/dealers and virtually all New York brokers/dealers make markets in and know how to create depository receipts. Alternatively, investor can deposit their non- US securities directly with a depository's custodian and request the issuance of depository receipts. Investors may also return depository receipts to the depository for cancellation and have the underlying securities released back intothe local market.
3) **Depository receipts are liquid:** Depository receipts are liquid as their underlying securities because they are interchangeable. For example, if a US broker can't purchase or sell depository receipt in the US, it can always create a depository receipt by purchasing the underling non-US securities for deposit with the depository, which will then issue depository receipts for the securities. Alternatively, the broker can sell the underlying non- US securities surrender the depository receipts and instruct the depository to deliver the underlying securities. Liquidity and ease of execution are major reasons why many institutions invest in depository receipts.
4) **Depository receipts are global:** Investors can choose from more than 1500 different equity depository receipts and several debt depositories receipts from 50 countries, including Australia, Brazil, United Kingdom, France, Germany, Hong Kong, Italy, Japan, Mexico, Singapore, Spain, Sweden and Thailand. Most of the companies are researched by US analysts, while others have a local following.
5) **Depository receipts are convenient to own:**

- Depository receipts trades clear and settle through standardized US clearance systems within business days; while direct investments in non- US share are subject to complicated and varied standards for international trades.

- Depository receipts are negotiable US securities. They are quoted in dollars, pay dividends or interestin dollars and trade exactly like any other US securities.

6) **Depository receipts are:**

- Holding depository receipts may facilitates the process of reclaiming excess to withholding on dividends and reduces transfer taxes.
- Dividend and other cash distributions are converted into dollars at competitive foreign exchange rates.

Disadvantages of ADR

ADR has the following disadvantages:

- Investors need to wait for a long time to generate good returns on ADR.
- It presents a risk of foreign exchange fluctuations
- A limited number of companies register via ADR; hence investors have fewer choices forinvestment.

GDRS – Global Depository Receipts

What is GDR?

A Global Depository Receipt (GDR), also known as international depository receipt (IDR), is a certificateissued by a depository bank, which purchases shares of foreign companies and deposits it on the account.

A global depositary receipt (GDR) is a bank certificate issued in more than one country for shares in a foreign company. GDRs list shares in two or more markets, most frequently the U.S. market and the Euromarkets, with one fungible security.

GDRs are most commonly used when the issuer is raising capital in the local market as well as in the international and US markets, either through private placement or public stock offerings. A global depositary receipt (GDR) is very similar to an American depositary receipt (ADR), except an ADR only lists shares of a foreign country in the U.S. markets.

Global Depository Receipt is a general name for a depositary receipt where a certificate issued by a depository bank, which purchases shares of foreign companies, creates a security on a local exchange backed by those shares. They are the global equivalent of the original American Depositary Receipts (ADR) on which they are based. GDRS represent ownership of an underlying number of shares of a foreign company and are commonly used to invest in companies from developing or emerging markets by investors in developed markets. Prices of global depositary receipt are based on the values of related shares, but they are traded and settled independently of the underlying share.

What are the features of a GDR?

The following features best describe a Global Depository Receipt

- It is a negotiable instrument that can be traded like any other security instrument freely.
- Indian companies that have a solid financial record of about three years are readily allowed access to global financial markets through the use of a GDR. However, clearances are required from the Foreign Investment Promotion Board (FIPB) and the Ministry of Finance.

- Since it can be denominated as multiple forms of freely convertible currency, GDRs are issued to investors across the country.
- GDR is denominated in any foreign currency but the underlying shares would be denominated in thelocal currency of the issuer.
- The holder is entitled to dividend and bonus on the value of shares underlying the GDR.
- Under GDR, the issuing company transacts with only one entity for all its transactions.

Advantages of Global Depository Receipts (GDRs)

- Depository receipts increase the number of international shareholders and make it easier for overseasinvestors to access the local market.
- An investor's portfolio becomes a worldwide portfolio by investing in depository receipts. In overseasmarkets, investors can benefit from greater risk, higher return securities.
- The key benefit for GDR issuers is that their shares can reach a larger and more diverse audience of potential investors and that having their shares listed on major global exchanges can help to elevate the status or legitimacy of a previously unknown foreign company.
- It gives investors a simple option to diversify their portfolio internationally without having to open foreign brokerage accounts or deal with exchange rates.
- Depositary receipts are simply easier and more cost-effective than buying stocks on internationalexchanges.

Disadvantages of Global Depository Receipts (GDRs)

- Taxation can be a little tricky. Typically, the bank withholds the appropriate amount to meet expensesand international taxes automatically. To avoid double taxation on any capital gains achieved, investors would need to seek a credit from or a refund from the foreign government's taxingauthorities.
- They may have poor liquidity, which means there aren't many buyers and sellers, causing delays in entering and exiting positions.
- They may also come with considerable administrative fees in some circumstances.
- Investors are exposed to economic risks, as the foreign company's home nation may undergo a recession, bank collapses, or political turmoil.

Following are some of the points of difference between ADR and GDR

ADR	GDR
Stands For	
American Depository Receipts	Global Depository Receipts
Definition	
American Depository Receipts (ADR) is a type of negotiable security instrument that is issued by a US bank on behalf of a non-US company, which is trading on the US stock exchange.	Global Depository Receipts (GDR) are a type of negotiable instruments that are issued by a foreigndepository bank for trading of shares of a company in an international market
Currency traded in	

US Dollars	US Dollars, Euro
Purpose	
To acquire resources in the US Market	To acquire resources in the International Market
Listed in	
NASDAQ	Listed in Non-US stock exchanges such as LSE (London Stock Exchange) and Euronext (France)
Issued By	
US Capital Market	European Capital Market

Major Difference between ADR and GDR

- The abbreviation ADR stands for American Depository Receipt, while GDR stands for Global Depository Receipt.
- ADR stands for American Depository Receipt, which is a depository receipt issued by a US depositorybank in return for a set number of shares of non-US business stock that trades on the New York StockExchange.
- GDR is a negotiable instrument issued by an international depository bank that represents the shares of a foreign corporation that is available for purchase on the international market.
- Foreign corporations can trade in the US stock market through numerous bank branches using ADR. GDR, on the other hand, uses ODB's branches to assist international corporations in trading in stock markets other than the US stock market.
- The ADR is issued in the United States, while the GDR is issued in Europe.
- ADRs are traded on the New York Stock Exchange (NYSE) or the National Association of SecuritiesDealers Automated Quotations (NASDAQ) (NASDAQ). GDR, on the other hand, is traded on non- US stock exchanges such as the London Stock Exchange and the Luxembourg Stock Exchange
- ADR can only be negotiated in the United States, but GDR can be negotiated everywhere in the globe. When it comes to the market, the ADR market is a retail investor market where a big number of investors participate and the stock of a firm is properly valued.
- Unlike the GDR, where the market is more institutionalized and there is less liquidity.

ECBs - External Commercial Borrowings.

Unlike many other emerging market economies, India has a vibrant corporate sector at home. Many of them have overseas operations as well. The domestic financial market is not often able to provide big sized loans at competitive rate of interests to the corporate. Here, External Commercial Borrowings have emerged as a valuable source of investable resource of funds for domestic companies.

External Commercial Borrowings are commercial loans widely used by eligible resident entities who raise ECB from recognized non-resident entities. ECBs should adhere to the criteria like minimum maturity period, maximum all-in-cost ceiling, permitted and non-permitted end-uses, etc. ECBS are governed by the Foreign Exchange Management Act (FEMA). With reference to

India, External Commercial Borrowing is an instrument that helps Indian firms and organizations raise funds from outside India in foreign currencies. Indian corporates are permitted by the Indian government to raise funds using External Commercial Borrowing to help the companies expand their current capacity. External Commercial Borrowing can also be used to bring in fresh investments.

What are External Commercial Borrowings?

ECB is basically a loan availed by an Indian entity from a non-resident lender. Most of these loans are provided by foreign commercial banks and other institutions. It is a loan availed of from non-resident lenders with a minimum average maturity of 3 years.

The significance of ECBs their size in India's balance of payment account. In the post reform period, ECBs have emerged a major form of foreign capital like FDI and FII.

Methods to avail External Commercial Borrowing

There are currently two methods for using ECB to raise funds:

1) Automatic route: The government has created a number of eligibility requirements for people who want to use the automatic method of receiving money. These rules govern, among other things, amounts, industries, and the final use of funds.
2) Permission route: The approval method, on the other hand, necessitates explicit authorization from the RBI or the government before obtaining funds through External Commercial Borrowing. The RBI has specified the borrowing structure in circulars and formal guidelines. The RBI has established the categories of "eligible entities" among borrowers and "recognized non-residents" among potential lenders to ensure that the inflow remains clean. Furthermore, it has implemented safeguards such as the ECB, end-use restrictions, minimum maturity periods, and so on.

Advantages of External Commercial Borrowing

- **Low Interest Rate:** To begin with, the value of funds borrowed from external sources is generally lower.
  - For example, there are numerous economies with lower interest rates; if Indian firms and organizations could borrow at lower interest rates from Europe and the United States, they would undoubtedly benefit.
- **Borrowing without giving control:** Another advantage is that ECB is, at their most fundamental level,simple loans.
  - The company's stakes shall not be diluted, despite the fact that they do not have to be of an equity nature.
  - Because debtors will not have voting rights in the company, the borrowers will be able to raise fundswithout relinquishing control.
- **Global Exposure:** While ECBs allow borrowers to diversify their investor base, they also provide borrowers with greater exposure to global markets, which is not to say that ECBs do not feed the localeconomy.
- **Economic Growth:** The government of India can direct inflows into the sector, increasing the sector's potential for growth. For example, the government can allow a higher percentage of

ECB funding forthe SME and infrastructure industries, thereby contributing to the country's growth.

Disadvantages of External Commercial Borrowing

- **Reckless Borrowing:** One could speculate that the company's attitude may soften as they increasingly come across funds available at lower rates. This could lead to companies borrowing recklessly, resulting in higher debt on the company's balance sheet and a negative impact on financial ratios.
- **Low Creditworthiness:** The fact is that rating agencies view companies with more debt on their balance sheets negatively, which could result in a market downgrade for such companies.
- **Stock Decline:** Furthermore, the company's stock may experience a decline in market value over time.
- **Currency Swap:** Because funds are raised through External Commercial Borrowing in foreign currencies, the principal and interest must also be paid in foreign currencies. As a result, the companyexposes itself to the risks associated with currency exchange rates.
- **Restrictions to Borrowing:** Although it is established that ECBs can be obtained at lower rates, there are several guidelines and restrictions that must be followed.

FCCB - Foreign Currency Convertible Bond

What is FCCB?

A Foreign Currency Convertible Bond is a kind of external commercial borrowing and as the name suggests the funds are raised in foreign currency through these bonds, specifically outside India. These funds are borrowed funds. These bonds are also convertible bonds, unlike the usual bonds which are non- convertible. These bonds could be converted into equity shares on the option of the investor/bondholder after the expiry of a fixed time period.

Features of the FCCBs

- FCCB is an unsecured instrument
- It has a fixed rate of interest
- The investor has an option for conversion into a fixed number of equity shares of the issuing company
- Interest/ coupon and redemption price are to be payable in foreign currency
- FCCB shall be denominated in any foreign currency

Benefits to issuing company and investor

- The Coupon rate is low- as it is a hybrid instrument the investor is at the advantage in both cases.
- No credit ratings assessed by the rating agencies are required
- Immediate equity dilution
- Less time consuming comparatively with other instruments
- Favourable in the exchange rate which results in the reduction in the cost of debt

Drawbacks to issuing company and investor

- If the stock market is in a negative cycle, the demand for FCCB would be low.
- The ownership dilutes when the bonds are converted into equity.
- If the currency exchange rate is changed it will be a loss to the company.
- If not converted need to pay back.

Masala Bond

What are Masala Bonds?

- These are the bonds issued outside India, by an Indian entity, in Indian currency
- The major objectives of Masala Bonds are to fund infrastructure projects, ignite internal growth (viaborrowings) and internationalise the Indian rupee
- In case of any risk, the investor has to bear the loss and not the borrower
- The first Masala Bonds were issued by World Bank in 2014 to fund an infrastructure project in India
- There are certain rules and regulations which have been set up by the Reserve Bank of India (RBI) regarding Masala Bonds:
  - Any corporate and Indian bank is eligible to issue Rupee denominated bonds overseas
  - Money raised through these bonds cannot be invested in real-estate activities. However, they can beused for the development of integrated township or affordable housing projects
  - Also, the money raised through Masala Bonds cannot be invested in capital markets
- It is known as Masala bond because the word 'Masala' means spices. As the word evokes the cuisineand culture of India, the International Finance Corporation (IFC) decided to use the word Masala Bond.

Characteristics of Masala Bonds

1) Investors

- These bonds can only be issued to a resident of such a country which is a member of the FinancialAction Task Force (FATF)
- Also, the security market regulator of the country must be a member of the International Organisationof Securities Commission
- These bonds can also be subscribed by regional and multilateral financial institutions where India is amember country

2) Maturity Period

- The minimum original maturity period for bonds raised up to 50 million US Dollars equivalent in INRper financial year should be 3 years
- The minimum original maturity period for bonds raised above 50 million US Dollars equivalent inINR per financial year should be 5 years

3) Eligibility

- Investors from outside of India who are interested to invest in Indian assets are eligible to invest inMasala bonds
- HDFC, NTPC, India bulls Housing Finance, are a few Indian entities who have raised

funds usingMasala Bonds

Benefits of Masala Bonds

- Masala bonds have opened up an investment route for global investors who have no access to the domestic market through the Foreign Institutional Investor (FII) or Foreign Portfolio Investment (FPI)route
- The documentation work is also less as the registration does not have to be made as FPI in India
- It is an easy medium to internationalise Indian rupee by making it familiar to the international investors
- It will also boost the development of domestic bond markets due to competition with overseas market

Limitations of Masala Bond

- RBI has been making periodical rate cuts in Masala Bonds which has made it a bit less appealing tothe investors
- The money raised through these bonds cannot be used everywhere. There are fixed fields where themoney can be invested
- Masala Bonds is a challenge as investors are expected to be cautious in taking on currency risks fromemerging markets

International Working Capital Management

Working capital is the life blood and nerve centre of a business. Just as circulation of blood is essential inthe human body for marinating life, working capital is very essential to maintain the smooth running of abusiness. No business can run successfully without an adequate amount of working capital. Working capital, also called net working capital, represents the difference between a company's current assets andcurrent liabilities. Working capital is a measure of a company's liquidity and short-term financial health.Working capital management is a business strategy designed to ensure that a company operates efficiently by monitoring and using its current assets and liabilities to their most effective use. The importance of maintaining adequate amount of working capital are as follows:

1) **Solvency of the business:** Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.
2) **Goodwill:** Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.
3) **Easy Loans:** A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and other on easy and favourable terms.
4) **Cash discounts (an incentive that a seller offers to a buyer in return for paying a bill before the scheduled due date):** Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.
5) **Regular supply of raw materials:** Sufficient working capital ensures regular supply of raw materials and continuous production.
6) **Regular payment of salaries, wages and other day-to-day commitments:** A company

which has ampleworking capital can make regular payment of salaries, wages and other day-to-day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and enhances production and profits.

7) **Exploitation of favourable market condition:** Only concern with adequate working capital can exploit favourable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.
8) **Ability to face crisis:** Adequate working capital enables a concern to face business crisis in emergenciessuch as depression because during such periods, generally, there is much pressure on working capital.
9) **Quick and regular return on investments:** Every investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favourable market to raise additional funds in the future.
10) **High morale:** Adequacy of working capital creates an environment of security, confidence, and high morale and creates overall efficiency in a business.

Netting, Leads & Lags

- Netting or intercompany netting is the process of reducing risks in financial contracts by combining or aggregating multiple financial obligations to arrive at a net obligation amount.
- Netting is a method of settling pending transactions by offsetting them against each other in favour of one. For example, one party requires another to pay a net balance amount after deducting the values of what they owed to each other. The process speeds up and simplifies monetary settlements.
- Netting definition describes a process of consolidating the financial obligations between two or moreparties to find out the net amount payable for the final settlement between them.
- It helps in lowering the chances of a default. At the same time, it tries to provide enough liquidity fora business to function smoothly.
- Leading and lagging are two different forms of indicators that help in the assessment of the current state of any business and the prediction of its future conditions. The lagging indicators assess the current state of the business, whereas the leading indicators predict the future state of affairs. The twoindicators help in the measurement of performance and management in an organization. They help any organization to achieve what the management has planned or predicted. The management gets to know the current business environment and trends. It also helps them analyze if the company is on theright track in converting its goals and plans into reality.
- A company uses leading and lagging indicators to create an optimum mix of backward-looking indicators and indicators that are future-oriented or forward-looking. We assess whether the plans were achieved or not by using the lagging indicators. The leading indicators are forward-looking and focus on future events and results. In other words, they are the indicators that result in the performanceof lagging indicators sometime in the future. Leading indicators are the drivers of key results and decide the future performance of any business.