Hedging strategies

Business

A hedge is a position to minimize unwanted risk or to manage operating and transaction exposure. The goal is to compensate the loss in value of one item with the increase in value of the offsetting item.

There are different reasons for hedging a position; first of all, the price increase and the fluctuation of price are volatile. Secondly, every company should have a fixed calculation basis or price basis to plan a short and long-term horizon. If not every buyer of a company does not know how to deal with the budget. Furthermore, there are a lot of different possibilities to hedge a position, but the easiest way is hedging with complete specific financial vehicles. Without hedging is business nowadays impossible and more gambling. 2.

HEDGING STRATEGIES 2. 1CONTRACTUAL RISK-SHARING The first hedging strategy is called contractual risk-sharing. This method includes two parties which sign a contract for exchange rates. The contract sets boundaries for the exchange rates and reduces the risk for both parties. In this context, the construction of the contract should be fair and reasonable, but this is very seldom.

Often, there are quality impacts and other problems, which conclude into disaffection for one party of the contract. So the decision-making for a construction is very important. 2. 2BACK TO BACK LOANS This type of strategy includes two parties again; a company finances their foreign operations in a local currency. The goal in this scenario is to find a similar firm which is in the same situation. If this is possible, each firm will take out a loan and both firms will swap their loans for a given period of time.

The basic of the method is to reduce the foreign exchange risk. 2. 3CONTRACTUAL APPROACHESRead alsoMajor Pricing StrategiesIn this case, the company uses a long-term currency option to hedge the exchange risk. This proceeding is prohibitively expensive, because long-term options are composite short-term options, so the company has to buy various options. Another disadvantage is the uncertainty about changes in competitiveness, this could change every day and is hard to hedge.

2. 4CURRENCY SWAPS A further hedging strategy is called currency swaps. In this method, the firm switches the denomination of outstanding loans. The company looks for a partner in the foreign country in the same situation that is capable of borrowing in foreign currency with lower costs. So they will set up a swap with this company. 2.

5″NATURAL HEDGING” Also, is called as Matching Currency Cash Flows – this proceeding is much differ to the other strategies. In this scenario, no financial products or partners in foreign countries will be need anymore. The principle of this concept is easy, the company receives cash inflows in a defined currency (i. e. dollar $) and finances their operations in the same currency. It is important that the dollar inflows are perfectly matched with dollar outflows in time and volume.

So the company is not dependent about fluctuation of prices anymore. But it is questionable, if a perfect matching is ever possible, because inflows and outflows perfectly in time are nearly impossible. For example: •BMW acquire debt capital in the US dollar markets •Use US dollar cash inflows from export sales to service principial and interest payments •Be “ naturally hedged” 3.

TWO POINTS OF VIEW 3. 1EXPORTER The exporter typically has operating cash inflows in one or more foreign countries.

These foreign currency cash inflows could be hedged by locking in foreign currency cash outflows through financial markets. The exporter has several possibilities to hedge. First of all, the firm could sell foreign currency with long-dated forward contracts. Secondly, they could finance a foreign project with foreign debt capital. Another proceeding could be the use of rolling hedges to repeatedly sell the foreign currency with short-term forwards or future contracts. And the last type for the exporter is to acquire financial liabilities in the foreign country with swaps.

These alternatives include cash outflows that are in the same currency like the firms operating cash inflows. . 2IMPORTER Conversely, importers have operating cash outflows in foreign currencies and importers bus their goods from foreign suppliers. As well as the exporter, the importer has different possibilities, too, for hedging foreign currency outflows through the financial market. To begin with, the importer buys a foreign currency with long-dated forward contracts or the company could invest this money in long dated foreign bonds and get coupons. Another advantage could be buying foreign currencies with a series of consecutive short-term forwards or futures.

Lastly, the importer could use currency swaps to acquire financial assets in the foreign currency, such as with a swap of existing foreign currency debt for domestic currency debt. 3. FINANCIAL MARKET HEDGE The financial instruments to hedge operating exposure are the same for transaction exposure. As already described operating exposure can be hedged by

Futures, Forwards, Swaps and Options. After contemplating the hedging opportunities at the capital market it seems to be that currency risk can be eliminated through hedging, but it is questionable for operating exposure. Because, if the assumption would apply that operating cash flows in the future are known and changes in exchange rates in the future would not occur.

As it has been described operating cash flows are exposed to currency risk through exchange rates and therefore the cash flows are not known exactly. Now the problem is, which occurs for hedging the risk is that financial hedges are almost every time over-hedged or under-hedged, because the hedge does not reduce the exposure itself. It just minimizes the risk of the exposure to currency risk and its impact on future cash flows and as these two positions are not perfectly correlated the risk cannot be hedged perfect. 4. 1ADVANTAGE There are some advantages by hedging through the financial markets. First of all, the firm could control the profit risk over a transfer of risk to customers.

Furthermore, they could sell risk in to risk-sharing markets with high returns. Secondly, the costs of buying and selling financial instruments are low compared to the costs of investing in real assets. However, the financial market transactions are likely zero NPV and so there is no change in the firms operations. Another aspect is the diversification of the fluctuation prices, which reflect a noticeable price basis to plan in long-term horizon. 4.

2DISADVANTAGE The most important disadvantage is that the financial market hedge never can completely hedge operating exposure. In addition,

financial market hedge do not match the uncertain cash flows of an operating exposure. The uncertain cash flows of firm's real assets cannot be fully hedged by financial instruments. Furthermore, the financial market hedge does not reduce the operating exposure itself, because in reality it is the transaction exposure – the company could reflect the series of consecutive short-term options as operating exposure. These transaction exposures of the firm should hopefully offset the operating exposure. 5.

MANAGING OPERATING EXPOSURE TO CURRENCY RISK 5. 1OPERATING EXPOSURE TO CURRENCY RISK Operating exposure to currency risk is defined as change in the value of nonmonetary cash flows due to unexpected changes in currency values. The term operating exposure itself shows changes in the value of operating cash flows generated by the firm's real assets due to unexpected changes in one or more foreign currency values. This type of exposure is the most important and less visible exposure because it effects on the firm's competitive position, which cannot be measured precisely. The level of exposure depends on the market structure. There are two types of market structures integrated market and segmented market.

Is the market integrated then purchasing power parity holds. Therefore the prices of similar goods are the same no matter where they are traded. Does the purchasing power parity not hold then the market is segmented. In such a market the prices of similar goods depend on where they are traded. In an integrated market the domestic prices change with the exchange rates.

For example if the U. S dollar appreciates then the price of goods imported from the U. S rise (and vice versa). On the other hand, in a segmented market the prices do not always change with the exchange rates because as mentioned before the prices differ depending on the trading location. Real world prices are not integrated or segmented, they lie somewhere in between the two market types. Revenues and operating expenses also have big impact on the operating exposure.

For example, if revenues are done locally and the operating expenses the local factor and product markets are segmented from other markets. The local companies tend to compete with other local companies and not with global companies therefore both revenues and expenses depend more on the local economy then on foreign currency values. Hence, the domestic firms face zero exposure. On the other hand, if the firm is an exporter and therefore produces its goods locally and makes its revenues globally it faces positive exposure. 5.

2MANAGING OPERATING EXPOSURE THROUGH OPERATIONS Instead of hedging the operating exposure in the financial market, the exposure can be hedged by operating hedges. There are three types of hedging the exposure to currency risk by operating hedges. MNCs which have a number of companies all around the world can reduce its exposure by having costs based in different currencies by actually having production capacity in different countries. This can be done by moving the production to the competitors market. Therefore the MNCs can shift their production among the plants in response to real exchange rate change. Another possibility is

for importers and MNCs to shift the production toward locations with the lowest real costs when local costs or exchange rate change.

The third and last possibility is to increase the purchasing power of foreign customers. This can be done when the local markets are segmented from global competition and the costs and local prices adjust slowly to changes in exchange rates. Therefore an appreciation in a foreign currency leads the exporters to increase the purchasing power of foreign customers. Hence the marketing efforts can be shifted to countries with overvalued currencies. 5. 3PRICING STRATEGY Pricing decisions also affect the firm's operating exposure to currency risk.

A firm can either leave the foreign currency constant or leave the domestic currency constant. The optimal pricing strategy depends on the competitive structure of the firms industry, the price elasticity of demand for its products and its marginal costs. The price elasticity of demand measures the sensitivity of the sales volume to very small changes in the price. Is the elasticity equal to one then the prices are unit elastic and is the elasticity larger than one then the prices are elastic. 6. TYPES OF OPERATIONAL HEDGES 6.

1PLANT LOCATION The MNC should secure low-cost labor, capital, or resources through plant location decision, so they have an advantage over domestic rivals. These decisions should be keep in mind and include number of factors, taxes and tariffs, institutional and social infrastructures, labor costs, labor knowledge and capital productivities. In industry countries everything is much more expensive, but there the companies could

guarantee necessary quality to sell the products. In developing nations, everything is cheaper, but the entry into such a country is much more risky. So this decision depends on the main structure and orientation of the firm.

6. 2PRODUCT SOURCING MNCs with global manufacturing and customers all over the world are more flexible to currency changes than domestic competitors without international trading. If there is any change or trouble in market, the MNCs could react very fast and shift the production toward lowest real costs. Secondly, they could diversify the production across countries to hedge against exposures to political risks. For example, if Germany would not agree with a defined tax basis, the company could set down the production in Germany and increase the production in China. So they could improve a better negotiation position for their firm to get the favored tax basis for a further co-operation with Germany.

6. 3MARKET SELECTION AND PROMOTION Local markets with segmentation from global competition develop slower than global markets, which increase every day. So the Promotion plays an important role for every MNC, they could shift marketing efforts toward countries with overvalued currencies to get a better position. Most important for such methods are a spectrum of favorable pricing alternatives. These alternatives give the company the opportunity to act flexible with the market. The market selection is a complex decision, every product have own advantages and disadvantages, but it is easier for MNCs to get in different markets as companies which does not have a global interactive, because of capital, contacts and assertiveness.

The question is what kind of product could be use in which market and how long the products could be a cash cow. Furthermore, a market has a lot of competitors with old and new products. A analyze of the market is required before entering in. 7. CONCLUSION According to the investigation of impacts for financial and operating hedges on risk management and firm value – without the combining of operational and financial hedge is the maximum hedge not given.

The scientists Allayannis, Ihrig, and Weston research the financial hedge without operating hedge and the operating hedge without financial hedge. The result is, if one of this factors miss, the MNC’s exposure to currency risk is lower than the combination of both is given. Just financial hedging is related to a lower currency risk ratio. Firms with a higher market value tended to use operational hedge in conjunction to financial hedge. So the main conclusion of this investigation was that the combination of both could help to maximize the value of the firm.