INTERNATIONAL FINANCE FIN 370
HOMEWORK SET # VIII
EXPORT VERSUS INVEST DECISION

Text in Red
Indicates the infusion of the **Elements of Reasoning**
Text in Blue
Indicates the infusion of the **Intellectual Standards**
Text in Green
Indicates the infusion of the **Intellectual Traits**
[Bracketed Text]
Indicates the indirect use of critical thinking ***[Elements]***, ***[Standards]***, or ***[Traits]***

View more about the Paul-Elder Framework of Critical Thinking

Palo Alto Electronics (PAE) of the US exports 150,000 sets of telephone routers per year to the Philippines. It sells them for the equivalent of $80 per set. Current total costs are $60 per set and are expected to stay the same for the next ten years. PAE is studying an offer to start a subsidiary in the Philippines (to be named PAE Philippines) that would establish a project to produce and sell the routers locally. Initial investment would be $1,000,000 in plant and equipment and $500,000 in net working capital. Plant and equipment will be depreciated to zero on a straight-line basis for ten years, and will have $100,000 salvage value. PAE Philippines would import all the parts it needs from the parent company at a cost of $25 per set. Additional local costs are $5 per set. No other costs are incurred by PAE Philippines (i.e. all costs are estimated on per unit basis). PAE's pre tax profit margin on the $25 sale is $12. Tax rate in the US and Argentina is 40%. Discount rate for Santa Clara is 16% across the board. Assume there is no increase in the number if units sold over the ten year period.

a. On an income statement format and using an excel spreadsheet calculate all relevant cash flows from the subsidiary's perspective.
b. Is the project profitable in its own right? Show all calculations that enter into this decision making process.
c. Assuming no limits on repatriation, what are the effective annual cash flows to PAE (the parent company)?
d. Should PAE build the plant in the Philippines instead of exporting the routers? Show all calculations.

Remember to Think Critically:

1. **Question:** Should we stop exporting and instead establish a subsidiary in a foreign country?
2. **Information:** Do we have the data we need to make a decision?
3. **Assumptions:** Are our foreign exchange assumptions and customer response realistic?
4. **Point of View:** Use CAPM or DDM for WACC?
5. **Concepts:** Which models do we use to make decision: NPV, IRR, etc..?
6. **Purpose:** Why do we do this exercise?
7. **Ultimate goal:** Maximize value.
8. **Implications:** Outsourcing good? Bad? What are the issues to analyze so that we take a reasoned point of view?