Economic exposure

Economics

This report reviews the foreign exchange exposure of Reject due to the future development plans and growth of the low cost airline company, this report also highlights the various risks Reject, faces in operating in different countries identifying, measuring, and managing the various foreign exchange exposures that might be faced by Reject. However, some of these issues will be analyses differently.

Foreign Exchange Exposure: According to Buckley (2004, peg. 135) foreign exchange exposure means that a firm has assets, liabilities, and profits or expected future cash flow streams such that the mom currency value assets, liabilities, profits or the present value in the home currency terms of expected future cash flows changes as exchange rate change.

ISSUE 1: foreign risk exposure management Identifying Reject foreign exchange risk For Euro]et the risks that might arise currently for being an international business is the concentration of Reject airlines with significant exposures in Euro areas (Dublin Dusseldorf, London-Standee, Milan, Brussels,) and North Africa, means that they need to be aware of this risks before they analyses, and agree on what to do about it. Therefore, this exposure occurs due to their currency movements in operating centre, which may alter their home currency (Buckley, 2004, peg. 43) giving rise to exchange rate fluctuations and risks. Therefore Euro]et exposure to exchange rate fluctuations will come in three forms: transaction exposure, economic exposure, and translation exposure. In addition, these different exposures will be analyses by applying to Reject. Transaction exposure Transaction exposure occurs because; a payable or receivable is denominated in a foreign currency (Buckley, 2004). It is also a cash flow exposure including sale of an set and the receipt of the payment.

Within this time interval exchange rates might change, and will exposed Reject to a risk either positive or negative, which will have an impact on Reject exposure to international contractual transactions to exchange rate fluctuations. Reject transaction exposures will therefore have an impact on the exchange rate fluctuations in the value of committed cash flows. From Reject income statement (appendix 2-note 5), due to the contracts for the supply of fuel and oil to Reject invoiced in US foreign currency (dollars).

It could be analyses that Reject will be faced with currency risk. This is going to affect the price of fuel cost due to exchange rate movements. So the current price of fuel cost is ?¬multimillion, so to get the fuel cost in dollars. It will be ?¬1887 divided by IIS$I . 59686 (current exchange rate value in dollars) will equal to IIS$1181694075- this is how much reject have to pay in dollars to get fuel supplied to their airlines, which is certain. However, there is also an issue of uncertainty as to what the fuel cost in dollar will be in the future.

Due to dollar invoicing of fuel, the dollar price will vary with the exchange rate. Although reject can lock in the dollar price on its current orders, it as no idea what the will be the dollar costs of its future orders of fuel. This also explains the volatility of fuel prices, as when reject buys fuel they have to pay for it immediately. So they will need to hedge fuel price to establish fuel costs. However, losses due to transaction exposure merely result in lower sales revenue. Reject also faces currency risks as regards to the British pound sterling.

From thecase study, 40% of Reject revenues come from its London-Standee operations, this means that a change in pound sterling will hugely affects Reject profitability. In calculation, 40% of ?¬mm= 1953. 6) to get the real revenue, we say 1953. 6 divided by ?¬1. 19683(currency exchange rate) 632. 312024-so therefore, this is Reject revenue from its London-Standee operations. To measure transaction exposure, Euro]et will need to project the net amount of inflows or outflows in each foreign currency, and determine the overall risk of exposure to those currencies (Pliable, 2006).

And then it will measure any gains or losses that may arise from the settlement of existing financial obligations whose terms are included in the foreign currency. Economic exposure According to Tease and Dominique (2006), factors such as firm size, multinational status, foreign sales, international assets, and competitiveness and trade at the industry level may influence economic exposure of the companies Economic exposure the impact of long-term currency exposure and analyses thehealthof a company's business in the long run.

The changes registered in the expected future cash flows depend of the change in the position the company holds In the case of Euro]et foreign operations and competition, managing economic exposure will involve all aspects of the company. Economic exposure will arise in all markets for Euro]et against US dollar, British pound, Swiss Franc. This arises because Reject has its costs base in Euros whereas competitors might have theirs in

British pound, US dollar etc. Although it is difficult to reduce economic exposure, Euro]et can reduce the risk by offering same as competitors.

Airlines, like many industrial companies, are potentially exposed to risks resulting from adverse movements in interest rates, foreign currency prices, and commodity prices, particularly fuel prices. Airlines' fuel price exposures are particularly reentrant because oil is a widely traded global commodity, and the poor economic condition of airlines (partly as a result of higher fuel prices) has frequently been in the news since the terrorist attacks of September 1 1, 2001 Translation exposure Under the FAST 52, Euro]et translation gains and losses of ?¬138 million will be included in their stockholders equity.

So therefore, when the Euro strengthens, the consolidated earnings of Reject will be unfavorable affected by the translation exposure, and when the Euro weakens the consolidated earnings are favorably affected. Also from Euro]et income statement, it could be analyses that currently reject concentrates on local sales and has little foreign competition, although obtains foreign fuel supply from the US (-denominated in foreign currency) this will likely be hurt by depreciated local currency. As in the case of translation exposure the NC can have an equal amount of exposed foreign currency assets and liabilities.

By doing so the company will be able to offset any gain or loss it may have due to changes in the exchange rates of that currency, also known as balance sheet hedging. (Teatime, Stonewall, & Motto exposure/risks 007) Management to tottering exchange Reject Foreign exchange risk management will focus on identifying areas in the operations of Reject, which may be an issue to foreign exchange exposures, evaluating and analyzing the exposure, and choosing the right approach to manage the risk to the final performance of Euro]et. Before establishing hedging policies, Euro]et will need to measure its economic exposure.

In order to do that a reject can invest some of its resources in evaluating its exposure, I. E. , identifying the set of environmental contingencies affecting and relevant to the creation of shareholder alee (Miller, 1998). This identification allows the assessment of alternative environmental scenarios and consequent adoption of improved strategic decisions by the company. Furthermore, Frost et al. (1993) analyses that firms find hedging more valuable when the connection between investment opportunities and cash flows resulting from haggled risks is lower.

For Euro]et, it could be implied that hedging will increase their value and investment opportunities, which are available when fuel prices are high (and internal cash flow is low as a result). In addition, hedging can assist Reject ability to invest by negotiating with US aircraft manufacturer in advance of delivery of some of the aircraft. In essence, Hedging might preserve Reject internal cash flow to meet future commitments to purchase aircraft. In dealing with economic exposures efficiently, a NC may have to diversify either itsfinanceor its operations.

It can diversify its operations by either moving to locations where the cost of production is low, or having a flexible supplier policy, or changing the target market for its products and the types of products it deals in. As it can be illustrated from the 1994 example f Toyota, when a strong Yen made

Japanese exports to US more expensive, it decided to shift its production from Japan to US, where it achieved comparatively lower costs of production, enabling it to compete in the US car market. (Nun & Arsenic, 2007).

ISSUE 2 Firstly, for Reject expanding to more routes, this will mean more revenues as regards to cash inflows and outflows. And Reject achieving their business objective of airline ambitious growth plans. One of the Risks reject is mostly likely to face is operating risk, which it will incur from the US dollar. This also reveals that exchange ate has been a big challenge for the airline industry. The instability of an exchange rate makes it impossible for airlines to match in transaction and timing of foreign currency expenses.

Furthermore, in extending its route network Reject might incur a net cash outflows in currencies (dollars and rubbles) when operating in US and Russia (Moscow and SST Petersburg) which will create a higher exposure to exchange rate. As Reject currency (?¬) will represent a net cash outflows on the balance sheet thereby giving rise to translation exposure due to the increase in proportion of earnings as generated by these foreign subsidiaries ((Mueller, 2005).

So therefore as reject wants to operate in US and Russia areas, if they want to fly from other European locations they will need to approach government to deal with US and Russia Reject also tact the risk to weather turmoil in Russia, compounded with volatility of risk in Euro-dollar exchange rate. Also in expanding to Russia areas, there are some legal issues due to tightening regulations from government authorities. As non-refundable tickets, charging for meals, and hiring of foreign pilots ISSUE 3: Firstly, due to Euro]et opportunity for network growth, by ordering 200 aircraft from US, and China manufacturer.

Here Reject will be considered to be an importer, and their exchange rate risk will be limited to net cash flows in US and China currency. Reject transaction risk will arise in the US (dollar) and China (yen) order received immediately for the manufacture of 200 aircrafts to Reject, payable within 10 years. Also, the quantity of US dollar and China yen price is already known. This means that the transaction risk will concern the Euro value of the dollar payment in 10 years, and he China quotes the yen value of the dollar payment in 10 years-as the price of china aircraft in Remain .

To buy the COCA aircraft offered by the Chinese manufacturer, reject might face exchange rate risk as they will need the dollar to buy the Chinese aircraft. In calculation, this will be 116, 307. Mm Remain divided by 6. CYNICAL= US$18995. 5854-this is how much it will dollars to pay for China aircrafts. Furthermore, Reject will also face exchange rate risks, as their transaction risk arise from their Euro currency denominated imports in the same ways as US and China foreign currency denominated exports. Reject economic risk will be subject to variations of its costs induced by exchange rate fluctuation.

This is also going to have an impact on Euro]et exchange rate variations on their stock market return, and controlling the return for their entire market (Adoring, 2008). So therefore Euro appreciation will increase Reject share value because it is Euro]et-operating currency. Also the exposure of Reject to US aircraft payment is 65% when measured over a 10 year period this can be quite difficult, to hedge as Adhering (2008) identified hat long term exposures are difficult to hedge than short term exposures as they could increase over the time horizon under consideration.

Risks involving short-term transactions can be dealt with using financial instruments but long-term risks often require changes in the operations of the company. In the case of Reject, importing aircrafts from US and China. Reject will have to pay in the currency of the US manufacturer (US dollars), therefore it is Reject who carries the risk as they have to buy dollars in order to pay the manufacturers. However, Euro]et can pay in its own runners (Euros) but this might mean that China manufacturer will carry the risk most as they have to change the Yen from dollars.

Furthermore, as Reject wants to contract out much of its production to US (including fuel supply) and China manufacturers, this means that Reject will face currency risk and uncertainty as US and China manufacturers are billing in their local currencies, There is also an issue of uncertainty as to what the dollar cost of its orders will be, both now and in the future. If it insists on dollar invoicing, the dollar price will likely vary with the exchange rate.

Hence, although Reject can lock in the dollar price of its current orders, it has no idea what will be the dollar costs of its future orders Furthermore, adding new aircrafts means that Reject needs more crew members, pilots and maintenance engineers, this will impact on the Euro]et profitability as the expenditure will go up. Euro]et will also face political risk due to significant foreign financing, foreign suppliers or customers, and international transactions or assets are relatively exposed to adverse changes in currency controls, capital flow barriers, and other laws and regulations (Graham, 2012).

The probability of expropriation can differ across industries. Firms whose cash flows are particularly sensitive to general economic conditions may be exposed to political risks due to their broad impact on the economy. APPENDIX 1 The main objectives of the Breton Woods system are to achieve exchange rate stability and promote international trade and development According to David Richard, with free international trade, it is mutually beneficial for two countries to each specialize in the production of the goods that it can produce relatively most efficiently and then trade those goods.

By doing so, the two countries can increase their combined production, which allows both countries to consume more of both goods. Any foreign currency (e non Euro) denominated transactions may give rise to transaction exposure if there is a delay between entering the contract and settlement Reject addition of 200 aircrafts of its existing operations reveals a strategic move by Reject. Bringing new flights will also require upgrading of its scheduling and reservation application, this is mostly related to change management, so Reject will need to understand the risk, which could arise due to it.

However, as the number of fleets go up, Reject will face the challenge of domestic aircrafts been rested for a short period. Inappropriate handling of this issues will lead to operating risk where the charges to be paid to authority will increase. Therefore Euro]et need to make sure that its scheduling application is proficient enough to take this challenge. There's also a risk, which might arise due to social acceptance from Reject passengers if this happens, Reject will have to educate its customers more on the usefulness of its new aircrafts may be by offering at discounted rates.

Reject will need to implement on the Job and off the Tracing programs for its new crew members and maintenance engineers. So they can learn how to operate the new fleet. For new employees the training will include, training for 8737 or COCA depending on which option it wants to buy. However, the aim of achieving this will generate some additional training costs for Euro]et, but it help Reject to enjoy its process driven operation rather than having its driven people operation Russia climbed eight places to the 12th position in The World Banks 2013 Doing Business Rankings, up from 20th in 2012.

Tax payment and contract enforcement fueled this improvement. However, despite this progress, Russian's overall ranking for doing business remains relatively average. According to recent estimates the Central Bank of Russia, approximately US$54. 1 billion of private capital was invested out of the country in 2012. This Asian improvement on the IIS$80. 5 billion of outward investment recorded in 2011, which suggests that some of the Government's efforts to improve this situation have been successful.

Also, the traditional literature on the choice of he invoicing currency of international business trade. Grossman law arts trot theobservationthat trade in manufacturing goods between industrial countries is mostly invoiced in the exporters currency Exchange rate changes can also impact on the level of competitiveness of the firms that are exposed to exchange rate risk, or affect the value of their net assets denominated in foreign currencies It is widely believed that changing exchange rates affect the competitiveness of firms engaged in international competition.

According to Allurement (1991), a falling home currency promotes the competitiveness of firms in home country by allowing them to undercut prices harder for goods manufactured abroad. Many simple partial equilibrium models (e. G. Shapiro) predict an increase in the value of the home country firm in response to a real drop in the value of the home currency. Economic theory suggests that under a floating exchange rate regime, exchange rate appreciation reduces the competitiveness of export markets; it has a negative effect on the domestic stock market.

Conversely, if the country is import denominated, exchange rate appreciation may have positive affect on the stock market by lowering input costs. Financial edging may be a more cost-effective strategy than operational hedging for many firms since it doesn't involve major redeployment of resources like building factories in other countries. One likely risk to be faced by Euro]et is the financial crisis. Involved with the foreign currency exchange markets.

It is also evident from the case study that due to reject current and future operations it is already dealing with more than one national currency especially in extending its routes to US travels. So therefore, the changes in the foreign exchange rates will affect reject profitability. Also this risks arises cause of currency movements may alter in home country values(Buckley, 2004), which depends on various variables such as the interest rate parity, government policies purchasing power parity on exchange rates Is there any direct evidence that risk management increases firm value?

The answer is yes, but the evidence is fairly limited as yet. A number of more recent studies show a clearly positive correlation between higher share values and the use of derivatives to manage foreign exchange rate risk and interest rate risk. And one study provides fairly compel-ling evidence that the use of commodity price derivatives by commodity seers increases share values. But studies of the hedging by commodity producers provide no clear support for the argument that risk management adds value.

At a minimum, whether hedging adds value appears to depend on the types of risk to which a firm is exposed to. Given investment patterns in the airline industry, the value premium suggests that hedging allows airlines more ability to fund investment during periods of high fuel prices. The constructive relation between hedging and value further suggests that investors view such investment as positive net present alee projects. We find that The interaction between hedging and capital expenditures captures a large majority of the hedging premium.

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We also examine a two-stage system in which hedging impacts value through its effect on capital expenditures. The results of this procedure also suggest that the hedging premium is largely attributable to the effect of hedging on capital investments. The results of this procedure also suggest that the hedging premium is largely attributable to the effect of hedging on capital investment. However, from airline industry research it could be assumed that Reject s faced with the following financial risks; change in fuel prices, foreign currency exchange fluctuations, and changes in interest rates.