

Swarzy Microwave Inc.

Swarzy, Inc. is a midwestern manufacturer of small microwave ovens. The market segment it caters to is midprice range. In recent years, it has been exporting 24,000 sets of microwave ovens to Argentina, under an import license that expires in five years. In Argentina, they are sold at the Argentine peso equivalent of USD 60 per set. The sum of direct manufacturing costs and shipping costs amounts to \$30 per set, and there are no other costs. The market for microwave ovens in Argentina is stable, and Swarzy holds the major share of the market. The sales price and production costs are expected to keep pace with inflation, which is forecast to be 5% per annum in Argentina for the foreseeable future. By comparison, long-run US inflation is forecast at 2% per annum. The current exchange rate can be found in the following website <http://www.oanda.com/convert/classic>

Recently, in an effort to increase the employment rate in the country, the Argentine government has invited the firm to open a manufacturing facility in La Plata (which is located just a couple hundred kilometers southeast of Buenos Aires). If Swarzy Inc. makes the investment, the plant will operate for five years after which the salvage value could be zero. Swarzy will be fully allowed to repatriate all net income to the United States. In this case, it is also quite likely that units sold will increase at the rate of 5% in year 2003 and 2004.

Swarzy Inc.'s anticipated cash outlay, in dollars in 2001 would be Building and equipment \$2,000,000. Building and equipment will be depreciated over five years on a straight-line basis. The Argentine peso is almost tied to the U.S. dollar through Argentina's currency board. Expected inflation is 5% in Argentina and 2% in US. Locally manufactured microwave ovens will be sold at the Argentine peso equivalent of \$60 per set. Whilst production costs would be \$10 per set this year, components imported from US (i.e., transfer price) would amount at \$10 per set. The \$10 transfer price for raw material sold by the parent consists of \$5 of direct costs incurred in the United States and \$5 of pretax profit. There are no other operating costs in either Argentina or the United States.

The corporate income tax rate is 50% in Argentina and 20% in the United States (combined federal and state taxes). Swarzy Inc. uses a 15% discount rate to evaluate all domestic and foreign projects.

Problems:

1. Calculate the net present value of the Argentine project (project viewpoint)
2. Calculate the net present value of the Argentine project when viewed from the parent perspective. Cash flows to Swarzy consist of
 - a. Profit on component sales to Argentina, less taxes
 - b. Project cash flows, i.e., dividends remitted from Argentina at 100% of net profit to the United States;
 - c. Net loss from cannibalized cash flows, such as those associated with lost exports on an after-tax basis,
3. Should Swarzy accept or reject the Argentine project. Why?
4. How do you set transfer pricing? Do you follow a high or low markup pricing?
4. Swarzy learns that Matsubara Electronics of Japan will make a similar investment in Argentina. Matsubara would be protected by the Argentine government from competitive imports. Analyze again whether Swarzy Microwave should accept the proposed Argentine project.