Initial screenings of 30 foreign countries were based on political and economic factors that contribute to country risk. For the remaining 20 countries where country risk was considered to be tolerable, specific country risk characteristics of each country were considered. One of JCPenney's biggest targets is Mexico, where it planned to build and operate seven large stores.

a. Identify the political factors that you think may possibly affect the performance of the JCPenney stores in Mexico.

b. Explain why the JCPenney stores in Mexico and in other foreign markets are subject to financial risk (a subset of country risk).

c. Assume that JCPenney anticipated that there was a 10 percent chance that the Mexican government would temporarily prevent conversion of peso profits into dollars because of political conditions. This event would prevent JCPenney from remitting earnings generated in Mexico and could adversely affect the performance of these stores (from the U.S. perspective).

d. Offer a way in which this type of political risk could be explicitly incorporated into a capital budgeting analysis when assessing the feasibility of these projects.

e. Assume that JCPenney decides to use dollars to finance the expansion of stores in Mexico. Second, assume that JCPenney decides to use one set of dollar cash flow estimates for any project that it assesses. Third, assume that the stores in Mexico are not subject to political risk. Do you think that the required rate of return on these projects would differ from the required rate of return on stores built in the United States at that same time? Explain.

f. Based on your answer to the previous question, does this mean that proposals for any new stores in the United States have a higher probability of being accepted than proposals for any new stores in Mexico?

19. How Country Risk Affects NPV Monk, Inc., is considering a capital budgeting project in Tunisia. The project requires an initial outlay of 1 million Tunisian dinars; the dinar is currently valued at \$.70. In the first and second years of operation, the project will generate 700,000 dinars in each year. After 2 years, Monk will terminate the project, and the expected salvage value is 300,000 dinars. Monk has assigned a discount rate of 12 percent to this project. The following additional information is available:

- There is currently no withholding tax on remittances to the United States, but there is a 20 percent chance that the Tunisian government will impose a withholding tax of 10 percent beginning next year.
- There is a 50 percent chance that the Tunisian government will pay Monk 100,000 dinar after 2 years instead of the 300,000 dinars it expects.
- The value of the dinar is expected to remain unchanged over the next 2 years.

a. Determine the net present value of the project in each of the four possible scenarios.

b. Determine the joint probability of each scenario.

c. Compute the expected NPV of the project and make a recommendation to Monk regarding its feasibility.

20. How Country Risk Affects NPV In the previous question, assume that instead of adjusting the estimated cash flows of the project, Monk had decided to adjust the discount rate from 12 to 17 percent. Reevaluate the NPV of the project's expected scenario using this adjusted discount rate.

21. Risk and Cost of Potential Kidnapping In 2004 during the war in Iraq, some MNCs capitalized on opportunities to rebuild Iraq. However, in April 2004, some employees were kidnapped by local militant groups. How should an MNC account for this potential risk when it considers direct foreign investment (DFI) in any particular country? Should it avoid DFI in any country in which such an event could occur? If so, how would it screen the countries to determine which are acceptable? For whatever countries the MNC is willing to consider, should it adjust its feasibility analysis to account for the possibility of kidnapping? Should it attach a cost to reflect this possibility or increase the discount rate when estimating the net present value? Explain.

22. Integrating Country Risk and Capital Budgeting Tovar Co. is a U.S. firm that has been asked to provide consulting services to help Grecia Co. (in Greece) improve its performance. Tovar would need to spend \$300,000 today on expenses related to this project. In 1 year, Tovar will receive payment from Grecia, which will be tied to Grecia's performance during the year. There is uncertainty about Grecia's performance and about Grecia's tendency for corruption.

Tovar expects that it will receive 400,000 euros if Grecia achieves strong performance following the consulting job. However, there are two forms of country risk that are a concern to Tovar Co. There is an 80 percent chance that Grecia will achieve strong