

Cadbury schweppes
plc



**ASSIGN
BUSTER**

Introduction

Cadbury Schweppes plc is a confectionery and non-alcoholic beverage company.

The Company's products include brands, such as such as Cadbury, Schweppes, Halls,

Trident, Dr Pepper, Snapple, Trebor, Dentyne, Bubblicious and Bassett.

Cadbury

Schweppes operates in five segments: Britain, Ireland, Middle East and Africa (BIMA),

Europe, Americas Confectionery, Asia Pacific and Americas Beverages. Americas

Confectionery, BIMA and Europe produce and distribute confectionery products in their

respective geographical markets. (Google Finance, 2008). The Asia Pacific segment

produces and distributes confectionery and beverages products in the Asia Pacific region.

Americas Beverages market, produce and distribute branded soft drinks in North

America. During the year ended December 31, 2007, the Company acquired

confectionery businesses in Romania (Kandia-Excelent), Japan (Sansei Foods) and

Turkey (Intergum). (Google Finance, 2008)

Rio Tinto plc and Rio Tinto Limited operate as one business organization (Rio Tinto). Rio Tinto is an international mining company. The Company's business is

finding, mining and processing mineral resources. (Google Finance, 2008). Its major

products are aluminum, copper, diamonds, coal, uranium, gold, industrial minerals

(borax, titanium dioxide, salt, talc), and iron ore. Businesses include open pit and

underground mines, mills, refineries and smelters, as well as a number of research and

service facilities. On October 23, 2007, Rio Tinto acquired Alcan Inc. (Google Finance,

2008)

Both companies have operations that span across national boundaries, as well as

long term liabilities. This indicates that they face both exchange rate and interest rate

risks. This paper is aimed at looking at the different exchange rate and interest rate risks

that these companies face, the risk management policies, the instruments used in hedging

these risks and the implications of these risk and risk management strategies to investors.

Having said this, the paper will now go on to discuss the different types of risks.

Currency Risk

Currency exposure refers to the risk of financial loss that a company suffers as a result of

changes or fluctuations in interest rates. The financial loss may come as a result of

changes in the value of cash flows or as a result of changes in the recorded value of assets

and liabilities of the company. There are three main types of exposure that a company

may face. These include (Shapiro, 2003):

- Translation exposure;

- Transaction exposure; and
- Economic Exposure.

Translation exposure is the exposure a firm faces because of its assets and liabilities that

are denominated in foreign currency. It is the exposure that is basically faced by

multinational companies that have subsidiaries in many other countries.

Translation

exposure has no major effect on value of the firm because it affects only balance sheet

and income statement items that are denominated in a foreign currency.

Transaction exposure is the exposure a firm faces as a result of its contractual obligations

that are denominated in a foreign currency. It represents the exposure a company faces as

a result of its contractual obligations that have already been booked but that would be

settled at a future date (Shapiro, 2003). These include for example, repayment of loans

denominated in overseas currencies, purchases from overseas companies and dividends

from overseas subsidiaries.

Economic exposure otherwise referred to as operating exposure is a measure of the

changes in the present value of the firm which occurs as a result of fluctuations in

exchange rates. Economic exposure encompasses transaction exposure but it is far more

extensive in that it includes the future operations and transactions of the firm that are yet

to be booked. For example, a company that sources inputs from another country faces

economic exposure given that prices of inputs may increase in future if the foreign

currency happens to appreciate against the domestic currency. This is so because if the

foreign currency appreciates against the domestic currency in future, it will have to pay

more in terms of the domestic currency for the same quantity of inputs than it currently

pays at the current exchange rate.

Currency Risk Faced by Cadbury Schweppes

Cadbury Schweppes faces two main types of risks. These include transaction exposure

and translation exposure. The company faces translation exposure because it has

subsidiaries in many different countries. Its main translation exposure comes as a result

of its presence in the USA. (Cadbury Schweppes Annual Report, 2007). For example, the

company has both floating rate and fixed rate debt denominated in foreign currency.

Appendix 1 shows the impact on the income statement of the company of a 10%

weakening of the GBP against other currencies. It can be observed from appendix 1 that

if the GBP depreciates against other currencies by 10%, its cash and cash equivalents will

increase by £36million, borrowings will increase by £351million and currency exchange

rate contracts (including embedded derivatives will increase by £2million.

The company

also has debt denominated in foreign currency. For example, as at 2007, the company had

bank loans denominated in foreign currency to the tune of £770million for floating rate

debt. It also had floating rate debt in foreign currency including 4.9% Canadian dollar

(CAD) notes due in 2008 to the tune of £142million, it had 3.875 US dollar (USD) notes

to the tune of £502million due in 2008. It had 4.25% Euro (EUR) notes to the tune of

£440million due in 2009 as well as 5.125 USD notes to the tune of £501million due in

2013. All these debt contractual obligations in foreign currency represent part of the

transaction exposure faced by Cadbury Schweppes since fluctuations in the values of the

foreign currency may affect the cash flows of interest and principal repayments in future

periods.

Currency Risk Faced by Rio Tinto Plc.

Rio Tinto Plc has activities that span the world especially in Australia, North America,

South Africa, Asia, Europe and Africa. Consequently, it faces significant exposure to

currency risk. Like Cadbury Schweppes, Rio Tinto Plc is basically affected by all three

types of foreign exchange exposure: translation exposure, transaction exposure and

economic exposure. As concerns translation exposure, the company has a number of

subsidiaries and must translate the various income statement, balance sheet and cash flow

items to the US dollar on each balance sheet date. These translations result to foreign

currency exchange gains and losses. Translation exposure is a measure of the foreign

exchange losses when it is translating its foreign currency items into the US dollar. In

addition to the translation exposure that results from translating financial statement items

of subsidiaries, Rio Tinto also faces translation exposure with respect to its other foreign

currency-denominated assets and liabilities. Rio Tinto faces transaction exposure in that it

has contracts with cash flows that are denominated in foreign currencies. Its transaction

exposure comes as a result of the fact that these changes in these exchange rates may

result to lower cash inflows from receivables that will be settled at a future date, as well

as higher cash outflows for financial obligations such as interest and principal repayments

that will be settled at a future date. Rio Tinto Plc faces economic or operating exposure in

that some of its inputs are sourced from different parts of the world.

Movements in the

home currency value of the currencies of these countries may greatly affect Rio Tinto's

costs of inputs. The main currencies that affect Rio Tinto in terms of translation,

transaction and economic exposure are the Australian dollar, The US Dollar and the

Euro. (Rio Tinto Plc Annual Report, 2007). Appendix 3 shows the average exchange rate

between the US dollar and the major currencies that Rio Tinto interacts with.

These

include, the Australian dollar, the Canadian dollar, the Euro, the New Zealand Dollar, the

South African rand and the UK pound Sterling. The appendix also shows the effect on net

and underlying earnings of a change in the average exchange rate of any of these

currencies and the US dollar. It can be observed that a 10% change in the average

Australian dollar/US dollar exchange rates results into a US\$494million increase or

decrease in net and underlying earnings; A 10 change in the US dollar/Canadian dollar

exchange rate results into a US\$203million increase or decrease in net and underlying

earnings; a US\$65million loss is anticipated for a 10% change in the average exchange

rate between the US dollar and the Euro; a 10% change in the average US\$/South African

rand exchange rate results into a US\$55million increase or decrease in net and underlying

earnings; whereas a 10% change in the UK pound sterling/ US\$ exchange rate results into

a US\$24million increase or decrease in net and underlying earnings. (Rio Tinto Plc

Annual Report, 2007). Minimal changes are observed for a 10% change in the US\$

/Chilean peso and the US\$ /New Zealand dollar average exchange rates, that is,

US\$12million and US\$17million respectively.

Interest Rate Risks

Interest rate risks is the risk that the value of an investment will change as a result of

changes in the absolute level of interest rates, the spread between two rates, the shape of

the yield curve or in any other interest rate relationship. Bond prices are more affected by

interest rate risk than other securities such as stocks. Interest rates are inversely related to

the value of a bond, that is, when interest rates rise, the value of the bond falls and vice

versa. This is because as the interest rates increase, the opportunity cost of holding a bond

decreases since investors are able to realize greater yields by switching to other

investments that reflect the higher interest rate. For example consider a bond that pays

5% interest. This bond will be worth more if interest rates fall, since the bondholder will

be receiving fixed rate of return relative to the market, that offers a lower rate of return as

a result of the fall in interest rates.

Interest rate risk measures the sensitivity of a firm's cash flows, profit and firm

value to interest rate fluctuations. In addition to the interest risk that a company might

<https://assignbuster.com/cadbury-schweppes-plc/>

face as a result of changes in its cash flows, profit and firm value. Buckley (1996)

identifies two other types of interest rate risk, which include basis risk and Gap risk.

If interest rates are determined on a different basis for assets and liabilities then a

firm having loans and debts will face basis risk. A company faces basis risk when the

interest rates on its loans and debts are determined using different basis.

(Buckley, 1996)

Assume for example that Kaufman & Connelly Plc issues a fixed rate bond to fund its

financing needs and at the same time gives out a loan to another party at a floating

interest rate. Her interest payments will therefore be fixed while interest receipts will be

variable and will depend on prevailing rates. She will therefore be facing basis risk since

her interest expenses and revenues will be determined on different basis.

A company faces gap risk when it has both fixed rate liabilities and assets.

When

<https://assignbuster.com/cadbury-schweppes-plc/>

fixed rate liabilities exceed fixed rate assets then there is positive Gap, with a positive gap

a rise in short term rates increases margins while declining rates decrease margins. On the

contrary if fixed rate liabilities are less than fixed rate assets, then there is negative gap.

In this case a rise in short-term rates decreases margins while a decrease increases

margins.(Buckley, 1996).

Interest rate risk faced by Cadbury Schweppes

Cadbury Scwheppes has debt obligations. It has both fixed and floating rate debt

which entail interest rate risk. Fixed rate debt entails interest rate risk in that when

interest rates fall, the company will continue paying interest rates at the higher rates.

Floating rate debt does not carry high interest rate risk as the rates will be adjusted as

interest rates change.

Interest Rate Risks Faced by Rio Tinto.

Like Cadbury Schweppes, Rio Tinto Plc has both floating rate and fixed rate debt.

It faces interest rate risk with respect to the fixed rate debt in that changes in interest rates

may affect the cash flows with respect to interest payments. For example, it will have to

continue paying higher interest rates on its fixed rate debt when irrespective of a fall in

market interest rates.

How Cadbury Schweppes and Rio Tinto Manage Their Currency and Interest Rate Risks.**Cadbury Schweppes' Currency Risk Management Policies.**

Cadbury Schweppes does not hedge against translation exposure because the benefits

from hedging this exposure are temporal in nature. It seeks to establish an equal and

opposite relationship between the borrowing structure and the trading cash flows that is

used in servicing interest and principal repayments. It also seeks to maintain broadly

similar fixed charge cover ratios for each currency bloc and ensures that the ratio for any

currency does not go below by two times in any calendar year. (Cadbury Schweppes

Annual Report and Accounts, 2007). The group achieves this by borrowing in different

currencies, as well as through the use of hedging instruments such as swaps.

The group

manages its transaction exposure which arises from its international trade by entering

forward contracts for all forecasted receipts and payments for as far ahead as the pricing

structures are committed. The forward forex market therefore plays a significant role in

the exchange risk management structure of the group. Despite foreign exchange

restrictions and controls, which affect certain subsidiaries remission of funds to the

headquarters, the group believes that these restrictions do not have a material impact on

its operations as a whole. (Cadbury Schweppes Annual Report and Accounts, 2007).

Rio Tinto's Currency Risk Management Policies.

Since the US dollar dominates most of the affairs of the group, its consolidated financial

results are presented in US dollar terms. Most of the borrowings as well as surplus cash is

denominated in US dollars. The group also maintains a major portion of its cash in other

currencies most notably the Australian dollar, the Euro and the Canadian dollar since it

also has major operations in Australia, Canada and Europe. Most of its operations are

financed in US dollars directly or through the use of cross currency interest rate swaps.

Most subsidiaries maintain the US dollar as the functional currency. This helps to reduce

the translation exposure of the group as the need for translation of the subsidiary's

financial statements to US dollars is eliminated completely. Rio Tinto does not believe

that active currency hedging of transactions will result in long term benefits to its

shareholders. Currency hedging measures and therefore carried out only in specific

circumstances and are subject to strict limits laid down by the Rio Tinto board. The group

typically hedges capital expenditures and other significant financial items such as tax and

dividends.

Cadbury Schweppes' Interest Rate Risk Management Policies.

The company maintains both fixed and floating rate debt. It manages its interest rate

exposure by using interest rate swaps, cross currency interest rate swaps, forward rate

agreements and interest rate caps. It combines floating and fixed rate debts to enable it

reduce the impact of an upward change in interest rates while maintaining benefits if

interest rates happen to fall. The treasury risk management policy maintains minimum

and maximum levels of the total net debt and preferred stock permitted to be at fixed or

capped rates in various time bands, which range from 50% to 100% for the period up to

six months, to 0% to 30% when the period is over five years. (Cadbury Schweppes

Annual Report and Accounts, 2007). In setting the percentages, reference is made to the

current average level of net debt.

Rio Tinto Plc's Interest Rate Risk Management Policies.

Rio Tinto Plc maintains an interest rate risk management policy where it borrows

and invests at floating interest rates. In doing so, reference is made to historical

correlation between interest rates and commodity prices. Under certain circumstances, the

group considers fixed rate borrowing as well. Interest rate risk is mitigated through the

use of cross currency interest rate swaps which enable it convert fixed rate foreign

currency debt into floating rate US dollar borrowings. For example, the group had fixed

rate debt of approximately US\$4.9 billion in 2007 as opposed to US\$1.2 billion in 2006.

The group anticipates that its earnings will reduce by US\$158 million if its US dollar

LIBOR interest rate increases by a half percentage point. (Rio Tinto Plc Annual Report, 2007).

How the Companies Use Derivatives.

Cadbury Schweppes uses both short-term and long-term cross currency and interest rate

swaps to manage hedge against currency risks and interest rate risks on its debt

obligations. Appendix 4 is a table showing the different derivatives used by the company

in 2007. For example, the company receives interest at floating rates of 3 months or 6

month LIBOR rates (or the local equivalent on Swaps where fixed interest rates are

payable. the company also maintains foreign exchange forward contracts. As at

December 2007. The fair value for its embedded derivatives amounted to £0.3million as

opposed to £0.6million in 2006. (Cadbury Schweppes Annual Report and Accounts,

2007). Appendix 5 shows the different derivatives and the sensitivity analysis on how a

10% weakening of the £ sterling as well as a 1% change in interest rates will affect

income. (Cadbury Schweppes Annual Report and Accounts, 2007).

Unlike Cadbury Scwheppes, Rio Tinto Plc does not indulge in too much use of

derivatives to hedge against exchange rate risk. The group rather has a diversified

portfolio of commodities and markets which have different responses to movements in

business cycles such as exchange rates, interest rates and inflation rates.

Commodity

prices and currencies in various countries that the group operate are related in such a way

<https://assignbuster.com/cadbury-schweppes-plc/>

that the company achieves a long-term natural hedge. The group also borrows at floating

US \$ interest rate which enables it to counteract the effect of economic and commodity

prices. This therefore limits its use for derivatives and other synthetic protective

instruments.

Implications to Investors

The implications to investors for the different risks identified above as well as the

policies used by the different companies to mitigate these risk is that investors must

understand that such risks are bound to exist so long as a company operates in different

countries and there are movements in business cycles. Consequently, investors must

select a company that adopts the best policy towards managing these risks.

However,

despite how much effort is made towards reducing these risks, not all of the risks can be

hedged. Investors must therefore bear part of the risk when investing in these companies.

According to the Capital Asset Pricing Model and Arbitrage Pricing Theory, market risk

cannot be diversified completely. Interest rate risk and currency risks are examples of

market risks. (Ross et al., 1999; Bodie et al., 2005). Consequently, investors must bear

some of the risks and demand a risk premium for doing so.