Factors affecting multinational corporations cost of capital finance essay

This essay will consider the key factors which affect a company's cost of capital. The essay will analyse firstly the key components which contribute towards a company's cost of capital before going to consider how these factors differ for a multinational company as opposed to those operating within a single national market.

In the first instance, the essay will consider the issue of the cost of capital with specific reference to multinational organisations, as such the research will use the definition of a multinational organisation as provided by Johnson et al (2008). Here the definition given is a multinational company is simply one which operates in several diversified geographic markets which spans the borders of more than national boundary.

Every business is subject to the cost of capital, the cost of capital in essence represents the cost to a business of making use of the resources for which investors in various forms put into the business in the first place. The cost of capital is incurred through a variety of methods and includes interest payments and dividends, which an investor receives as a reward for investment within a business. For pragmatic purposes the cost of capital is usual expressed as a percentage, the most common expression being that of the Weighted Average Cost of Capital (WACC).

WACC is a useful way of analysing a company's cost of capital. Essentially WACC considers the relative costs of each of the component elements of the company's capital structure and then takes an average of those costs, based upon the relative weights of each component (Tennent 2008). Whilst company's may have many sources of finance, each of which have there own costs and nuances the cost of capital may be broken down into two major sources, namely debt and equity.

Debt

In a company's capital structure debt is usually one of the major components and consists of long term borrowings such as bank loans and other financial instruments such as bonds and debentures (Arnold 2007). The principal cost of capital with regards to the debt component of the capital structure is the payment of interest upon the capital borrowed in the first instance. In the case of a bond, interest rates are fixed at the issue of point of the bond with the company receiving a lump sum investment on issue in return for regular repayments of a fixed interest rate. On the other hand long term borrowing may have slightly more flexible approach to the cost of capital. The principal cost of long term borrowing is still an interest rate however, the borrower may opt to negotiate a fixed or floating rate of interest. Where a fixed rate of interest is agreed, then the cost of capital is also fixed for the duration and will operate like that of a bond or debenture. However, where the interest rate is a floating one, then the parties will negotiate an initial rate but this will then be amended to reflect changes in the underlying interest rates issued by central banks.

The question in relation to a multinational companies cost of capital which relates to debt is what interest rate will be paid. The answer would be a combination of the concepts of risk and central bank interest rates.

A company's capital structure in itself also has an impact upon the company's cost of capital. In general terms, whilst debt funding is seen as a lower cost source of capital than that of equity (Bringham and Ehrhardt 2005) the cost of debt however, in its self is not fixed. Bringham and Ehrhardt (2005) indicate that as a company takes on a greater level of debt within its capital structure, future borrowings become more expensive. This is due to the fact that investors consider that as a company increases its levels of leverage, the company becomes a more risky investment and thus a higher rate of interest is required to secure future funding. In essence, one may consider that the cost of capital for a company will increase, where the company chooses to increase its leverage by obtaining that capital through debt.

Equity

Equity represents the component of the capital structure of a company which relates to those who have a direct ownership of a company, in other words stocks and shares and their derivatives (Arnold 2004). Shareholders are rewarded through firstly the payment of dividends which represents a direct cost to a business. Secondly shareholders will also expect to see capital gains in the share price representing a further non-financial cost of the cost of capital.

As with the debt element of the capital structure, the cost of equity varies from company to company and from industry to industry. Bringham and Ehrhardt (2005) indicate that the relevant factors which will affect the cost of equity are risk, the risk free rate of interest and the return obtainable from alternative investment with a similar risk profile.

In general terms, the cost of financing a business via equity is considered to be a more expensive option than financing a business through debt. This is due to the fact that in effect equity represents a permanent source of capital, once issued shares remain in circulation in perpetuity unless a special action is taken to buy back the shares. On the other hand all forms of long term debt have a redemption date, even if that date is at a point far into the future.

Risk

As has been identified one of the central contributing factors towards consider what affects a company's cost of capital is the concept of risk. At the general level risk is simply defined as concept of uncertainty (Business Link 2009), more specifically risk is usually associated with the concept of uncertainly manifesting itself in a negative format.

The basic relationship between risk and reward for investors and company's alike is the consideration that in order to justify the taking of a higher level of risk, there must be the prospect of an increased level of reward. This may be seen as manifested on both the debt and equity side of the cost of capital of a company's capital structure. On the debt side of the capital structure, those company's that have high level of risk will be charged a higher rate of interest by banks or have to offer a higher rate of interest on bonds in order to obtain funding. As such, this pushes up the company's overall cost of capital. Bonds for instance are often given a credit rating, these range from government bonds which are often used as the risk free rate and those attract low interest rates through to low quality corporate bonds often referred to as “ junk bonds” (Brealey et al 2006) and attract a much higher coupon rate for the risk taken.

Risk is similarly incorporated into the cost of capital on the equity portion of a company’s capital structure. Where a shareholder invests in what they perceive to be a riskier share then in return the shareholder will expect a greater level of return in the form of higher dividends and greater capital growth. The concept of risk is often incorporated in the cost of equity by considering what analysts refer to as a risk beta. Betas are in effect an expression of the perceived risk of a sector or specific company, 1 represents a risk which is no greater or lower than that of the average whilst a positive figure represents a company with a greater risk and a negative figure as one with a lower risk. As such those industries and companies which are associated with long term profitability and stability will have a low beta and thus a lower cost of capital. Whilst those operating in a riskier sector, or with a shorter record of performance will have a higher beta and thus a higher cost of capital. This can be demonstrated by comparing the relative betas of Coca-Cola, a long established and profitable company with a beta of just 0. 6 (Reuters 2010 a) and Apple Inc a fashionable growth based company which thus has a beta of 1. 41 Reuters 2010 b).

As such one the essay has thus far identified that risk is probably the most important factor in determining the relative cost of capital for a specific company. The question now for those operating in the international business environment is what constitutes risk and how can risk be managed to affect the cost of capital.

One key consideration is that of diversification. Diversification is a strategic decision and can take on numerous forms from product diversification (Jobber 2007) through to market and geographic diversification (De Wit and Meyer 2004). In general terms, investors usually consider that businesses which have a greater level of diversification have a lower level of risk than those who have a smaller level of diversification. The consideration is that diversified firms are protected against a fall in any single market or geographic region. The down side of this of course is that a firm trades of its ability to make a large profit where a single market experiences a surge or growth spurt. Empirical evidence would seem to support this theory, well diversified firms such as Unilever and P&G having risk betas of 0. 73 and 0. 51 respectively (Digital Look 2010, Reuters 2010 d).

National ratings may also be seen as a key consideration for risk where multinational corporations are concerned. Whilst on the whole geographic diversification may be seen as a way of reducing risk, this is not always the case. In many cases companies have chosen to invest in emergent markets such as China, Indian and South America. Whilst these may be seen as areas of key growth which generate the possibility of high rates of return. National ratings would also suggest that investments in such countries also pose significant risks and thus raise the cost of capital. For instance those doing business in China face significant risks over issues related to the protection of intellectual property (Panitchpakdi and Clifford 2002), whilst on the other hand other countries suffer from problems relating to political stability or other such areas of conflict.

Interest rates

Interest rates may be seen as one of the other key elements which affect the cost of capital for those operating in the multination business environment. At its most basic level one may consider that the relative cost of borrowing will reflect that of the base rate of central banks around the world. Thus when interest rates are on the whole low as they are at present in the UK (BoE 2010) the cost of capital will also be lower due to lower interest rates from long term borrowings. On the other hand were interest rates rise, then the cost of capital will also risk as banks and long term lenders beginning to require a higher rate of interest than previously.

The multinational corporation does however, have a special consideration when it comes to the issue of interest rates and the company's cost of capital. Whilst a domestic company is wholly subject to interest rate fluctuations within their national market. There is the consideration that on a global scale interest rates are set locally to reflect national and regional interests. As such for the multinational corporation there is the consideration that the company can take advantage of such a divergence of interests by looking borrow or issue instruments in the countries which are exhibiting the lowest rate of interest on the behalf of central banks. For instance at present, many companies may be attracted either to conduct their business within the UK or to take out loans and issue financial instrument in the UK due to the low interest rate at just 0. 5% which would have a positive impact upon the cost of capital.

Alternative Investments

The final consideration which will affect the cost of capital for a multinational company is the consideration of the yield that investors can achieve elsewhere. In general terms investors will choose to invest in an investment which yields the highest return for the given risk profile of the investment. As such a company's cost of capital will also fluctuate dependent on the performance of others within the sector, where the market as a whole has performed well then one would expect that the cost of capital on the equity side of the equation would increase. This is due to the fact that the stated company must be able to offer a similar return to those operating in the sector. Conversely where the performance of the market as a whole or of the sector is poor, then a company's cost of capital will decrease based upon falling expectations of investors in equities.

Alternative investments must also be considered in the form of the risk free rate, the risk free rate being the rate one can obtain from investment in a high quality government bond. In general risking risk free rates will see risking costs of capital as investors are able to gain increasing levels of return at a lower risk elsewhere.

Having considered the research posed in this paper, one may conclude that there are a wide range of issues which contribute to the overall cost of capital for a company. Despite these considerations, one conclusion is that the single biggest factor which contributes towards the cost of capital is the consideration of the level of risk for which a company is seen as exposing its investors capital too. As such the management of the cost of capital may in effect be seen as an exercises in the discipline of risk management first and foremost.

In considering the cost of capital, one may also conclude that the multinational organisation has the ability to benefit from a lower level of the cost of capital through greater diversification and other risk reducing factors, which allow a company to reduce its risks.