BUSINESS STUDIES

Describe the methods of international expansion, and with reference to the objectives of financial management, evaluate the effectiveness of strategies used by business to manage global financial risk.

"Globalisation refers to the increasing interconnectedness of humanity and the many ways in which space and time have been compressed by technology, information flows, trade and power so that distant actions have local effects."[1]

Businesses expand internationally to present themselves to the global consumer and subsequently capitalize on the benefits of globalisation.

Businesses choose to expand internationally to:

1. Increase sales and find new markets
2. Diversify
3. Minimise competitive risk
4. Take advantage of economies of scale
5. Cushion the economic cycle
6. Benefit from regulatory differences
7. Minimise tax
8. Acquire resources and access new technology

Ultimately, however, a business which is seeking to expand internationally is seeking to increase these five *financial objectives*:

1. ***Profitability*** – the amount of money remaining after a business has paid all of its liabilities.

2. ***Liquidity*** – the business's ability to convert its assets into cash to enable it to pay its liabilities as they fall due.

3. ***Efficiency*** – the business's ability to manage its assets, liabilities and expenses in the operations of a business such as collecting debts, keeping costs to a minimum and turning over stock.

4. ***Return on capital*** – the investor's reward for investing money in the business.

5. ***Growth*** – the business's ability to expand its activities through increased sales, diversification, increased physical capacity and increased market share.

Global businesses, Blundstone Pty Ltd and Coca-Cola Amatil Ltd, have been examined to evaluate the effectiveness of the *strategies to minimise global financial risk* (which will be discussed later).

Methods of International expansion

There are several methods, called *entry strategies,* a business can employ to expand internationally. They are:

---

[1] Oxfam Australia

1. Export

Exporting is the most simple form of international expansion and involves the buying and selling of goods and services to consumers in overseas markets. It is a comparatively low-risk strategy as it does not involve major financial commitments and does not require a significant change to the operating hierarchy of a business. There are several methods by which a business may implement an export strategy, some of which are:

i. ***Direct export (from the primary base of operation)*****:** This business model is often employed by businesses seeking to market a typically niche product that is low in demand and high in monetary value. A high level of customization is usually offered to the client. Examples of products that could possibly incorporate this form of market structure are luxury vehicles, specialized manufacturing equipment and select vintage wines.

ii. ***Using overseas agents or distributors*****:** This type of exporting strategy involves the exporter appointing an agent or distributor to market or sell the product in the overseas market. It is important that the contract between the exporter and the agent specifically defines the responsibilities of each party such as expected sales volume.

iii. ***Through a foreign sales base*****:** this exporting method involves establishing a sales base in an overseas country where, demographically, sales and demand are very high.

iv. ***Licensing agreements*****:** involves the exporter granting a foreign third party the right (a license), sometimes the exclusive right, to market and sell the exported product in the export territory.

2. Foreign Direct Investment (FDI)

Foreign Direct Investment involves owning and operating a business in a foreign country. FDI is chosen as an entry strategy to increase sale, find new markets, diversify products or markets, cushion the economic cycle, minimise competitive risk by being located in as many overseas markets as possible, and to take advantage of different government regulations, such as tax rates. Owning a business in a foreign country allows a high degree of control of the business to be maintained. Comparatively, FDI is the highest risk entry strategy as it requires a considerable commitment of business resources and is subject to foreign political, economic fluctuations, exchange rates and taxation movements (for instance the super mining tax in Australia). There are five major types of FDI projects:

i. Investment in a new operation – Greenfield investment
ii. Developing or expanding an existing business – Brownfield investment
iii. The combination of organisations via mergers or takeovers
iv. Where parties form a joint alliance to achieve an investment outcome through joint ventures, strategic alliance and partnerships.

3. Relocation of Production

Relocation of Production involves establishing parts of a business in overseas destinations which aims to reduce costs and/or increase productivity. Organisations searches for countries which avoid trade barriers and tariffs, avoid government regulations, are in relatively close proximity to their clients or raw materials, and where the degree of skill of labour or labour costs are more appropriate.

4. Management Contract

A ***management contract*** is a legally binding agreement where one business provides managerial or specialized expertise to a separate organisation for a certain period of time, in return for a fee. For example, the business could outsource its accountancy, marketing services, training regimes or research functions. It is a relatively high risk method of international expansion as a significant commitment is required.

5. Licensing and Franchising

Licensing is an arrangement where a firm sells their intellectual property to another firm and in doing so gives permission to produce or distribute a product in a foreign market. The licensee pays a fee and/or ongoing royalties to the licensor.

Franchising is a specialised form of licensing in which a business (franchisee) enters into a continuing contractual relationship with the other business (franchisor). The franchisee operates under the franchisor's trade name and is usually given ongoing support and guidance.

Licensing and franchising allows a business to expand into global markets for minimal costs. However, these methods result in a loss of control over the business.

Global Financial Influences and Risks

When a business expands internationally it is significantly affected by financial influences. The three financial influences which business face are:

i. Currency Fluctuations

"Currency fluctuation refers to the changes in the value of one country's currency relative to another. Changes in the value of currency are reflected in the currency's *exchange rate*."[2] The exchange rate is the number of units of a different currency that can be purchased with one unit of the domestic currency, or conversely. Because currencies can *appreciate* (increase in value) and *depreciate* (decrease in value) unpredictably, the profitability of business transactions can be at risk. The risk posed by currency fluctuation is one of the most significant facing global businesses. Typically, in international trade it is expected that purchases be paid in the denomination (currency) of the base nation of the seller.

ii. Interest Rates

Interest rates refer to the 'cost' of borrowing money. That is, an interest rate is the price a borrower pays for the use of money borrowed from a lender. Comparing foreign interest rates with fluctuating domestic interest rates presents businesses with the prospect of sourcing the most competitive interest rates. Interest rates become a risk when large movements in the economy influence the interest of a borrowed amount which poses an unforeseen increased and unbudgeted cost to the business.

iii. Overseas Borrowing

Due to the deregulation of global financial markets businesses now have superior access to borrowed funds. Monetary funds are borrowed from overseas lenders to capitalise on lower interest rates. This finance is commonly used to expand the business. Such borrowings can however be subject to varying interest rates and currency fluctuations which can rapidly alter the business' budgeted costs.

---

[2] Macmillan HSC Business Studies, VCTA, Debra Owens, Tamra Hayek and Victoria Huxtable, p360, 2009

When businesses expand internationally, they need to implement management strategies to minimise these global financial risks.

Management Strategies to Minimise the Global Financial Risks

Global businesses are exposed to numerous financial influences including *currency fluctuations, interest rates* and *overseas borrowing*. Other risks are faced when operating globally such as non-payment by customers, the high costs associated with currency fluctuations and the loss or damage to goods during transportation. Several strategies can be employed to minimise these risks. These are:

1. Methods of Payment

Figure 1: Strategies to Minimise Financial Risks

Exporters make transactions with importers that are located in foreign countries. The transaction involves goods and services being distributed to the importer for a fee. Of course, some situations may occur where the exporter does not receive payment or when the importer does not receive goods or services. This poses a significant risk for both the exporter and the importer. To minimise the risk of this situation occurring, a number of ***methods of payment*** have been developed which aim to protect the welfare of all parties involved in export transactions. The four major methods of payment include:

1. ***Pre-payment (Cash-in-Advance)*** – Payment is received prior to the transfer of the ownership of goods. Whilst this method of payment is most attractive to the exporter, it is the least appealing to the importer as they are exposed to increased risk. Foreign buyers are concerned that the goods or services may not be received even though the payment has been made. Additionally, payment in advance creates cash flow/liquidity issues for the buyer.

2. ***Letter of credit (L/C)*** – A letter of credit is a contractual agreement between the importer and the exporter in a transaction that is guaranteed by the importer's bank. Provided that the terms and conditions (which are verified by relevant documents) of the contract have been met, the bank, on behalf of the importer, makes payment of the amount owing to the exporter. Letters of credit virtually eliminate any credit risk associated with exporting. That is, letters of credit decrease the risk of non-payment to the seller and of non-delivery to the buyer.

3. ***Bill of exchange*** – A bill of exchange is a signed document ordering an importer to pay an exporter a specific sum at a certain point of time. There are two types of bills of exchange (drafts):

   a. *Sight drafts (Bill against payment)* – are used when the exporter requests to retain ownership of the goods and services until it is delivered and paid for by the importer.

   b. *Time drafts (Bill against acceptance)* – are used when the exporter wants to extend credit to the importer so they can pay the amount at a fixed date in the future after acceptance of the goods or services.

4. ***Open account*** – An open account is an agreement where the exporter (seller) agrees to supply the goods to the importer (buyer) on credit. This method exposes the seller to the risk of non-payment, so exporters only agree to an open account method of payment when a strong, developed relationship has been established with the other party.

2. Credit Risks

Credit risk refers to the risk that exporters assume, such as not being paid by the importer on time or at all. Businesses can minimize the risk associated with credit by:

- Performing a credit check to ensure a customer's credit rating is satisfactory.
- Investigating and researching prospective customers for reliability, integrity and credit worthiness.
- Researching several payment methods and identifying which is most appropriate
- Acquiring a letter of credit which minimizes the degree of risk to an exporter as a transaction is made through an intermediary (third party – usually a bank which guarantees payment). This is the lowest risk method of avoiding non-payment.

"*Transaction exposure* refers to a global business's exposure to exchange rates currency fluctuations and the risk of financial losses associated with this."[3]

3. Hedging and Derivatives

Hedging is a process that is used to minimise the financial risks associated with global transactions, such as adverse price movements due to currency fluctuations. ***Derivatives*** are financial instruments by which hedging is achieved. Three common derivatives are:

1. ***A forward exchange contract (FEC or forward)*** is a derivative that involves negotiation of a fixed rate for a future transaction to ensure a certain cost of goods that is not reliant on the exchange rate. In doing this, businesses avoid the risk of unexpected currency depreciation and appreciation.

2. ***A currency option contract*** is a derivative that gives the buyer the right to buy (*'call' option)* or sell (*'put' option*) an asset (such as shares and foreign currency) at a premium rate within a certain period of time. So, a client can still capitalize on beneficial currency fluctuation but remains protected against adverse financial conditions.

3. ***A swap*** is a derivative that involves two counterparties coming to an agreement to exchange one type of asset, cash flow, investment, liability or payment for another. Common types of swaps are *currency swaps, debt swaps* and *interest rate swaps.*

4. Insurance

Insurance is the method of protecting a business against unforeseen occurrences by transferring the risks to an insurance company that specializes in risk management. A premium is paid for this service, and in the event of loss or damage, the insurance company will pay a benefit (sum of money) to compensate. Insurance is commonly used to minimise the risk associated with:

- International shipping and freight of goods whilst in transit
- Motor vehicle transportation – e.g. collisions and theft
- Credit insurance on customer's debts
- Commercial property – e.g. for buildings, stock and trade from fire, theft and certain natural events.

[3] Macmillan HSC Business Studies, VCTA, Debra Owens, Tamra Hayek and Victoria Huxtable, p382, 2009

- General liability (also called public liability) – protects the business against negligence claims from third parties.

The federal government has established Export Finance and Investment Corporation (EFIC) to provide insurance for exporters to cover circumstances where they do not receive payment for the goods supplied. EFIC also insures Australian businesses operating abroad against risks such as political risks.

5. Obtaining Finance

A large range of funds can be obtained by Australian business to obtain finance whether it is debt finance, equity finance or a merging of both (known as hybrid finance).

Businesses that relied on debt financing (lending from a financial institution) have experienced great difficulties refinancing those debts as a result of the GFC (Global financial crisis). Consequently, many publicly listed companies sought to raise funds by issuing shares to its shareholders at a discount. These share issues proved to be highly successful in Australia and minimised the business's financial risks because a company is not required to repay the equity provided by the sale of shares.

EFIC also provide assistance to new exporters by way of working capital guarantees and to allow businesses to arrange finance and offer export development grants and advanced payments.

Global businesses, Blundstone Pty Ltd and Coca-Cola Amatil Ltd, have been examined to evaluate the effectiveness of the *strategies to minimise global financial risk*.

Blundstone Proprietary Limited

Established in the late 1870, Blundstone is a renowned Australian footwear manufacturer that produces famous 'Blunnies' boots, sandals, hiking boots, casual shoes and gumboots. Due to some of the ***drivers of globalisation*** (including global consumers, the impact of technology and the role of government) Blundstone, in order to remain viable as a business, was coerced into entering the global market.

Blundstone's Methods of International Expansion

Initially, the private company adopted the method of ***direct exporting*** to expand into the international market. Blundstone exported directly to over twenty-three countries all over the world.

In 2000, Blundstone again expanded internationally through a ***Brownfield Foreign Direct Investment (FDI)*** which involved acquiring the New Zealand footwear company, John Bull Footwear.

Due to increased production costs, inflation, labour costs, and a reduction in technological improvements Blundstone Footwear was forced to ***relocate production*** and ***manufacturing*** activities away from Australia, China and New Zealand to Thailand and India in 2007 to lower manufacturing costs and to increase ***profitability*** and ***return on capital***.

Blundstone has increased the size of its market by expanding into many countries and has been able to increase the size of its production runs and output to meet increased demand whilst reducing its cost of manufacture by operating in cheaper labour markets.

Further, by spreading sales over a number of countries, Blundstone is less exposed to changes that may occur in the Australian domestic market (such as recession).

Three *methods of international expansion* (export, FDI and relocation of production) have been implemented in order for Blundstone to remain viable and, ultimately to maximise the *financial objectives of business* – profitability, liquidity, efficiency, return on capital and growth.

The Global Financial Influences and Risks Faced by Blundstone

Currency rate fluctuations influenced Blundstone's operations. As an exporter, there are foreign exchange risks. The manufacturer faced ***transaction exposure*** – this occurs when currency fluctuation affect the financial costs or revenues of an overseas business transaction. The value of the exchange rates of all currencies will vary from time to time which creates financial uncertainty for all global businesses as they try to predict what exchange rates will be in the future. Blundstone need to estimate with some certainty how much revenue it will generate from overseas sales. Strategies that Blundstone employ to minimise the risk of exchange rates and currency fluctuations are:

- ***Hedging*** with a ***forward contract derivative*** (particularly with the suppliers of raw materials) *or* ***a currency option contract*** (to ensure certainty of revenue as an exporter).

- Organising a suitable, low-risk ***method of payment*** such as a ***pre-payment*** as first choice and then ***bills of exchange*** as a second choice.

These strategies minimise the risk of currency fluctuations and exchange rates. By implementing these strategies to lower risk, Blundstone Pty Ltd is seeking to maintain and increase its ***profitability*** and ***liquidity***, ***return on capital***, ***efficiency*** and ***growth*** of the business. Therefore, in the case of Blundstone Pty Ltd, the hedging and methods of payment strategies are very effective at minimising the risks associated with currency fluctuations and exchange rates when expanding globally.

Blundstone was faced with the prospect of becoming non-viable financially if it did not embrace international expansion due to the rising costs of production, the lowering of tariffs and its inability to increase the sales price of its footwear. Consequently, Blundstone closed its manufacturing plants and relocated them to Thailand and India, in an effort to reduce costs and remain competitive in the world market. As a result, Blundstone has faced currency rate fluctuations, interest rate changes, and overseas borrowing risk. As Blundstone is a private company, its financial records are not available for review and accordingly, it is difficult to make an evaluation of the effectiveness of Blundstone's strategies to minimise those risks faced. Suffice to say, Blundstone appears to have prospered in the international market and remains to seem like a strong and vibrant company.

Coca-Cola Amatil Limited

Coca-Cola Amatil (CCA) is an Australian public company that bottles and distributes non-alcoholic ready-to-drink beverages within the Asia-Pacific region. In order to achieve greater profitability, sustainable growth and more stable return on capital, CCA expanded globally. Expanding internationally brings with it the significant risks associated with *currency fluctuations* and *exchange rates*, *interest rates* and *overseas borrowing*.

CCA's Methods of International Expansion

Foreign Direct Investment (FDI) is CCA's chief method of international expansion. For instance, in 1982, CCA entered the global market when it acquired two bottling plants in Austria (Vienna and Graz) and has continued to acquire and/or construct manufacturing plants in Fiji, New Zealand, Papua New Guinea and Indonesia in recent times. FDI has meant that CCA has:

- An ability to overcome high transport costs
- An ability to supplement domestic supply capacity
- An ability to overcome trade restrictions

- Capitalized on the benefits of lower production costs in the host country (particularly in PNG, Fiji and Indonesia)
- Diversified and increased its customer and supplier base
- Gained access to different and cheaper resources and knowledge

The Global Financial Influences and Risks Faced by CCA

CCA's global operations are influenced by ***currency fluctuations*** and ***interest rates***. The company imports raw materials to use in the production process of their products. Fluctuations in currency values and the *exchange rate* alter the price of the raw materials which, ultimately, changes the ***profitability*** of CCA's overseas operations.

Interest rates affect CCA's operations due to the fact that the approximately 20% of the company's borrowings come from overseas financial institutions. So, if foreign interest rates increase then the interest repayments that CCA will also increase which would reduce profitability. To minimise the risks associated with movement in interest rates and overseas borrowing, CCA often converts these foreign loans into Australian loans to reduce risk.

From the point of view of sales, increases in interest rates typically reduce product demand due to decreased consumer spending and vice versa with respect to decreases in interest rates.

CCA conducts ***credit checks*** to ensure the credit-worthiness of a client before an agreement is made to minimise the risk of non-payment and for some larger credit customers also takes out ***credit insurance,*** which in turn assists in maintaining ***profitability*** and ***liquidity***.

Derivatives instruments, such as ***swaps*** and ***options*** are used by CCA to ***hedge*** it against global financial requirements. These derivatives minimise the risk protecting the business against adverse currency fluctuations, exchange rates and interest rates. For instance, in 2003 CCA utilised hedging to protect itself from sharp increase in the Australian dollar and the impact of rising oil prices.

More recently, CCA has employed their hedging program to deal with their view that the cost of sugar will continue to increase with a view towards reducing the risk of the fluctuating sugar price.

In addition, CCA has diversified its product range to include products which are not reliant on sugar such as Coke Zero and Mount Franklin Water.

According to *CCA's 2009 Shareholder's review*, during the 2008-2009 financial year, CCA committed significant funds to its 'Project Zero' (notwithstanding the then current GFC) with a view towards substantially increasing its efficiency associated with manufacturing and producing its products. It is reported that cost savings from 'Project Zero' delivered a 22% increase in earnings growth. In addition, CCA also embarked upon a major review and update of its technology operating platform (Project One Amatil Information System [Project OAsys]) including finance, human resources, call centre, equipment service, pay roll and demand planning systems. The new system is also said to be delivering cost savings throughout CCAs international business.

Pacific Beverages is a 50:50 ***joint venture*** between CCA and SABMiller who manufacture and market a range of premium beers in Australia and New Zealand and also distributes Jim Beam, Canadian Club, the Famous Grouse and Cointreau. The joint venture appears to be delivering strong result for both parties, and in the 2009 year, the premium beer brands delivered volume growth of nearly 50% and now account for over 9% of Australia's premium packaged beer market. Their annual growth rate is now 3 times that of the Australian premium beer market.

International expansion has considerably minimised the risks linked with ***currency fluctuations*** as they have become less dependent on the Australian market as a source of revenue. For example, when sales decrease in volume during winter periods, CCA can fall back onto its investments in Indonesia and Papua New Guinea where drink sales remain constant all year round.

CCA recorded during the 2009 year a record result delivering increased ***profitability***, increased ***efficiency***, was able to deliver an increased dividend to shareholders (return ***on capital***), achieved solid ***growth*** particularly in the Asian markets and was able to maintain its ***liquidity***. Therefore, CCA's strategies to minimise global financial risks appear to have been very effective in achieving the financial objectives of business (as evidenced in the figure below), whilst many other companies during this same period (GFC) floundered.

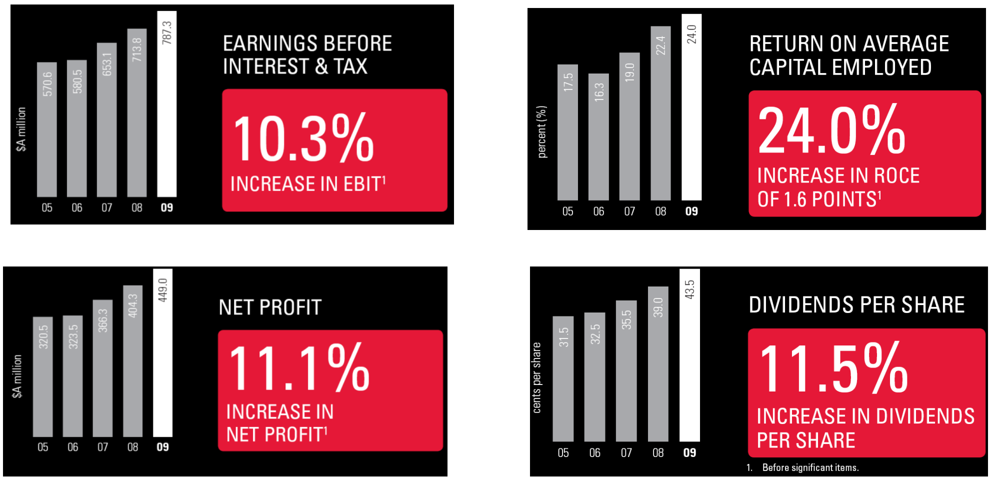

Figure 2: Coca-Cola Amatil's (CCA's) Increases from 2005 – 2009, Source: CCA Shareholder's Review

Whilst Blundstone Pty Ltd and Coca-Cola Amatil have effectively utilised strategies to minimise the risks associated with currency fluctuations, interest rates and overseas borrowing to increase profitability, growth, efficiency, return on capital and manage liquidity, these strategies would not be ideal for every organisation that expands globally. Every organisation is unique and pressured by different influences, not just financial, and these would all have a significant impact on the success or failure of a global business. Further, strategies which may work effectively for a business entity in one period of time may not work effectively for the same business entity in another period of time due to changes in currency, economic conditions (e.g. recession or credit crisis), political instability, shortage of raw materials, interest rate rises, and so on. As our two case studies have highlighted, having effective strategies to minimise global financial risk is essential for any business that ventures into the global market. Failure to understand and take suitable and effective action to minimise global financial risk can have devastating financial implications on the financial objectives of the business.

Reference List:

- *http://www.unzco.com/basicguide/c12.html*
- *http://www.export.gov/finance/eg_main_018103.asp*
- *http://www.investorwords.com/2293/hedge.html*
- *http://www.investorbuddy.com.au/specialist-investments/what-is-hedging*
- *http://www.businessdictionary.com/definition/swap.html*
- *http://en.wikipedia.org/wiki/Blundstone_Footwear*
- *http://www.blundstone.com.au/history_the_story.cgi*
- *http://ccamatil.com/Pages/default.aspx*
- http://ccamatil.com/InvestorRelations/AnnualReports/2009/2009%20Annual%20Report.pdf
- *Coca-Cola Amatil's 2009 Shareholder's review*
- *Coca-Cola Amatil's 2009 Factbook*
- *Coca-Cola Amatil's 2009 Annual Report*
- *Macmillan HSC Business Studies, VCTA, Debra Owens, Tamra Hayek and Victoria Huxtable, 2009*
- *Business Studies HSC, Longman, D. Sykes, V. Hansen, E. Codsi, 2001*