Point of View

How emerging economy firms lose money

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Introduction

In the past three decades, firms from emerging economies have expanded internationally in an aggressive manner. Cemex (Mexico); Vale (Brazil), Huawei, Lenovo and TCL (China); Tata Motors, Tata Steel, Tata Consulting Services, Infosys, Hindalco and Sulzon (India); and Lukoil (Russia) are among these firms. A number of them have engaged in cross-border acquisitions by buying out Western firms in an attempt to access complementary resources, such as technology, brand, distribution, business systems and management expertise. One important issue associated with foreign acquisitions is the financing strategy. This is directly related to the capital structure of the firm, i.e. the specific mixture of long-term debt and equity the firm uses to finance its operations. We have studied the financing strategies of foreign acquisitions and their impact on the financial performance of emerging economy firms. We illustrate this with a case study about Cemex (Mexico).

The dubious financial performance of Cemex

Cemex SAB de C.V, a Mexico-based firm, is one of the largest cement manufacturers in the world after Holcim (Switzerland) and Lafarge (France). Cemex produces, distributes and sells cement, clinker, ready-mix concrete, aggregates and related building materials in over 50 countries. Cemex started its international expansion strategy in 1992. Cemex has engaged in a series of acquisitions in Latin America and the Caribbean, Europe, Asia and North America. In 2002, Cemex was the first to enter the list of the top non-financial transnational companies from developing and transition countries by foreign assets in the UNCTAD report.

In 2007, Cemex paid US$14.2 billion to acquire Rinker Group, the Australian building materials supplier with more than 80% of its sales in the United States. However, the acquisition of the Rinker Group increased threefold the amount of debt it held and thus drastically changed its capital structure. Cemex primarily used short-term debt to finance this mega acquisition deal, as it had done with other acquisitions in the past. Consequently, Cemex had a negative working capital of US$6 billion in 2008.

With the burst of the US housing bubble and the falling demand for new construction, the demand for Cemex’s products decreased. The banks refused to renew the loans it held. By 2009, Cemex was close to defaulting on US$21.7 billion of debt and was subsequently downgraded in terms of S&P’s investment rating. Cemex had to negotiate with creditors and it finally reached a ‘financing agreement’, which outlined its obligations for US$15 billion in refinancing for the acquisition of the Rinker Group. Cemex subsequently sold assets in Australia, Austria, the Canary Islands, Hungary and the United Kingdom. Cemex used the proceeds from these sales to reduce debt and to rectify its balance sheet. The agreement also capped spending on acquisitions at US$100 million annually and stipulated that these should be approved by creditors. These restrictions, along with the company’s substantial debt and heavy losses in the past three consecutive years have left Cemex with little room to continue its growth strategy since its last acquisition in 2007.

Shortly after the acquisition of the Rinker Group in 2007, the US Department of Justice brought an antitrust lawsuit against Cemex in 2009. Cemex complied with regulators by divesting cement and concrete plants that were formerly part of itself or Rinker.

The performance of Cemex after the acquisition was poor. Cemex’s sales decreased by 26%, from US$20 billion in 2008 to US$15 billion in 2012. Its profitability ratio was very poor, from a positive 0.08% in 2008 to a negative (6.03%) in 2012. The return on assets ratio (ROA) fell from a positive 0.04% in
2008 to a negative (2.20%) in 2012. Its capacity for interest payment and debt servicing was poor. The average interest coverage ratio of Cemex for the five year period 2008–12 was negative, as Cemex had been operating at a loss, i.e. Cemex’s earnings before interest and tax (EBIT) could not meet its interest payments.

Compared to Holcim (Switzerland), Lafarge (France) and Siam Cement (Thailand) on key financial ratios, Cemex’s performance was far behind its global competitors (see Table 1). Cemex had underestimated the risks of short-term debt financing of cross-border acquisitions and the implications of debt financing on financial performance.

### Table 1: Comparative analysis of financial performance of Cemex SAB de CV with key global competitors, average 2008–12

<table>
<thead>
<tr>
<th>Key ratios</th>
<th>Cemex SAB de CV (Mexico)</th>
<th>Holcim (Switzerland)</th>
<th>Lafarge (France)</th>
<th>Siam Cement (Thailand)</th>
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<tbody>
<tr>
<td><strong>Financial stability</strong></td>
<td></td>
<td></td>
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<tr>
<td>Current ratio</td>
<td>0.976</td>
<td>1.066</td>
<td>1.118</td>
<td>1.428</td>
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<tr>
<td>Quick ratio</td>
<td>0.644</td>
<td>0.754</td>
<td>0.728</td>
<td>0.868</td>
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<tr>
<td>Total debt-to-equity</td>
<td>1.338</td>
<td>0.924</td>
<td>1.08</td>
<td>1.332</td>
</tr>
<tr>
<td>Interest coverage ratio</td>
<td>-0.499</td>
<td>5.850</td>
<td>2.236</td>
<td>6.540</td>
</tr>
<tr>
<td><strong>Growth rate</strong></td>
<td></td>
<td></td>
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<tr>
<td>Five-year sales growth (%)</td>
<td>-2.890</td>
<td>-4.450</td>
<td>-2.130</td>
<td>8.770</td>
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<tr>
<td><strong>Profitability</strong></td>
<td></td>
<td></td>
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<tr>
<td>Net profit margin (%)</td>
<td>-4.720</td>
<td>4.750</td>
<td>4.268</td>
<td>8.304</td>
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<tr>
<td><strong>Management effectiveness</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on assets (ROA)</td>
<td>1.730</td>
<td>3.282</td>
<td>2.568</td>
<td>7.572</td>
</tr>
</tbody>
</table>

Source: Annual reports 2008–12 of Cemex SAB de CV (Mexico), Holcim (Switzerland), Lafarge (France) and Siam Cement (Thailand); OneSource Database, Thomson Reuters, 2013.

### Agency problems of using debt to finance acquisitions

One question arises: why do emerging economy firms use debt, not equity, to finance foreign acquisitions? We use agency theory on capital structure to explain this phenomenon. The agency theory attempts to model the relationship that exists when one party, the ‘principal’, delegates its duties to another party, the ‘agent’. Conflicts between principals (creditors) and agents (shareholders) arise because the issue of debt gives shareholders an incentive to invest in high-risk projects. If successful, these projects offer high returns, most of which will be accrued to the shareholders. However, if the projects fail, the creditors bear the consequences due to limited liability of shareholders. This is generally referred to as the ‘asset substitution effect’ and it is an agency cost of debt financing.

This asset substitution problem is more severe in multinational enterprises (MNEs), since they operate in complex environments. These complicated operations increase creditor difficulties in terms of controlling or monitoring the behaviours of agents (shareholders). In turn, creditors anticipate that the risk of asset substitution will be higher. This kind of risk has been referred to as the agency cost of debt’.
By drawing upon the insights of the agency theory, we find that the use of debt reflects serious agency problems of emerging economy firms. For example, Mexican and Indian firms are managed and controlled by promoter shareholders, business founders and family owners. In addition, the corporate governance does not function well. These particular types of shareholders probably do not want their shares to be diluted when new shares are issued to finance foreign acquisitions. Consequently, they use debt, even short-term debt as illustrated in the case of Cemex, which is highly risky, to finance foreign acquisitions.

Further, Indian firms and Chinese state-owned enterprises (SOEs) can access artificially cheap and implicitly subsidised debts from national banks whose mandates are to support ‘national champions’. This explains their high debt-to-equity ratio. However, this increases significantly their risks and results in subsequent financial problems and challenges, such as being unable to service interest and principal repayments. This is due to poor financial performance in the post-acquisition period. Disposing of assets obtained through acquisitions is an option available to reduce debt and redress the balance sheet.

The original strategic objectives of acquisitions, such as to develop new dynamic capabilities, to augment current capabilities, and to exploit new firm-specific assets, have not been not achieved.

Conclusion

The implications of our findings for managers are clear and straightforward. The strategy of emerging economy firms to obtain new strategic assets through foreign acquisitions is not sustainable. The debt financing of such acquisitions is a curse for their subsequent performance. Overall, cross-border acquisitions are very difficult, and can result in financial losses, not just for emerging economy firms, but also for Western firms.

References


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She has published in refereed journals, including Management International Review (MIR), Multinational Business Review (MBR) and edited volume. Before joining academia, she had 13-year professional and managerial experience in accounting, finance and business administration. She worked for German, United States and New Zealand multinational enterprises in South East Asia and Canada.

Professor Alan M Rugman

Alan Rugman is Head of International Business & Strategy. He joined Henley Business School as Professor of International Business in 2008-9. Previously he has held tenured appointments at University of Oxford, Indiana University, University of Toronto and Visiting Appointments at Harvard University, Columbia Business School, UCLA and other leading universities in North America, Europe and Asia. Professor Rugman has published numerous books and refereed articles examining the strategies and performance of the World's 500 largest multinational enterprises. These works have been influential in building the field of International Business Scholarship leading to several thousand citations. His most important book develops the theory of internalisation in an North American context, ‘Inside the Multinationals’, Columbia University Press 1981, reissued 2006. Professor Rugman has been a consultant to leading MNEs, to the Canadian Government during the negotiations for NAFTA, and to the United Nations. He is co-author of a leading textbook, ‘International Business’, 6th Edition, FT/Prentice Hall, 2012.

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