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**Capital structure design
of foreign subsidiaries in multinational corporate
groups with a German parent company**

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Abstract

This essay gives an overview of the special features of funding foreign subsidiaries. The central issue discussed is the possibility of funding by equity capital or borrowed capital in the form of loans and trade accounts payable. Various environmental settings are introduced which lead to different decisions regarding the capital structure. The observations relate to a subsidiary company that is to be set up anew, where the possibility of design in the capital structure is given and therefore existing financing structures are not considered.

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1 Introduction

A decision concerning the design of the capital structure of foreign subsidiaries should be based on a uniform concept. Therefore, the essential terms corporate group, subsidiary, capital structure, and multinational company should be defined. A corporate group consists of companies that are legally independent and economically dependent. A corporate group is an economic entity. The key feature of the definition of a corporate group is the integrated management of the companies belonging to it. A **subsidiary** is a company within a corporate group, which is subordinate to another company in that group. In order to be a subsidiary the amount of equity participation must exceed 50 %. The **capital structure** describes the composition of the liabilities side of the balance sheet of a company. The amounts of equity and borrowed capital as well as the source of funds and the period of maturity for the capital are essential determinants of the capital structure. **Multinational companies** own manufacturing and distribution activities in different countries where they supply foreign markets with products from the company and all managerial activities are based on their overall corporate planning (see *Semler*, 1976, p. 1370f.).

This essay is broken down as follows: the introduction puts the concepts into concrete terms, the second chapter discusses the setting of objectives according to which the capital structure is arranged, and the third chapter describes the design parameters influencing the capital structure. Subsequently the environmental conditions to which subsidiaries are exposed to in foreign countries are discussed. These are finally associated to the design parameters in the fifth chapter, and a possible decision procedure concerning the choice of the funding is shown.

2 Setting objectives as starting point for the capital structure design

2.1 Profit maximization

The capital structure is usually designed under the primacy of the entrepreneurial system of objectives. A goal function often assumed is the maximization of profit. Profit is the result of revenue minus costs (see *Busse von Colbe*, 1964, p. 616). It is not possible to influence the revenue in a positive manner by using the capital structure design. Therefore, the principle that all actions are based upon is the minimization of costs. Concerning the capital structure design, the objective of **capital cost minimization** can be derived.

Besides striving for maximum profit, a company must consider **risk aspects**. This can be carried out by the maximization of profit up to a predetermined risk extent (auxiliary condition). However, when choosing between the different alternatives, attention should be paid to the fact that alternatives entailing higher risks also have a higher profit expectation.

It is vital that the company is solvent at all times for its' continuous existence. If this is not observed constantly, the continued existence of the company is jeopardized (see *Heinen*, 1976, p. 74). The objective of **safeguarding liquidity** is therefore an important auxiliary condition when striving for profit maximization (see *Weber*, 1983, p. 67).

The company objective of **growth** is a financing driver. For example, growth results in additional financing needs. In a company growing extensively, the equity capital is generally limited and thus the growth is more likely funded by borrowed capital. The growth target is aimed at the realization of higher future profits. Therefore, the growth objective is subordinate to the objective of profit maximization in the long-term review.

2.2 Maximization of the company value

Companies are increasingly judged by the extent of maximization of shareholder value. The value of the company can also be influenced by the design of the capital structure. The capital structure plays an important role in the **discounted cash flow method** (see *Copeland/Koller/Murrin*, 2000) which is the current prevailing assessment procedure (see *Lorson*, 1999, p. 1330), The discounted cash flow procedure is based on the free cash flow in the future, which is discounted using the weighted average cost of capital (see *Lorson*, 1999; *Schmidbauer*, 2000). The rates of equity capital are higher than those of borrowed funds due to the expectations of the shareholder. Therefore, the discount rate drops as the use of borrowed capital increases. The value of the company is defined as the sum of the discounted free cash flows for the corresponding periods in the future and the discount rate should be as low as possible in order to achieve maximized company value. This is the reason why borrowed capital should be used whenever possible. However, the lenders will increase the rate of return they require (see *Eckert*, 1997, p. 31f.) if the debt-to-equity-ratio exceeds a certain factor. The problem in this context is how to find the optimal debt-to-equity-ratio. (see *Schneider, D.*, 1992, p. 550 f.).

2.3 Striving for independence and freedom of disposition

The possible influence of external groups on the decisions of a company must be considered when designing the capital structure. It is therefore important for many companies to protect their independence and freedom of disposition and decision. In decisions regarding funding, the additional raising of borrowed capital restricts the freedom of disposition. The borrowing of funds must therefore be limited in order to keep independence from lenders (see *Perridon/Steiner*, 1999, p. 10). However, the granting of shares in equity capital to third parties can also lead to an increase in their exertion of their influence, as the newly admitted shareholders have the right of co-decision (see *Heinen*, 1976, p. 77).

3 Design parameters of the capital structure

3.1 Equity capital resources

Besides the source of the funds, the amount of the equity capital is the key design parameter of the capital structure. In order to determine the optimal capital structure, the functional relationship between the debt-to-equity-ratio and equity capital return must be considered (see *Perridon/Steiner*, 1999, p. 473). This so-called **leverage-effect** is based on the following reflection: The lenders of borrowed capital are served to an extent previously fixed. Interest is earned on the equity capital (E) as residual parameter of the annual net profit before interest (NPBI) minus the interest on borrowings (C_{FK}). Therefore, the rate of return on equity is:

$(NPBI - C_{FK})/E$. Thus, if the equity capital is substituted by additional borrowed capital, the equity return increases, if the return on total capital employed is higher than the return on borrowed capital. In this case, a higher return is realized with the borrowed capital than the interest that would be paid. However, if the return on total capital employed is lower than the return on borrowed capital, the equity capital return falls by the substitution of equity capital with additional borrowed capital. This case is called leverage-risk or leverage-danger (see *Perridon/Steiner*, 1999, p. 476). In addition to this, an increase of the debt-to-equity-ratio also leads to a higher risk for the lenders of the equity capital. Therefore, they will increase the rate of return they require accordingly (see *Schneider, K.*, 1991, p. 121).

The amount of the borrowed capital interest rate is essential for the **credit rating** of the corporate group. The risk for the lender of borrowed capital increases as additional borrowed capital is raised, because the liable equity capital remains the same with given equity capital, and the relation between equity capital and borrowed capital is getting worse. This leads to a downgrading of the credit rating and therefore to more expensive company funding.

The amount of equity capital also determines the level of **liability** related to it. In subsidiaries belonging to international corporate groups, the liability is limited to the equity capital. Some countries, however, impose legal restrictions that are incorporated into the so-called “piercing of the corporate veil”. This direct liability of the controlling shareholder means that the corporate group parent must always guarantee for the subsidiary company. In many cases the assumption of the parent company’s additional liability is required if loans are granted to the subsidiary.

3.2 Geographic capital source

There are several possibilities to source the **equity capital**. The corporate group can raise the equity capital in the parent company’s country from a financing company in a third country or a national holding in the subsidiary’s country. It can also be financed in the subsidiary’s country by issuing shares or through the participation of shareholders (see *Laubscher*, 1981, p. 51).

The sources for **borrowed capital** are identical to those for equity capital. The borrowed capital can be raised locally or offshore. The borrowed capital can be borrowed from the companies within the corporate group or from the capital market. The parent company can also make a deposit at a bank and then grant a loan to the subsidiary. In legal terms this would be an external loan, however, for the corporate group it is effectively an internal loan (see *Giesel*, 1982, p. 122f.).

3.3 Capital maturity

The period of maturity is an essential aspect related to funding. In some cases, the liquidity of a company can be threatened if funding does not match maturity. The questions concerning the maturity are similar in both the parent company and the subsidiary. However, the period of maturity of the capital in the subsidiary can be designed more easily as it is possible to limit, for example, the consequences resulting from political or exchange rate risks. Other design

parameters such as source of the capital and equity capital stock contain a higher potential for realization of the company objectives. Therefore, the problems of maturity are discussed secondarily when reflecting regarding the capital structure.

3.4 Participation structure

Companies try to limit the exertion of influence by third parties and minimize their participation rights by skilful choice of financing instruments. Participation rights are information rights, veto rights, and rights of co-determination in decisions concerning the company. Lenders of borrowed capital only have the right to be informed, while lenders of equity capital have further rights of influence on the company's management. If the subsidiary's equity capital is not fully funded by the corporate group parent, the management must consider the rights of the other lenders. Therefore, in practice 100% participation in subsidiaries is striven for in most cases (see *Scharrer*, 1989, p. 95).

4 Environmental conditions influencing the capital structure

Different settings and environmental constellations apply to the foreign subsidiary in comparison to the German parent company. Political, economic, and currency-related risks vary in the individual countries. The company is subject to different tax regulations, and laws. Government grants, special interests, and the influence of other groups must be taken into account.

4.1 Country-related risks

The term "country-related risk" summarizes all possible dangers of losses resulting from macroeconomic, political, and cultural situations (see *Meyer*, 1987, p. 16). According to the extent of the country-related risk, different action recommendations are made regarding the intensity of the business relationship with the individual country.

The **political risk** expresses the danger that a country becomes unwilling to pay for political reasons (see *Jokisch*, 1989, p. 1257). The political risk is divided into five components (see *Engelhard*, 1992, p. 370f.) which include the risk of condemnation, the disposition risk, the transfer and conversion risk, the security risk and the fiscal risk.

The **economic risk** describes the danger of partial or total insolvency of a country. It is determined by several domestic and external economic indicators (see *Bueschgen*, 1997, p. 286ff.). As domestic economic indicators also influence a country's interest rate level, interdependence between the country-related risk and the interest rate level exists. In cases where there is a high country-related risk there tends to be a higher interest rate level (see *Jokisch*, 1989, p. 1255). This is mainly the result of the higher inflation and the risk premium for investments in countries with a high risk.

Currency risk is the possible loss because of changes in the exchange rate. The currency risk is divided into the three components: currency translation risk, currency transaction risk, and economic exchange rate risk. The **currency translation risk** results from the danger of the

depreciation of the equity originally paid and later arising equity capital by the surplus retained within a given period by the subsidiary from the parent company's viewpoint (see *Bueschgen*, 1997, p. 312ff.). The **currency transaction risk** results from the exchange rate risk of individual transactions, e.g. payment of dividends or license fees, when currencies are exchanged at the outset or on completion (see *Giesel*, 1982, p. 126; *Bueschgen*, 1997, p. 316). The **economic exchange rate risk** describes the danger that the competitiveness of a company will get weaker due to changes in the exchange rate (see *Schulze*, 1994, p. 111).

4.2 Tax laws

The tax burden suffered by the corporate group can be reduced by the choice of the capital structure. Therefore, the tax aspects in a sense of the objective of cost minimization are important with regard to the capital structure design. The tax burden must always be assessed from the viewpoint of the company as a whole.

The **subsidiary** pays different taxes in the country of its seat. Its' profit is subject to taxation by corporate income tax. Further income tax is levied in some countries, which is comparable to German trade tax (see *Potthof*, 1998, p. 40). In some countries taxes on non-income items are levied in the form of general capital tax if they are funded by equity capital (see *Potthof*, 1998, p. 42ff.). Concerning the payment of dividends, in most of the countries taxes arise that are collected at the source, so that in case of the distribution of a dividend a tax deducted at the source must be withheld by the parent company and paid to the subsidiary's local tax office (see *Richter*, 1993, p. 127).

In accordance with the principle of residence, the **parent company** is subject to taxation in the country of its corporate seat (see *Schulze*, 1994, p. 96). If a dividend is distributed, it results in income for the parent company and the taxes must be paid there. In many countries, a double taxation of corporate profits arising in this manner is stopped by mutual double taxation agreements. The following characteristics must also be observed for a German parent company: interest on internal corporate group loans is taxable in the parent company. If the parent company takes up long-term borrowed capital to finance the subsidiary this results in addition to the trade tax to approximately the order of 50% of the debt interest (see *Potthof*, 1998, p. 69).

It may be worthwhile to establish a **financing company** for tax purposes. It is typical for a financing company to be located in a foreign country, to be part of a corporate group, have economic interests in other countries outside the country of corporation, and to execute financing functions (see *Potthof*, 1998, p. 12ff.; *Salzberger/Theisen*, 1999, p. 406). A financing company is utilized if better financing can be guaranteed and/or the extent of the tax burden can be reduced (see *Steven*, 1995, p. 11). Financing companies may reduce the tax deducted at the source (withholding tax) that is to be paid if the country of corporation has imposed lower withholding tax rates with the country of corporation of the subsidiary than would arise should direct payment be made to the German parent (see *Steven*, 1995, p. 51ff.).

4.3 Laws and subsidies

Besides the taxation rules, there are laws in some countries that limit the flexibility and the freedom of decision made by companies. Several countries try to protect their industry by imposing customs barriers or local content regulations. Some countries require, for example, that at least one local partner is admitted as subsidiary shareholder (see *Brandt*, 1982, p. 112). They also charge high duties on imports, making them practically impossible. Furthermore, laws may regulate the monetary transactions thus influencing the capital flow of the companies. Normally these restrictions apply to long-term borrowed capital (see *Giesel*, 1982, p. 92). On the other hand, efforts are also made to get investors within their own country by attracting them with subsidies and other benefits. Design possibilities may be given depending on the specifics of the individual case. The requirements of local content influence the real net output to be created in the country and therefore the extent of investments planned by the subsidiary and the financing requirement related to them.

4.4 Interests and influence of other groups

A company is in the focus of the public and deals with many interest groups. These can be customers, suppliers, employees, financial authorities, the government, the public, and lenders of borrowed capital or investors of equity capital. According to the country, it is necessary to check which groups there are and how much they can influence the policy of the company.

5 Connecting the design parameters with the environmental conditions

5.1 Outline

Environmental conditions have an essential influence on the design parameters. However not all design parameters are similarly influenced by every environmental condition. Table 1 outlines the intensity of the effect of the environmental conditions on the design parameters.

Design parameter Environmental conditions	Equity capital resources	Geographic capital source	Maturity	Participation structure
Political risk	High	High	Medium	Low
Economic risk	High	High	Medium	Low
Currency risk	High	High	Low	Low
Taxes	High	High	Low	Low
Subsidies or laws	Possible	Possible	Possible	Possible
Interests/influence other groups	Low	Low	Low	High

Table 1: Influence of the environmental conditions on the design parameters

Table 1 explains the complexity of the decision situation for the determination of the optimal capital structure. For a detailed adjustment of the design parameters, several environmental conditions must be considered simultaneously. Some of these conditions conflict and others intensify. A high political risk, for example, leads to a lower equity capital stock. The high-borrowed capital share is accompanied by taxation advantages. As a high political risk is often accompanied by a high economic risk (high inflation and high interest rate differential), a high equity capital stock is recommended due to inflation and the interest rate level in real terms. There is often no optimal solution for a design parameter, as different environmental conditions would require inconsistent characteristics at the same time.

5.2 Effect of the country-related risk on the design parameters

The **political risk** mainly has an effect on the amount of equity capital, the geographic source, and the maturity of the capital. With an increasing political risk, one usually tries it by increasing insurance coverage and/or minimization of the amount of the equity capital. If the risks seem to be unbearably high, the project is not executed. Raising a credit in the country of the subsidiary reduces the risk for the parent company as, for example, in case of condemnations such loans are not paid back by the parent company. Finally, the political risk also influences the decision regarding the period of maturity for the borrowed capital. In order to be able to react quickly to increased instability, a company is more likely to fund on a short-term basis.

The components of **economic risk** which include interest and inflation are highly significant for the company. In countries with a very high inflation rate, a very high interest rate level also prevails. If funding by borrowed capital in local currency takes place, a company would have to bear very high fixed charges by the repayment of existing debts as a result. Borrowed capital funding in local currency is therefore avoided. In countries with high interest and inflation rates, long-term financing is often not feasible, as no bank is prepared to bear the risk of a change in the interest rate. However, short term financing transfers this risk to the company that is no longer able to calculate and has to suffer a high interest burden in case of a considerable interest rate increase. Therefore, it would be sensible to try to utilize as much equity capital as possible and to raise additionally required borrowed capital in foreign currency as long-term capital.

Currency risk is mainly significant for the geographic source of the borrowed capital. If the company takes up loans in foreign currency, interest and repayment must be made in this currency. The debt service expense can increase by a change of the exchange rate. For exports, the risk can be reduced by specific borrowing of credits in the export currency. Besides the payment of imports, the exchange proceeds realized by the export business can be used to fund the debts. Therefore, neither the loan nor the export proceeds are subject to a currency risk (see *Broll*, 1995, p. 53f.).

5.3 Effect of taxes on the design parameters

Taxes have a strong effect on the capital structure, especially on the amount of equity capital. This is the result of the different treatment of equity and borrowed capital for tax purposes.

While dividends and income taxes must be paid for equity capital, the interest rates on borrowings are tax-reducing expenses. Because of the withholding tax deducted at the source, foreign subsidiaries are initially provided with less equity capital and must therefore create an appropriate equity capital base for themselves through the retention of profits.

The existence and the content of a double taxation agreement between the countries of the recipient and the lender are essential before making the decision regarding the geographic source of the capital. If the double taxation agreement in the country of the financing company has conditions that are more favourable for the company than the conditions of the country of the parent company, the capital for the subsidiary should be raised by the parent company and not by the financing company.

In addition, the maturity and participation structure can be influenced by tax regulations. In Germany, for example, the maturity of the borrowed capital has an influence on the amount of the trade earnings tax. For loans with a term of more than one year, only half of the interest must be calculated when computing the trade tax.

5.4 Effect of subsidies and laws on the design parameter

Dependent on their nature, subsidies and/or laws can take effect on all influence parameters. For subsidies, their monetary advantage must be compared with the disadvantages resulting from the conditions of granting the subsidy. Laws may determine restrictions preventing the choice of an optimal capital structure. For example, in some countries a minimal equity capital stock or a maximum debt-equity-ratio is stipulated. In such cases, it should be checked whether the project is economically viable within the legal restrictions.

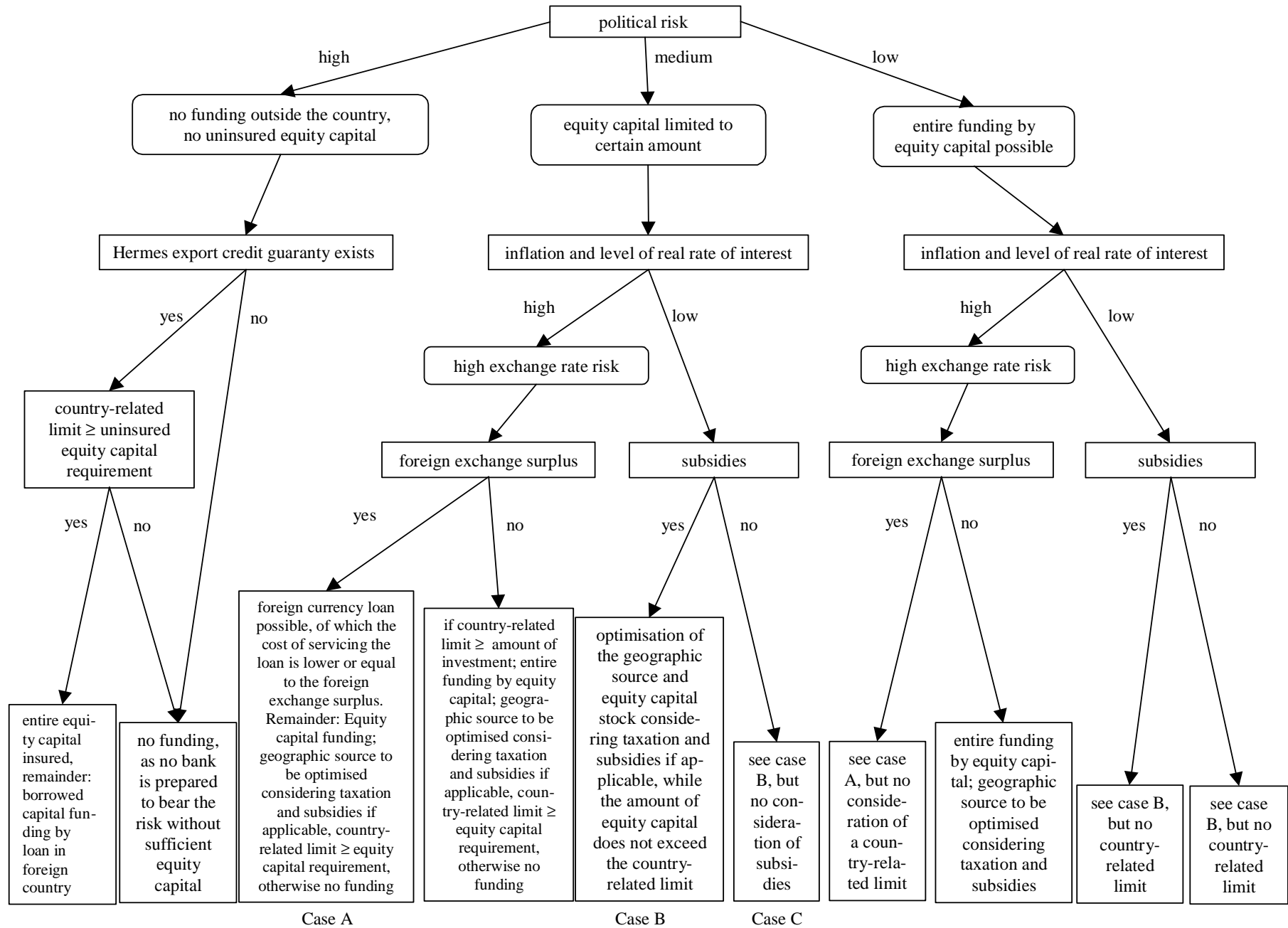
5.5 Effect of the influences of other groups on the design parameters

The effect of other groups on the design parameters is similar to the effect of the law. The company has the opportunity to limit the effects as much as possible. By skilful choice of the financing instruments, the rights of co-decision and veto of the interest groups can be limited. However, the economic efficiency of an investment plan can be improved by the participation of third parties.

5.6 Decision process for funding a foreign subsidiary

Summarizing the previous observations, diagram 1 shows a decision process for the determination of a target-related capital structure. In order to keep structure of the diagram clear, no distinction was made between subsidies that were granted and those that were not in cases where there was high inflation. The statements made are only valid in a very limited sense in the areas of political risk, inflation/level of the real rate of interest, and exchange rate risk (ER-risk) as only particular characteristics (low, medium, high) were examined in order to keep the structure clear.

Diagram 1: Decision process



First, a company assesses the extent of the political risk as such risks could lead to the failure of the project. In order to limit the risks, the maximum amount of equity capital (EC) is determined in accordance with the extent of the political risk. Thereafter, the company must establish the required amount of equity capital without considering the environmental conditions to make the subsidiary independent of further financial support by the parent company.

If the current political risk is too high, no company should be prepared to invest equity capital in such a country, unless it is possible to insure the equity capital and the company only has to bear the retention costs. In this case, no financing is performed outside the country as in case of riots or condemnations the offshore credit would have to be serviced and this is not necessary for a domestic loan. In case of medium political risk, the inflation and the level of the interest rate in real terms are examined. If the risk is high, there is usually also a high exchange rate risk.

Therefore, it must now be determined whether the company exports and thereby realizes a foreign exchange surplus. This can be used to service a foreign currency loan then to be taken up. If the foreign currency surplus is not sufficient for the service, the missing amount must be made available by equity capital. Otherwise, the risks from outstanding currency positions would be too high for the subsidiary. If the equity capital requirement is higher than the country limit determined based on the political risk, the project will not be executed.

The **geographic source of the capital** must be optimized, particularly from a taxation point of view. If there is no foreign currency surplus, the project can only be executed if funding can be carried out by equity capital after utilization of possible subsidies. However, the amount of equity capital may not exceed the country-related limit. Otherwise, the project cannot be realized.

In case of low inflation, a low interest rate level can be assumed, so that a possible exchange rate risk has no influence on the decision. Therefore, the equity capital stock must be determined considering taxation regulations and subsidies. The equity capital stock must be chosen in a manner that ensures that the cash flow in the planning period is sufficient to pay interest, redemption, dividends, and investments.

The only difference between a case of low political risk and a case of medium political risk is that in the first case no country limit is to be considered in principle. Therefore, projects that could not be executed in case of medium political risk due to the country limit can be realized in case of low political risk.

6 Conclusion

This article describes the parameters of capital structure formation of foreign subsidiaries for a German parent company. A goal system was assumed using the elements of capital cost minimization, limitations of liability and risk, measures safeguarding liquidity, striving for independence/ freedom of disposition, and growth and maximization of the company value. Besides the amount of equity capital, the choice of the geographic source of the capital, the

period of maturity and the decision concerning the participation structure are essential for the success of the company. These four parameters determine the capital structure of a company. Environmental conditions have a decisive influence on the decision concerning the distinction of these parameters. Such conditions include country-related risks, tax laws, laws/subsidies as well as interests and influence by other groups. The decision problem regarding the design of the capital structure for a company is complex. Besides the setting of objectives, its' solution depends on the constellation of the environmental conditions and the company's management's tendency to bear risks. The decision process model developed describes the connections in a structured way and makes a satisfactory solution possible.

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