

# The rising euro hammers auto parts manufacturers essay sample

[Economics](#), [Currency](#)



The given case highlights the importance for every global managers to clearly understand the foreign exchange market and act consciously to hedge the exchange risk from the business. The exchange rate are always volatile and failure to minimize this risk not only hampers the profitability of a company but even the survival of the firm. The similar fate has been suffered by the German manufacturer of machine tools to engineer crankshafts for cars that signed a deal in late November 2004, to supply the U. S. operations of DaimlerChrysler with \$1. 5 million worth of machines.

When the deal was signed, Pfeiffer calculated that at the agreed price, the machines would yield a profit of € 30, 000 each. Within three days that profit had declined by €8, 000 due to adverse depreciations in dollar as DaimlerChrysler used to pay Elotherm in dollars. Udo Pfeiffer, the CEO of SMS Elotherm neglected this issue and fell into serious trouble and it went from bad to worse because due to intense competition, it could not charge higher prices for the tools. On the other hand, another small German supplier to U. S. automobile companies, Keiper, was faring somewhat better as it was clever enough to open a plant in London, Ontario and had a real hedge against the value of the euro.

1: Could SMS Elotherm have taken steps to avoid the position it now found itself in? What were those steps? Why do you think the company did not take these steps? SMS Elotherm could have taken several steps to hedge their exchange risk. First, depending on the competition in the marketplace, they could have stipulated a price pegged to the exchange rate value on the day the contract was signed, thus transferring the exchange rate risk to the

buyer. Perhaps competitive conditions would not allow for this. They could have hedged by buying euro forward in the futures currency market with their dollars. Such a hedge would have had a transaction cost. Depending on the size and type of their foreign operations, there are other hedging techniques SMS might have explored. These could include currency swaps, leading and lagging payables and receivables, managing transfer prices, local debt financing, accelerating dividend payments, and adjusting capital budgeting to reflect foreign exchange exposure.

In addition, SMS could have diversified their production location and market location to reduce their exposure to economic shocks. This is more of a long term strategy. SMS likely did not take the precautionary steps because (a) they are overconfident about the stability of the currency market, or (b) they did not expect the profit to drop so precipitously. 2: Why was Keiper weathering the rise of the euro better than SMS? It can be said that the management of the Keiper was clever and efficient enough to understand and predict that the adverse movements in the foreign exchange rate can take the company into serious troubles. Keiper had partially insulated themselves against exchange risk by moving to Canada because it somehow hedged from exchange rate risk. Now many of their costs were in Canadian dollars, although some were still in euro, and there is risk between the euro and the Canadian dollar but the risk was less between the dollar and the euro.

3: In retrospect, what might Keiper have done differently to improve the value of its “ real hedge” against a rise in the value of the euro? Although,

Keiper was not exposed to exchange risk as the Elotherm, but still, Keiper had no better hedge to reduce the risk significantly. By only shifting to Canada hoping the movements of rate between Canadian dollars and US dollars would not hurt the company significantly is not enough for company to hedge the risk it is exposed to. Keiper could have further reduced exchange risk by reducing its euro-based imports so that all of its costs were in U. S. and Canadian dollars. Long term-wise, Keiper could have further reduced exchange risk by diversifying their production and market into markets that use different currencies. They also could have hedged their transactions in the forward markets and followed some of the other hedging techniques mentioned in Q1 above, if appropriate to the scope of their business.

4: If the U. S. dollar had appreciated against the euro and Canadian dollar, instead of depreciating, which company would have done better? Why? If the U. S. dollar has appreciated against the euro, obviously SMS would have benefited from the change. SMS has all of its costs in euro and it is selling into dollars. So each dollar would have bought more euro as the dollar strengthened. Keiper would have benefited to the extent that its costs were in euro, assuming that it was selling into a U. S. dollar market. Since some of its costs were in Canadian dollars, and they might have grown weaker against a strengthening dollar, Keiper would also have benefited because a stronger U. S. dollar might well have purchased increased amounts of Canadian dollars. If the U. S. dollar had appreciated more against the euro than the Canadian dollar, SMS would have benefited more. If the U. S. dollar

had appreciated more against the Canadian dollar than the euro, Keiper would have benefited more. This question shows that overall, Keiper is in the safer position with regard to currency risk exposure.